ECONOMIC OUTLOOK AT MID-SUMMER

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HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
HOUSE OF REPRESENTATIVES

NINETY-FIFTH CONGRESS

SECOND SESSION

JULY 11, 12, 13 AND 31, 1978

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CONTENTS

Page

Hearings held on—
- July 11, 1978 1
- July 12, 1978 73
- July 13, 1978 139
- July 31, 1978 189

Statement of—
- Blumenthal, Hon. W. Michael, Secretary of the Treasury 112
- Bolling, Hon. Richard, Chairman, Joint Economic Committee, and a Representative in Congress from the State of Missouri, accompanied by John R. Stark, executive director, JEC; and Doug Lee, economist 2
- Bosworth, Barry P., Director, Council on Wage and Price Stability 46
- Harris, Shearon, chairman; Richard Lesher, president; and Jack Carlson, vice president and chief economist, Chamber of Commerce of the United States 258
- McIntyre, Hon. James T., Jr., Director, Office of Management and Budget, accompanied by Bowman Cutter, Executive Associate Director for Budget; and Carey P. Modlin, Deputy Assistant Director for Budget Review 217
- Miller, Hon. G. William, Chairman, Board of Governors, Federal Reserve System 139
- Oswald, Dr. Rudy, research director, American Federation of Labor and Congress of Industrial Organizations, accompanied by Robert M. McGlotten, legislative representative, AFL–CIO 196
- Rivlin, Dr. Alice M., Director, Congressional Budget Office, accompanied by Dr. William J. Beeman, Assistant Director, Fiscal Analysis Division; and James L. Blum, Assistant Director, Budget Analysis Division 23
- Schultze, Hon. Charles L., Chairman, Council of Economic Advisers 73

Additional information submitted for the record by—
- Blumenthal, Hon. W. Michael:
  - Estimated revenues of unified budget receipts 120
    - Enclosed tables:
      - Comparison of estimated and actual unified budget receipts, 1963–68 121
      - Estimated revenues of unified budget receipts, 1963–68 121
  - Prepared statement 115
- Bolling, Hon. Richard, table showing real GNP growth and inflation CPI in percent 6
- Bosworth, Barry P.:
  - Prepared statement 51
    - Tables in statement:
      - Alternative measures of price inflation 55
      - Alternative measures of employment cost 55
  - Replies to questions by Congressman Simon 293
- Chamber of Commerce of the United States, prepared statement submitted on its behalf by Shearon Harris, chairman 262
- Harris, Shearon, prepared statement submitted on behalf of the Chamber of Commerce of the United States 262
- McIntyre, Hon. James T., Jr.:
  - Assessment of the First Year of Zero-Base Budgeting, from the Office of the White House Press Secretary 243
  - General Services Administration program for locating Federal facilities in cities 239
  - Guidance in estimating effects of higher inflation on the budget 235
  - Prepared statement 221
    - Attached tables to statement:
      - Change in budget outlays, 1978 and 1979 225
      - Change in budget authority, 1978 and 1979 226
    - Proposed social security cuts 228
    - Urban data task force 239

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Additional information submitted—Continued — Page

Mattox, Hon. Jim, a Representative in Congress from the State of Texas:
"CETA: $11 Billion Boondoggle," by Ralph Kinney Bennett 193
Economic stability and inflation indexing of the individual income tax 190

Miller, Hon. G. William:
Effective ways of stimulating investments 167
Evaluating cost-effectiveness of Government programs 170
Prepared statement with attached charts 144
Description of charts:
Chart 1—Current economic indicators 156
Chart 2—Measures of aggregate inflation 157
Chart 3—Household borrowing 158
Chart 4—Corporate finance 159
Chart 5—Interest rates 160
Chart 6—Budget outlays as a percent of GNP 161

Rivlin, Dr. Alice M.:
Prepared statement 29
Tables in statement:
Table 1.—Economic projections based on current policy, calendar years 1978 and 1979 30
Table 2.—Federal budget totals: By fiscal years 32
Full-employment budget balance (national income accounts basis) 33
Reply to question by Congressman Obey, letter dated July 18, 1978 37

Schultze, Hon. Charles L.:
Indexation of capital gains 111
President Ford's WIN program and President Carter's approach to inflation 106
Prepared statement 83

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ECONOMIC OUTLOOK AT MID-SUMMER

TUESDAY, JULY 11, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:45 a.m., in room 210, Cannon House Office Building, Hon. Robert N. Giaimo, chairman of the committee, presiding.

The CHAIRMAN. The committee will please come to order.

Today the House Budget Committee begins a series of hearings on the economic outlook and other concerns in preparation for the Second Budget Resolution for Fiscal Year 1979.

As you know, the second resolution will set a binding ceiling on Federal spending and a floor on revenues. Tentatively we expect the Budget Committee will be marking up the second resolution early next month with consideration on the House floor expected in the middle of August, just before the recess.

Our concern, in my view, must be the same as it was with the First Budget Resolution for Fiscal Year 1979, which set targets for spending and revenues. That concern is that we exercise reasonable restraint in Federal spending while providing funding for important programs to meet human needs.

I believe that prudent spending restraints are essential if we are to be able to reduce the Federal deficit and hold the line on inflation.

Our witnesses today are ideally equipped to give us an information base upon which to begin fashioning the second budget resolution. They are Congressman Richard Bolling, of Missouri, chairman of the Joint Economic Committee; Dr. Alice M. Rivlin, Director of the Congressional Budget Office; and Barry Bosworth, Director of the Council on Wage and Price Stability.

As for my colleague, Mr. Bolling, it is a pleasure, as always, to have you with us. I really think that putting together this second budget resolution at this particular time in the economic and social history of this country is going to be something to which we are really going to have to give our greatest efforts.

I will appreciate even more than usual your insights, your suggestions, and your advice. We know you are as concerned as we are with the problems that confront us—high unemployment and high inflation and high deficits and the whole matter of financing the Federal Government. We look forward to your testimony.

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STATEMENT OF HON. RICHARD BOLLING, CHAIRMAN, JOINT ECONOMIC COMMITTEE, AND A REPRESENTATIVE IN CONGRESS FROM THE STATE OF MISSOURI, ACCOMPANIED BY JOHN R. STARK, EXECUTIVE DIRECTOR, JEC; AND DOUG LEE, ECONOMIST

Mr. BOLLING. Thank you, Mr. Chairman.

Before I begin, on my left is John Stark, the executive director of the Joint Economic Committee; and on my right, Doug Lee, an economist who has been most helpful to me and to the committee in dealing with the overall problems the Joint Economic Committee confronts.

I would like to say I agree with you. I think it is going to be an enormously difficult and interesting task for you to mark up your second resolution.

I think we are in an extraordinarily difficult and complicated situation economically, which impinges on the work of the Congress to a very great degree at a time when the Congress, I fear, has not yet totally assimilated—I don't mean to suggest that is true of this committee—but assimilated the significance of the budget process.

We are still having a great deal of difficulty—and I don't need to tell this to any of you—in getting some of the Members to understand what it is all about, and it is a pity that that is so, because it makes it more difficult to do a very necessary task.

Mr. Chairman, I am pleased to be here this morning to discuss the Second Concurrent Resolution for Fiscal Year 1979 budget. Since the Joint Economic Committee has not completed its midyear report, on which we are currently holding hearings, the views I express are my own and not necessarily those of the full committee.

First, I would like to more formally congratulate your chief economist, Mrs. Teeters, on her nomination to the Board of Governors of the Federal Reserve System. Prior to joining your staff, she authored or coauthored a number of papers for us, so Mrs. Teeters is an old friend of the Joint Economic Committee, and we wish her well in her new endeavor.

This morning, I want to direct your attention primarily to the economic outlook. This is an area which the Joint Economic Committee monitors very closely and one where opinions seem to be changing. As you are aware, the administration has just revised its forecast of real growth in 1978 down from 4.7 percent, the January forecast, to 4.1 percent, the July forecast. Similarly, the forecast for 1979 has been reduced from 4.8 to 4.3 percent.

The administration has not been alone in these downward revisions. Table 1 at the back of the presentation indicates that other well-known forecasters have also substantially revised their predictions for both inflation and real growth.

As we think about fiscal policy for 1979, we must do so in the context of a more pessimistic view of the outlook. Some witnesses testifying before the Joint Economic Committee have cautioned against the possibility of a recession or at least a "growth" recession next year. It is clear that the outlook has deteriorated in the last 6 months.

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Earlier this year when the Joint Economic Committee prepared its annual report, we noted that on a full-employment basis the budget proposed by President Carter was relatively neutral throughout most of 1978 and 1979. However, with the higher inflation that we have experienced, recent estimates must be revised upward. This means that although no policy change was intended, inflation has changed a relatively neutral policy into a mildly restrictive one. Therefore, at the same time that the economic outlook has been deteriorating, fiscal policy has become more restrictive. If the size of the tax cut is reduced from President Carter's original recommendation of about $25 billion to the $15 billion now being discussed, then fiscal policy will be restraining economic growth throughout 1979, if we are reading the tea leaves correctly.

The First Concurrent Resolution provided for outlays of $498.8 billion. With the revisions recently announced, the administration estimates outlays at $496.6 billion. Although I am somewhat skeptical of these spending estimates because of the consistently large downward revisions in them, I would urge you not to alter them in any substantial way. I realize that some minor changes may be needed for technical reasons, but I supported the general policies outlined in the First Concurrent Resolution and continue to do so. I do not feel that large budget reductions are appropriate at this time. I would be doubtful that large spending increases could be put in place in a short period of time.

The tax side of the budget is somewhat more complicated. As you know, the First Concurrent Resolution provided for an extension of the temporary tax reduction and a tax cut of about $15 billion to become effective January 1, 1979. This gave a total tax cut in 1979 of about $25 billion.

Two issues have been receiving a great deal of attention both in the press and in the congressional discussions: First, the appropriate size of the tax cut and second, the proper composition.

With respect to the size of the tax cut, I was not unhappy with the levels set by the First Concurrent Resolution. In my judgment, it would be a mistake to reduce the tax cut allowed by the budget resolution just because President Carter seems willing, or, I might add, forced, to reduce his recommended tax cut.

If the economic situation does deteriorate next year, Congress may need to act quickly to provide economic stimulus. In this situation, a budget resolution that inhibited congressional action would be very unfortunate. I recommend that the revenue levels be maintained at roughly the same levels established in the First Concurrent Resolution.

The second issue concerns the composition of the tax cut. The Kemp-Roth proposal to reduce individual income taxes some 33 percent has been under discussion in recent weeks, and I have several comments to make.

First, I think it would be a mistake to try to legislate a $98 billion tax cut 3 years in advance. It may be necessary to reduce taxes in 1979 or 1980, but I do not feel confident enough, and I don't really know anybody who does whose overall judgment and track record I find first-rate, but I do not feel confident enough in our ability to foresee the future to make this commitment today. Even if I were sure that a tax cut would be needed, I could not

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presume to know the proper amount. While I should stress the importance of looking as far into the future as possible, the limitations of our foresight make it necessary to also maintain our flexibility.

A second comment relates to the economic response which might be expected from such a tax cut. The authors of this bill and some economists have claimed that the Kemp-Roth tax reductions would produce a veritable bonanza of jobs and increased economic output. I find this difficult to believe.

Although the Kemp-Roth proposals are frequently compared to the Kennedy tax cuts, back in 1963–64, Walter Heller, the principal author of those tax cuts, has told the Joint Economic Committee that those who use the experience of 1964–65 as support for large tax reductions today are "misreading the verdict of history." This is the statement as Dr. Heller made it to the committee, and I am going to supply it to the Budget Committee with some slight revisions, but I am going to read the statement that he made to us. According to Dr. Heller:

> Contrary to their assertion that the Kennedy-Johnson tax cut achieved its economic stimulus and consequent revenue flows "by increasing aggregate supply, by increasing the reward to work and investment," the record is crystal clear that the great bulk of the success of the "great tax cut" that was phased in during 1964–65 came, as expected, from its stimulus to demand, its release of some $10 billion of consumer purchasing power and another $3 billion or so of corporate funds.
>
> Second, the economic setting for the Kennedy tax cut was sharply different from our setting today. The 1964 cut was injected into an economy characterized by (a) Plenty of slack in both labor and product markets, coupled with (b) virtual price stability—inflation averaging about 1.2 percent per year—and stable-to-falling unit labor costs. In other words, the "aggregate supply" capacity already existed in the form of high unemployment and low industrial operating rates, and inflation was not a problem. So the tax cut was able to activate idle physical and human resources without more than minimal impact on the price level.

I would like to add to that the fact that I had the opportunity to talk to the not-yet President, but Presidential candidate Kennedy at some length in October 1960, and while I accurately described Dr. Heller as the principal author, because he put together the details, the principal motivator was the President, himself.

He was far more sophisticated about economics than any President I have ever had the privilege of dealing with. And his first preference, interestingly enough, was for the kind of package that President Carter offered, a package of tax reform plus tax cut. When it became obvious that there was no way to get that through the Congress that Saturday in 1963-64, he backed off on the tax reform in a fashion which is not unlike the situation that we have today.

So what I am trying to say in quoting Dr. Heller, is that we were working then on the second choice. That tax bill was almost worked out in 1963, and when the President was shot and Lyndon Johnson took over, there were still a few things to deal with in the Senate, and they were dealt with, and the tax cut that went through was essentially the second-choice Kennedy version, and it did have a very good effect, and I think it would have had a better effect if it had been politically possible to put through the first-choice Kennedy version.

Mr. DERRICK. Could I interrupt?

Mr. BOLLING. Sure.

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Mr. DERRICK. What was the first choice?

Mr. BOLLING. It included some tax reform, and the tax reform he sent up I haven't looked up the details, but it would be the same kind of things, bringing a little bit more equity to the Tax Code.

Mr. DERRICK. Thank you. Excuse me for interrupting.

Mr. BOLLING. This, of course, was not stated precisely publicly, although there was some tax reform in the initial presentation.

Another argument used by those who support very large tax reductions is based on the so-called Laffer curve. This is based on the theory that the bigger the tax bite, the less incentive there is to work, save, and invest. This lowers production, causing slower growth, higher unemployment, and lower taxes. Those who use this argument say that by reducing taxes, we can increase the incentive to work and invest and thereby increase economic growth and tax revenues.

I have not been able to find any economic evidence that supports the Laffer curve. The Joint Economic Committee has looked for such evidence but has not found it. Professor Laffer testified before our committee but did not offer convincing evidence. And you may be interested in how it came about that he testified. The committee asked Dr. Heller, who was on a panel very recently, to comment on Roth-Kemp, and Senator Roth is a very distinguished member of the Joint Economic Committee. For some reason his staff did not advise him of the circumstances that had led to that invitation, and he talked to me and felt that he had been ill-treated, and I said if he hadn't been advised that Dr. Heller was going to come and comment, he was right; he hadn't been well-treated and didn't discuss the question of whose fault it was.

He said, would it be all right if he had Laffer up, and I said it would be fine. We had Professor Laffer up in the hearing that we added on to one we had with Dr. Heller and a number of other people, and Professor Laffer had every opportunity to testify.

The only hard information I have seen related to people's response to an increase in take-home pay comes from the 1960's. Instead of working and producing more because income was higher, people took more vacations and worked shorter hours. The evidence of history does not support the argument that taxes have reduced economic incentive to the point that growth is inhibited. This country still has a significantly lower tax-take, relatively speaking, than most of the developed nations.

In summary, I have no quarrel with the overall size of the Kemp-Roth tax cut in 1979, inasmuch as it would be about $20 billion; it is, however, skewed in favor of individuals. But I think it would be a mistake to try to commit future Congresses to large tax reductions, and I am skeptical of the potential benefits claimed by the supporters of this legislation.

A final comment concerns the relationship between fiscal policy and monetary policy. I have long been a supporter of better coordination between these two tools of economic management. Better coordination, however, does not mean that we must compromise our goals of economic performance. It simply means that we must have these tools working together rather than at cross-purposes.

Recently we have seen reports that the Federal Reserve Board is willing to exchange a somewhat smaller tax cut for a somewhat

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more expansive monetary policy. Determining the policy mix is as much a political decision as an economic one. But in the process of making this decision, we must never forget that determining economic goals for the Nation is the business of Congress; determining the policy mix to best reach these goals is a joint project of Congress, the administration, and the monetary authorities. In this latter negotiating process, Congress should not be intimidated by the positions taken by either the Federal Reserve Board or the administration.

Let me conclude this statement by returning to the estimates contained in the First Concurrent Resolution: Revenues of about $448 billion, outlays of about $499 billion, and a deficit of about $51 billion. These estimates continue to appear reasonable. Given the weaknesses which could develop in our economy next year, fiscal policy should avoid becoming more restrictive.

Thank you for inviting me to testify. I will be delighted to try to answer questions.

[The table referred to by Congressman Bolling follows:]

TABLE 1

[In percent]

	Real GNP growth		Inflation CPI	
	1978	1979	1978	1979
Wharton:				
Jan. 6, 1978	4.9	4.9	5.4	5.6
June 29, 1978	4.2	3.7	7.2	7.9
DRI:				
Dec. 21, 1977	4.5	4.1	5.8	5.5
June 24, 1978	4.0	3.4	7.0	6.3
Chase:				
Jan. 20, 1978	4.3	4.2	6.1	6.1
June 22, 1978	3.7	2.8	7.0	6.4
Administration:				
Jan. 23, 1978	4.7	4.8	5.9	6.1
July 6, 1978	4.1	4.3	6.8	6.4

The CHAIRMAN. Thank you very much, Congressman Bolling.

Let's talk about taxes and tax cuts and the Kemp-Roth proposal. If I understand what you are saying, you would more or less agree with a tax cut in the general area of about $20 billion.

Mr. BOLLING. $15 or $25 billion.

The CHAIRMAN. $15 to $20 billion?

Mr. BOLLING. $25 billion. I am going to stick with it.

The CHAIRMAN. Are we talking fiscal year or calendar year, or doesn't it matter?

Mr. BOLLING. It does matter, in fact. But I don't think it matters that much.

The CHAIRMAN. Let's talk fiscal year, $15 to $20 billion, with calendar year amounts out to $20 to $25 billion. A fiscal year level of $15 billion was recommended by this committee in its first budget resolution. This is in the area that the Ways and Means Committee and the Senate Finance Committee, as well as the administration, seem to be considering.

Unfortunately, we are talking about tax cuts several months before an election, and it is awfully difficult to address this subject in any kind of objective fashion, but, if I understand what you are

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saying, a tax cut in that range, from $15 to $20 billion, or even to $22 billion, would not offend you very much?

Mr. BOLLING. It wouldn't offend me at all.

The CHAIRMAN. What you do object to, however, is projecting a tax cut out into the out-years.

Mr. BOLLING. Absolutely.

The CHAIRMAN. As Kemp-Roth proposes to do and speaks of a 3-year cut in the area of $90 billion?

Mr. BOLLING. We have just been through a period which proves, I think, conclusively that we can't be that sure of what is going to happen. It just does not make any sense to me to have a 3-year tax cut of those proportions. I think we have to reserve our options.

The CHAIRMAN. You are right in your statement that the Fed has been a major source in pushing for a smaller tax cut.

Can we develop a more reasonable partnership with the Fed by trading off the size of the tax cut for a more accommodative monetary policy by the Fed? Would that be a desirable goal? Can it be accomplished?

Mr. BOLLING. We had Chairman Miller before the Joint Economic Committee last week, and he and I had a discussion after he made a brief summary statement of his more formal presentation, and we agreed on a complicated kind of interlock that is necessary to achieve the purposes that we all adhere to with one or another emphasis on the component parts, and his approach would essentially involve some sort of an understanding that the administration and the Congress would seek to systematically lower the deficits, that thus they would be in a position of assisting in the problem directly of dealing with inflation, that in return for that, but not on the basis of some kind of a hard deal, in return for that as a conceptual approach and a gentlemen's agreement, then the Fed would feel that it was getting help in dealing with inflation, and it might find it reasonable to do less of the unilateral tightening up that it has the separate power to do.

Now that is a very crude representation of a rather skillfully made presentation by a man who obviously had not only thought of the concept but also thought of the words to express the concept. But that is essentially what he was talking about.

I not only think it is necessary; I not only think it is possible; I think it is just plain flat essential. I was in on one of the old fights that revived the Fed as a national instrument of monetary policy coming after World War II, when it had really bowed always to what the Treasury needed in order to finance the war, and I have very strong feelings that the Fed should be independent, but I have also read the books that are available, I believe, including the last one that I know of, with regard to a very important Fed Chairman, Marriner Eccles. It is almost an authorized biography, and it is very clear that Chairman Eccles often disagreed with President Roosevelt, and he often disagreed with the Congress, but he always worked out some kind of an accommodation so that the actions of the whole Government were coordinated so there was no conflict, and I think that that is the kind of thing we are talking about now.

I could have just said, yes, but I think it is more complicated than just yes.

The CHAIRMAN. Thank you very much. Mr. Mitchell.

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Mr. MITCHELL. Thank you very much. It is good to see you again.

Mr. BOLLING. It is good to be here.

Mr. MITCHELL. I am particularly interested in the present accommodation between the administration and the Congress and the Federal Reserve System. I am indeed distressed by the fact that the Feds presented the Congress with a set of targets for monetary growth, particularly M_1 and M_2, and, as I recall the range was somewhere between 4½ and 6 percent, which were subsequently retracted.

For example, within less than 4 or 5 months after that arrangement was worked out—and, by the way, it was an arrangement which entered into the consideration of this committee in terms of fiscal policy, we saw the Federal Reserve beginning to exceed its own range.

As I understand it now, the upper limit is about 8 percent of money going out. Seemingly, this type of monetary policy directly contravenes any fiscal policy this Congress would try to establish.

I know you are familiar with the fact that a few short weeks ago the discount rates were raised again. Of course, this inevitably will lead to an increase in interest rates. If you have been reading the papers, you see where that increase is in excess of the primes and it is adversely affecting the interest rates offered by our smaller lending banking institutions.

So I agree with you that it is imperative that some sort of arrangement be worked out by means of which we work in tandem rather than having the Federal Reserve present a policy which it purports to follow for a year and then because of some changes in the economic system, it violates its own policy.

The net result of this violation, the net result of the present increase in prime interest rates, is going to impact negatively on the pitifully small efforts that we are now making to reduce unemployment.

That is a statement rather than a question. Now let me get to a question, if I may.

In light of the predictions that our real growth rate over the next 12 months will be around 4 percent or even less, what is your assessment of this estimate on unemployment rates? Would you assess that unemployment rates will remain at their prevailing rates? Will they increase? Will it be a temporary increase? That is the question.

Mr. BOLLING. I am supposed to be pretty outspoken, and I guess, relatively speaking, I am, but after our experience with unemployment in the last few months, if the statistics turn out to be accurate, I am not sure I am brave enough to make any guess as to what is going to happen. I don't know of anybody who predicted this last drop from 6.1 to 5.7 percent. I don't know anybody who 6 months ago was going to predict we were going to come down from wherever we were then, 6 or 7 months ago, going to come down to 5.7 percent.

I will be perfectly honest with you, Mr. Mitchell, I don't know, and I am not sure anybody else does, whether there is some statistical error in that or we have an entirely new kind of economic situation going on, because we don't have a growth rate that would

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justify our being able to predict that substantial decrease in unemployment.

Nobody that I know of, no matter what point of view they represent, predicted it 7 months ago; nobody predicted it a month ago, for that 0.4 percent.

My guess is, and the guess of all the informed people that I have talked to directly, is that it is going to have a bad effect on growth. The lack of growth is going to have a bad effect on unemployment.

But with this incredible mix of an enormous increase in jobs, of a relatively low productivity, of unemployment going down substantially when not expected——

Mr. MITCHELL. If I have time, I would like to ask one additional question. In terms of a real growth rate at 4 percent or less, would you, or would you not, agree that such a growth rate can have little or no impact on the structural unemployment in this country?

Mr. BOLLING. Absolutely.

Mr. MITCHELL. Thank you, Mr. Chairman.

The CHAIRMAN. Mr. Derrick.

Mr. DERRICK. Thank you, Mr. Chairman.

Mr. Bolling, if I interpret Mr. Miller, and the thrust of your statement correctly, it seems to me that they are pretty much in disagreement. As I understand Mr. Miller, he would like to see us cut back considerably in spending and end up this year with around a $35 billion deficit, next year, a $17 billion deficit, and as I understand his program, a balanced budget in 1982.

He goes a step further, in a veiled threat, I suppose, maybe not too veiled, and says if we don't do that, we are going to cut back drastically on the money supply.

As I read your statement, you indicate that this is not a time to cut back on programs, spending, and, as a matter of fact, you had rather see us go toward a $25 billion tax cut.

Now, I would just like you to comment on that. You made the comment just a few moments ago, from which I gathered that you and Mr. Miller had some meeting of the minds.

Mr. BOLLING. In terms of what would be ideal. And you know, before I comment on that, I think I should add that one of the real problems in all of this is that Congress for a variety of reasons, some good and some not so good, is a very nearly totally unpredictable partner in all of this process.

It is extraordinarily difficult to say what the Congress is going to do if you look at it from the point of view of the administration or the point of view of the Federal Reserve.

I guess that one of the things we need to do is figure out how to make a treaty with the Senate on some of these economics, and I don't say that with any disrespect.

Mr. DERRICK. Your name will go down in history along with Henry Clay if you do that.

Mr. BOLLING. But, to answer your question, of course Mr. Miller and I have slightly different perceptions of what the bottom line is. I am closer to Mr. Mitchell's bottom line than I am to Mr. Miller's, by a considerable degree.

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If you scratch me hard, you are going to find I am not prepared to suffer a very substantial increase in unemployment without taking some risks at the other end of the scale.

Now, Mr. Miller deals with that particular end of the scale, the inflation end, and that is one of his prime functions, not his only prime function, but it has become sort of traditionally one of the prime functions.

I would deal, I think, with inflation if there were any way on earth to get it through the Congress; I would deal with inflation somewhat as the Joint Economic Committee has consistently recommended for some years, that we would have pre-price increase notification.

First, we would have a piece of legislation that would regularize and legitimatize jawboning. It would give the council that deals with these matters more specific powers. As a matter of fact, I think this is about the only way we are going to avoid a sudden panic where the people of the country insist on direct wage and price controls unless we have some kind of a technique for moving in and cutting this ratchet effect.

Our friend, Mr. Fisher, has made some recommendations on this that I am in the process of having my staff study. But we have got to break in.

Mr. DERRICK. For instance, United States Steel would be required to give 30 days' notification before any price increase. Is this the sort of thing you are talking about?

Mr. BOLLING. That is the kind of thing. About 60 days probably. People immediately come back and say why don't you intrude on the collective bargaining process. That is why you don't, because it is a collective bargaining process, and you have an opportunity to see early what is going on and what is going to happen.

But if you once begin to move in the direction of doing something about price; then you could come up with whatever the sensible proposal was to do something about slowing down wage increases. I don't think there is any question that we are going to have to face that, too, as bitterly opposed as it may be under certain circumstances by the American labor movement.

I don't think we can tolerate the kind of situation we have when you have a very, very serious deflation and a very high unemployment and prices don't come down and wages don't come down. I just don't see how you can tolerate that and expect it to work. And there may be ways that I haven't thought of that we have to use, but we clearly are going to have to deal with inflation or we can't deal on anything like a permanent basis with unemployment.

Mr. DERRICK. I am convinced that the business community thinks that we are going to have a recession next year. They are convinced of it, and as far as I can see, they are doing everything they possibly can to make it happen. That is all I hear back home, and businessmen regularly quote Mr. Miller to back up their statements. Not that Mr. Miller is saying that we are going to have a recession, but he says we are not doing the things we must do to prevent it.

I am delighted to hear there are substantial differences in your opinions. I thank you very much.

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The CHAIRMAN. The time of the gentleman has expired. Mr. Latta.

Mr. Latta. Mr. Bolling, I want to commend you for your statement. As per usual, we don't agree on everything. One thing you have apparently overlooked when you are looking for ways to turn down some of this inflation is to reduce Government spending. Would you like to comment on why you leave this out?

Mr. BOLLING. I kind of leave it out now because I don't want to encourage the tendency of this particular year. I don't have any trouble saying I am for reducing Government spending. I think there is an incredible amount of waste. As a matter of fact, I was one of a minority that voted to cut some water projects. It is not the first time I have done it. One of them is in my own State.

I think that the Congress makes itself look to be difficult when it votes for meat ax cuts and then votes the other way on specifics. I am for reducing spending, but I am for reducing the ones that I think are the low-priority items that are really, if the truth must be said—you said that we sometimes disagree, the ones that I think ought to be reduced, and I think are low-priority items, are the darlings of the conservatives of both parties. They are the pork barrel programs, many of which are terribly important.

Mr. LATTA. Let me say I don't think they are terribly important. I voted against the entire bill.

Mr. BOLLING. That is an easy way to go, and I can't disagree with you. I can't fault you.

Mr. LATTA. Maybe we see eye-to-eye on that.

Mr. BOLLING. We see at least eye-to-eye on it if we particularize it.

Mr. LATTA. On page 6 of your statement, you say, "The evidence of history does not support the argument that taxes have reduced economic incentive to the point that growth is inhibited." What history are you talking about, the history of the United States, or history generally?

Mr. BOLLING. I have never seen any hard evidence that what goes on in this country has reduced incentives enough to make people get out of an active engagement in making more money unless they just prefer the alternative. I don't think people are motivated only by the desire to make more. There are people, and I have known a few of them, who suffered very ill effects of this disease, who are multimillionaires, but greedy, and they always want more.

But it is sad that people who make over $100,000 or $200,000 a year can choose to pay taxes. There are a whole lot of people that make substantially that or more, or have that kind of income, who choose to pay taxes.

Mr. LATTA. You are more or less limiting, then, the history to the American history. What I had in mind was Britain, for example. I think most economists will agree, having taxed to the extent they have, they have inhibited growth by their taxes. Wouldn't you agree on that?

Mr. BOLLING. I think what I would have to do is put that in a much larger context, because I think that charge is surely made, but when you talk about the United Kingdom, you are talking about what was the world power. Suddenly as a result of what it

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did in two wars, having to totally change its way of living and its economy, the whole nature of the British economy changed as a result of a whole series of events, World War I and World War II, and decolonization, and what I would fault the United Kingdom for is a misguided attempt to maintain a grandeur that was gone and an economic system that no longer existed, and I think in the process of doing that, it got very badly out of skew, and I suspect there were some people there who had a very much higher tax rate than we, with a very much higher level of social service than we, very much higher; that there was some disincentive. Maybe there should have been some for some of the people involved.

Mr. LATTA. My third and last question deals with the fact that you don't have any quarrel with Kemp-Roth as far as the 1979 fiscal year is concerned, but into the future.

Don't you think that people generally ought to be able to plan for more than 1 year ahead and Government should be planning for more than 1 year ahead, and when we are talking about planning, we are looking at budget receipts that were just recently revised by OMB, which shows a tremendous increase in 1979 receipts of $47 billion, and then in 1980 we are going to have a $59 billion increase over and above that, and in 1981, a $73 billion increase in receipts over and above that? Don't you think that people should have the right or the opportunity to plan more than 1 year ahead; that maybe their government is going to give them a tax cut?

Mr. BOLLING. I think it would be nice if people had an opportunity to plan, and I think it would be nice if everybody up here would get together and decide that it is time that the biggest business in the world, the U.S. Government, have an opportunity to do a little planning, itself, and anytime you suggest that in legislative form, you find automatic violent resistance, and I will say in both parties, and you are not going to be able to have tax cuts a year in advance or 2 years in advance until there is a more effective way for the Government to look down the track and decide how it is going to relate what it does to what happens in the economy.

I don't think there is any question that we need more planning, but the toughest place to find effective planning is at the Federal level, and the greatest resistance to planning is at the Federal level, and specifically in the Congress.

Mr. LATTA. I couldn't agree more.

Mr. MITCHELL [presiding]. Your time has expired. Mr. Lehman.

Mr. LEHMAN. Thank you. I just came back, as most of us did, from talking to people in my district. I think if there was one recurring theme, it was a general disillusionment with the Federal Government's ability to solve problems people see at the local level, with regard to employment or anything else. They bring to me such things as the inability of CETA employees to get jobs in private industry and ask whether the money is really doing the job.

In the youth employment programs, they tell me some summer job programs are put in neighborhoods where the low-income youth cannot even get to because of transportation problems. There are all kinds of Federal programs that try to accomplish things but have built-in roadblocks. Those are the kinds of problems that I hear from the people as I get around in my district.

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In regard to the rollback in the capital gains tax rate, it was strange to me that while I talked to a number of business people in the $100,000-plus bracket, they didn't have any problem. They didn't seem to want a rollback particularly, and some were even uneasy with the tax rollback idea. The people who did want the tax rollback were the retired people, who had acquired maybe $100,000 worth of securities. They felt they were locked into those securities and they wanted some relief on capital gains so they could sell if they needed to. This was a switch I didn't expect.

Some people questioned whether the official unemployment figure is really valid or not, either at the 5.7 or 6.1 percent rate. I saw a lot of people who wanted the Federal Government to do things for them, like put needed parks in areas of low-income housing. But there was little demand for federally funded job programs unless they resulted in concrete evidence. People wanted to see those parks, perhaps, or the enlargement of an airport facility, or senior-citizen housing. People asked me for something they could see or feel, not abstract programs.

Then, some of the people that you mentioned, that are already making $100,000 or more, seemed to have stopped trying to make more money. Instead, they were trying to drop down into what I guess we're now calling the underground economy. I see this growing more and more apparent, people dropping out of the high-income, high-tax activities, and, say, renting little strips of individual stores where they can deal in cash and escape all or part of their tax burden, or going into flea market operations, or just getting into all kinds of rather bizarre vocations where they seem to be able to make more money without being part of the mainstream of the economy.

I don't see them trying to move up, any more, whether they are doctors or business people or whatever, but just trying to avoid the taxes, the paperwork, the pressure of the mainstream economy. People also tell me that in the small businesses they cannot hire people except off book.

Now, just within the last 2 or 3 months, I have run into the expression "off book." I didn't even know "off book" existed, but it's big economy now. I think that is typical of what I see happening. An awful lot of people evidence their greed not by trying to roll back taxes but by trying to avoid them, to get into an area that is gray and no longer subject to the ability of this country to tax.

I am just giving my little speech, Mr. Bolling. You can react in any way you want.

Mr. BOLLING. I think it's important to comment. There is nothing mysterious about the underground economy. It's there and has been growing. The last census in 1970 admits it probably missed 5 million people. I don't know, you pay your money and you take your choice; you can decide what 5 million were missed and where. But I think that figure is probably pretty good, and there is clearly an underground economy. Some of it is probably just barely illegal, off book in its nature.

Mr. LEHMAN. Would you yield? I met a man who rents the site for just one of the flea markets in Miami, for just 1 day a week. He pays $600,000 a year rent and collects at least that much by rent-

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ing out the stalls to the flea market vendors. And nobody in that flea market even collects sales taxes, much less pays income taxes.

Mr. BOLLING. I think you will find when you get at it that there is one statistic that tends to respond to that whole question. I am as concerned, and we are doing some work on trying to find out about the underground economy, trying to find more facts, but there is one very interesting factor, and that is that we have had the most incredible increase in employment, listed employment, in the last—I don't know what the right time period is—but the last year or 2 years, that has ever happened.

Now, those are people who are above ground, and one of the reasons—I don't want to grind my pet ax, but I have got to at some point—one of the reasons that the Joint Economic Committee and the Congress, by resolution, are undertaking a special study on economic change is that we think there are a lot of unanswered questions. This is not designed as a criticism of professional economists or anything else.

We just think that the economy has grown so big and has changed so much and has so many variations, and you have just begun to mention some of the more complex ones, the more complex ones are international. We have some changes; we have to take a fresh look and try to figure out maybe why it is we can't do a better job of projecting the future.

But sure, I think the kind of thing you have been seeing, I think you saw it in a larger dose than I usually do when I am in my district, and I don't know whether that is just a question of how or where you happen to be going this trip, but I think we have all got some of that, no matter how staid and conservative our districts are.

Mr. MITCHELL. The gentleman's time has expired.

Mr. LEHMAN. May he comment on the one thing about the lower income people and retired people being more concerned about capital gains taxes?

Mr. MITCHELL. Mr. Obey, you are next; do you have any objection to an extension of time?

Mr. SIMON. Mr. Chairman, if I may also suggest he insert in the record, or someone insert in the record, the definition of "off book," because I had to ask the chairman and Mr. Latta what "off book" meant.

Mr. MITCHELL. It does not deal with parimutuels.

Mr. LEHMAN. Mr. Bolling, if you have the time, would you comment on the fact that retired people are more interested in the capital gains rollback than business people are?

Mr. BOLLING. If I may say so, and maybe this is a little bit unkind, I think there has been a very deliberate effort, as there always used to be in housing and rent control, and a very successful effort to convince retired people that they are going to be the real beneficiaries and that is not what the tables show. What the tables show is that the very well off are the ones that are going to be the major beneficiaries.

There is another factor involved. I think in the original recommendations of the Carter administration, at least the housing capital gains windfall was taken care of, and I understand that there is

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a move afoot now to take care, specifically, in any tax bill, of that kind of thing. But that is not the real target.

All the tables I have seen, the ones by the people who are for the Steiger amendment and for the Jones amendment and the ones that are against all the tables I have seen, would indicate to me that the beneficiaries are people of high income. And the people who incidentally get a little bit of the benefit are the people that you describe.

But, as is always the case when an attempt is made to sell one like this, they always send the grandmothers who are retired.

Mr. MITCHELL. The gentleman's time has expired again. Mr. Obey.

Mr. OBEY. Mr. Bolling, I have just two questions that really don't relate directly to the budget resolution at this point. You indicated in response to Mr. Derrick's question that one of the things you do on the inflation front, my concern is that given political reality we have only two choices: Either to face the pressure of tax cuts and larger tax cuts down the line and the pressure for reduced Federal spending below the amount that you would recommend for this year, or else something else, and my question is, since nothing seems to be happening in the private end that would encourage people on inflation, the only visible target at this point that seems to be getting any political attention is the spending level.

In addition to what you have already suggested to Mr. Derrick, what would you suggest by way of Government actions to attack inflation and what would you also suggest to deal with the question of capital formation?

Mr. BOLLING. I am involved, and I am not yet entirely successful, in a private effort to have a real deficiency study made on how to get better capital formation, by completely reputable people, and the dilemma we have is we cannot get people who represent all of the interest groups to commit themselves to participate.

They are so afraid of coming together to settle a controversy that it takes an incredible amount of negotiation between well-intentioned people to get a real study that would have standing in the whole community with everybody because of the participants and funding, and so on, underway. That is a classic illustration of the dilemma that we have.

One illustration of it is sort of a small thing, but not really small. We have a capitalist labor movement in this country. There is more conflict between management and labor in the United States of America than there is in the other developed countries where they have Socialist labor movements.

What is happening is that everybody is quarreling about getting more for themselves, and we are not able to put together the kind of combined effort that has always been necessary in this society for the society to function. And we see a great deal of this in the activity of both business and management and labor in their response to the President's plea to help on inflation.

Now, I told—and maybe you were there—I told the executive board of the Business Round Table, when they were before the Democratic Steering Committee, that they were going to have to get together with the labor leaders before Government was going to be able to come up with a program.

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I think everybody in the room, including the Speaker, was mystified by what I meant, and I have explained it and it is just what I said a little bit earlier. We have to get the best minds that we have got from all points of view to come together with a public interest kind of approach.

Now, I think what it is going to contain is a specific involvement of everybody in reversing the ratchet. That is implicit in what I said earlier about the need for wages to be modified. I don't happen to think that it's possible to do it totally fairly. I think the inflation we have had up to date has been largely a cost-push inflation. It may now be turning a little bit the other direction, but I think we are going to have to have techniques of intervention which are acceptable to a variety of interest groups and which are implemented by government by law.

Mr. OBEY. Let me ask you a question, because you mentioned it earlier. You indicated you thought Bosworth's Council needed additional powers. When he was before us the last time, I think it was the last time, he indicated he did not think they needed any more formal authority than they had now.

Mr. BOLLING. Well, he is, after all——

Mr. OBEY. I recognize that, but what specifically are you suggesting?

Mr. BOLLING. I think one of the things we recommended was that they should issue reports estimating the impact of Government activity on inflation, price supports, import restrictions, minimum wage, take a hard look at all of that. That has not been done effectively because some of those things are off limits. And they should not be.

I mean, we are at a point, I can understand why he said what he did, but I cannot believe he would resist the opportunity to have subpena power and so on and so on. I think he has to have more power.

Mr. OBEY. I am just asking you to lay out your laundry list.

Mr. BOLLING. I think the easy way to say it, the quick way to say it is we are going to have to have structural tools to deal with what is in essence a sort of structural inflation, just as we finally and belatedly came to the notion that we had to have structural programs to deal with unemployment to complement the macropolicies. I do not think we can deal with inflation solely with macropolicies. I think there has to be a detailed range of weapons, and I would not even presume to think of all of them, since I have not even been able and my committee has not even been able to get the first step, which is to give them some increased power to function, for reasons which are obvious.

Mr. MITCHELL. The gentleman's time has expired. Mr. Burgener.

Mr. BURGENER. Thank you, Mr. Chairman. Chairman Bolling, it's always a privilege to listen to your provocative and excellent testimony.

Mr. BOLLING. Thank you.

Mr. BURGENER. I appreciate it very much. I hope the Congress does not wait to be hit over the head with a very blunt weapon such as we were the recipients of in California recently. We were collecting money at our State level literally faster than they could

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spend it, believe it or not, and they amassed a $5 billion to $7 billion surplus.

I think they wisely did not spend it. But the government out there lives on inflation, much as it does here, and in the absence of any restraints such as indexing, the taxes just piled up and up to $7 billion. Now, at the same time people's property taxes doubled and tripled, and senior citizens particularly and anybody on a fixed income got priced out of their homes, and they were angry and frustrated and they had to actually sell, and reduce their standard of living in an expanding economy.

I think if we don't get the message here that people want spending cut, even modestly, and taxes cut rather substantially, we will be missing the boat.

In all I have read about the Kennedy tax cuts and Johnson and Heller and so on in the early 1960's, it seemed to me that the best thing about them, and I would echo what Mr. Latta said, they were permanent; they were not quicky, one-time rebates; they were permanent in nature, and I guess they are still with us in large measure.

You argue that they didn't result in higher productivity, that people worked fewer hours and took more vacations and so on. Now, economists differ. Some don't like Professor Laffer because he is new and a bit of an upstart perhaps. Milton Friedman is certainly not an upstart. He won the Nobel Prize for economics, and he argues, I believe I am correct, that permanent tax cuts are absolutely in the public interest.

It might restore investor confidence. Am I correct that we are the only large industrial nation with a capital gains tax? Would someone correct me if I am wrong about that?

Mr. BOLLING. I think that is probably true, or so I am informed. I don't know of any other nation, but that is, I must say, and I know you are aware of it, the missison of taxation in other nations and ours is extraordinarily different. That is not the only difference.

Mr. BURGENER. The President has labeled the capital gains reduction as a millionaire's relief act. I would not care if it is if it also benefited the general public. I don't care how many millionaires get help if it helps the general public as much or more. I think a lot of people involved in capital gains are not millionaires, by the way, and an immense amount of public investors, large and small, would be benefited.

So I would like to try to focus in on the differences in the economy in 1960 and today. Inflation is one. Your testimony said inflation was very low and we had ideal plant capacity.

Mr. BOLLING. That is correct.

Mr. BURGENER. And yet if we didn't increase productivity, what happens then to increase revenues to the Treasury? I am told $50 billion plus in the next 5 years after those permanent tax cuts.

Mr. BOLLING. My impression of the intent at the time, as I said I had some small involvement myself, and the result as interpreted by the people at the time was that the success of that cut was that it added to demand, not to supply, and that the effect was there was a multiplier, the cut was in the order of what, 13 to 15, and you multiply it out in sort of a normal fashion because of the

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increase in demand which increased, in effect, production and employment.

Now, we had a much better level of productivity in those days than we do today. One of the really weird things, and weird is a strong word, but I think it is weird, is we have this enormous increase in the labor force. We don't have very much sign of economic growth, and we have got a terrible productivity compared to earlier times. We don't really understand why.

Mr. BURGENER. One final point. Am I mistaken or is there not a massive amount of purchasing power out there, that there is money floating around, funny money maybe, not worth much, but it's out there in droves, that purchasing power is more massive, savings are higher, spending levels are higher than ever before? Or am I wrong?

Mr. BOLLING. I suppose you can say that without being relative, but as soon as you are relative, then your problem, I think saving is a little bit higher than it has been, but we are not getting the satisfactory level of investment, and that is supposed to be partly because people cannot look ahead and feel sure, and we have not even started to get into that because one of the fundamental reasons they cannot look ahead and be sure is we finally figured out that what Germany and Japan do is critical.

That is why we are going to get an awful lot back, feedback from whatever happens at this summit, which in some theories has no meaning, but in other theories has all of the meaning. But I don't know the answer. That is why I would like to see us be able to study, under auspices that are impeccable and not political, with a neutralization on interest and the politics, the problem of capital formation, and I have been working with a variety of people around the country, academics and businessmen, to try to get that done. We don't know the answers, at least I sure don't.

Mr. BURGENER. Thank you. My final point, I just hope Congress will cut spending modestly because I think it's unrealistic to cut it heavily, but do it each year, and cut taxes substantially and of a permanent nature.

I think it will work, but you have to have a lot of confidence in the private sector or free market to take that route, and I am not sure there is that much confidence. I have it. I hope it is not misplaced. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. Mr. Mineta.

Mr. MINETA. Thank you, Mr. Chairman, and thank you, Mr. Bolling, for your very fine statement. On the second page of your testimony you refer to the number of witnesses who have appeared before the Joint Economic Committee cautioning against the possibility of a recession or at least "a growth recession." What is your definition of a growth recession?

Mr. BOLLING. In effect, it means we would have a moderate amount of growth, but still have an increase in unemployment.

Mr. MINETA. Also on page 2, and I appreciate your comments on the Kemp-Roth proposal because we do have all kinds of cure-all panaceas these days. Kemp-Roth is based on the so-called Laffer curve and, in fact, someone described the Laffer curve as being in the shape of half a potato, but it was half-baked.

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Rather than exaggerated promises, Congress should be working on carefully crafted policies in this whole area you have mentioned. My colleage from California has very accurately, I think, portrayed what happened in California in terms of an inflation situation that brought more tax revenues to the State government. I am wondering whether or not you feel that inflation-induced tax increases are serious, and whether or not we should be considering indexing the Tax Code to automatically offset the effects of inflation. What problems might we encounter if we were to do that?

Mr. BOLLING. We have an economist who has done a lot of work on that. I have a little trouble with any kind of index. I voted for it a couple of times, but I am coming to the conclusion that as a fundamental rule of thumb it is better to leave flexibility and demand on the wisdom of Congress and the administration rather than indexing. I am not very firm on that conclusion. I vacillate on it. But I have not seen enough to convince me that indexing is the way to go. I rather take a position that it's terribly unpopular in Congress, in fact, so unpopular that people say it will never happen.

I would rather give to any administration, and as I look back on it I don't think there is an exception to this, I would rather give to any administration the right to raise and lower taxes neutrally by a certain percentage, to get the flexibility in.

Now, that is not fine tuning, it's sort of gross tuning, but the more I have watched Congress perform and I am pretty well committed to the idea that the House is important and the Senate is important, the more I watch us perform the more I am convinced that we are incapable because of the nature of the society, not the nature of the Congress, that we are incapable of dealing quickly with tax changes, and I think that would solve much of the problem that you are confronting when you recognize that inflation forces people into higher brackets and that there should be some kind of I suppose reverse indexing to compensate for that.

I would rather see the President have the right to pop them out of those higher brackets just by having the right to maybe 5 percent, 6 percent up or down. Down, obviously, to pop them out of the higher brackets. I think that makes more sense.

Now, you might have a veto on that, a congressional veto, but you have to be able to do it relatively quickly if you want to have some reasonable economic effect. I am not sure that makes sense either, but it's the best I have come up with.

Mr. MINETA. On this other issue that we continue to face, the area of capital investment, it seems to me part of the problem is that we are drying up the sources of capital investment and equipment and plant, partly due to the fact that people are getting out of the stock market, out of the equity market and into real estate speculation where the returns are greater. At least we are experiencing that in California. I was wondering if you had any comments on that kind of a shift.

Mr. BOLLING. That I think is based on people trying to find some safe place where their money will be protected somewhat from inflation, and I think what has happened is we had an enormously successful 20 years from 1946 to 1966 and the interesting thing

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about that is that it was through all different kinds of administrations.

Some of the best years, although there were more recessions in them than I liked, were in the Eisenhower years. So you had conservative Presidents and more liberal Presidents and you have a long period of fantastic and unbelievable economic growth, and a whole variety of things happened from 1966 through 1973, and a few things have happened since, but everything has turned upside down.

I think virtually every professional economist who is old enough to know the whole period or to have looked at the whole period or experience the whole period would agree. And we have not yet arrived at the synthesis of the new factors.

I don't think we know the details of the new factors. Thirty years ago what Germany thought or did was not very important. The same is true of Japan. Today they are absolute keys in the health of the American economy. The smaller countries still have great power, economic power, and great influence on what happens.

France and England, for example, are trying to invent new techniques to protect their own manufacturing. All kinds of strange things are happening, but we don't even know the facts, the facts on our labor force. We are trying to dig out and find out what really has happened in the American labor force. Its character has changed absolutely, from my point of view, incredibly.

Mr. MINETA. If we are to try and deal with these issues, instead of gross tuning, as you referred to it, we ought to be doing some fine tuning, it seems to me; we ought to be coming back with some carefully crafted policy.

Mr. BOLLING. I think first we have to get the facts, Mr. Mineta, and we are always involved in dealing with the next crisis or the next political problem and that again, I have to come to one of my pet projects, that is why we have, and you voted for it, and so did I, I guess most people in the room, we have a special study on economic change going on which is going very slowly and trying to be very careful about bringing everybody into it.

We started out with demography, and we are going to move from there on into the more conventional kinds of things. But in the process of conflicts over what is the score on the labor force is just unbelievable. We don't know.

Mr. MINETA. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Ohio.

Mr. REGULA. Thank you, Mr. Chairman. First of all, Mr. Bolling, I think your idea on the flexibility on the tax structure for the executive branch has more merit than giving the executive branch flexibility on the outlay side, and I suspect it would be a healthier technique for stimulus in periods of slight recession. I am intrigued with the idea.

First, have you reached any conclusion as to what percentage is the magic figure in terms of total tax take? We hear the idea that if it gets above 33 or above 35 it begins to have a regressive impact. Would you have an opinion on that?

Mr. BOLLING. I have sort of reluctantly come not to believe any magic figures exist, even 4-percent unemployment.

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Mr. REGULA. Fair enough. The second question is does the idea of deferring tax on capital gains until it is actually used as an expenditure for personal purposes, in other words, the idea of allowing an individual to roll over from one security to another security such as we do on a residence now for those that are actually living, or it's their principal place of business and also allowing a factoring in of the inflation during the period of the investment and then taxing the ultimate money that is going to be expended as income after having factored out the impact of inflation at the standard rate, have any appeal to you?

Mr. BOLLING. I would like to run it through some specifics to see what the specific effect would be. What you are trying to reach is some kind of more equitable and more inflation-proof approach to capital gains. Obviously, I agree with the purpose and I just simply don't know what the impact would be. But it's an interesting thought, and I will be glad to pursue it a little.

Mr. REGULA. My next question is, I note in the table on the back of your statement that it seems without exception that Wharton, Chase, and the others agree we are going to have from 0.2 percent to 0.6 percent lower real growth than the administration forecasts. Does this concern you and do you think that we should be concerned about this happening in terms of policies that are effectuated by this Congress?

Mr. BOLLING. Yes. That is one of the reasons, a good part of the basis for the fundamental thrust of the statement, which is that we need a substantial tax cut.

Mr. REGULA. As a stimulus to growth?

Mr. BOLLING. That is correct. I am very much concerned about it. I have a hard time facing my friend, Mr. Mitchell, when he talks about unemployment, because I know exactly what he is talking about. We have this substantial reduction in unemployment across the board, and where we have minority youth at 37.5 percent, which is absolutely incredibly destructive, I cannot say it strongly enough, because you are wiping out that generation.

Mr. REGULA. That is true. Do you think that the deficit has a substantial or moderate or very little impact on inflation, and I am talking about the deficit as we face it in fiscal years 1978 and 1979?

Mr. BOLLING. I used to think it has less impact than I think now, and the reason I think now it has more impact than I used to is I have watched it used as a device, and I want to be careful about this because this has not, in my opinion, been done by a party, although it may be in the end. It has been a device used very cleverly by some organized groups to try to pursue their desire to cut down the amount of Federal spending.

Now, I am sure it has been done consciously by some of the people that are involved in the outside in it because I know them well. And the reason for that is a highly uncomplicated one. With all its flaws and particularly leaving out social security, which is a peculiar kind of tax, the Federal tax take, in my opinion, is much fairer than the State or local tax takes. It's much more progressive.

Therefore, those who want to protect as much as they can higher incomes always want to take the spending away from the Federal level and put it into the State and county and the city, because

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their tax takes are much less progressive, much less based on ability to pay.

I think a monumental amount of the maneuvering seen over a relatively long career has been based on that one simple factor, and I am sure there are a great many people who advocate proposals that stem from that approach who are not even conscious that that is really what the approach is all about.

Mr. REGULA. The last question. Do you agree or disagree that we are forcing the Federal Reserve to substitute monetary policy for fiscal policy in view of the fact that we apparently are unwilling or unable to restrain the deficits?

Mr. BOLLING. I think that is a fair question, and it's very difficult for me to answer it. I think that is true up to a point. My impression is, and somebody can correct me, I suddenly realize I am not sure on this, but my impression is that the Chairman voted against the last increase in the funds, in the Federal funds percent. There was some flurry in the paper. I happen to have considerable admiration for Mr. Miller, and I happen to be somebody who has pretty consistently supported the concept of an independent Fed.

I think there are times when we put too much of a burden on them and force them as they see their duty to go pretty hard. Now, sometimes I think they go too hard, and I think they may be at that point now. I am not prepared to say on a quarter of a percent basis I know for sure.

Mr. REGULA. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. We want to thank you very much, Mr. Bolling, for spending the time with us on a very important subject, and we appreciate the help, and the suggestions, and the inputs.

Mr. BOLLING. Thank you very much. I enjoyed it as always.

The CHAIRMAN. Thank you very much. Our next witness this morning is Dr. Alice M. Rivlin, who is well known to us, of course, on this committee, Director of the Congressional Budget Office. Dr. Rivlin, we welcome you to the committee.

We are interested in hearing your views as to the future course of the economy and your recommendations as to the size and type of tax cut that should be included in the second resolution. We would also like your assessment of the outlook for inflation and unemployment over the next 18 months.

I understand that the CBO is currently analyzing the "Mid-Session Review of the 1979 Budget" released July 6 by the Office of Management and Budget. Those reestimates predict a "shortfall" of $10.7 billion for fiscal year 1978 below the January estimate. Do you have an explanation as to why the overestimates of expenditures are continuing?

Also, the Congressional Budget Office completed a study last week for the committee on the impact of passage of Proposition 13 in California which reduced property taxes. Would you briefly summarize your findings?

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STATEMENT OF DR. ALICE M. RIVLIN, DIRECTOR, CONGRESSIONAL BUDGET OFFICE, ACCOMPANIED BY DR. WILLIAM J. BEEMAN, ASSISTANT DIRECTOR, FISCAL ANALYSIS DIVISION; AND JAMES L. BLUM, ASSISTANT DIRECTOR, BUDGET ANALYSIS DIVISION

Dr. RIVLIN. It is a large order, Mr. Chairman. I think most of these points, except Proposition 13, are covered in the statement. I will read part of it and summarize the rest.

The statement covers four topics: The economic outlook as projected by CBO; the budget estimates included in the mid-session report on the fiscal year 1979 budget recently released by the administration; fiscal policy options for fiscal year 1979 now receiving attention in Congress; and the need for closer coordination of monetary and fiscal policies and/or structural approaches to controlling inflation.

THE ECONOMIC OUTLOOK

This committee begins its consideration of the Second Concurrent Resolution on the Budget for Fiscal Year 1979 at what I believe to be the most difficult moment for economic policymakers since the beginning of the budget process and possibly longer. Inflation is accelerating just at the moment that the economic recovery is showing signs of running out of steam. Despite last month's drop, unemployment remains high by postwar standards. Most forecasters project little improvement in the jobless rate in the months ahead and some foresee deterioration. As a result, policymakers face a most troubling dilemma. On the one hand, the standard remedies for inflation may weaken economic growth and perhaps trigger a new recession. On the other hand, actions designed to sustain the recovery run the risk of aggravating the already rapid increase of prices.

It is also a particulary difficult time to forecast the behavior of the economy. The contours of any economic projection depend critically on the resolution of this policy dilemma, and that final outcome is still very much in doubt. For the purposes of this forecast, we have made the following policy assumptions: As is customary, we have taken as given the fiscal policies included in the First Concurrent Resolution. With respect to monetary policy, we have assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

Based on these assumptions, CBO expects economic activity to grow at a 3.5 to 4.5 percent rate during 1978, slowing by about one-half of 1 percentage point during 1979. As shown in table 1, the unemployment rate is forecast to range between 5.2 and 6 percent by the end of 1979, that is to say, about where it is right now.

[The tables referred to may be found in the prepared statement.]

Dr. RIVLIN. The most unpleasant side of this scenario is the outlook for prices. While inflation is likely to moderate from the double-digit rates during the first half of 1978, the increase in the Consumer Price Index—CPI—for the entire year is expected to be in the range of 6.8 to 7.8 percent, substantially above the 6.6 percent rise during 1977. Prices are projected to continue to rise at

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a rapid rate in 1979, although, in the absence of any unanticipated shocks, they will probably decelerate somewhat from this year's pace.

There are at least three aspects of this projection that deserve some further examination. First, in a period of relatively high unemployement, why has the outlook for inflation deteriorated so badly? Second, given the assumption of an accommodating monetary policy, why have we forecast a slowdown in the growth of economic activity? Third, if there is a slowdown, why won't it turn into a recession?

OUTLOOK FOR INFLATION

Inflation has accelerated sharply since the beginning of the year. The rate of increase of consumer prices between December and May was about twice the rate during the second half of last year. This upsurge did not reflect widespread shortages of labor and capital, but rather was associated with the simultaneous occurrence of three events: A rapid increase in food prices resulting from the harsh winter and the beginning of a cattle cycle, the depreciation of the dollar, and the January increases in payroll taxes and the minimum wage.

Although the CBO forecast assumes that no comparable food and depreciation shocks will occur next year, the rate of price increase is projected to moderate only slightly from this year's pace. The principal impetus to this continued high level is expected to be rising labor costs. If past behavior holds true, the recent jump in the CPI will cause a lagged acceleration of wage gains and a corresonding markup of prices late this year and in 1979.

Past performance unfortunately also indicates that restrictive macroeconomic policies would have only a small effect on inflation during the first few years. Like the special factors that induced the price acceleration earlier this year, subsequent wage catchup, once there has been a price increase, has proved to be relatively insensitive to variations in total demand. Under such circumstances, it takes many years of high unemployment to reduce inflation significantly.

REASONS FOR THE SLOWDOWN

The foreign trade and State and local government sectors are expected to provide moderate stimulus to the economy during the next year and a half. Thus, the outlook for slower growth through 1979 rests largely on the behavior of three sectors of the economy: Housing, consumption, and business fixed investment.

Spending on residential construction provided significant impetus to the rise in real GNP last year. Such strength, however, probably will not continue through the projection period; this year's rapid tightening of credit markets has already limited the availability of funds for home mortgages. Savings and loan institutions have experienced a significant deceleration in deposit inflows and by May commitments outstanding for future mortgage lending had fallen for 5 consecutive months.

The prospects for consumer spending also appear less bright. Personal debt has risen sharply relative to income, and tighter mortgage conditions will reduce opportunities to convert real estate equity to cash, a practice that apparently helped sustain consump-

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tion throughout the expansion. Furthermore, consumer attitude surveys indicate that the recent surge in retail sales may be based in part on the attempt to avoid expected future price increases. Such buy-in-advance behavior would reduce consumer spending in the remainder of this year and perhaps in 1979.

The growth of housing and consumer spending typically slows as an expansion ages, but such slowing is usually somewhat offset by increased outlays for plant and equipment. According to the Commerce Department's survey of business anticipations, constant dollar business fixed investment is again likely to increase faster than overall growth, but less rapidly this year than last. Moreover, a slowdown in the overall pace of economic activity means less pressure on capacity utilization throughout the forecast period. As long as existing productive capacity remains underutilized, there is little likelihood of an investment boom.

REASONS FOR NO RECESSION

Most forecasters agree that growth will slow, although many go further than the CBO projection and predict a recession within the next year and a half. This is admittedly a difficult call, but, given our policy assumptions—particularly our monetary policy assumptions, CBO does not believe that current economic trends point to a recession. This assessment is based on a number of factors:

The tax cut included in the First Concurrent Resolution more than offsets the effects of rising payroll taxes and fiscal drag on disposable personal income and should help sustain consumer spending. In addition, the tax package should stimulate business fixed investment.

The impact of higher interest rates on housing activity may be softened somewhat by the new option available to lending institutions to pay market interest rates on deposits of $10,000 or more. The recent depreciation of the dollar is expected to boost net exports.

Perhaps most importantly, there is little evidence of the kind of imbalances between production and final sales that typically characterize a period preceding a recession. Throughout the current expansion, businesses have pursued a cautious inventory policy, keeping stocks closely alined with sales.

These reasons, however, do not touch on the principal differences between the CBO projection and those who foresee a near-term recession; that is, the future course of monetary policy.

As I noted earlier, CBO has assumed no significant further tightening of credit markets. By contrast, many forecasters anticipate a recession brought about by a credit crunch, as the Federal Reserve responds to the recent acceleration of inflation and rapid growth in the basic money supply.

EVALUATION OF OMB JULY BUDGET ESTIMATES

In its Mid-Session Review of the Fiscal Year 1979 Budget released last week, the Office of Management and Budget—OMB—lowered its estimates of the budget deficits by over $10 billion for both fiscal years 1978 and 1979, as compared with its January estimates. The reduction in the 1978 deficit estimate is almost

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entirely caused by lower outlay estimates as a result of the continuing shortfall in expenditures. For 1979, the deficit reduction results partly from lower spending estimates, but mostly from changes in the administration's tax reduction proposals. Table 2 compares the latest OMB estimates for the budget totals with the 1978 Second Concurrent Budget Resolution limits and the 1979 First Concurrent Resolution targets.

Mr. Chairman, we are now reviewing the new OMB estimates, and will submit the results of this review to the Budget Committees within the next 10 days. Let me just summarize by saying that at the moment we don't see any distinct reasons to disagree with the OMB, that we expect this review will roughly confirm the estimates they have given.

Let me skip, in the interest of time, to the top of page 11 on policy options.

POLICY OPTIONS

Recognizing the need for stimulus to sustain economic growth, the Congress enacted a First Concurrent Resolution last spring with several new initiatives, including a sizable tax cut. With these measures, the deficit is expected to be about $50 billion in fiscal year 1979, about the same as in the current year. The full-employment budget deficit, one measure of fiscal stimulus, would increase slightly from fiscal year 1978 to 1979, as you can see in the table in my prepared statement.

The Congress now has an opportunity to review that earlier decision in the light of changing economic conditions. Recent economic developments are mixed. Inflation is considerably worse than expected, while the unemployment rate has declined more rapidly than anticipated. At the same time, however, most forecasters believe the outlook for economic growth has not improved, if anything, it has worsened. Hence, the policy dilemma: Measures aimed at reducing inflation could slow growth and risk a new recession, while policies designed to sustain economic growth could accelerate inflation.

RESTRICTIVE FISCAL POLICY OPTIONS

If the Congress feels that continuing the current fiscal policy provides too much stimulus at this stage of the economic expansion—particularly in light of the persistence of inflation—it can take steps to reduce the fiscal year 1979 deficit. Perhaps the easiest way to achieve a more restrictive budget at this time would be to forgo all or part of the $15 billion tax cut for fiscal year 1979—$20 billion annual rate—that was included in the first resolution to take effect in January 1979.

The CBO forecast described earlier includes this tax cut, assumed to be $11.4 billion in personal and $3.6 billion in corporate taxes. What would the outlook be without the tax cut? CBO's guess is that the effect on our forecast by the end of 1979 would be to reduce real growth by about three-fourths of 1 percentage point and to raise the unemployment rate by about two-tenths. A policy of no tax cut would not reach its maximum restrictive effects on real economic activity until the end of 1980, however, when the impact would be somewhat larger. In terms of inflation, prices

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might be 0.2 percent lower by the end of 1980. Inflation reacts to stabilization policies more slowly than unemployment.

A significant restrictive economic effect could also be attained by cutting expenditures. For example, the House of Representatives has voted to reduce spending by 2 percent in a number of fiscal year 1979 appropriation bills. If such a reduction were applied to the First Concurrent Resolution outlay target for 1979, total outlays would be lowered by about $10 billion, to $489 billion. The CBO economic forecast already assumes a shortfall of about $4 billion from the First Concurrent Resolution. To achieve further reductions, however, would require difficult actions, such as forgoing, or requiring full absorption of, the October pay raise for Federal employees, and forgoing or reducing sharply the planned new spending initiatives for defense, agriculture, urban aid, veterans' benefits, and other programs that have not yet been acted.

Alternatively, savings could be sought in existing programs to achieve the spending reduction and still provide for some needed new spending initiatives. One way of achieving this would be an across-the-board cut in budget authority provided in all 1979 appropriation bills for nonmandatory payments under existing law. Assuming that the Congress could achieve a cut in spending of, say, $10 billion beyond the estimated shortfall, the effect on economic activity would be roughly similar to that described above for eliminating the tax cut, depending on the composition of the reductions.

If the Congress were to forgo the tax cut or take comparable action on the spending side, fiscal policy would be more restrictive in 1979 than in 1978. To the extent that the economy is approaching full employment, such a reduction in fiscal stimulus could reduce the risk of generating excess demand inflation. But we must recognize that real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become restrictive simultaneously, a shift that in the past has generally been followed by recession.

EXPANSIVE FISCAL POLICY OPTIONS

In contrast to these various restrictive measures, the Congress has before it a proposal for substantial tax reductions. H.R. 8333—the Kemp-Roth Tax Reduction Act—proposes large tax cuts over a period of 3 years without comparable reductions in spending. Conventional economic analysis indicates that, as a result of such a policy, the budget deficit would rise sharply. With the economy likely to reach full employment during this period, a large stimulus of this kind would be highly inflationary.

Some of the proponents of this policy option, however, argue that the conventional view is incorrect. They contend that large tax cuts increase incentives to work, save, and invest to such an extent that the cuts would pay for themselves in the first or second year and, therefore, would not be inflationary.

CBO does not know of any empirical evidence for the view that the supply side effects of tax cuts are so large and so quick. The evidence available to us supports the conventional view that the stimulative effects of most types of tax cuts occur primarily

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through increased aggregate demand and that these effects are not large enough for tax cuts to be self-financing.

THE COORDINATION OF STABILIZATION POLICIES AND STRUCTURAL MEASURES

Past experience suggests that some incidences of poor performance by the economy have resulted from excessive shifts of monetary and fiscal policies in the same direction. The fiscal and monetary authorities each assumed that the other would not take appropriate action in response to current economic trends; together they overreacted. Such an overreaction appears to be possible at this time. If monetary and fiscal policies are both used to reduce inflationary pressures, the chances for a recession are great.

Closer coordination of monetary and fiscal policies might result in a more desirable mix of policies. For example, the longrun performance of the economy might be improved by a tighter fiscal policy and an easier monetary policy. That policy mix might: Reduce Federal deficits and, perhaps, decrease the size of the Federal sector as well; and encourage investment spending, with the resulting growth in capacity reducing inflationary pressures.

At present, however, adequate arrangements for choosing specific economic goals and implementing a coordinated policy simply do not exist. Although attempts at closer coordination of fiscal and monetary policies are not without their risks, the benefits in terms of stabilization could be substantial. Hence, this seems to me to be an appropriate time to examine mechanisms for improving coordination of monetary and fiscal policies, such as requiring the Federal Reserve to: Clearly specify its money and credit targets for the ongoing and upcoming fiscal year before enactment of the budget resolutions; reveal its estimates of the level of unemployment, production, and prices for the end of the fiscal years that go with those policies; and explain periodic revisions of its objectives and plans.

Finally, the dilemma facing policymakers today could be made less acute by improving the tradeoff between inflation and unemployment—as this committee has discussed many times in the past—through the use of structural programs, including: Skill training, public service employment, reform of Government regulations, more vigorous enforcement of antitrust legislation, reducing the minimum wage for youth, incomes policies, such as TIP—tax-based incomes policies—and reductions in payroll taxes.

But even with structural improvements and better coordination, however, simultaneous inflation and unemployment will continue to present difficult choices for macroeconomic policy. Measures to deal with one of these problems may well worsen the other. Ultimately, the resolution of this dilemma will depend on whether the Congress gives greater emphasis to inflation or to sustaining economic growth.

[Testimony resumes on p. 34.]

[The prepared statement of Dr. Rivlin follows:]

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Prepared Statement of Dr. Alice M. Rivlin

Mr. Chairman, my statement this morning will cover four topics: The economic outlook as projected by CBO; the budget estimates included in the midsession report on the fiscal year 1979 budget recently released by the administration; fiscal policy options for fiscal year 1979 now receiving attention in Congress; and the need for closer coordination of monetary and fiscal policies and/or structural approaches to controlling inflation.

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It is also a particularly difficult time to forecast the behavior of the economy. The contours of any economic projection depend critically on the resolution of this policy dilemma, and that final outcome is still very much in doubt. For the purposes of this forecast, we have made the following policy assumptions: As is customary, we have taken as given the fiscal policies included in the First Concurrent Resolution.

With respect to monetary policy, we have assumed that short-term interest rates will not rise much further and that credit conditions will not become so restrictive as to abort the expansion.

Based on these assumptions, CBO expects economic activity to grow at a 3.5- to 4.5-percent rate during 1978, slowing by about one-half a percentage point during 1979. As shown in table 1, the unemployment rate is forecast to range between 5.2 and 6.0 percent by the end of 1979. The most unpleasant side of this scenario is the outlook for prices. While inflation is likely to moderate from the double-digit rates during the first half of 1978, the increase in the Consumer Price Index (CPI) for the entire year is expected to be in the range of 6.8 to 7.8 percent, substantially above the 6.6-percent rise during 1977. Prices are projected to continue to rise at a rapid rate in 1979, although, in the absence of any unanticipated shocks, they will probably decelerate somewhat from this year's pace.

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TABLE 1.—ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1978 AND 1979

Economic variable	Levels			Rates of change (percent)		
	1977:4 (actual)	1978:4	1979:4	1976:4–1977:4 (actual)	1977:4–1978:4	1978:4–1979:4
GNP (billions of current dollars)	$1,962	$2,160–$2,202	$2,354–$2,457	11.8	10.1–12.2	9.0–11.6
Real GNP (billions of 1972 dollars)	$1,360	$1,408–$1,421	$1,446–$1,481	5.7	3.5– 4.5	2.7– 4.2
General price index (GNP Deflator, 1972=100)	144	153–155	163–166	5.8	6.4– 7.4	6.1– 7.1
Consumer Price Index (1967=100)	185	198–200	210–214	6.6	6.8– 7.8	6.2– 7.2
Unemployment rate (percent)	6.6	5.5–6.1	5.2–6.0			

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There are at least three aspects of this projection that deserve some further examination. First, in a period of relatively high unemployment, why has the outlook for inflation deteriorated so badly? Second, given the assumption of an accommodating monetary policy, why have we forecast a slowdown in the growth of economic activity? Third, if there is a slowdown, why won't it turn into a recession.

OUTLOOK FOR INFLATION

Inflation has accelerated sharply since the beginning of the year. The rate of increase of consumer prices between December and May was about twice the rate during the second half of last year. This upsurge did not reflect widespread shortages of labor and capital, but rather was associated with the simultaneous occurrence of three events: A rapid increase in food prices resulting from the harsh winter and the beginning of a cattle cycle, the depreciation of the dollar, and the January increases in payroll taxes and the minimum wage.

Although the CBO forecast assumes that no comparable food and depreciation shocks will occur next year, the rate of price increase is projected to moderate only slightly from this year's pace. The principal impetus to this continued high level is expected to be rising labor costs. If past behavior holds true, the recent jump in the CPI will cause a lagged acceleration of wage gains and a corresponding markup of prices late this year and in 1979. Past performance also indicates that restrictive macroeconomic policies would have only a small effect on inflation during the first few years. Like the special factors that induced the price acceleration earlier this year, subsequent wage catchup has proved to be relatively insensitive to variations in total demand. Under such circumstances, it takes many years of high unemployment to reduce inflation significantly.

REASONS FOR THE SLOWDOWN

The foreign trade and State and local government sectors are expected to provide moderate stimulus to the economy during the next year and a half. Thus, the outlook for slower growth through 1979 rests largely on the behavior of three sectors of the economy: Housing, consumption, and business fixed investment.

Spending on residential construction provided significant impetus to the rise in real GNP last year. Such strength, however, probably will not continue through the projection period; this year's rapid tightening of credit markets has already limited the availability of funds for home mortgages. Savings and loan institutions have experienced a significant deceleration in deposit inflows, and, by May, commitments outstanding for future mortgage lending had fallen for 5 consecutive months.

The prospects for consumer spending also appear less bright. Personal debt has risen sharply relative to income, and tighter mortgage conditions will reduce opportunities to convert real estate equity to cash—a practice that apparently helped sustain consumption throughout expansion. Furthermore, consumer attitude surveys indicate that the recent surge in retail sales may be based in part on the attempt to avoid expected future price increases. Such buy-in-advance behavior would reduce consumer spending in the remainder of this year, and, perhaps, in 1979.

The growth of housing and consumer spending typically slows as an expansion ages, but such slowing is usually somewhat offset by increased outlays for plant and equipment. According to the Commerce Department's survey of business anticipations, constant dollar business fixed investment is again likely to increase faster than overall growth, but less rapidly this year than last. Moreover, a slowdown in the overall pace of economic activity means less pressure on capacity utilization throughout the forecast period. As long as existing productive capacity remains underutilized, there is little likelihood of an investment boom.

REASONS FOR NO RECESSION

Most forecasts agree that growth will slow, although many go further than the CBO projection and predict a recession within the next year and a half. This is admittedly a difficult call, but—given out policy assumptions—CBO does not believe that current economic trends point to a recession. This assessment is based on a number of factors:

The tax cut included in the First Concurrent Resolution more than offsets the effects of rising payroll taxes and fiscal drag on disposable personal income and should help sustain consumer spending.

In addition, the tax package should stimulate business fixed investment.

The impact of higher interest rates on housing activity may be softened somewhat by the new option available to lending institutions to pay market interest rates on deposits of $10,000 or more.

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The recent depreciation of the dollar is expected to boost net exports.

Perhaps most importantly, there is little evidence of the kind of imbalances between production and final sales that typically characterize a period preceding a recession. Throughout the current expansion, businesses have pursued a cautious inventory policy, keeping stocks closely alined with sales.

These reasons, however, do not touch on the principal difference between the CBO projection and those who foresee a near-term recession: The future course of monetary policy. As I noted earlier, CBO has assumed no significant further tightening of credit markets. By contrast, many forecasters anticipate a recession brought about by a credit crunch, as the Federal Reserve responds to the recent acceleration of inflation and rapid growth in the basic money supply.

EVALUATION OF OMB JULY BUDGET ESTIMATES

In its Mid-Session Review of the Fiscal Year 1979 Budget released last week, the Office of Management and Budget (OMB) lowered its estimates of the budget deficits by over $10 billion for both fiscal years 1978 and 1979, as compared with its January estimates. The reduction in the 1978 deficit estimate is almost entirely caused by lower outlay estimates as a result of the continuing shortfall in expenditures. For 1979, the deficit reduction results partly from lower spending estimates, but mostly from changes in the administration's tax reduction proposals. Table 2 compares the latest OMB estimates for the budget totals with the 1978 Second Concurrent Budget Resolution limits and the 1979 First Concurrent Resolution targets.

TABLE 2.—FEDERAL BUDGET TOTALS: BY FISCAL YEARS, IN BILLIONS OF DOLLARS

	1978		1979	
	Second Resolution limits	OMB July 6 estimates [1]	First Resolution targets	OMB July 6 estimates
Revenues	397.0	400.3	447.9	448.2
Outlays	458.25	451.4	498.8	496.6
Deficit	61.25	51.1	50.9	48.5
Budget authority	500.1	502.9	568.85	571.4
Public debt	775.45	768.3	849.1	847.8

[1] The OMB July 6 estimates have been adjusted to treat the earned income credit payments as income tax refunds, as was done for the Second Budget Resolution for 1978. The First Concurrent Resolution for 1979 and the OMB July 6 estimates classify these payments in excess of an individual's tax liability as outlays and budget authority.

We are now reviewing the new OMB estimates, and will submit the results of this review to the Budget Committees within the next 10 days. The review will also incorporate our new assumptions about the economic outlook, an analysis of actual outlay and receipt patterns in recent months, and other relevant programmatic information provided by the administration. At this time, I can only provide a preliminary assessment of the budget totals.

On the spending side, the July OMB estimates of total outlays for both 1978 and 1979 appear to be realistic in terms of our analysis of spending patterns. For our latest economic forecast, we assumed that total outlays in fiscal year 1978 would be $451 billion, almost precisely the same level as the latest OMB estimate, adjusted for the treatment of earned income credit payments. For 1979, we assumed that budget outlays would total $495 billion, only slightly less than the OMB midsession review estimate.

OMB's downward reestimates of $4.5 billion for fiscal year 1979 about matches the outlay figures incorporated in the First Concurrent Resolution. Based on the new OMB information and other factors, I expect that we will propose some further downward adjustments in 1979 outlay estimates in the range of $2 to $4 billion.

For fiscal year 1978, the administration revenue estimates remain virtually unchanged from the January budget, but slightly above the CBO figures. CBO now estimates 1978 receipts at $397.7 billion, compared with $400.3 billion for OMB. Of the $2.6 billion difference, about $1.5 billion is because of higher wage assumptions by the administration, and about $1.0 billion is attributable to differences in estimating techniques.

OMB has revised its fiscal year 1979 receipts estimates upward from its January estimates. Changed legislative assumptions increase revenues by about $10 billion, but revised economic assumptions and technical estimating adjustments reduce revenues by over $2 billion, leaving a net increase of about $8 billion. While CBO has not yet completed its revenue estimates for the Second Concurrent Resolution,

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our preliminary work suggests that the adjustment OMB has made for economic assumptions and estimating revisions is not out of line. CBO's revenue estimates will be ready for the committee's markup of the Second Concurrent Resolution.

POLICY OPTIONS

Recognizing the need for stimulus to sustain economic growth, the Congress enacted a First Concurrent Resolution last spring with several new initiatives, including a sizable tax cut. With these measures, the deficit is expected to be about $50 billion in fiscal year 1979, about the same as in the current year. The full-employment budget deficit, one measure of fiscal stimulus would increase slightly from fiscal year 1978 to 1979:

Full-Employment Budget Balance

(National Income Accounts Basis)

Fiscal year:	*Billions of dollars*
1977	−14.5
1978	−17.9
1979	−20.7

The Congress now has an opportunity to review that earlier decision in the light of changing economic conditions. Recent economic developments are mixed. Inflation is considerably worse than expected, while the unemployment rate has declined more rapidly than anticipated. At the same time, however, most forecasters believe the outlook for economic growth has not improved; if anything, it has worsened. Hence, the policy dilemma: Measures aimed at reducing inflation could slow growth and risk a new recession, while policies designed to sustain economic growth could accelerate inflation.

RESTRICTIVE FISCAL POLICY OPTIONS

If the Congress feels that continuing the current fiscal policy provides too much stimulus at this stage of the economic expansion—particularly in light of the persistence of inflation—it can take steps to reduce the fiscal year 1979 deficit. Perhaps the easiest way to achieve a more restrictive budget at this time would be to forgo all or part of the $15 billion tax cut for fiscal year 1979 ($20 billion annual rate) that was included in the first resolution to take effect in January 1979.

The CBO forecast described earlier includes this tax cut (assumed to be $11.4 in personal and $3.6 billion in corporate taxes). What would the outlook be without the tax cut? CBO's guess is that the effect on our forecast by the end of 1979 would be to reduce real growth by about three-fourths of 1 percentage point and to raise the unemployment rate by about two-tenths. A policy of no tax cut would not reach its maximum restrictive effects on real economic activity until the end of 1980, however, when the impact would be somewhat larger. In terms of inflation, prices might be 0.2 percent lower by the end of 1980. Inflation reacts to stabilization policies more slowly than unemployment.

A significant restrictive economic effect could also be attained by cutting expenditures. For example, the House of Representatives has voted to reduce spending by 2 percent in a number of fiscal year 1979 appropriation bills. If such a reduction were applied to the First Concurrent Resolution outlay target for 1979, total outlays would be lowered by about $10 billion, to $489 billion. The CBO economic forecast already assumes a shortfall of almost $4 billion from the First Concurrent Resolution. To achieve further reductions, however, would require difficult actions, such as forgoing, or requiring full absorption of, the October pay raise for Federal employees, and forgoing or reducing sharply the planned new spending initiatives for defense, agriculture, urban aid, veterans' benefits, and other programs that have not yet been enacted.

Alternatively, savings could be sought in existing programs to achieve the spending reduction and still provide for some needed new spending initiatives. One way of achieving this would be an across-the-board cut in budget authority provided in all 1979 appropriation bills for nonmandatory payments under existing law. Assuming that the Congress could achieve a cut in spending of, say, $10 billion beyond the estimated shortfall, the effect on economic activity would be roughly similar to that described above for eliminating the tax cut, depending on the composition of the reductions.

If the Congress were to forgo the tax cut or take comparable action on the spending side, fiscal policy would be more restrictive in 1979 than in 1978. To the

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extent that the economy is approaching full employment, such a reduction in fiscal stimulus could reduce the risk of generating excess demand inflation. But we must recognize that real growth appears to be slowing, and there is a substantial danger that monetary and fiscal policies will become restrictive simultaneously, a shift that in the past has generally been followed by recession.

EXPANSIVE FISCAL POLICY OPTIONS

In contrast to these various restrictive measures, the Congress has before it a proposal for substantial tax reductions. H.R. 8333 (the Kemp-Roth Tax Reduction Act) proposes large tax cuts over a period of 3 years without comparable reductions in spending. Conventional economic analysis indicates that, as a result of such a policy, the budget deficit would rise sharply. With the economy likely to reach full employment during this period, a large stimulus of this kind would be highly inflationary.

Some of the proponents of this policy option, however, argue that the conventional view is incorrect. They contend that large tax cuts increase incentives to work, save, and invest to such an extent that the cuts would pay for themselves in the first or second year and, therefore, would not be inflationary.

CBO does not know of any empirical evidence for the view that the supply-side effects of tax cuts are so large and so quick. The evidence available to us supports the conventional view that the stimulative effects of most types of tax cuts occur primarily through increased aggregate demand and that these effects are not large enough for tax cuts to be self-financing.

THE COORDINATION OF STABILIZATION POLICIES AND STRUCTURAL MEASURES

Past experience suggests that some incidences of poor performance by the economy have resulted from excessive shifts of monetary and fiscal policies in the same direction. The fiscal and monetary authorities each assumed that the other would not take appropriate action in response to current economic trends; together they overreacted. Such an overreaction appears to be possible at this time. If monetary and fiscal policies are both used to reduce inflationary pressures, the chances for a recession are great.

Closer coordination of monetary and fiscal policies might result in a more desirable mix of policies. For example, the longrun performance of the economy might be improved by a tighter fiscal policy and an easier monetary policy. That policy mix might:

Reduce Federal deficits and, perhaps, decrease the size of the Federal sector as well; and

Encourage investment spending, with the resulting growth in capacity reducing inflationary pressures.

At present, adequate arrangements for choosing specific economic goals and implementing a coordinated policy do not exist. Although attempts at closer coordination of fiscal and monetary policies are not without their risks, the benefits in terms of stabilization could be substantial. Hence, this is an appropriate time to examine mechanisms for improving coordination of monetary and fiscal policies, such as requiring the Federal Reserve to:

Clearly specify its money and credit targets for the ongoing and upcoming fiscal year before enactment of the budget resolutions;

Reveal its estimates of the level of unemployment, production, and prices for the end of the fiscal years; and

Explain periodic revisions of its objectives and plans.

In addition, the dilemma facing policymakers today could be made less acute by improving the tradeoff between inflation and unemployment through the use of structural programs, including: Skill training, public service employment, reform of Government regulations, more vigorous enforcement of antitrust legislation, reducing the minimum wage for youth, incomes policies such as TIP (tax-based incomes policies), and reductions in payroll taxes.

Even with structural improvements and better coordination, however, simultaneous inflation and unemployment will continue to present difficult choices for macroeconomic policy. Measures to deal with one of these problems may well worsen the other. Ultimately, the resolution of this dilemma will depend on whether the Congress gives greater emphasis to inflation or to sustaining economic growth.

The CHAIRMAN. Thank you very much, Dr. Rivlin.

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Dr. RIVLIN. I have said nothing about Proposition 13, Mr. Chairman. I wonder if you would like to have me enter the report, or its summary, in the record?

The CHAIRMAN. Well, I don't think we need it in the record. We have it as a committee paper.

Dr. RIVLIN. Fine.

The CHAIRMAN. Would you like to comment on it, briefly?

Dr. RIVLIN. I could comment on it very briefly. We were asked to look at the impact of the recent decision in California on the national economy and on the Federal budget. We estimate the impact on the national economy to be minimal. At first the effect will be some marginal reduction in the general level of economic activity; further in the future it will cause a marginal stimulus as the tax reduction effects begin to dominate the expenditure reduction effects. As a result of this impact in California alone, there will be some drop in the inflation rate although, of course, it is marginal.

The effect on the budget will be, in the first instance, some increase in Federal revenues, largely stemming from the fact that Californians will no longer be deducting so much property tax from their Federal tax. The effect on Federal expenditures, we think, could go either way. There may be some increases and some decreases, and we have detailed some of those possibilities in the report.

The CHAIRMAN. Thank you very much. You note that passage of the Kemp-Roth tax proposal would be highly inflationary. Have you made any specific estimates of how much it would add to existing inflationary pressures?

Dr. RIVLIN. No, I don't believe we have. That estimate would be based on going out beyond the first-year effects, which would be not very different from the other tax cut proposals before the Congress.

The CHAIRMAN. That is the point I am trying to get at. Are you saying that the inflationary characteristics of Kemp-Roth would be because of its projection out into the second and third year, rather than in the first year where it is similar to the tax cut that the President has recommended and that the Budget Committee and Ways and Means Committee seem to be considering, one in the $15 billion and $20 billion area?

Dr. RIVLIN. Yes, we are saying that, Mr. Chairman. The tax cut in the Kemp-Roth bill would be somewhat larger than the tax cut assumed in the First Concurrent Resolution, but not enough larger to make a lot of difference in the first year. It is in the second and third years, in which additional tax cuts are proposed as the economy approaches full employment, that one would worry seriously about the inflationary impact.

The CHAIRMAN. Let's talk about a tax cut that we are recommending. In the first budget resolution we were recommending a fiscal year tax cut of about $15 billion. Is that inflationary, given the present state of the economy?

Dr. RIVLIN. No, I don't think so, if by that you mean would inflation be significantly less if you didn't pass a tax cut. If you didn't pass any tax cut at all, we have estimated that by 1980 you might lower the inflation rate by 0.2 percent.

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The CHAIRMAN. Let's back up to 1978 and 1979. We are going to recommend in the Congress and probably pass a tax cut somewhere between $15 billion and $20 billion. Isn't that going to contribute to an already high and unacceptable inflation rate? Isn't it bad economics to have a tax cut in a period of high inflation?

Dr. RIVLIN. That depends on what causes the inflation, and I think the answer is that the tax cut would not significantly contribute to the inflation rate at this moment. As I said in the statement, the acceleration of inflation that we have seen recently seems to be caused by an acceleration in food prices, the depreciation of the dollar, and other factors, such as the increase in the minimum wage, that are not reflections of high aggregate demand.

Those factors will be passed on probably, if the past is any guide to the future, in wage increases next year, which will mean that we will have continued high inflation. But we will have continued high inflation anyway. You wouldn't significantly affect that by forgoing the tax cut.

The CHAIRMAN. Thank you very much. Mr. Obey.

Mr. OBEY. I would like to pursue the chairman's line of questioning on Kemp-Roth. You say that Kemp-Roth would down the line be highly inflationary, but you haven't measured what degree of inflationary pressure that would create.

If I am back home talking to my Rotary Clubs, trying to explain to them what I mean by highly inflationary, quoting you, what do I tell them?

Dr. RIVLIN. I am not sure we can give you a number at this moment for two reasons: First, because to look at, say, the third year goes into an area of great uncertainty in economic projections; second, with the economy so close to full employment, nobody is quite sure at what moment that additional stimulus through tax cuts will be highly inflationary. But we are certainly now moving close to that critical time.

Mr. OBEY. My point is when you say highly inflationary, what do you mean by the word "highly"? What is your range? Otherwise, frankly, that statement to me is meaningless.

Dr. RIVLIN. I think it means that the inflation rate, instead of being 7 percent, could take off into the double-digit range again. We have had that experience in the last few years, and we could have it again, with a rapid stimulus to the economy at a time when it was approaching full employment.

Mr. OBEY. You think that would be possible within 3 years?

Dr. RIVLIN. Yes, I do, within 3 years of the tax cut.

Mr. OBEY. On page 4, you are talking about the causes of inflation, and you mention three: Increase in food prices, depreciation of the dollar, and the January increases in payroll taxes and the minimum wage. Approximately what degree of inflation, what amount, would you attribute to each one of those factors?

Dr. RIVLIN. Let me see if Dr. Beeman would like to have a try at that one.

Dr. BEEMAN. Each one of these alone probably had a pretty modest effect. It is when you add them up that you get some appreciable increase in the Consumer Price Index. Some have estimated that the depreciation of the dollar will increase the CPI this year by one-half of 1 percentage point. I think, the effect of the

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minimum wage is usually estimated to be quite a bit smaller than that. The point is, however——

Mr. OBEY. Like about what?

Dr. BEEMAN. I can't recall offhand what the estimates are, maybe two-tenths, something like that.

Mr. OBEY. What about payroll taxes?

Dr. BEEMAN. I am trying to recall the exact number for the payroll tax but again it is probably something like two-tenths or three-tenths—the point being that you add them up and you can come up with a considerable amount. Of course, the other aspect of it is that it results in some acceleration in future years, as the increases in the CPI cause increases in wages later on.

Mr. OBEY. What about food prices?

Dr. BEEMAN. The recent increase in food prices?

Mr. OBEY. You have given me the figures for the other three items.

Dr. BEEMAN. It depends on which period you look at. In the last 6 months, the acceleration in food prices has been about double-digit figures and that has made a large contribution to the acceleration in the CPI. Almost all the acceleration in consumer prices can be attributed to these three factors.

Mr. OBEY. Again, I am simply trying to get——

Dr. BEEMAN. Comparing 1978 with the previous year, it probably adds one-half of 1 percent. I will supply you with more information on that.

[The following information was received for the record:]

CONGRESSIONAL BUDGET OFFICE,
July 18, 1978.

Hon. David R. Obey,
U.S. House of Representatives,
Washington, D.C. 20515.

DEAR CONGRESSMAN OBEY: At the Budget Committee hearings on July 11, you asked how much of the acceleration of inflation so far this year had to do with rising food prices, the dollar depreciation, and the January increases in payroll taxes and the minimum wage. The following presents the relevant data:

1. The acceleration in the rate of increase of the Consumer Price Index has been great; from December 1977 to May 1978, the CPI rose at a 10 percent annual rate, compared to a 4.7 percent rate during the second half of last year.

2. It is straightforward to calculate the contribution of food inflation to this acceleration, since we have separate food price data; nearly half (45 percent) of the overall acceleration resulted from rapidly rising food prices, especially for meats.

3. The effects of depreciation and the cost-raising programs are more difficult to derive, because they have widespread impacts on the CPI components. The CBO, however, has estimated these effects, and the results are briefly summarized in the following:

a. A trade-weighted dollar depreciation of 6 percent—the actual change between October 1977 and April 1978—has in the past been associated with a 1¼ percent rise in the CPI; if one-half of this effect on consumer prices occurred since last December (a reasonable estimate), then the depreciation induced more than a quarter (27 percent) of the overall acceleration in the CPI.

b. The impact on inflation of the January increases in the minimum wage and payroll taxes has been estimated to be ½ to ¾ percentage points; assuming some lag before the full effect of these cost-raising measures occurs, they may have caused one-fifth of the recent CPI acceleration.

4. Given the above estimates, more than 90 percent of the recent acceleration in consumer price inflation resulted from rising food prices, the depreciation of the dollar, and the January cost-raising legislation.

Sincerely yours,

ALICE M. RIVLIN, *Director.*

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Mr. OBEY. OK. On page 6, you say, "As long as existing productive capacity remains underutilized, there is little likelihood of an investment boom." As you know, there is an increasing number of people who are suggesting that perhaps we have been measuring that productive capacity under old terms; we haven't taken into account the inflationary costs sufficiently as we reach that productive capacity.

What is your judgment on that? Do you think that percentage figure has really changed any in the last year or two, given the tremendous increase that we have had in energy prices and things like that?

Dr. RIVLIN. There are certainly some problems with measuring capacity, and the statistics we have are anything but optimum. They do show very little change in capacity utilization over the last year and a half.

If it is true that capacity utilization is higher than the numbers show, then it is surprising that it hasn't shown up in more investment. It is alleged that some of this capacity may be obsolete because of energy price increases or other causes, but this would be an argument, or a factor, that would tend to increase investment, and we haven't seen that in this recovery. For perhaps any number of reasons, investment has lagged behind what one would have expected in a recovery at this stage.

Mr. OBEY. So your answer is that you don't think the character of that has changed very much?

Dr. RIVLIN. I don't see any evidence of it in what has happened.

Mr. OBEY. On page 12, you are talking about, in the second paragraph, the effect of your forecast by the end of 1979 would be to reduce real growth by about three-quarters of 1 percent and raise unemployment by about two-tenths. How many people is that?

Dr. RIVLIN. It is 200,000.

Mr. OBEY. That is all, Mr. Chairman.

The CHAIRMAN. Mr. Lehman.

Mr. LEHMAN. Thank you. I have some problems with trying to understand inflation.

Dr. RIVLIN. You are not alone.

Mr. LEHMAN. I just wonder whether we are really measuring it right. Despite claims that increases in the prices of essentials is eating up people's income, people seem to have more disposable money these days to spend on extra items.

I met with some people in Florida who control a large portion of the moderate-priced motel rooms in the State. They told me they just can't accommodate all the middle-income Americans that are coming into Florida. Recreational vehicle people I talked to say there is a new explosion in the sale of recreational vehicles.

I go to restaurants fairly often in Miami and Washington. The last six times, at all different levels, not just luxury, I had to stand in line. I had a terrible time trying to get back to Washington on the airplane. I also talked to people building condominiums in Florida, and was told that a well-located two-bedroom condominium that sells for $85,000 in Florida is likely to be bought for investment purposes by someone from overseas, because nowhere

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else in the world can you buy a new condominium, they tell me, two bedrooms in a good location, for $85,000.

One other thing that happened; my son built a row. of 21 little shops, a minishopping center and every single shop was rented to a nonnecessary type of tenant. There were boutiques and beauty parlors and pastry shops, and none of them is selling essentials. They all cater to disposable income. If we have all this inflation, where is all the disposable income coming from?

Dr. RIVLIN. You are picking up two factors operating at the same time, I think. One is that we have had inflation at the same time that the economy was recovering from a quite severe recession. It is true that disposable income has increased, employment has gone up, unemployment has gone down, and, on the average, people are better off, a lot better off than they were in, say, 1974.

You are also picking up the relative improvement in the so-called Sun Belt, which has been a high-growth area relative to much of the rest of the country.

Mr. LEHMAN. One other question, if I have time. You stated to the Congressional Clearinghouse on the Future when you were there the last time that you think prices for scarce material and energy resources should be allowed to rise to their replacement cost. I think I am quoting you, more or less. If that happened, how would it affect inflation?

Dr. RIVLIN. It is clear that it would aggravate inflation in the short run, but that again is one of those difficult weighing decisions. If we want to induce economizing of scarce materials, particularly of oil, it may be worth paying the price in inflation.

Mr. LEHMAN. One other question: One of the problems with our tax system is that taxes are so visible. We see what we are paying in withholding and social security taxes and property taxes. Many other Western industrial nations kind of hide it in their value added taxes. Do you think the tax resistance we are seeing today might force us to shift our sources of revenue to things that are less apparent to the people, that we are going to have to reduce the painful visibility of our taxes?

Dr. RIVLIN. I think that is possible. You are already seeing a bit of that in California, where local jurisdictions are switching to fees and various other devices to make up the difference.

The CHAIRMAN. Mr. Burgener.

Mr. BURGENER. Thank you. If they switch to very many fees, they are going to find themselves in a new occupation, I predict, but that is an aside.

Dr. Rivlin, on page 16 of your excellent testimony, you outlined some options about the tradeoff between inflation and unemployment. One is reducing the minimum wage for youth, and many of us, but not a majority, or it would be law, favor this.

I really think many of us believe that this youth differential would result in positive effects, less unemployment, more money earned, and more self-pride, and so on. But there are people who honestly disagree. You feel this should at least be considered?

Dr. RIVLIN. Yes. This is a list of structural options to remind the committee there are other possible changes in microeconomic policy you should be thinking about that might reduce inflation.

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Clearly a youth differential in the minimum wage is one possibility.

Mr. BURGENER. Is it a fair statement to say we are in a period of economic uncertainty?

Dr. RIVLIN. Yes.

Mr. BURGENER. We have agreed on that. It seems to me that many businessmen, particularly of the less sophisticated variety, which most of us are, small business people who still constitute a big part of our economy, which I think is a very positive thing, I think they understand what deficits are, and they read about them and react psychologically, in a period of uncertainty particularly.

I am not sure they ever heard of a shortfall or know what that means, and I am not sure I do. I think it means either the inability or the unwillingness to spend money we have appropriated. Is that correct?

Dr. RIVLIN. It means that the actual expenditures come in lower than the estimates.

Mr. BURGENER. Is it inability to spend or unwillingness, or a combination of both?

Dr. RIVLIN. It may be either of those, but I think it is more likely to be that the estimates themselves were unrealistically high to begin with. There is a tendency to overestimate the amount that can be spent, a tendency on the part of Federal bureaucrats to say they expect to spend more than they realistically can.

Mr. BURGENER. It would seem to me that overestimating, as a habit, would tend to result in inflation, or more spending than underestimating, as a habit. Or am I wrong? If we habitually underestimated?

Dr. RIVLIN. If you are a bureaucrat, the penalties for underestimating are considerable. Then you run out of funds. If you overestimate and don't spend quite as much as you thought you were going to, you are in less trouble.

Mr. BURGENER. Your statement indicates, or does it, about $4 billion for fiscal year 1979 current projection shortfall?

Dr. RIVLIN. Yes, it depends on where you start from.

Mr. BURGENER. OK, what would be the best guess for fiscal year 1978, the current year we are in?

Dr. RIVLIN. Let me ask Mr. Blum to speak to that. It depends on where you start from.

Mr. BLUM. We believe at least $7 billion, and it could be as much as $9 to $10 billion. I am using the second resolution level of $458 billion as the estimate from which the shortfall could occur.

Mr. BURGENER. Based on that, I find that encouraging, not discouraging, somewhere between $7 and $10 billion, and we project $4 billion for next year; why wouldn't it be good psychologically to reduce authorizations and appropriations by at least $4 to $5 billion in anticipation of that? Might that not appear to be fiscal restraints without hurting any program, without really taking any dollars out of the spending stream, so to speak?

Dr. RIVLIN. I wouldn't want to guess on the psychological effects. It might have that effect.

Mr. BURGENER. There are dollars indeed not spent, I take it. What happens to those dollars?

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Now the fiscal year is going to end on September 30, and take a figure, let's assume it turns out to be $7 billion in shortfall. What happens to that $7 billion?

Dr. RIVLIN. It just doesn't get spent. When we were first dealing with the shortfall phenomenon, it was thought that money that wasn't spent in one fiscal year would create a bulge in the next, but we haven't found that. We have found that the shortfall phenomenon has been consistent over several years, although it is getting less. The OMB and the CBO, I think, are getting better at estimating what the actual expenditures will be, and the shortfall, as a percentage of the total has been reduced.

Mr. BURGENER. A final question: It appears we have at the moment high employment; it depends on your point of view, but compared——

Dr. RIVLIN. Certainly higher than it was.

Mr. BURGENER. The cost of hiring more people, the labor costs are still less, are they not, than building new plants and equipment, and is this an important factor in holding back investment incentives? Is it cheaper for employers to put on more people rather than increase in plant and equipment?

Dr. RIVLIN. I don't think there is a general answer to that. It depends on what kind of business one is in, but we have not seen——

Mr. BURGENER. I mean to increase productivity?

Dr. RIVLIN. We have certainly not seen any dramatic increase in productivity recently. Productivity has been in a rather dismal state, which certainly partially accounts for the unusual decrease in the unemployment rate, relative to the growth rate. One wouldn't have expected that much drop in the unemployment rate if productivity increases were holding up, but they haven't been.

Mr. BURGENER. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. Mr. Mineta.

Mr. MINETA. Thank you, Mr. Chairman. Dr. Rivlin, on page 2, you explain your table on economic projections and state that you assume that, "Short-term interest rates will not rise much further, that credit conditions will not become so restrictive as to abort the expansion." Could you give us a little more detail about what that means? Do you think the Federal Reserve Board is going to adopt such a policy? Would you characterize that policy as expansionary or restrictive?

Dr. RIVLIN. First, we are not venturing a prediction of what the Federal Reserve Board will do. We are not good predictors of that—I don't know that anybody is—but in order to make a projection we have to assume something about monetary policy.

Interest rates have already risen quite rapidly in the last several months, enough to affect the mortgage markets somewhat, and we are simply assuming for the purposes of projection that they will not rise much more. If they did, it would affect our forecast in a negative direction. If they rose substantially more, then we would have to go with the forecasters who are predicting a possible recession in 1979.

Mr. MINETA. In your discussion of inflation, you also point out, "Wage catchup has proved to be relatively insensitive to variations

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in total demand." In this regard, I have noted recently that economists are increasingly talking about wages and prices being "inflexible downward."

I would see this as being as much a social and political development as an economic one. I am wondering if you might comment on that and what structural changes in the past 10 years would you say have contributed to this inflexibility.

Dr. RIVLIN. I think wages and prices have been inflexible downward for quite a long time, partly because of the degree of unionization and collective bargaining and long-term contracts that keep wages from falling, and partly for psychological reasons.

We are dealing now with a situation not of downward inflexibility but with the persistence of upward movements, even in the face of considerable unemployment which is a step further.

Mr. MINETA. Momentum inflation?

Dr. RIVLIN. Momentum inflation is a way to characterize it. The not surprising fact that once an increase in the Consumer Price Index has occurred, then it tends to be reflected within a few months in wage settlements and continues over the next several years. There is not very much that seems to be possible to do about it—it is our estimate that, even if unemployment rose considerably, this lagged effect of past price increases would not be mitigated very much.

Mr. MINETA. You project a slowdown in the business investment—a change from your January projection. Of course, here in the Congress we are struggling over this whole question of how to stimulate investment in plant and equipment. Would you give us your thoughts on the desirability of changing the capital gains tax rate as opposed to increasing the investment tax credit, and are there any other specific steps that you would recommend that the Congress might consider?

Dr. RIVLIN. I think everybody has agreed that increasing investments would be good for the economy, both in the short run and in the long run for the economy. It's very difficult to know how to do it because investment has such psychological overtones. I think the evidence is stronger that using a specific tax change, like an investment tax credit, is more effective than changing a general tax rate, whether it be the corporate income tax or even the capital gains tax.

Mr. MINETA. When you mention this question about unemployment going down, it seems to me that a great deal of employers have taken advantage of the $4,200 employee tax credit that was granted in last year's tax reduction act. Have you looked at that to see whether or not that has been an impact on it?

Dr. RIVLIN. I don't believe we have. It phased in slowly, but let me turn to Dr. Beeman on that.

Dr. BEEMAN. At this moment I don't think we have the data to analyze its effect. It has not been in effect long enough, but we hope to be able to do so in the future.

Mr. MINETA. I know in our area where we have an expanding job market because of the electronics and semiconductor business that the numbers, just a slug of them, we have over probably 50 companies involved in that whole semiconductor business with about 60,000 employees, but I know a lot of them have just taken advan-

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tage of that, and I just wondered whether or not it has not had that kind of salutary effect in terms of impacting on the employment rate.

Dr. RIVLIN. It may well have.

Mr. MINETA. Thank you, Mr. Chairman. Thank you, Dr. Rivlin.

The CHAIRMAN. The gentleman from Ohio.

Mr. REGULA. Thank you, Mr. Chairman. Dr. Rivlin, I note in your statement on page 5 you say, "Under such circumstances it takes many years of high unemployment to reduce inflation significantly." That is sort of a depressing thought.

What I would wonder is, how do you explain the fact that in the Eisenhower-Kennedy years that we had relatively low inflation, and relatively low unemployment. What was magic in that time we cannot duplicate now?

Dr. RIVLIN. I don't think anybody knows for sure. But certainly we are in a situation in which outside shocks to the economy have produced inflation, and they didn't have that then. I think what we are experiencing now is that once you have inflation, it's awfully hard to get rid of.

Mr. REUGLA. What do you mean outside shocks?

Dr. RIVLIN. A whole complex of things, beginning with the oil price increase, depreciation of the dollar.

Mr. REGULA. Guns and butter.

Dr. RIVLIN. Food, guns, and butter. Food price increases and all kinds of other events happened in conjunction with each other and that got inflation started. Conceivably, it depends on how far back you want to go; certainly the high budget deficits in the face of full employment in the late 1960's were a contributing factor. Monetary policy in 1973–74 has been faulted. But however inflation got started, it did get started, and we have not been able to wind it down.

Mr. REGULA. Would you, if you were running the show, be able to recommend a scenario that we could dampen inflation without tremendously penalizing the unemployment situation?

Dr. RIVLIN. Not quickly. I really think there isn't any easy answer to this, and the only thing to do is to push on all fronts—some of the structural options listed in the statement, cautious monetary and fiscal policy, and be prepared to have to fight this battle over a long time.

Mr. REGULA. What would you recommend to stimulate real growth? I note in Mr. Bolling's statement that the statistics indicate a depressing reduction in real GNP growth rates which obviously has a lot of implications. What would you recommend, if anything, that we could do?

Dr. RIVLIN. This again, I think, is a difficult question to answer, and nobody really knows. The investment stimulating strategies, with much uncertainty about what works, clearly have to be tried.

Mr. REGULA. I was interested—you say we must recognize that real growth appears to be slowing, and there is substantial danger monetary and fiscal policies will become restrictive simultaneously. Don't you think that the Federal Reserve could respond rather quickly if we had a little bit of fiscal responsibility on the Hill to not having a similar move on monetary policy? Aren't they flexible enough to avoid that scenario?

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Dr. RIVLIN. There have been times in the past when they were not.

Mr. REGULA. But doesn't the potential exist? Maybe they weren't, but could not they be much more responsive than we are in fiscal policy in a short time?

Dr. RIVLIN. They do have in many ways a more flexible set of instruments to adjust policies more quickly. Dr. Beeman, do you want to say something on that?

Dr. BEEMAN. One of the problems is that monetary policy does affect the economy with considerable lags.

Mr. REGULA. I understand.

Dr. BEEMAN. It's very difficult now to tell what the current tightening is going to do in the next year.

Mr. REGULA. Don't you think they are reacting to the absence of a fiscal responsible policy on the Hill or in the administration both?

Dr. RIVLIN. I would not want to second guess Chairman Miller on that. You had better ask him.

Mr. REGULA. Reading from page 15: "Closer coordination of monetary and fiscal policies might result in a more desirable mix of policies. For example, longrun performance of the economy might be improved by tighter fiscal policy and an easier monetary policy," and you point out some of the advantages.

I think you are absolutely correct. Although I note that on page 16 you seem to put the burden on the Federal Reserve system to do the coordinating. Don't you think there is some responsibility that rests up here always?

Dr. RIVLIN. Yes, and I didn't mean to imply that. I think the main point there is that, if you want to experiment with the mix of fiscal and monetary policies, you do not now have a mechanism for doing that. Certainly this committee does not have. And it suggests not that the burden be on the Federal Reserve, but that the Congress work with the Federal Reserve to find a mechanism for coordinating.

Mr. REGULA. What would you recommend as a mechanism?

Dr. RIVLIN. I think perhaps the most obvious first step is to ask the Chairman to come in and tell you what he is doing, what are his goals for the economy, what does he expect to happen, and what unemployment rate and price assumptions go with the actions that he expects to take.

Mr. REGULA. Mr. Chairman, is it possible that we could get Chairman Miller?

The CHAIRMAN. He is scheduled to come in Thursday.

Mr. REGULA. That is a first step, then. Thank you.

The CHAIRMAN. Thank you. Dr. Rivlin, on the shortfall, why are the overestimates of expenditures continuing at such a high rate?

Dr. RIVLIN. I don't think we really know. They are diminishing. as I said. The difference in fiscal year 1977 estimates between the beginning and the end was as much as 4 percent. For next year we expect it will be only around 1 percent. But I think there is this psychological factor involved. If you are a Federal bureaucrat and you are asked in advance how much you expect to spend, you protect yourself by estimating on the high side, and that tendency may continue.

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OMB and CBO and perhaps the top management in the major agencies like Defense are getting a little bit more sophisticated, however, in dealing with those estimates and scaling them down sooner.

The CHAIRMAN. Thank you.

Mr. MINETA. Mr. Chairman, could I follow up?

The CHAIRMAN. Yes.

Mr. MINETA. Isn't that what zero-base budgeting is supposed to be doing, and OMB supposedly says they are using a zero-base budget approach in trying to put together as they did in the 1979 budget for the first time and more thoroughly hopefully in the 1980 budget?

Dr. RIVLIN. No. I don't see a direct connection between zero-base budgeting, which is a mechanism for arriving at budget proposal priorities, and shortfall phenomenon which has to do with how fast will that money spend out after the budget authority estimates have been made.

Mr. MINETA. But then if they cannot apply zero-base budgeting to try and eliminate programs that are not working or that are unnecessary in 1978, then it seems to me without a question that the legislature, the Congress, is going to have to impose sunset.

Dr. RIVLIN. That is possible, but I think it's a different question from the shortfall question. Certainly some form of sunset legislation would enable the Congress periodically to look carefully at how programs are working and eliminate or change those that are not working well.

Mr. MINETA. Isn't the shortfall also coming from the lack of oversight then on the part of Congress?

Dr. RIVLIN. No; I don't think so. The shortfall is coming from a very real difficulty in estimating how fast you can spend money once you have decided to spend it. If you have decided to build an aircraft carrier, it's hard to know how fast the money is going to spend out on building it. You may have a strike; you may have all kinds of problems. There is genuine uncertainty there.

Mr. MINETA. Those add to costs; they don't add to the shortfall.

Dr. RIVLIN. No, they affect the timing. The money may just not spend out as quickly as you thought it would.

Mr. BURGENER. Would the gentleman yield?

Mr. MINETA. Surely.

Mr. BURGENER. They always overestimate. I never heard of anybody underestimating around here. Or am I wrong?

Dr. RIVLIN. I am a veteran of the Johnson administration. We used to underestimate all of the time. We didn't have any idea what medicare was going to cost.

Mr. MINETA. Thank you, Mr. Chairman.

Mr. BURGENER. It gets farther and farther back, doesn't it? Thank you.

The CHAIRMAN. Thank you very much, Dr. Rivlin, for your very helpful testimony.

Dr. RIVLIN. Thank you, Mr. Chairman.

The CHAIRMAN. The committee will be in recess until 2 o'clock.

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AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order. Our witness this afternoon is Barry Bosworth, Director of the Council on Wage and Price Stability.

It is a pleasure to welcome you once again to the Budget Committee. As you know, we are holding hearings in anticipation of developing the Second Concurrent Resolution on the Budget for Fiscal Year 1979.

The committee is interested in your forecast on inflation for the next 12 to 18 months. We are extremely interested in your assessment of the success of the voluntary program of wage and price restraint. Are you obtaining agreements from businesses to moderate their price behavior? What sort of cooperation are you receiving from organized labor? The effort you are making is of prime concern, not only to this committee, but to the Nation as a whole.

We understand that there are only a few major labor settlements remaining in calendar year 1978, but that there will be a larger number of settlements in calendar year 1979. Hopefully you can tell the committee what groups are involved in the settlements and how you expect them to go.

STATEMENT OF BARRY P. BOSWORTH, DIRECTOR, COUNCIL ON WAGE AND PRICE STABILITY

Mr. BOSWORTH. Mr. Chairman, I have a prepared statement, which I thought I would submit for the record.

The CHAIRMAN. Fine. Without objection, we will include it in the record.

Mr. BOSWORTH. In my opening remarks I will try not to filibuster but summarize. In terms of examining where we are, I'd like to take the committee through a couple of tables attached to the end of my testimony and try to summarize the inflation situation at present.

The first table looks at alternative measures of price inflation and what has been happening. And through the first 5 months of this year, the rate of increase of consumer prices has now hit a full 10 percent annual rate of inflation.

But while that is extremely discouraging, and obviously in the opposite direction from where we want to go, there are some special factors about it that should be taken into account.

First, the annual rate of increase in food prices has been 19 percent. As best as we can determine, but realizing the tremendous uncertainty associated with any forecast of food prices, we believe that nearly all of the food price inflation for this year should be behind us. We may see a fairly significant increase in June, but the second half of the year many sectors of the food industry give hope of price declines.

The next category, energy, has been rising at about 7½ percent annual rate. Compared to earlier periods, energy prices have not been a major source of accelerating inflation in the first 6 months of this year. But there are a couple of other items that have contributed heavily to the apparent acceleration of the inflation, and yet are somewhat unrelated to the basic underlying economy.

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First, in the housing area there has been an enormous acceleration for home financing, insurance, and taxes on new homes; it's rising at almost 20 percent annual rate of increase, even higher than food prices.

Second, another component of consumer prices, is used-car prices, which have historically fluctuated widely from month to month and can sometimes distort the underlying trends.

If we exclude those four somewhat special items and focus on what is happening in the industrial sector of the economy, it is apparent that the Consumer Price Index for other items shows an acceleration of the rate of inflation of about 6¾ percent through the first 5 months of the year. So there has been a worsening of the inflation, but not quite of the magnitude suggested by the 10 percent annual rate of increase.

In addition, we put into the table for your information some of the sectors where price increases have been particularly dramatic. The housing sector shows over a 10 percent annual rate of price increase in the first 5 months. Medical care prices have continued to run high, although they have slowed slightly in the rate of increase compared to last year. The private sector is attempting to establish a voluntary cost containment program for hospitals. There seems to have been some progress and some results from that program at present, at least in the sense that the rate of medical care inflation has leveled out and has not accelerated to the same extent that other components have.

Another interesting thing about the food price inflation this year is that last year we had a very rapid rate of food price increase as well, 8 percent. But that 8 percent inflation last year was heavily composed of imported food items, beverages, coffee, and tea. This year, imported food item prices are declining, and they have been a major source of stability for overall consumer prices. Unfortunately, the prices of domestically produced farm products have accelerated enormously, so overall prices are up about 19 percent. The retail value of domestically produced farm products is rising at 23 percent of the annual rate of inflation. That is comparable to the rates of increase in 1972 at the same time.

If you look at the farm value of those same commodities, with the same weights that are used in the Consumer Price Index, you see that at the farm level those prices are rising at an annual rate of 50 percent. Obviously, we do not expect that rate of inflation to continue, nor do we believe it can possibly continue. We believe that farm prices will level out over the remainder of the year despite all the talk about rising food margins and the middlemen.

I would also like to point out that the marketing margins of the farm retail price spread is rising at about 7½ percent a year, almost exactly in line with the overall rate of inflation. That has been true for the last 10 years; the comment that the source of the rising food price inflation in this country is a very rapid increase in food margins is misleading. The farmer's share of the consumer food dollar has been absolutely constant over the last two or three decades. Of course, if you go back to a period like 1973, the farmers share went up because farm prices went up so dramatically. But the long-term trend will find that the farm value of food prices rises in step with the general rate of inflation, as do the marketing

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margins, and the distribution between marketing margins and farm prices has been almost constant.

The recent food price acceleration can be traced to farm prices, and not acceleration of the middlemen margins.

The Wholesale Price Index over the first 6 months of this year tells us about the same story. The overall rate of inflation is near 10 percent, but if you look at the prices in the industrial sector, the rate of inflation shows obvious acceleration from the 6-percent average of the last 2 years but not quite of the magnitude that would be suggested by 10 percent; it's a range of about a percentage rate of acceleration. If we project this forward, trying to be optimistic about a substantial moderation of food prices, it is possible to hold the rate of overall consumer price increases for the year to about 7 percent. But it is obvious that if you just count up the magnitude of the changes, if you average 10 percent for the first half of the year and want to get to 7 percent for the year as a whole, you have to have very low rates of price increase for the second half of the year.

While I think it is possible, because food prices have contributed so much to the first half of the year, it is still optimistic and it will not be easy to realize. It certainly implies more voluntary support and effort than we have had so far.

The second table looks at employment costs in the economy. There you will find that basically the same trend is occurring; we are getting a gradual acceleration in the first half of the year. About the best short-term measure we have of wage trends in the economy is the average hourly earnings index. While those wage increases have been in the magnitude of about 7 percent a year, in the first 6 months of this year they have accelerated to an annual rate of wage increase of about 8 percent.

If we add on social security tax increases and increases in private fringe benefits, for the first half of the year you would get rates of increase in employment cost between 9 and 10 percent. So there has been a worsening of the inflation situation on the wage side as well as on the price side.

One interesting statistic, which I am not too sure of how to interpret, shows that if you look at the average hourly earnings since January, after the minimum wage increase, the rate of wage increase has been only 6½ percent; this is a major moderation of the rate of wage inflation in this country. It is surprising to me, because I can't readily explain why the numbers show a big deceleration. It appears to be mainly in the services sector——

Mr. FRASER. Could you go over that once more?

Mr. BOSWORTH. Yes; in January, there was an 18-percent increase in the minimum wage. Instead of taking the change shown in the table between December and June, at an annual rate which was 8.3 percent, if we instead take the rate of wage change since January, after the minimum wage increase, the average rate of wage inflation has been only about 6½ percent. That is sharply below the average of the last 2 years.

If you try to explain why, by looking at the individual sectors of the economy, you find that almost all of that wage deceleration is concentrated in the service sector of the economy. There has been no major moderation, for example, in manufacturing, contract con-

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struction, and mining. All show substantial acceleration in the rate of wage increase.

I am not sure why the service sector numbers show up that way. I think one cautionary factor is that this is one area where the Government data is very bad. So I am not sure I believe it. But if it is true, it is a very optimistic sign.

You would be more impressed with the aggregate number if it were reflected in more sectors. The difficulty is that it is mainly in services, and therefore I am doubtful that it represents a lasting trend for the rest of the year.

So I continue to believe that for the economy as a whole, the best data we have suggests that there has been an acceleration of the rate of wage increase. Certainly there has been acceleration of the rate of wage increase in the basic industrial sector of manufacturing, contract construction, and mining.

If you look at what has actually happened this year, both on the wage side and on the price side, you will see that we have made absolutely no progress in beginning to moderate inflation. Moreover, it appears to be worsening; at least for 2 years before we had held inflation to 6 percent, it had stabilized, and we hoped to work it down. Mainly because of the destructive effects of the food price inflation, the economy is now headed in the opposite direction. The best outcome for the year as a whole would appear to be 7 percent. We have to admit that inflation is worsening, not improving.

There are three parts to the anti-inflation program that the administration has proposed to try to deal with, and I will summarize briefly where I think it stands.

First I think we have to admit and identify Government actions as a major inflationary factor in the economy. In 1978 we had the social security tax increase, the minimum wage increase, and the increase in unemployment insurance tax rate. These increases themselves added about three-quarters of 1 percent to the inflation rate. Our own less reliable estimates indicate that in terms of the measured rate of price inflation, Federal regulatory activities are adding about another three-quarters of 1 percentage point.

Since April there has been a major change both on the part of the administration and the Congress in taking a much harder line toward some of the individual proposals that would have an inflationary impact. The farm bill did not go through as proposed. The modified version of it had only a very modest impact on inflation. The President's action to increase meat imports has at least broken the speculative boom that had gotten going in meat prices and has stabilized them a little bit.

Several actions have been taken by the administration and the Congress which indicates that the Government is finally beginning to face up to and take a stronger stance against its own inflationary actions. Because of that, we are encouraged in terms of the inflation outlook in the next year or two.

In 1979, even if one assumes there is an oil import tax or a crude oil tax of one form or another, Government contributions to inflation will be less than they were in 1978. In the regulatory area, we have made some progress in getting the regulatory agencies to begin to review the economic impact of their regulations, to realize that although many of these regulations are desirable, they are not

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free. There is a cost associated with them, and there is a limited amount of resources to spend on them. There is now a requirement that every regulatory agency must do an economic analysis of its regulations, and I think that has been helpful. Within the administration there is a regulatory review group to assure that those regulatory analyses are reflected in actual regulations and get incorporated into the decisionmaking.

The general deceleration objective for business prices is that an individual, industry-by-industry basis we have asked them to try to limit their price increases significantly below the average of the last 2 years. Business has given us general verbal support. In terms of actual results, however, if you look at the first half of the year, you see that the trend of prices is not consistent with that voiced support.

We have talked to many individual firms about the outlook for prices in their industries, and they all tell us the second half of the year will be much better than the first half. We certainly wanted to get out of the nickel-and-dime business, where businesses used to come in with separate price increases and say they wanted 6, and we said too much, and we compromised on 5. So we have gone to the year as a whole and have not yet been able to comment very effectively on price increases to date.

As the last half of the year goes on, we will have to emphasize more strongly to the individual firms the importance of achieving the deceleration objective. So, in the last half of the year, I would expect that the Council will become more actively involved in prices in individual situations.

But, as I said earlier, we have not seen any evidence of a deceleration of the rate of price increases in the first half of the year. If it is going to occur, it will occur in the second half.

I think it is fair to characterize our progress so far on the labor side as zero, at least in terms of trying to get acceptance for a general concept of what is meant by noninflationary wage behavior. We haven't yet been able to propose a way to deal with wages and to handle labor contracts that has received any support from organized labor. I think that remains the biggest difficulty of the anti-inflation program.

It is almost impossible, for example, to talk about moderation of the average worker's wage increases, who has been receiving 7 to 8 percent, when he can look about him and see some very prominent and public unions whose workers have been and are continuing to receive 10 percent annual rates of wage increase.

It is absolutely necessary to have labor's cooperation if we are going to slow down inflation.

Therefore, that program first has to be made credible; the people who have been getting the largest increases must begin to come down back in line with the rest of the economy. So far, we have made no progress in trying to achieve that. That is evident with respect to the coal settlement, and I think it will be evident with respect to the railroad settlement.

I understand the difficulties there. They have 3-year labor contracts. They are being asked to put faith in an anti-inflation program they have no confidence in, to believe that, in fact, prices will decelerate. I however, also remind you that the major contracts we

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are dealing with contain cost-of-living escalator provisions. It is not true that workers are being asked to exercise wage restraint with no assurances that prices will come down in step. They will get wage increases in line with the price increases over the next 3 years of the contracts by the automatic provision of the cost-of-living escalators. But we continue to search for some formula or approach on the labor side that could be effective.

As I said earlier, on the business side, there has been acceptance in a verbal sense. We've heard a lot of words and a lot of pledges. It will remain to be seen over the last half of the year whether, in fact, those words will be translated into any effective actions.

Therefore, I think we have to report that the inflation situation is not as bad as it appears by just looking at the first 5 months. It is way too early to give up on the voluntary program and say there isn't a way to try to induce people voluntarily to cooperate and decelerate. The administration has only pursued it vigorously for the last couple of months. At the same time, the present trends don't give you a great deal of optimism.

Thank you, Mr. Chairman.

[Testimony resumes on p. 56.]

[The prepared statement of Mr. Bosworth follows:]

PREPARED STATEMENT OF BARRY P. BOSWORTH

Mr. Chairman and members of the committee, it is a pleasure to appear before you today. I do indeed wish I had some good news to offer. Unhappily, this is not the case. The latest inflation indices speak for themselves. I have attached some tables indicative of recent inflation trends.

I do think, however, that the picture is not quite as bleak as the cold figures indicate. They show inflation running at an annual rate of about 10 percent. I believe when the year ends it will be at a rate of about 7 percent. That certainly is not something that gladdens the heart. But neither is it cause for panic. We are not heading pellmell into double-digit inflation rates.

Most of the increases we have been experiencing during the past few months have come from food. We expect those prices to moderate sharply in the next few months. We already are seeing a decline in fresh vegetable prices after the effects of the bitter winter and record rains in California; and the large increases in meat prices are behind us, with a more stable level of prices for the remainder of the year. Food price inflation should slow sharply in the second half of the year.

Beyond the second half of this year the outlook is far less certain. Much depends on the effectiveness of our efforts to reduce the rate of inflation.

We do have an anti-inflation program in place with stated objectives for each major sector of the economy. I know there is criticism that it has not so far produced any tangible results and that there remains a good deal of skepticism about its voluntary nature. But let me be perfectly candid. We did not expect the decelertion program to produce immediate improvement in a situation that has worsened for more than a decade. We have not sought a quick fix. The objective is to get a gradual but sustained improvement over the next few years. The multiyear nature of many of our wage and price contracts does not make it feasible for a voluntary program to achieve dramatic results in a short time period. I will grant you that in recent months the rate of inflation has worsened when we hoped it would improve.

But I believe it is too early to conclude that this Nation cannot solve its inflation problems through cooperative efforts or that we must again resort to fighting inflation by throwing people out of work. The President announced the concept of the deceleration effort last January and then further implemented it with a number of positive steps of which you are all aware in April.

Our first priority was to explain to business, labor and various branches of the Federal Government what it is we are trying to do and then convince these groups that the program is a credible one that requires their support. It is true that there are still a good number of skeptics. It is up to us to convince them that the program is both equitable and vital if we are to avoid sinking into a recession.

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The Council on Wage and Price Stability for the past several months has been meeting regularly with individual groups to review inflationary conditions in their industries and solicit their support. A number of industries and individual firms believe that they can achieve the deceleration objective of holding their 1978 price increases below the average of the last 2 years. A number have committed themselves as well to hold down executive compensation. I will readily admit that none of this has been translated into a slower rate of inflation. But I do believe that we are beginning to achieve the first steps of an effective national effort to reduce inflation.

There has been considerable criticism about the voluntary approach to reducing the rate of inflation. Some of that criticism is well founded. But let's look at the options available.

A lot of people say if you balance the budget it would end inflation. Others argue that we could end this inflation by reducing the rate of money supply growth.

The advocates of both these positions are absolutely correct. You could reduce the amount of fiscal stimulus to the point that inflation would end. You could hold down the money supply growth to achieve the very same result. But let's be honest about what we are talking about. Since no businessman sets prices by the size of the budget deficit and no one demands wage increases because they feel the money supply is rising too fast, what we really mean is cut Government spending, cut production, throw a few million more people out of work and maybe they will quit asking for wage increases.

I agree that we could end inflation by this old-fashioned demand restraint. But let's not fool ourselves. The price, in terms of human costs, would be enormously high. The best economic estimates are that it would take an additional 1 million unemployed for 2 years just to bring down the rate of inflation 1 percentage point. In my opinion, that is an unacceptable price tag. We do not have an inflation by excess demand and it cannot be halted by creating an even larger pool of the unemployed.

There was a time when just a little aggregate demand restraint applied through fiscal or monetary policy achieved results. But this is no longer true. We have undergone a number of structural changes in our economy—such as the reduction of competition both in labor and in pricing markets and the growth of Government involvement—that have markedly altered our options. The use of the fear of unemployment and lost sales as incentives to hold down wage and price increases has become relatively ineffective for several major sectors of the economy.

At the other extreme, of course, we have wage and price controls. But they are simply not applicable to the kind of inflation we have today. Controls are short-term solutions to emergency situations. This is not what we have. Inflation has been a problem for us and all other industrial democratic nations for several decades. The use of controls or a sustained basis would cause distortions and inequities and would not address the fundamental structural problems. The administration has said repeatedly and emphatically that it rejects this approach. One very basic reason is that we just don't know how to operate controls. There are millions of prices in this country and when you try to set them from Washington, you inevitably make serious mistakes that ultimately lead to bottlenecks and distortions. And when you try to set wage rates in Washington I think you run the risk of creating basic changes in our political structure. The political activity of labor and business would concentrate primarily on persuading the Government to approve their higher wages and prices.

In between these two extremes there is very little left. We have been looking at some new incentive ideas that are loosely lumped together as Tax Incentive Plans. I believe that these options should be fully explored because they appear to address the problem of insufficient incentives for the individual firm and worker to exercise restraint in their wage and price decisions. But, there are serious administrative problems. The idea certainly is well worth exploring. Significant progress has been made in identifying and solving these problems; but, we do not yet have a version of such an incentive approach that is a viable option.

At present we have identified the major areas in which our anti-inflation efforts will need to concentrate and we have tried to develop for both business and labor reasonable guidelines for noninflationary wage and price decisions.

The program has four major parts. First, the administration recognizes that the Federal Government itself is an important contributor to inflation.

The administration is committed to working with Congress to maintain a responsible longrun budgetary policy that balances concern for sustained economic growth with a determination to avoid excessive surges in aggregate demand relative to supply. The President has reduced the size of the proposed tax cut to avoid excessive

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demand stimulation and has indicatd that he will veto budget bills that exceed his requested levels.

In other areas the President has strengthened the review and analysis of the Government regulatory process in an attempt to simplify regulations and assure that their objectives are achieved in the most cost-effective manner. It is reliably estimated that Government regulations add about three-quarters of 1 percent annually to the rate of inflation.

The President as well has frozen the salaries of the White House senior staff and has recommended a 5.5-percent ceiling on this year's Federal white collar pay raise. He has ordered the executive branch to reduce where possible the purchases of goods and services where prices are rising rapidly.

But while the Federal Government must do its share, it alone cannot solve the problem. Cooperation of the private sector is vitally needed.

The anti-inflation program is based on the premise that deceleration must be achieved in every market. To achieve this goal individual industries are being asked to limit price increases to less than the average over the last 2 years. The objective, as well, is to assure that there is no widening to profit margins. Several individual firms already have pledged to meet this deceleration target and we are continuing a full schedule of meetings to persuade others to do the same. In this effort I am working closely with Robert Strauss, the President's special counselor for inflation.

We adopted a guideline for price behavior that refers to the cumulative magnitude of price increases for the year 1978 as a whole in order to avoid encouraging a multitude of small price increases for which we did not have resources for analysis, and to encourage firms to be responsible for their own cost increases rather than accepting a passthrough of costs as adequate justification for price increases.

One consequence of that policy has been that we have not had a basis on which to comment with respect to many pricing actions in the first half of the year. During the next 6 months, however, many industries will be approaching the deceleration target that we expect them to meet. I anticipate that we will need to expand the Council's activities in that area over the next few months. On the basis of price developments through June, for example, we have begun a process of contacting these firms in industries with price increases approaching the deceleration objective to inquire as to what actions they contemplate taking during the remainder of the year in order to achieve the objective. If they cannot do so, we would like to obtain a detailed explanation of the factors responsible for accelerating inflation in this industry.

The third part of the program involves gaining labor support. a moderation of prices can only be sustained if there is an equal reduction in the magnitude of average wage increases.

Quite candidly we have not succeeded in obtaining the full support of groups. Realistically a lot of the blame for this should probably fall on my shoulders. Perhaps I did not explain the labor side of the program well enough and did not address myself adequately to some special problems labor has with a voluntary program.

It is a lot easier for business to make a price commitment than it is for labor to make a wage commitment. If inflation fails to moderate, businessmen can simply pull out any time and raise prices. But labor contracts are in effect for 2 or 3 years.

So there has to be an understanding that the workingman will be protected if the cost of living continues to rise.

But, I think there are equitable means of handling this problem. Many major labor agreements contain cost of living escalator provisions alternatively, they could choose to negotiate shorter term contracts or to include provisions for annual wage reopeners. But our problem has been that, in the name of protection against inflation, some labor groups have obtained wage increases far in excess of the average American worker. These increases also exceed productivity gains plus increases in the cost of living. We cannot continue this trend toward a dual labor market where the wages of one group rise far more rapidly than those of the average worker. Nor can we ask the average worker to participate in the anti-inflation effort by restraining his wage increases when the gains of others are so much greater.

Both on the labor side and the price side the voluntary deceleration program provides for flexibility to meet specific problems and situations. This is what distinguishes it from a rigid guidepost approach. The program expects more from those industries and those workers who have done very well in recent years. And it understands that it will have to accept less from those who have done poorly.

We recognize, for instance, that firms that lowered their price-cost margins during the recession will experience a rise in those margins as demand strengthens.

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The program is not designed to penalize those firms who have in the past varied prices in response to market conditions. By the same token there should be flexibility to allow for uncontrollable mandated costs from Government programs such as payroll tax increases, regulatory actions, tax changes and imported raw materials.

On the other side, it is indeed true that the average American worker has not fared well because of inflation. This does not apply, however, to those workers in the central industrial core of our society. They have been receiving gains of about 10 percent annually. If we are really going to do anything about inflation, these groups must begin to moderate their gains and bring them back in line with the 7-percent average of the rest of the economy.

The final part of the program deals with those sections of the economy that present special inflation problems. These include medical care, food, transportation, and housing. In general the rate of price increases in these sectors has consistently exceeded the economywide average.

There is before Congress a hospital cost containment bill that was designed to provide significant relief in this area. Congress has not acted on it. Recently the Council on Wage and Price Stability met with representatives from the American Medical Association in an effort to persuade individual doctors to hold down their rate of fee increase, which has been accelerating much faster than the general rate of inflation.

I think it is equally essential that we defeat proposed legislation that would sharply raise the raw U.S. sugar price. Anything more than what the administration has proposed is simply unnecessary to protect domestic producers.

In recent months a significant number of actions have been taken to moderate inflationary pressures. These include the expansion of meat imports and directing Federal procurement programs to avoid the purchase of goods and services whose prices are rising rapidly, and limiting the automatic escalation of procurement contracts.

The administration will continue to search for ways to reduce the Government's contribution to inflation.

But in the final analysis it is up to business and labor, working with the Government, to find ways to reduce the rate of both wage and price increases.

No one is asking for any great sacrifice. But, realistically, an effective effort will require that everyone give a little.

But if we fail to begin this downward process, the consequences seem quite apparent. The Federal Reserve will refuse to continue to finance the economic expansion. We will find ourselves again in a recession—and with very little likelihood that it will significantly ease the pains of inflation.

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ALTERNATIVE MEASURES OF PRICE INFLATION

	Dec. 1977 relative importance (percentage)	Annual changes [1] 1976	Annual changes [1] 1977	Percent change year to date [2]
Consumer Price Index: [3]				
All items	100.0	4.8	6.8	10.0
Food	17.7	.6	8.0	18.7
Energy	8.6	6.9	7.2	7.4
Home finance, insurance, and taxes	9.2	1.6	11.2	19.3
Used cars	3.0	19.0	−4.1	14.0
Other items	61.5	6.1	6.2	6.7
High inflation components:				
Housing	43.9	5.4	7.6	10.8
Medical care	5.0	10.1	8.8	8.7
Food	17.7	.6	8.0	18.7
Consumer food:				
Prices:				
Away from home	5.5	6.1	8.0	11.6
At home	12.2	−.9	8.0	22.1
Domestically produced farm food: [4]				
Retail value		−3.2	5.1	23.0
Farm value		−10.6	4.3	50.9
Farm-retail margin		2.1	5.6	7.5
Imported food		15.9	25.7	N.A.
Wholesale Price Index:				
Finished goods	41.2	3.3	6.6	10.5
Producer	12.2	6.4	7.2	8.3
Consumer	29.0	2.1	6.4	11.1
Consumer less food	18.7	4.9	6.1	7.9
Intermediate less food	45.5	6.4	6.4	7.7
Crude less food	4.0	13.5	11.4	14.0

[1] December over December of prior year.
[2] CPI figures show December to May changes, WPI figures show December to June changes. All figures are seasonally adjusted at annual rates.
[3] CPI for all urban consumers.
[4] Domestically produced farm food comprises 100 percent of consumer food at home. Relative importance of the components of this group are: Retail food (100 percent), farm value (41 percent), and farm-retail margin (59 percent).

Source: U.S. Department of Labor and U.S. Department of Agriculture.

ALTERNATIVE MEASURES OF EMPLOYMENT COST

	Average annual percentage change 1967–77	Average annual percentage change 1976–77 [1]	December 1977–June 1978 [2]	June 1977–June 1978
Private nonfarm sector:				
Average hourly earnings	6.9	7.6	9.4	8.4
Hourly earnings index	7.1	7.2	8.3	8.2

	Average annual percentage change 1967–77	Average annual percentage change 1976–77 [1]	1977: IV–1978: I [2]	1977: I–1978: I
Hourly Compensation (all persons)	7.7	8.9	13.2	9.1
Labor productivity	1.6	3.0	−3.3	.9
Unit labor costs	6.0	5.7	17.0	8.2
Real wages:				
Average hourly earnings	.8	2.9	.0	1.4
Real spendable earnings [3]	.3	2.2	−11.9	1.9

[1] Average annual percentage change 1975: IV to 1977: IV.
[2] Seasonally adjusted at annual rates.
[3] Real spendable weekly earnings of a worker with 3 dependents.

Source: Bureau of Labor Statistics.

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The CHAIRMAN. Why do food prices go up during the first half of the year and seem to go down during the second, and what is the impact of the farm bill that we passed last year on higher food prices?

Mr. BOSWORTH. The major reason is that we have seen extremely bad winters in the last 2 years.

The CHAIRMAN. Is that a phenomenon of just the last 2 years?

Mr. BOSWORTH. Yes, the weather has been a lot worse than usual, which triggered some price increases. There has also been a speculative element in a lot of the agricultural commodity markets, and once something like that gets started, there is a tendency for it to get exaggerated. We saw that in the meat market, when pork production was less than expected during the winter months, prices went up. That touched off a general movement within the meat markets and prices soared for a period of time.

Then last month, they finally broke. Beef prices in particular fell dramatically, and in the last couple of weeks have been edging their way up again. We had, and still have, an agricultural situation we are only gradually working our way out of.

There were no grain reserves available, so everything depended on the weather. The moment someone heard a rumor of a bad storm in the West, they said, "Grain shortage" and prices skyrocketed. Whereas in the 1960's, no one cared, because we had a large grain reserve to stabilize the market.

We are now rebuilding that grain reserve, but it is still at a marginal level. We could take 1 year's crop failure, but it would put us in pretty desperate straits. Over the next couple of years, if we continue a policy of building up the grain reserves and providing more protection against the severe weather, I think that market will begin to stabilize.

As important as food prices are, it is a little silly, in my view, to run an economy as we have, and leave food prices to be determined by the weather, when it is completely unnecessary. If you have grain reserves you can smooth the fluctuations out.

The CHAIRMAN. That holds true for grains. What percentage of the total food picture would that be?

Mr. BOSWORTH. Grains would be a small element on consumer prices, but as an underlying foundation, they build producer expectations in the meat and dairy sectors of the industry. They are very important. When the beef, pork, and chicken producers never know what feed grain prices are going to be from one day to the next, they are not about to expand production.

I think, for example, that one of the explanations for the pork situation, where supplies have not expanded even though we expected them to, is not the weather; it was the continual debate in the Congress last fall about raising or not raising corn support prices. That created a lot of uncertainty among pork producers. They didn't know what was going to happen to the prices, so they held back production.

We kept telling them that now it is a profitable situation, which is true, but it wouldn't be if corn prices went up. The uncertainty for many months surrounding that debate did contribute to some increases in prices.

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However, I think the fundamental problem has been beef prices, and that was the price you were going to pay. It has a legacy going back to 1973 and 1974, when those grain prices first went up, getting the whole production cycle out of phase. They have been slaughtering off the herds ever since. Sooner or later, that had to end, and when it did, a reduced amount of meat would come to the market while they rebuilt the herd.

In the first part of this year that appears to have happened. Second, for reasons we don't fully understand, there was a strong growth in consumer demand for meat products in the early part of this year and the last part of last year.

Now the meat demand seems to have leveled out; at least it is not rising as dramatically. But I do think the long-term solution is grain reserves. They are fundamental reasons that food prices fluctuate in the short run on the basis of random events. If you had that grain reserve, these little developments wouldn't affect anything. They wouldn't change people's expectations. But it is now a market very dependent on people's expectations, both on the part of the producers and on the part of the purchasers.

Outside that area, the rest of it is weather. It was a bad winter in California, and the fruit and vegetable crop was cut significantly.

The CHAIRMAN. The increases that you mentioned in housing, real estate, how significant a role do they play in the inflationary increases, and what can we do in that area to bring them under some sort of control or restriction?

Mr. BOSWORTH. People have identified food, housing, and medical care as the three particular problem areas. Of those, housing is the largest. It has the largest weight in the Consumer Price Index. Medical care is a problem, but in terms of overall inflation it has a small weight, perhaps 4 percent of the overall Consumer Price Index.

There are just a multitude of problems in the housing area. There are difficulties at almost every stage of the process you can look at. First, take the level of raw materials. We continually use monetary policy to put the brakes on or take them off of the overall economy. The brunt of that policy falls on the housing industry, and it looks like a roller coaster over the last decade. Every time we have a monetary crunch, we destroy capacity in the basic materials part of the housing industry, and then we turn around and want easy monetary policy and expansion and overstimulate and run out of the raw material prices, and they soar. That is what happened last year.

This year, as the year goes on, you will find a dramatic drop in raw material prices. There are exceptions to that, of course. In timber, for example, we have run into a lot of environmental difficulties. We do not want to cut the national forest because of the environmental concerns. At the same time, we say we want cheap and affordable housing for Americans.

The price of lumber is one of the largest elements in the cost of building a home, and it has been increasing at tremendous rates. That's because we can't resolve those public policy issues. How are we going to tradeoff what we want in increased timber for houses and environmental concerns? Is there a better way of balancing it?

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So, in that one instance anyway, I think environmental concerns have been a problem.

The brick industry and the glass industry were both heavily disrupted by the fuel crisis of 1974. When you turn to the rest of the housing industry, you find that labor costs have not been a problem. There have been moderate rates of increase in labor costs, but it is a declining portion of the cost of the house.

One problem that remains is financing charges, which are going up enormously. That is happening mainly because of the overall inflation and the fact that the Federal Reserve uses monetary policy as a way to fight that inflation, which drives up interest rates. To stay competitive, mortgage rates are driven up.

For decades prior to the 1970's we were able to offset increases in mortgage interest rates by a gradual easing of the terms of mortgage contracts. We lengthened out the time period over which you paid it. We allowed a bigger proportion to be lent. Those tended to offset increases in interest rates, and so financing costs for a home declined as the industry evolved.

Now we have gone about as far as we can go. We have mortgages up to about 90 percent of the value of a house. The term of the loan is out there as far as it can be. If you look at people's first 2 or 3 years' payment for a mortgage, 99 percent of it is interest. There is not much more you can do about liberalizing and postponing the day you pay off the principal. You can't have interest payments that are 110 percent of the monthly payment. It won't work. You would have a rising mortgage value over time. So, because of inflation and because monetary policy has been the primary weapon against it, mortgage interest rates have gone up dramatically.

The third problem area is site costs. There has been an explosion in the cost of a site for a home. There are many reasons for that. Local zoning practices are probably the biggest contributor to it. A couple of decades ago, people used to build their home only, not paying for streets, sidewalks, sewers, or street lights. All that would be paid for by the community out of general taxes. The city put them in and your deal was they paid for yours, and in future years you paid for somebody else's out of your taxes.

Nowadays, we don't finance housing that way. Those of us who owned the houses said, "Enough of that. I don't like that any more," and we have forced new home buyers to put all their money up front. Now they have to have the street, their sidewalk and sewer before they can build their house. So the rest of us bought houses years ago and benefited from the old deal, and then we canceled it. We have thus piled up those costs of site development in the price of the house. The developer has to do it now, and he puts the cost up front precisely when most people are ill prepared to pay for it. They don't have a lot of money at the time they buy the house. That made the purchase price go up rapidly.

In many cases, Washington, D.C., for example, communities don't want low-income groups in, so they require very large-sized lots. They don't let mobile homes in. By eliminating the cheaper form of housing, we forced an upgrading of housing, creating shortages of the lower cost, more affordable housing that the average American could buy. A lot of that is associated with local zoning law changes

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and what we required. Some were for environmental reasons, but other ones because we wanted to maintain a certain type of community. And it has become much more costly than it was before.

Behind that there is also a sewer moratorium in many parts of the country which creates shortages of housing. One of the interesting things about it is that the housing price problem is, in a sense, a regional problem. When you look around the country as a whole, you find many regions that have very modest rates of housing inflation. The rates of price increase are not dramatic in the Midwest or in the South. They are less than the overall Consumer Price Index.

The problem with housing lies in the major metropolitan areas like Washington, D.C., and Los Angeles. There has been enormous speculative increases, and that affects the national average that goes in the Consumer Price Index.

But the notion of expensive housing, in a sense, depends on where you live. Some parts of the country have not had this difficulty. Where land has not become a short commodity, home price increases have been less than the rate of overall inflation.

The CHAIRMAN. Under the administration's policy of voluntary action against inflation, what do you propose in this area, real estate and housing?

Mr. BOSWORTH. The Department of Housing and Urban Development just completed recommendations that tried to identify what were the factors responsible for housing price inflation. This task force was made up of Government builders, consumers, and others. They identified, as I recall, over 100 items, some of them minor, some major.

They are now trying to see how many of those they can implement. One example of things that you could do is to put forth a model national building code. That is a local issue, but if the Federal Government proposed the outline of what one should look like, maybe more local communities would adopt it. Building codes can make substantial cost savings possible.

The same thing is true of zoning ordinances. At the financing level, however there is not a great deal you can do without subsidizing housing, and subsidies have not worked very effectively in the past.

There the problem is to solve the overall inflation. Their interest rates would come down and housing costs wouldn't go up as rapidly. In commodities and materials we have largely been unsuccessful. I am afraid there will be another crunch in the housing industry over the next year and production will again go down, and that will postpone the expansion that is needed in the supply side of the industry. For example the cement industry has finally gotten back to a profitable situation, a situation where normally we begin to look for some expansion of capacity. Well, already an economic downturn has begun, and you wonder if that will keep going.

We tried to do something about a Federal timber policy. That was too complicated an area with too many conflicts of interest, and I don't think we are going to produce anything that is very effective.

The CHAIRMAN. Thank you. Mr. Fraser.

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Mr. FRASER. I was struck by the candid nature of your remarks. You suggested we would be lucky if we ended up with 7 percent.

Mr. BOSWORTH. I have learned to be a little pessimistic on the 6 months.

Mr. FRASER. On the whole, things aren't working very well. That is what I get from your statement. You pose two choices in your statement. You said that on the one hand we can go back to the, I hope, discredited policy of throwing people out of work as a means of reducing demand and bringing down inflationary pressures. On the other, you said we can go to wage/price controls and all the difficulties of Washington making the price and wage decisions.

You talked about TIP, but said so far there isn't a feasible formulation at this time. How bad does inflation have to get before we do something more than we are doing now?

Mr. BOSWORTH. Well, I hope it doesn't have to get a lot worse. One answer is to look at Great Britain. There is a point where you can push a country; the inflation situation deteriorates so far that finally people look over the edge; they don't like what they see, and they are willing to pull back.

They have done it largely with a voluntary program. They have been enormously successful. They had a 25-percent rate of inflation, and now it is lower than ours. They did it in about a 2-year period. In this country the general public attitude is one of upset, but I don't think we are past the point of poking fingers at each other. We still continue to look for a villain, for the simple answer, like balancing the budget, or something like that.

I will tell you what the correlation between inflation and the budget deficit is—zero. There isn't any. You look back over the post-war period, and see that they don't balance out at all.

In our efforts to try to get a voluntary program going, we still haven't gotten to that stage of looking over the edge. We still have problems, and labor is symptomatic of them. They don't believe others are going to go along, and we continue to look for a formula or means by which we can try to convince them other people will cooperate. It is a problem of getting momentum going. If you started to show success, people would have a little more faith, and it would tend to build on itself. But how do you get it started?

Mr. FRASER. Do you have a responsibility for developing a feasible TIP program?

Mr. BOSWORTH. Yes. We have spent a lot of time over the last year looking at different types of approaches and trying to see what could be done. There are two problems at present that we are stuck on. One is the administrative problem. If you try to run a TIP program, which is an incentive, you are going to give a tax cut, and that suggests you have to give it to everybody. You can't exclude people from the program.

But in order to measure people's wage change, you need the same administrative machinery as you had for controls. And administratively it is very complicated. You are going to give money away on the basis of determining people's wage increase, so you have to figure it out. It is not easy to measure people's wage increases on an individual basis.

I think we have determined that it is impossible to do on the price side. The problems of trying to construct price indexes for

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little individual companies are just too much. Look at the corner grocery store. There are a couple of thousand items in one man's operation. It just is not feasible on the price side. If we were to limit it to just a few companies where the administrative problems were more solvable, we would have to exclude a lot of people.

The only way I know how to do that is make it a penalty system. Nobody wants to be included in a penalty system if they don't have to, so it would be easy to get people to volunteer to keep out of it. You could focus on the major industries or something like that.

The difficulty there is if they don't respond to the tax incentive, if it doesn't lead them to reduce the magnitude of the wage increases, for example, then it simply adds to the inflation. They give the same wage increase as before, we tax them, and that is just another cost increase on top of that wage increase, and they would pass it through.

In other words, if the system did not work, it could make things worse. There have been a lot of administrative problems. We have found some ways to minimize those, about how to define employee groups and the like, and so within the voluntary program we are getting close to having a version whose administrative problems look resolvable.

The next question that comes up is if anybody would really pay any attention to it. I may be wrong, but I think the first test of really doing something on the wage side in this country is to get the major, very large increases back in line. By this I mean the basic industrial core, the teamsters, auto, and steel workers, whose wages have been far above average.

I am afraid if we had a TIP program, they would ignore it. They would get the same wage increases as before. They wouldn't pay any attention to it, and therefore we would go through the work of proposing this program, finally getting the Congress to pass it, and then they wouldn't cooperate.

Mrs. HOLT. Will the gentleman yield at that point? I want to ask why—would you yield?

Mr. FRASER. Yes.

Mrs. HOLT. Why are they reluctant to join in an anti-inflation program? It seems to me that it is obvious to everybody that would be a good place to start.

Mr. BOSWORTH. To be fair to the industrial core of the economy, the large companies and the large unions, they have learned to live with inflation quite well. It is not hurting them. They get labor contracts with a cost-of-living escalator. If the cost of living goes up, the wages go up. The companies pass it through without any particular difficulty. They are not suffering particularly from inflation.

The people who are suffering from inflation are the minority groups, the people in retail trade, and the people on the fringes. They get hurt by unemployment and by inflation.

The industrial core people are being asked to give up a sure thing. They negotiate their own contract. They have learned how to take care of themselves. If you come in with a little tax gimmick proposal and say, "I will give you a tax cut instead," they could say, "Why bother; I will take a sure thing."

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Mr. FRASER. I have one last question. It has been frequently suggested that a selected intervention might work. This approach would focus on the 1,500 largest corporations, or pick out certain basic sectors and establish mandatory guidelines for them on the theory that competition will restrain prices if you can affect this core group. Is that feasible? Clearly it reduces the administrative problem.

Mr. BOSWORTH. Clearly it is a way of reducing the administrative problem. Also, I myself agree with the thesis that the basic inflationary problem we face is in this highly concentrated segment of the economy, where the labor market tends to be highly unionized, and the private markets are dominated by a few companies. You really don't have a problem in retail trade and in some other segments.

Yet even in 1,500 firms, with an enormous incentive to avoid controls, the accounting is very complex. There is also the question whether or not politically, people are willing to accept controls, knowing what happened last time around. The last time we did not have general controls; we only really controlled tier 1 firms. They are much like that 1,500 you spoke of. And that program wasn't very successful.

The CHAIRMAN. Could we interrupt you here? There are a lot of questions we would like to ask you. I have just taken a little poll here of the members. We have about 8 minutes to vote on an amendment. Could you wait until we come back?

Mr. BOSWORTH. Certainly.

The CHAIRMAN. Good, and would you all please go over and vote and come right back?

[After recess.]

The CHAIRMAN. The committee will please come to order. Mr. Bosworth, have you evaluated the inflationary impact of Federal environmental requirements?

For example, you know the Aircraft Noise Revenue and Credit Act will divert more than $3 billion over 5 years from the Airport and Airways Trust Fund to private airlines to assist them in meeting Federal noise regulations. Is the improved noise environment and many of the other improvements to the environment worth the inflationary impact of higher fares which result as a result of this type of legislation?

I think you alluded to the role of regulation in the field of housing, additional zoning requirements, site development costs, all of which are increasing prices. Would you give us your thoughts in general on the question of regulation at all levels of Government?

Mr. BOSWORTH. I don't think you can make a general statement that the benefits have necessarily been worth the costs in aggregate, because the value you put on it is in the eye of the beholder. However, the problem is not that the benefits that we are trying to achieve in the environmental area, health and safety area, or any other areas are unrealistic. The problem is not the establishment of the goals or targets, it's the means that are used to get there. What bothers us the most is not that the benefits are unimportant, but that in regulation after regulation there is an alternative method that could be followed where economic costs would be much, much lower. Therefore, that the regulations are inefficient

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in the sense that there are less costly means, without ever challenging the question of whether or not——

The CHAIRMAN. Can you give us an example of that?

Mr. BOSWORTH. That was the argument recently over cotton dust. We just filed on another, which is a relatively little issue, but it illustrated some principles and it's going to become a big issue, and that is noise regulation.

One example of this was motorcycles. That is a little thing, and you say why do you care? Because the proposed EPA regulation calls for the manufacturer to completely restructure and rebuild the motorcycle to meet a lower noise standard, which is very costly.

There is some argument about whether the major American motorcycle firm will, in fact, do it or whether it will go out of business because of the economic effects.

This is going on despite the fact that all of the studies indicate that the problem with motorcycle noise is not with the manufacturer. It's with the owner, who buys the motorcycle and then modifies it by putting a new muffler back on the system. Now, the logical way to try to deal with that, in my mind, is better enforcement of the existing noise regulations by the motorcycle users, by placing some burden on them.

For example, many motorcycle mufflers exists that do not meet the present noise standards. So if you take the existing muffler off and put a new one on, it's noisy. People like noisy motorcycles, the people who own them, not the people who have to listen to them.

In that area, there is a much less costly means of achieving exactly the same targets. I think we should reduce motorcycle noise; the question is, how do we do it?

If we went through all the existing muffler manufacturers, for example, and required that motorcycles be evaluated and carry a label on them that says what their noise level is, then when somebody stops a motorcycle on the street because of its noise, all they have to do is look at the label on the motorcycle. This either meets the standard or does not meet the standard, so you have a lobbying requirement on mufflers and better logical enforcement.

But it seems to me that in regulation we never want to do anything that makes the cost very evident to a consumer. The difficulty with this approach is that EPA would have to tell city governments to spend more money on police and motorcycle inspection. That will make the cities mad at you, so you can't go that route.

You go the manufacturer route, even though the cost to society as a whole is a lot higher. I think it is a question of whether or not we are going to tell somebody this is where we want to get to, and we don't care how you get there, just do it. If you don't you will be penalized very heavily. This approach favors firm standards, absolutely firm, and if you don't meet them you are going to pay. But how you do it, that is your business. The alternative approach of design standards, where we will tell you in great detail exactly how to build the machines that are supposed to attain a certain objective, is a very costly way. In my view no Federal bureaucrat can ever know how to run a business firm very efficiently. We are meddling in a business that is none of our concern. So our argument is that the method itself is overly costly, not the goal.

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The same sort of thing came up with respect to cotton dust and others. In general, we worry that regulatory agencies place far too little reliance on economic incentives; they don't make it in the manufacturer's interest to want to meet the standards because it would save him money to do so.

Instead we do it the other way around. Under the present system, maximum available technology is required. If a firm discovered a new way to reduce pollution, it would be in its own interest to keep it a secret. Otherwise, if EPA finds out about it then EPA is going to order it and everybody else in the industry to use it. Thus, any research and development it does just ends up costing it money; it imposes a tighter standard on it without any incentives for it to find cheaper and more effective ways to reduce pollution.

The way the economy operated in the past, we made it in the interest of the firms to cut their costs, and thus had enormous productivity growth. They didn't like paying a lot of labor costs, so they found ways of using labor more effectively.

I argue the same thing. If pollution costs firms money, they will find ways to reduce its costs by avoiding that pollution, but we don't use that incentive mechanism anymore. Therefore, at the risk of angering the environmentalists, I am afraid in many areas that the Federal regulations are a mess.

We don't have the foggiest notion any more of what we are doing in environmental regulation. I don't believe there is anybody in the country that can tell you what the economic impact of the Clean Air Act and its amendments is going to be.

We have been working on it for months and we cannot figure it out. If we ask the regulatory agencies, they say, well, we haven't got the time to figure that out, we have to get the regulations out. We just simply don't know anymore what we are doing to the regional patterns of economic development and incentives that operate in this country.

Businesses are moving away from our major population centers because those are the heavily polluted ones and they can't get plant permits. It's so difficult that I don't even understand the terminology. For our own purposes we are now writing a dictionary of environmental regulatory terms because we cannot remember what the definition of them is from one day to the next.

The CHAIRMAN. I agree with you. Mrs. Holt.

Mrs. HOLT. Thank you, Mr. Chairman. Thank you for your very candid, interesting testimony. You have said we need to solve the overall inflation we have built in this cost-of-living syndrome and that we need some way to start the downward trend.

Economist Gary Shilling says that 2 to 3 percentage points of our current inflation is being generated by just the things you were talking about there, the budget deficits, the price supports, import controls, regulation.

Wouldn't that be the place to start for the administration? We pass all of these beautiful laws over here and we turn it over to the executive branch and then they impose the regulations.

Wouldn't that be the place for the administration to really bear down if it could? You said yourself it accounted for 1½ percentage points, I think, three-quarters in one, and three-quarters in the other.

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Couldn't we make more of an effort there to try to start this downward trend by limiting the growth to a smaller amount, or trying to take steps in that direction?

Mr. BOSWORTH. In several respects I agree. First, we have to recognize we are all part of the inflation problem. Except for maybe a few retired people in this country, there is really no one who is not part of the inflation problem. I am absolutely convinced there is nothing that can be done within the framework of doing business as usual to solve it. Unfortunately most people want to continue somehow to do business pretty much as usual with perhaps some minor modifications, hoping that will stop inflation.

We are going to have to disrupt almost everything else we are trying to do until we can get inflation under control. Logically when you say that sort of a sacrifice and risk has to be made, it is the obligation of the public sector to start those risks and sacrifices.

But then I think you have to be very careful about what sort of public sector you are talking about. I am not in favor of lumping into the Government—the Government budget deficit—and using the panacea of balancing the budget. Certainly balancing the budget will stop inflation, but you had better be very clear about the economic consequences of those types of Government actions.

There is no way a budget deficit reduction can have an impact on inflation except by throwing people out of work. It has to be a policy of demand restraint and cutting Government expenditures. That worries me, because, in fact, in the past we had a combination of monetary restraints and fiscal restraints to stop inflation. The cost of that approach is putting people out of work.

Just looking back at the last three or four recessions, we estimate that to get 1 percent off the inflation rate, you will have to put 1 million people out of work for at least 2 years. And that just strikes me as too costly.

Mrs. HOLT. This is not the point I was trying to make. If you slow the growth rate, that is what some of us have tried to do here, to offer a slowdown in the rate of increase in Government—don't you agree that that would start the downward trend and then the cost of living increases would be less and less, and if we could restrain ourselves then we would be setting an example that I think maybe would filter over into the private sector.

Mr. BOSWORTH. Yes, I agree that there are things that the Government does that directly has impact on prices and wages, and it would be helpful if we tried to have a moratorium on those, especially these special interest kinds of legislation that raises a price someplace or puts a trade restriction in place for somebody else.

I understand as well the demonstration effects for the rest of the economy in slowing the rate of growth of Government expenditures. My concern is not with the size of Government, but rather the balance. I think the demonstration effects are a good idea. The approach of falling back again on saying that somehow there is a solution to inflation by having another recession and less fiscal stimulus is not the way that will work.

I am very much in favor of the other methods you mention. I think that the public sector should show more leadership. But it's tough. Whatever are you going to do with the sugar bill that is still

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up here before Congress? You have to vote one way or another. Farm bills will continue to come along, and others. It's not easy, given the other concerns, to just say no to every one of those bills, but I think that is about what it takes.

Mrs. HOLT. It's not so tough.

Mr. BOSWORTH. Wait until you get one that affects one of your constituent groups.

Mrs. HOLT. Impact aid.

Mr. BOSWORTH. It's tough.

Mrs. HOLT. Given the low increase in labor productivity we are seeing, should we not be encouraging the administration, to support efforts to encourage capital formation such as the Steiger proposal to decrease capital gains taxes?

Mr. BOSWORTH. I have tried to stay out of that controversy if I could. But let me try to outline my feeling.

First it is very clear, particularly over the next couple of years, that if we are going to keep the economy expanding there is a great need for expanding capital formation. The question is what you ought to do about that.

Realistically, looking at the pattern of both savings and investment in this country, the problem is not a shortage of savings. If there were a shortage of savings you would not have a Federal Government deficit soaking up $55 billion of it because there is too much of it around.

Our problem now in this economy in the savings-investment area is that savings are about in line with historical trends, people are saving the same proportion of GNP they always were. However, there are no incentives to invest it in a very physical sense by American corporations, and it's the lack of those incentives that's exacerbating the problem. Now, how do you try to address those?

One, business has no confidence that the economic expansion will be continued. Why build a plant if you are going to have a recession in the future and you won't need it? That is the first point. You have to follow a policy more like the 1960's, of a sustained economic expansion they can count on instead of this roller coaster of the last decade.

Two, they are worried about the implications of being able to sustain that expansion with inflation.

Three, they just don't have any idea what sort of regulations their new plants are going to be subject to, since they change every couple of days.

Four, there are the tax questions. Now, I think there are some very real, demonstrated ways to stimulate business fixed investment in plants and equipment, and that is the investment tax credit, a reduction in the corporate profits tax rate, and accelerated depreciation.

To the extent that it does anything, capital gains is mainly a way to stimulate savings. It's in the financial markets, and its impact on savings is even open to question.

If there were, on the other hand, a way to stimulate venture capital, I think that would probably be a good idea. Unfortunately, if you look at what capital gains are claimed on, that is not what capital gains are used for. Capital gains are used for land specula-

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tion. I think the big effect of the program would be increased urban land speculation in ghetto housing and other areas like that.

It also goes into cattle ranching; it goes into all sorts of rather strange investments. If you knew it was going to go into venture capital, into physical investment that contributes to productivity, you would be for it. However, the evidence is that that tax credit is used for a lot of different things that are not particularly productive in the social sense.

So if you want to stimulate capital formation, I would opt instead for investment tax credits, accelerated depreciation, not a lower corporate tax rate. I think this would be far more immediate and would have a bigger bang for the dollar than playing around with capital gains taxes.

Mrs. HOLT. What if we abolished all regulations, if we just one morning said, we are not going to have any more regulations on anybody. Would that cause tremendous unemployment?

Mr. BOSWORTH. No, you would have a lower rate of inflation, expanded output, more cancer, and a dirty environment.

You cannot ignore the fact that in a modern economy there are very real problems. If a businessman can produce any chemical he wants to, the fact that it causes cancer is none of his business. He is only out to produce that product and sell it in the marketplace. It is an externality that has to be regulated somehow.

We have to have these regulations. There is just too much evidence that many of these chemicals cause cancer. There is too much evidence of the damage that we are doing to the environment with unrestrained pollution.

The issue should not be put that way. The issue should be, is there a better way to regulate? A way that is far less costly and makes more use of economic incentives that contributed in the past to productivity improvements? I think the answer to that is, yes, and one of the answers is to get the business out of the hands of lawyers and back into the hands of people who know something about how the economic system operates.

It has been run too much by administrators and lawyers who are always thinking of a court case instead of thinking about how the economy operates effectively.

Mrs. HOLT. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. Would the gentleman from South Carolina like to be recognized?

Mr. DERRICK. I guess so. I had thought that the administration had gotten off the lawyer kick. That didn't help its ratings so I thought maybe they would get onto something else.

Mr. BOSWORTH. I have nothing personal against lawyers.

Mr. DERRICK. Or Congressmen, either, I hope. Let me make just a couple of observations and then ask you a question or two.

I notice that when the administration was pushing the minimum wage we were told that it was not inflationary, and now I hear that it is part of the inflation picture.

I was interested in what you had to say about the speculation in the area of the agricultural middle man. When we were talking about the 100-percent parity bill, as I recall the administration argued that the middle man really didn't have much to do with it, but my farmers keep telling me that they did. Apparently, accord-

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ing to your testimony, there is some validity to my farmers observations.

On this matter of a balanced budget; you are not telling me that the fact we are borrowing at the projected rate for fiscal year 1979, around $50 billion, that this does not exert substantial upward pressure on interest rates that causes an inflationary situation in the housing area?

One other thing: I was rather interested in your comments on regulation and that we would have better legislation if we just told industries they ought to clean up their act or they are going to be penalized and let the individual industries do it and not have the Federal Government tell each industry how to do its business.

That sounds great, and I agree with you. I think that is the way we handled the automobile industry; I don't recall that we told them specifically how they had to do it, we just told them they had to do it. And we have seen the price of automobiles rise substantially, not entirely because of the pollution devices, but a substantial part of it. If you would care to comment on any of that then I have a couple more questions for you.

Mr. BOSWORTH. Let me see if I remember the two in order. Does budget borrowing, add to raise interest rates?

Mr. DERRICK. By the way, let me say this, on the matter of lawyers, I am very serious about it because I go back home and I defend my President because I think he is a great man and he is the President of the country, I am a lawyer and I think that this country would not be enjoying the freedoms and the democratic form of government that we have today were it not for the contributions that were made by the legal profession over the last several hundred years, and I do resent it.

Mr. BOSWORTH. The remarks I made, though, were about the structure of the regulations, not as an attack or nonattack on lawyers. The question is whether or not——

Mr. DERRICK. I was not directing those remarks to you; I was asking you to carry that message back.

Mr. BOSWORTH. I will carry the message back. In this case my concern is that the regulations are structured in a way that does not take economic incentives into account but are too legal in structure. Economic incentives are not reflected enough in the regulatory process; it's more what can be proven or not proven in court.

But, to your other, more fundamental questions about budget borrowing and its impact, I think the key thing about budget borrowing is that the Federal Government would cut back on its expenditures and wouldn't borrow money. One possible outcome is that the reduction in borrowing could lower interest rates, and could lead to further investment by others in response to that.

Mr. DERRICK. Basically the question of what will happen with interest rates depends upon the Federal Reserve. If they accommodate the borrowing by the Federal Government, then there would not be an increase in interest rates, and the difficulties in the past have been that even without an increase in interest rates, and you know interest rates did not go up in 1975, the Federal Government's deficit dramatically increased from 1975.

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Mr. BOSWORTH. That is exactly the point. There was not a corresponding demand during 1975. It depends on what the demand is.

Mr. DERRICK. We were not meeting the needs of housing at that time, either.

Mr. BOSWORTH. Because interest rates were high in 1974. Starting in 1975 things turned around, and the housing industry picked up. So if demand is very high in the private sector and if at the same time the Federal Government tries to borrow those resources that the private sector wants to use for investment, then, yes, it's inflationary because they will drive them back out of the market through the mechanism of high interest rates.

If, on the other hand, there are lots of resources out there, and that is not the constraining influence on it, lots of savings available——

Mr. DERRICK. I understand all of that, that is all very elementary. What I am talking about is that you cannot sustain the deficit borrowing and support the need in the housing industry at the same time.

Mr. BOSWORTH. It depends on how strong the other sectors of the economy are. Suppose I told you that consumers decided that instead of the historical 5 percent or 6 percent of their income they have been saving that all of a sudden they decided to start saving 10 percent of their income. This happened in 1975. Now, that provides additional savings at that time to do both, if you wanted to. It depends upon the total demand for resources.

Mr. DERRICK. That is fine, but we live in a world of reality, and 10-percent savings rate is not reality over the long run. We cannot support deficit borrowing and, at the same time, meet the needs for housing over the long period of time.

So my point was there is no correlation between the deficits and inflation. I wanted you to address that issue.

Mr. BOSWORTH. No, if you are saying that over a very long period of time, over the business cycles, year after year you run a very large deficit of public borrowing, yes, then that does come out of things like housing. That has not been the historical situation.

Mr. DERRICK. And those deficits would be inflationary.

Mr. BOSWORTH. Yes. The historical situation, however, has been that the deficit has swollen and shrunk over the business cycle in a way that there has been no historical correlation between inflation and changes in the budget deficit. Now the questions you have to ask each time are: Is there a shortage of resources? Do we have too much employment in this country?

Mr. DERRICK. We do have a shortage of resources when you have the excessive borrowing on the Federal level which causes the interest rates to go up, and then you go back into the same cycle that we ran into in 1973 and 1974, and it's all the same thing over again. Anyway, I think we understand each other on that. What about the automobile industry?

Mr. BOSWORTH. With respect to the regulations in the automobile industry, one problem is that you should never think regulation is free. You want regulation to improve the environment, and the increase in automobile prices is just a measure of that environmental cost. We are now spending about $200 to $300, per automobile, as I remember, for environmental purposes.

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I would prefer a regulatory system that says this is where I want you to go, I can't be too sure when the technology will be invented for you to do it, but here it is. If you don't meet the standard you will have to pay a tax penalty or some other penalty. However, that is not what we did.

We tried to guess how soon technology could be made available in the auto industry. In looking at the legislative history of those acts, what happened is the auto industry will come in and say, "I think it will take about 7 years to do it." You reply, "Oh, all those guys always lie a little bit, I bet they can do it faster than that, and you say 4 years instead." It turns out in 4 years they cannot do it, even though you tried to guess what technology is.

You are trying to guess what things are going to happen in the future. The alternative would have been to have had a system saying this is the environmental pollution level we wish to achieve. For every increment you are over that you are going to pay a tax. If they cannot do it, they will pay. But as soon as they can do it, they will, because they will then avoid the tax.

Mr. DERRICK. What is some other major area of regulation we have operated correctly and has resulted in tremendous savings? My time has expired.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Illinois.

Mr. SIMON. If you will get your pencil out, I have a series of questions and we are not going to have time for you to answer them, but I would like to get them in writing if I could.

One: In the whole tax reduction area, I am interested in what the impact on inflation is of a $20 billion tax reduction versus $15 billion, versus the Vanick-Pickle proposal for no additional tax reduction. Or, also in theory just the theoretical question whether it is wiser to have a general tax reduction that stimulates the economy generally or to put a specific amount into a Government program where you aim it at structural unemployment.

Two: In view of your comments on the agricultural situation, I am interested in the set-aside and what impact that has, and if this is wise, taking a look at inflation.

Three: In connection with agriculture, whether we should not be much more reliant on target prices and in the process lower the price of food.

I have suggested the possibility of the Congressional Budget Office having an inflation impact statement with every bill that emerges from a committee of the House. I would be interested in your reaction to that.

You mentioned regulations. I just had some correspondence which amazed me that shows that the environmental impact statement has increased the length of the time it takes to authorize bridge construction from 1 year to about 5 years.

I would be interested in, and I have made notes for Allen Cissell of my staff to find out whether any bridge anywhere was ever turned down for environmental impact reasons.

My guess is every bridge gets approved, but we put an automatic inflation factor in there and there are probably a lot of other structures like that.

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I think I am correct in saying Italy and the United States are the only nations that do not have either standby wage and price controls or some type of wage and price controls. Does it in theory make sense to have some standby wage and price controls and, if not, Richard Bolling this morning before this committee talked about some advanced notice on price increases. Does something like that make sense?

Finally, do you have any impression of the impact or the desirability of having off-budget agencies with their expenditures without congressional control, and the off-budget guaranteed loans? Maybe you can send me a one page letter with all of the answers to those.

Mr. BOSWORTH. I'd be happy to.

[Replies to questions by Mr. Simon may be found on page 293.]

The CHAIRMAN. Thank you very much.

Mr. SIMON. Thank you.

The CHAIRMAN. We may have some questions also for you from Mr. Obey. If so, we will get them to you and if you can respond for the record that will be helpful.

Mr. BOSWORTH. Sure.

The CHAIRMAN. We thank you very much. It has been a most helpful afternoon, Mr. Bosworth, and come back again. The committee will stand adjourned.

[Whereupon, at 3:55 p.m., the committee adjourned until Tuesday, July 12, 1978, at 10:30 a.m.]

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ECONOMIC OUTLOOK AT MID-SUMMER

WEDNESDAY, JULY 12, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:30 a.m., in room 210, Cannon House Office Building, Hon. Robert N. Giaimo, chairman of the committee, presiding.

The CHAIRMAN. The committee will please come to order.

Our witness this morning is Charles L. Schultze, Chairman of the Council of Economic Advisers. Mr. Schultze, it is a pleasure to have you appear once again before this Budget Committee. As you know, we are conducting hearings in anticipation of developing the Second Concurrent Resolution on the Budget for Fiscal Year 1979.

The committee is particularly interested in your forecast of economic developments over the next 12 to 18 months and your recommendation as to the size and composition of the tax cut that should be included in the Second Concurrent Resolution. We would also be interested in your assessment of current monetary policy. In addition, we would like your assessment of the progress toward reducing inflationary pressures under the voluntary program of wage and price control, and if that isn't enough, we want your evaluation of the impact on the economy and on Federal receipts of the Kemp-Roth and Steiger tax proposals.

We again welcome you to the committee, as always, and you may proceed as you wish.

STATEMENT OF HON. CHARLES L. SCHULTZE, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS

Mr. SCHULTZE. Thank you, Mr. Chairman. I appreciate the relatively easy assignments you have asked me to cover this morning. I trust I shall at least cover them both succinctly and to the point.

As you know, Mr. Chairman, more than 3 years have gone by since our economy touched the bottom of the worst recession of this post-war period. During those 3 years, the economy has indeed staged a notable recovery.

Let me interject, Mr. Chairman, that I will read part of my statement and submit the whole thing for the record to save some time.

The Nation's output of goods and services has increased by 16 percent over this recovery. We have made major progress against unemployment. In May 1975, 9.1 percent of the civilian labor force was out of work. In December 1976, the rate was still 7.8 percent. By last month, the rate of unemployment had fallen to 5.7 percent.

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We are now in the fourth year of economic recovery. While the pace of recovery will, and indeed should, moderate, there is no fundamental reason it cannot continue—if we pursue the appropriate budgetary and economic policies in the months and years ahead.

Unfortunately, in the battle with inflation, the record of the past 3 years is not so good. During the first half of 1975, the rate of inflation came down quickly from the double-digit pace of 1974 to a range of 6 to 6½ percent. Since then, however, there has been no fundamental improvement in the inflation situation. And since late last year, prices have been moving up at a disconcertingly rapid pace.

The challenge that confronts us is to deal with inflation in ways that do not undo our progress in promoting economic growth and reducing unemployment. Specifically with respect to the overall fiscal policies that concern this committee, we must act with prudence and caution, pursuing a budgetary course that promotes a moderate pace of economic growth. To seek a rate of economic growth substantially greater than the growth of the Nation's potential would, under current conditions, seriously court the danger of heating up inflation. But to adopt policies that severely depress the rate of economic growth would be equally unwise.

The record of the past 10 years, Mr. Chairman, demonstrates that an overheated economy will indeed accelerate inflation, but that a sluggish economy will not cure it except very, very slowly and at very great cost. Unemployment is still very high among the young, the poor, and minorities. Trying to "wring-out" inflation with economic slack would set back for years progress in bringing those individuals into the mainstream of the economy. It would also reduce business profits and sales, and discourage business firms from investing—worsening the outlook for productivity growth and so contributing to inflationary problems in the longer term future.

Let me turn specifically to the administration's recommended goals and policies for the remainder of 1978 and 1979 on page 4 of my statement.

In the January budget, the administration set as its objective real growth of our gross national product of 4.5 to 5 percent in 1978 and in 1979. In the intervening months, unemployment has declined far more rapidly than we had anticipated, while inflation has worsened. Under these circumstances, economic growth at the pace projected very early this year would probably cause the rate of unemployment to drop substantially below our current estimates, and put strong upward pressure on wage rates. Inflationary pressures in the economy might be aggravated.

We have therefore set more modest growth objectives for the period ahead. We are aiming for an overall growth rate in the economy of about 4 percent per year in 1978 and 1979. That is slightly above the longrun growth rate of the Nation's productive potential. That productive potential grows at something like 3½ percent a year.

We still can and should make gradual further progress against unemployment, but we must design our economic policies to main-

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tain rates of economic growth that do not add an element of excess demand to the inflation problem.

In cooperation with the Congress and the Budget Committees, the administration has adjusted its fiscal policy recommendations to reflect recent changes in the economic situation. We have reduced the size of the recommended tax cut by $5 billion and postponed the effective date that we recommended to January 1, 1979. This has trimmed $10 billion from the magnitude of tax reduction in fiscal year 1979.

Budget outlays, and the budget deficit, in the current fiscal year are expected to be about $11 billion lower than projected in the January budget. Outlay projections for fiscal year 1979 have also been lowered by $4½ billion, and together with the smaller tax cut, this will reduce the projected deficit in fiscal year 1979 by $12 billion.

In order to achieve this result, and this lower deficit, we urge the Congress, in its authorization and appropriation actions, to stay within the limits proposed by the President. On its part, the administration will continue to seek economies and efficiencies in the operation of Federal programs, so as to carry out the programs enacted by the Congress at the lowest possible cost to the American taxpayer.

Final decisions on the President's recommendations for the fiscal year 1980 budget will not, of course, be made until the end of the year, and will take into account economic developments over the intervening period. The prospect today indicates quite clearly that keeping economic growth along the desired path, not too much and not too little, will require that the budget deficit in 1980 will be significantly below that for 1979. To that end, the President has instructed Federal agencies, in planning their 1980 budget submissions, to reduce outlays substantially below those currently projected in the Mid-Session Budget Review, which was sent to the committees a short time ago.

Let me turn to the economic outlook for the remainder of 1978 and for 1979.

The course of fiscal policy we are now recommending to the Congress is, in our view, consistent with an economic growth rate of about 4 percent in 1978 and again in 1979. Since January, several developments besides the change in budgetary policy have been working to reduce the outlook for economic growth. The rate of inflation increased in the first half of this year. That increase was due in substantial measure to sharply rising food prices and the effects on prices of imports and the depreciation of the exchange value of the dollar. These sources of higher inflation absorb purchasing power of the majority of consumers, who must spend more of their incomes to buy food and imported goods, and who therefore have less to spend on other goods and services. So, the outlook for real personal consumption expenditures has dimmed.

The sharp rise in interest rates has also had a direct dampening effect on economic expansion by raising the cost of buying a home or making a business investment. Interest rates have risen in response to the increased credit demands that have accompanied continued growth and more rapidly rising prices, combined with

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actions by the Federal Reserve to tighten credit in an effort to hold down the growth in the monetary aggregates.

Our forecast for the rest of 1978 and for 1979 takes account of these developments. It is based on three key assumptions about economic policy:

First, that the Congress, in its actions on tax and expenditure legislation, pursues the overall fiscal policies recommended in the Mid-Session Budget Review.

Second, that conditions in the money and credit markets do not lead to a significant rise in interest rates.

Third, that the high rate of inflation in the first half of the year—which was fed by a number of special factors—eases during the second half, and that the underlying rate of inflation does not accelerate in 1979. For the second half of this year we expect economic growth to be in the 3½- to 4-percent range. Growth would weaken in 1979 in the absence of the $20 billion tax cut proposed by the administration and incorporated in the First Concurrent Budget Resolution. With it, however, growth in personal consumption and investment should be strengthened enough to maintain a growth rate of close to 4 percent again in 1979. To say that another way, Mr. Chairman, we don't have the numbers in yet for the second quarter of the year, but for the first half this year's growth should be in the neighborhood of, say, 4½ percent. Growth in the second half should be somewhat below 4 percent, perhaps 3½, 3¾ percent. With the tax cut in effect, growth would then go up a bit again in 1979, so that between putting all this together, you would have about 4-percent growth in both years with the kind of economic policies we are recommending to the Congress.

The CHAIRMAN. How do we know that is going to happen in the second year, that we are going to get a reduction which will then contribute toward bringing down the inflation rate?

Mr. SCHULTZE. Let me start by saying, Mr. Chairman, of course, that all of this is based on our best efforts to peer into the future.

The CHAIRMAN. I know.

Mr. SCHULTZE. As I indicate further on in my testimony, we have an economy—maybe I can make two characterizations of it. We are going into the fourth year of economic recovery. We have not, during this recovery, built up the kind of major distortions that in the past have often turned recovery into recession, excessive inventories, heavy speculation in raw materials, tight liquidity for business firms so they can't move. None of that has really happened. So we do have, on the one hand, the prospects for continued growth in the sense there are not any key distortions that are going to turn us off.

On the other hand, we are going into the fourth year of recovery; the unemployment rate has dropped substantially. We have got, on the one hand, to keep economic growth going, but we can't keep it growing at the same rate we had in prior years; it would just overdo it. If you put those two together, it seems to us that: (a) it is possible to continue this recovery, and (b) we need a set of fiscal policies that will help continue it, but at the relatively moderate pace.

Next, with respect to the tax cut, we are not in a world in which, barring a tax cut, tax rates would stay constant. We know there

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are increases in tax rates facing the American taxpayer, social security taxes, the impact of inflation on the tax system, and we need to offset at least a good chunk of that.

Now, you put all of this together, and it does suggest that moderation is the right course and that our economic circumstances are such as to make moderation possible—neither too much nor too little. It is admittedly a difficult line to walk, but presumably that is what we are here for, to try to put in place policies that do that.

In a way, I have covered in fairly general terms some of the specific points of the economic outlook that appear on pages 7, 8, 9, and 10 of my testimony. Let me turn, if I might, to page 11 of my testimony, where I specifically talk about unemployment and then turn to prices.

Growth of about 4 percent a year, this year and in 1979, will probably mean a gradual further reduction in the rate of unemployment. But forecasting the future course of unemployment is more difficult than usual. During the past year, even before taking into account the dramatic fall in unemployment in June, unemployment declined much further, given the growth of economic activity, than past relationships would have suggested. We do not yet know the extent to which this is a temporary phenomenon that may be reversed, or symptomatic of a more persistent new relationship. The very sharp additional decline in June simply adds to this puzzle. It is possible—although there is no hard evidence—that part of the very large decline in unemployment in June reflects a statistical aberration. Given these uncertainties, our best estimate is that the rate of unemployment will stay close to its current level for the remainder of 1978, and then drift slowly downward next year, although, admittedly, as I indicated, forecasting the unemployment rate is more difficult than usual.

Let me turn to prices. The rate of inflation began to move up late in 1977 and has accelerated further this year. From December to May, consumer prices rose at an annual rate of 10 percent and prices of producers' finished goods at a 10-percent rate in the first 6 months of the year.

The acceleration in inflation early this year is reminiscent of the experience in 1977, when rapidly rising food prices pushed up the CPI at a 9-percent annual rate in the first 6 months of the year. The increase in food prices moderated during the second half of 1977, and the overall rate of inflation therefore declined substantially. Although the sources of the latest inflationary surge are somewhat different, there is good reason to expect a repeat of last year's pattern. While any slowdown in inflation later this year would, of course, be welcome, the longer term rate of inflation will remain too high, and the risks that it will accelerate are too great to ignore. Inflation is our most serious economic problem, and dealing with it must receive top priority.

The worsening of inflation early this year stemmed to an important degree from a very rapid increase in food prices, as I indicated. From December to May, food prices at the consumer level rose at an 18½ percent annual rate.

Other special factors made modest contributions to the higher inflation rate, such as the increase in the minimum wage in Janu-

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ary and the effect on prices of imported items of the 7½-percent devaluation of the dollar which occurred in the past year.

As in 1977, the outlook for the second half of 1978 is for considerable improvement in the rate of inflation. The rise of food prices should slow substantially. Cattle prices are below their earlier peak levels. The strong production of poultry and increased output of pork in the second half are expected to moderate the rate of meat price increase for the remainder of 1978. Vegetable supplies should increase significantly as the summer crops are harvested, and prices of some of them should decline.

The contribution to inflation from other special factors should also be less in the second half of this year and in 1979. A more stable dollar in foreign exchange markets should contribute less to inflation. And, the increase in Government-mandated payroll costs will be less in 1979 than in 1978.

In stressing the role of special factors that have aggravated the rate of inflation this year, I do not mean, Mr. Chairman, to minimize the seriousness of the inflation problem. Even after all of these special factors are allowed for, some worsening in the course of inflation remains. The chief problem lies in the fact that pressures on costs of production have mounted somewhat.

The longer term trend rate of growth in unit production costs is a fundamental determinant of the underlying rate of inflation. How much the underlying rate has increased over the past year is difficult to judge, but it may have crept up from the 6- to 6½-percent range to the neighborhood of 7 percent.

Moreover, this upcreep could continue if wages and fringe benefits received by small unions and by nonunion workers rose still more rapidly in an effort to close the gap which opened up earlier between settlements won by large unions and the wages and benefits earned by others.

If an acceleration of inflation is to be avoided, it is essential that the remaining gap be closed by a significant deceleration in the rate of increase in major union contracts in the new round of collective bargaining that begins in 1979.

Let me now turn, Mr. Chairman, to the kinds of policies we must pursue to combat the serious inflation problem that confronts us. Monetary and fiscal restraint have an important role to play in this endeavor. Past experience indicates that an overheated economy leads to an acceleration of inflation, then tends to become built into the economic system.

We must therefore follow a course of policy that avoids the emergence of excess demand, which would cause prices to rise even faster than they have recently. As I indicated earlier, the degree of fiscal stimulus has been cut back for just that reason. At the present time, we are aiming for a rate of economic expansion near the growth of our longrun potential so that economic overheating will be avoided.

You may ask why, in light of the seriousness of our inflation problem, we should not slam on the fiscal and monetary brakes hard in an effort to make even greater progress in reducing inflation. But experience clearly demonstrates that this would be an ineffective route to follow.

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Slowing economic growth still more, to a pace well below the economy's potential, would have some effect on the rate of wage and price increase, but only a small one. Over the past two decades, the rate of wage and price increase has become increasingly insensitive to slack demand in the economy. In the 1969–70 recession, rising economic slack had no effect on the rate of inflation. What little moderation did occur in the rise of consumer prices in 1970 reflected developments affecting food prices. Moreover, the increase in average hourly earnings in the private nonfarm sector of the economy did not decelerate at all.

In the recession of 1974–75, the improvement which did occur on the price front appears to have been due much less to economic slack than to the termination of special factors affecting prices in 1974. Food supplies became more ample, the OPEC oil price increase worked its way through the economic system, and the one-time adjustment of wages and prices after the removal of controls finally ended. And so from the middle of 1975 until very recently, the underlying rate of inflation, despite several years of very high unemployment, remained in the 6- to 6½-percent range.

Significant reductions in the inflation rate could be accomplished today if we were willing to tolerate massive unemployment for very long periods of time. Such a policy would not only be unacceptable from the perspective of social policy, but would also complicate our efforts to curb inflation over the longer pull.

As economic growth slows excessively, the unemployment rate begins to rise. As high unemployment continues, pressures mount to inaugurate major new Federal programs to provide employment. And as capacity utilization rates fall, business profits are reduced even more than other forms of income.

Sluggish growth of sales, low utilization rates, and depressed profits discourage businesses from investments that are needed to increase productivity and to keep the Nation's capital stock growing in line with a rising labor force.

We have been through a period like this only recently, and the resulting slowdown in business investment has clearly affected our rate of productivity growth. We do not need another such period. We are better off to seek cautious, prudent policies that avoid a roller coaster of boom and bust.

For these reasons, the administration has recommended an economic policy posture that will enable us to maintain growth of output near the economy's long-term potential. Accomplishing this objective will require a tax cut next year. Otherwise, increases in social security taxes scheduled under law and the automatic increase in tax burdens that results from inflation will drag heavily on consumer spending and imperil that source of strength in the economy.

We also need a substantial business tax cut to stimulate investment, both to keep the current rate of economic growth at a satisfactory level and to provide the growth and modernization of capacity required over the long run to deal with the inflation problem.

The Federal deficit for fiscal year 1979 still is very large, even though it has been reduced by $12 billion in the most recent budgetary projections. We must work to bring that deficit down

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over time as the economy strengthens, and indeed, we expect to make substantial progress in that direction in 1980.

Mr. Chairman, as I stated, a significant reduction in business taxes is essential both to continued economic growth and to our anti-inflation effort. I would like to make clear, however, that a large reduction in capital gains taxes, as has been proposed by some Members of Congress, is not an effective substitute for the reductions in business taxes proposed by the President.

Reductions in capital gains taxes are not likely to be an efficient method of stimulating investment. Of all capital gains realized each year, about 60 percent or less can be attributed to the sale of assets that are closely related to productive enterprise. A large part of capital gains stems from sales of private homes, timber, land, jewelry, art, and similar items. Relative to reductions in the corporate income tax, increases in the investment tax credit or liberalization of depreciation, capital gains tax reductions are, therefore, a far less effective means of allocating scarce revenue resources toward the stimulation of investment.

It has been asserted that the cut in capital gains along the lines proposed by Congressman Steiger would lead to increases in stock prices as great as 20 to 40 percent, and thus provide a major spur to investment. Now, no one can predict with any confidence the impact of tax reductions on stock prices, and I am not going to try. But estimates of this magnitude border on sheer fantasy. The total reduction in taxes under Congressman Steiger's proposal, for example, would be about $2.1 billion per year, at current income levels, of which only about $500 million would accrue to holders of common stock, given the ratio of realization of capital gains on stocks to other realization of gains that we have experienced normally.

Five hundred million dollars is roughly one-half of 1 percent of the $1 trillion total value of common stock in this country. How an increase in the after-tax income equal to one-half of 1 percent of asset values is supposed to increase those values by 20 to 40 percent escapes me.

Moreover, the argument that capital gains taxes are a particularly onerous disincentive to investment is difficult to accept on the basis of the data and statistics we have. Only 10 percent of all Federal income taxes on returns to capital stems from the capital gains tax. Other taxes—including corporate profits taxes and individual income taxes on property income, dividends, and interest—account for the other 90 percent of taxes on income from capital. And while, theoretically, the maximum capital gains tax rate could be almost 50 percent, the average rate actually paid in 1976 was only about 16 percent. Even of taxpayers with more than $200,000 in adjusted gross income, the average tax paid on capital gains was only about 27½ percent. Fewer than five-hundredths of 1 percent of taxpayers reporting capital gains paid a tax as high as 40 percent on that income.

The issue, Mr. Chairman, is not whether the economy needs tax reduction designed to stimulate business investment. Such a stimulus is indeed vitally necessary. Rather, the issue revolves around the fairest and most efficient means of doing so. The administration has proposed net business tax reductions of over $5½ billion

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and total tax reductions on capital income of $7 billion. Analysis of both fairness and effectiveness in investment stimulation indicates that this approach is far superior to the kind of tax cuts incorporated in the Steiger amendment.

Mr. Chairman, in your letter to me asking me to testify, and in your opening comments, you also indicated you had some interest in an analysis of the impacts of the Kemp-Roth tax proposal. On the one hand, I have not incorporated those in my formal testimony, but, on the other hand, I do have some written analysis which I furnished to the committee this morning and would like to submit for the record. Let me summarize, if I might, what I believe that analysis would show.

[The information referred to was not submitted for the record at time of printing.]

Mr. SCHULTZE. Let me start with the fact, and I am repeating what I said in my testimony, that the American economy does need a tax reduction. It does need a tax reduction in 1979. Individuals confronted with rising social security taxes and inflation-generated increases in effective tax rates need tax relief if consumption is not to falter. Business tax relief is needed to promote greater investment.

The administration has proposed a $20 billion reduction effective January 1, 1979. Depending upon the course of private economic activity, additional tax reductions may be necessary in later years. So the question at issue is not whether tax reduction is needed but the appropriate size and timing of the cut.

The Kemp-Roth proposal would enact a 3-year tax cut that would reduce taxes by about $30 billion in 1979, and build to a $110 to $120 billion rate of tax reduction by 1981. Committing the Federal Government now to a tax cut of such dimensions is, I think, a sure-fire recipe for inflation. What the effects of the Kemp-Roth proposal would be on economic activity and prices is a matter of some dispute. Congressman Kemp, in testimony before the House Ways and Means Committee, presented simulations from an econometric model suggesting that his proposal would increase the annual rate of GNP growth over a 10-year period by only 0.13 percentage points—about one-tenth of 1 percent—a year but would increase the rate of consumer price inflation by 1 percentage point per year by 1982. Moreover, these simulations suggested that the Federal deficit would rise to $90 billion—3½ percent of GNP—by 1980. Some proponents of the Kemp-Roth proposal claim that, because it would unlock private incentives and thereby increase productive capacity, the national income would rise so much that the tax cut would actually increase, rather than decrease Federal revenues.

Let me first examine this latter claim that we get a free lunch, in effect. Let me start first by noting that the Kemp-Roth tax proposal, when fully in effect in 1981, would cut the Federal revenue yield $110 billion to $120 billion. As a rough rule-of-thumb, Mr. Chairman, at the new, lower tax rates in the Kemp-Roth proposal, it would take about a $5 increase in GNP to generate $1 of additional revenues. There is a 20-percent relationship. So, if you cut taxes by $110 billion, you would have to have a $550 billion increase in GNP to generate enough revenue to give us a free lunch, that is, to make it all up. That is about a 20-percent increase in

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what the GNP is likely to be in 1981, give or take a little. Estimates are not that certain, but an 18- to 22-percent increase in GNP is required.

Now, traditional analysis of the effects of economic policy do indicate that $1 of tax cut will give you more than $1 of the money value of GNP. The typical analyses incorporated in virtually all the major economic models suggest it is $2. That is, for $1 tax cut, you may get back $2 in additional value of GNP. The Kemp-Roth proposal, in order to raise GNP enough to make it back, would require that number to be five, which is out of line with any estimates I have seen of the impact of taxes on GNP. But let's say you did cut taxes by 1981 by $110 billion to $120 billion, and you got it back in the sense that you had a $550 billion increase in the demand for goods and services. What would that do?

Well, it is fairly clear that unless there were substantial slack in the economy to be made up—substantial excess capacity and substantial unemployment—this magnitude of increase in GNP, 20-percent in the demand for goods and services, would have to be matched by a 20-percent increase in the supply of goods and services. Suppose for generosity that we assume there would be 3- or 4-percent slack in the economy by 1981, so you could get 3 or 4 percent additional supply out of using up the slack. You would still have to increase supply of goods and services by 15 percent through this tax cut in order to get a free lunch—that is, in order to get GNP up enough without inflation, in order to pay back the taxes.

What is the possibility of a tax cut increasing the supply of goods and services, the capacity in the economy, by 15 percent? There are only two ways you can do it logically. You can increase the supply of labor. Because of the lower taxes, people could work longer hours, or more people could come into the labor force. That is one way of doing it. But, virtually everything we know about the response of the labor force to higher income suggests this is highly unlikely. The Kemp-Roth tax cut would add about 5 percent to the average income of the average worker.

In the past, as income has risen quite logically over long periods of time, working hours have been reduced as people took out some of their increased living standards in more leisure. So, to suggest there would be a big burst of additional labor input on account of a 5-percent increase in after-tax income, flies in the face of experience.

But let me assume, again to be generous, that this 15-percent increase in supply is made up partly by a 5-percent increase, which is a big increase, in the hours of work or of the total labor effort, if you will, put in the economy. I still have to get 10 percent addition to supply out of higher productivity.

So the Kemp-Roth tax cut would cut taxes by $110 billion. The proponents claim you would get enough GNP increase to get it back, that is, $550 billion times 20 percent. Being very generous all the way across the board, I come down to the bottom line, I have to have a 10-percent increase in productivity in a 3-year period because of higher investments in order to make that possible.

Now, we do have a lot of economic estimates from a lot of analyses on how much increase in investment it would take to get a 10-percent increase in productivity in our economy. Remember

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that productivity grows about 2 percent a year. How much would it take over a 3-year period to get another 10 percent? What these analyses show is, first, in 3 years it is physically impossible. The point is that designing, planning, ordering, installing, and breaking in new plants and equipment, on a big scale is more than can be done in 3 years.

I am going to be generous again. Let's give them 10 years. How much investment would be needed to increase productivity by 10 percent over a 10-year period? It turns out, using average estimates of the relationship that you would have to double the share of investment in GNP in order to do it, from 10 percent of GNP to 20 percent of GNP or about a $200 billion increase in the annual rate of investment.

It seems to me when you go through all these assumptions, Mr. Chairman, it is clear, first, that there is nothing in the economic evidence to suggest the demand for goods and services would increase by five times the size of the tax cut, but, second, even if it did, the impact of that kind of increase in the demand for goods and services would be incredibly inflationary unless supply rose to meet it, and all the evidence indicates there is absolutely no likelihood of that. What you can therefore be sure of is that this proposal would be very substantially inflationary. It wouldn't increase GNP by any $550 billion. It would, however, increase the demand for goods and services maybe by a $200 billion. No question, put $110 billion back in the people's pockets, and you would get a big increase in the demand for goods and services, only partly matched, because it is so huge, by an increase in supply. With that you would have yourself in a real inflation.

Now, again, let me close as I began; this is not a debate about whether this economy needs a tax cut. It needs one; the administration proposed one; the Budget Committees have it included in their budget resolution. Whatever the kind of arguments between the administration and the House Ways and Means Committee, they are also planning and proposing a significant tax cut. That isn't the question. The question is how big, and, more importantly, whether it is wise to commit ourselves now for an uncertain future to a huge tax cut 3 years down the way in the hope, which cannot be supported by economic analysis, that it will somehow unlock such a cornucopia of additional capacity and supply that it won't be inflationary. I should suggest it would be highly improper to make such a commitment.

Thank you, Mr. Chairman.

[Testimony resumes on p. 90.]

[The prepared statement of Mr. Schultze follows:]

PREPARED STATEMENT OF HON. CHARLES L. SCHULTZE

Good morning, I am pleased to appear before this committee today to discuss the economic outlook for the rest of 1978 and for 1979, and to outline for you the administration's recommendations on budgetary and fiscal policies.

More than 3 years have elapsed since the American economy touched the bottom of the worst recession of the postwar period. During the past 3 years, our economy has staged a notable recovery.

The Nation's real output of goods and services has increased by 16 percent. We have made major progress against unemployment. In May 1975, 9.1 percent of the civilian labor force was out of work. In December 1976, the rate was still 7.8 percent. By last month, the rate of unemployment had fallen to 5.7 percent.

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The utilization of our Nation's industrial plant has also improved—rising from 70 percent in early 1975 to 84 percent recently. Per capita disposable income, after adjustment for inflation, has risen by 13 percent, and business profits have increased substantially.

We are now in the fourth year of economic recovery. While the pace of recovery will, and indeed should moderate, there is no fundamental reason it cannot continue—if we pursue the appropriate budgetary and economic policies in the months and years ahead.

Unfortunately, in the battle with inflation, the record of the past 3 years is not so good. During the first half of 1975, the rate of inflation came down quickly from the double-digit pace of 1974 to a range of 6 to 6½ percent. Since then, however, there has been no fundamental improvement in the inflation situation. And since late last year, prices have been moving up at a disconcertingly rapid pace.

Inflation is the most serious economic problem we face today. It creates major inequities, since some people and groups have far less protection against it than others. As inflation has remained high in the United States—indeed increased in recent months—while continuing to fall in many other industrial countries, downward pressure is exerted on the exchange value of the dollar. Most importantly, we must make better progress against inflation as a prerequisite to continuation of strong economic recovery.

The challenge that confronts us is to deal with inflation in ways that do not undo our progress in promoting economic growth and reducing unemployment. Specifically with respect to the overall fiscal policies that concern this committee, we must act with prudence and caution, pursuing a budgetary course that promotes a moderate pace of economic growth. To seek a rate of economic growth substantially greater than the growth of the Nation's potential would, under current conditions, seriously court the danger of heating up inflation. But to adopt policies that severely depress the rate of economic growth would be equally unwise.

The record of the last decade demonstrates that an overheated economy will indeed accelerate inflation but that a sluggish economy will not cure it except very, very slowly and at very great cost. Unemployment is still very high among the young, the poor, and minorities. Trying to "wring-out" inflation with economic slack would set back for years progress in bringing those individuals into the mainstream of the economy. It would also reduce profits and sales, and discourage business firms from investing—worsening the outlook for productivity growth and so contributing to inflationary problems in the longer term future.

By exerting a drag on the growth of world trade, a weak U.S. economy would also undermine prospects for sustaining the fragile and incomplete recovery abroad. Slow growth in foreign economies, in turn, would dim the outlook for our export markets, and heighten still further the pressures for protectionism that are building across the globe.

Economic policies in the period ahead, therefore, must aim to keep us on a course that is consistent over the long run with steady and sustainable improvement in the health of the overall economy. Let me turn now to the goals and policies the administration recommends to achieve that objective.

GOALS FOR 1978 AND 1979

In the January budget, the administration set as its objective real growth in GNP of 4.5 to 5 percent in 1978 and in 1979. In the intervening months, unemployment has declined far more rapidly than we had anticipated, while inflation has worsened. Under these circumstances, economic growth at the pace projected early in 1978 would probably cause the rate of unemployment to drop substantially below our current estimates, and put strong upward pressure on wage rates. Inflationary pressures in the economy might be aggravated significantly.

We have therefore set more modest growth objectives for the period ahead. We are aiming for an overall growth rate of about 4 percent per year in 1978 and 1979. That is slightly above the longrun growth rate of the Nation's productive potential, which is about 3½ percent a year. We still can and should make gradual further progress against unemployment, but we must design our economic policies to maintain rates of economic growth that do not add an element of excess demand to the inflation problem.

In cooperation with the Congress and the Budget Committees, the administration has adjusted its fiscal policy recommendations to reflect recent changes in the economic situation. We have reduced the size of the recommended tax cut by $5 billion and postponed the effective date to January 1, 1979. This has trimmed $10 billion from the magnitude of tax reduction in fiscal year 1979. Outlays, and the budget deficit, in the current fiscal year are expected to be about $11 billion lower

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than projected in the January budget. Outlay projections for fiscal year 1979 have been lowered by $4½ billion, and together with the smaller tax cut, this will reduce the projected deficit in fiscal year 1979 by $12 billion. In order to achieve this result, we urge the Congress in its authorization and appropriation actions to stay within the limits proposed by the President. On its part, the administration will continue to seek economies and efficiencies in the operation of Federal programs, so as to carry out the programs enacted by the Congress at the lowest possible cost to the American taxpayer.

Final decisions on the President's recommendations for the fiscal year 1980 budget will not of course be made until the end of the year, and will take into account economic developments over the intervening period. The prospect today indicates quite clearly that keeping economic growth along the desired path will require that the budget deficit in 1980 be significantly below that for 1979. To that end, the President has instructed Federal agencies, in planning their 1980 budget submissions, to reduce outlays substantially below those currently projected in the Mid-Session Budget Review.

THE ECONOMIC OUTLOOK FOR 1978 AND 1979

The course of fiscal policy that we now are recommending to the Congress is, in our view, consistent with an economic growth rate of about 4 percent in 1978 and again in 1979. Since January, several developments besides the change in budgetary policy have been working to reduce the outlook for economic growth. The rate of inflation increased in the first half of this year. That increase was due in substantial measure to sharply rising food prices and the effects on prices of imports of the depreciation of the dollar. These sources of higher inflation absorb purchasing power of the majority of consumers, who must spend more of their incomes to buy food and imported goods, and who therefore have less to spend on other goods and services. As a result, the outlook for real personal consumption expenditures has dimmed.

The sharp rise in interest rates has also had a direct dampening effect on economic expansion by raising the cost of buying a home or making a business investment. Rates have risen in response to the increased credit demands that have accompanied continued growth and more rapidly rising prices, combined with actions by the Federal Reserve to tighten credit in an effort to hold down the growth in the monetary aggregates.

Our forecast for the rest of 1978 and for 1979 takes account of these developments. It is based on three key assumptions about economic policy:

First, that the Congress, in its actions on tax and expenditure legislation, pursues the overall fiscal policies recommended in the Mid-Session Budget Review.

Second, that conditions in the money and credit markets do not lead to a significant rise in interest rates.

Third, that the high rate of inflation in the first half of the year—which was fed by a number of special factors—eases during the second half, and that the underlying rate of inflation does not accelerate in 1979.

Due to the cold winter weather, the effects of the coal strike, and other special factors, the economy did not grow at all in the first quarter of 1978. But all the indicators suggest a strong rebound in the second quarter, with real GNP growing at an annual rate of 8 to 9 percent. Much of the second quarter's strong performance represents a makeup of first quarter losses, and recent data suggest that much of the bulge in growth associated with this makeup process is already behind us.

We expect the rate of growth in the second half of this year to be in the 3½- to 4-percent range, or somewhat slower than the average of the first two quarters. Growth would weaken further in 1979 in the absence of the $20 billion tax cut proposed by the administration, and incorporated in the First Concurrent Budget Resolution. With it, however, growth in personal consumption and investment should be strengthened enough to maintain a growth rate of close to 4 percent again in 1979.

By early next year, the recovery from the 1975 recession will be 4 years old. Some analysts have questioned whether it is realistic to suppose that recovery can be stretched into a fifth year. Past experience does suggest that recoveries tend to lose momentum as they age. In this recovery, as in earlier ones, consumers have added to their stocks of durable goods, and in the process have increased their installment debts. Backlogs of housing demand have been reduced, and mortgage debt has risen. With less thrust from these two critical sectors, growth in the recovery is slowing. But that process does not imply that a recession is just around the corner, or even that growth must slowup unduly.

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During the current upswing we have generally avoided the kinds of major imbalances that, in the past, often have brought recoveries to an end. Inventories today are lean. The ratio of inventories to final sales of businesses at the end of 1977 was the lowest in over a decade.

The overhang of apartments and offices that glutted the market 4 or 5 years ago has largely been eliminated, and vacancy rates for apartments today are unusually low. Nonfinancial corporations are less liquid today than a year or two ago, but distortions in balance sheets that undermined corporate health in the early 1970's have not been a significant problem in this recovery.

Finally—aside from some residential building materials—there are no major signs of bottlenecks or shortages that could lead to hoarding of raw materials and skyrocketing prices for materials and finished goods. The rise in unfilled orders for durable goods has been moderate; in fact, the ratio of such orders to shipments of durable goods is about as low now as at any time since mid-1964.

Thus, the prospects remain good that economic growth can continue at a moderate but satisfactory pace. Business investment should be an important source of thrust to the economy. The most recent survey by the Commerce Department of business intentions to invest implies an investment increase in 1978 of about 5 to 5½ percent, after adjustment for inflation. Other indicators suggest a somewhat larger rise. New orders and contracts for new plant and equipment have been strong in the early months of 1978—some 11 percent above 1 year ago, adjusted for inflation. Capital appropriations of manufacturing firms have also remained strong. The substantial cut in business taxes proposed by the administration should strengthen business profits and investment plans in 1979.

Personal consumption expenditures also should continue to rise at a healthy 4-percent rate next year, about in line with growth in the overall economy. The individual tax reductions proposed for 1979 will strengthen consumers' purchasing power. And the impact of rising food prices and of the depreciation of the dollar on consumer buying should be lessened as those sources of inflation moderate in the period ahead. The personal saving rate has returned to about a normal level by historical standards. A modest increase in the saving rate could occur next year, but we see no reason to expect a major shift in consumers' savings patterns. Consumer confidence, although it has declined somewhat, is still quite high. While consumer spending will not be a major source of new thrust to growth, the evidence does not suggest a significant weakening in consumer spending is on the horizon.

Some decline in housing starts and in residential construction is likely later this year and in 1979, given current levels of mortgage interest rates. Mortgage lending institutions are in a stronger financial position now, however, than they were in previous periods of cyclical expansion when rising market interest rates dried up the inflow of savings. Moreover, the demand for housing remains strong. Therefore, given the maintenance of roughly current monetary conditions a sharp decline in housing starts is unlikely, and the strength of business investment and personal consumption should provide for a relatively healthy economy late this year and in 1979.

Growth of about 4 percent per year in 1978 and 1979 probably will mean a gradual further decline in the rate of unemployment. Forecasting the future course of unemployment, however, is more difficult than usual. During the past year—even before taking into account the dramatic fall in unemployment in June—unemployment declined much further, given the growth of economic activity, than past relationships would have suggested. We do not yet know the extent to which this is a temporary phenomenon that may be reversed, or symptomatic of a more persistent new relationship. The very sharp additional decline in June simply adds to the puzzle. the unemployment data are based on a *household* survey of employment and unemployment. Independent data on the June employment increase, based on a survey of *business firms* showed a much smaller rise in employment than that shown in the household survey. It is possible—although there is no hard evidence—that part of the very large decline in unemployment in June reflects a statistical aberration. Given these uncertainties, our best estimate is that the rate of unemployment will stay close to its current level for the remainder of 1978, and then drift slowly downward next year.

The marked improvement in the unemployment picture over the past year is a welcome contribution to achieving our most important economic and social objectives. But it has occurred in large measure because of disappointingly small increases in productivity—a development that, if it continues, would add to costs and complicate an already serious inflation problem.

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THE OUTLOOK FOR PRICES

The rate of inflation began to move up late in 1977 and has accelerated sharply further this year. From December to May, consumer prices rose at an annual rate of 10-percent, and prices of producer finished goods rose at a 10-percent annual rate in the first 6 months of this year.

The acceleration in inflation early this year is reminiscent of the experience in 1977, when rapidly rising food prices pushed up the CPI at a 9-percent annual rate in the first 6 months of the year. The increase in food prices moderated during the second half of 1977, and the overall rate of inflation therefore declined substantially. Although the sources of the latest inflationary surge are somewhat different, there is good reason to expect a repeat of last year's pattern. While any slowdown in inflation later this year would, of course, be welcome, the longer term rate of inflation will remain too high, and the risks that it will accelerate are too great to ignore. Inflation is our most serious economic problem, and dealing with it must receive top priority.

The worsening of inflation early this year stemmed to an important degree from a very rapid increase in food prices. From December to May, food prices at the consumer level rose at an 18½-percent annual rate. Meat prices rose substantially, in part because the long period of reducing our beef cattle herds was coming to an end and some increase in price was necessary to encourage cattle ranchers to rebuild herds. Other meat prices rose as consumers switched from beef to less expensive meats. The price of pork was driven up further when unexpectedly cold winter weather reduced prospective pork supplies for 1978. Cold and rainy weather in California during the winter and spring also adversely affected prices and supplies of fruits and vegetables.

Other special factors made modest contributions to the higher inflation rate, such as the increase in the minimum wage in January and the effect on prices of imported items of the 7½-percent devaluation of the dollar which occurred in the past year.

As in 1977, the outlook for the second half of 1978 is for considerable improvement in the rate of inflation. The rise of food prices should slow substantially. Cattle prices are below their earlier peak levels. Moreover, strong production of poultry and increased output of pork in the second half are expected to moderate the rate of meat price increase for the remainder of 1978. Vegetable supplies should increase significantly as the summer crops are harvested, and prices of some of them should decline. Major grain and feed crops—such as wheat, corn and soybeans—are in relatively good supply this year, and prices for those crops should be increasing less rapidly as the year proceeds.

The contribution to inflation from other special factors should also be less in the second half of this year and in 1979. A more stable dollar in foreign exchange markets should contribute less to inflation. Moreover, the increase in Government-mandated payroll costs will be less in 1979 than in 1978.

In stressing the role of special factors that have aggravated the rate of inflation this year, I do not mean to minimize the seriousness of the inflation problem. Even after all of these special factors are allowed for, some worsening in the course of inflation remains. The chief problem lies in the fact that pressures on costs of production are mounting.

A year ago, unit costs of production were rising at an annual rate of around 6 to 6½ percent. Since then, the average rate of wage increase appears to have risen by one-half of a percentage point. Productivity growth, meanwhile, has been very disappointing.

The longer term trend rate of growth in unit production costs is a fundamental determinant of the underlying rate of inflation. How much the underlying rate has increased over the past year is difficult to judge, but it may have crept up from the 6- to 6½-percent range to the neighborhood of 7 percent. Moreover, this upcreep could continue if wages and fringe benefits received by small unions and by nonunion workers rose still more rapidly in an effort to close the gap which opened up earlier between settlements won by large unions and the wages and benefits earned by others. If an acceleration of inflation is to be avoided, it is essential that the remaining gap be closed by a significant deceleration in the rate of increase in major union contracts in the new round of collective bargaining that begins in 1979.

ECONOMIC POLICY AND THE INFLATION PROBLEM

Let me now turn specifically to the kinds of policies we must pursue to combat the serious inflation problem that confronts us. Monetary and fiscal restraint have an important role to play in this endeavor. Past experience indicates that an overheated economy leads to an acceleration of inflation then tends to become built

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into the economic system. We must therefore follow a course of policy that avoids the emergence of excess demand, which would cause prices to rise even faster than they have recently. As I indicated earlier, the degree of fiscal stimulus has been cut back for just that reason. At the present time, we are aiming for a rate of economic expansion near the growth of our longrun potential so that economic overheating will be avoided.

You may ask why, in light of the seriousness of our inflation problem, we should not slam on the fiscal and monetary brakes in an effort to make greater progress in reducing inflation. Experience clearly demonstrates that this would be an ineffective route to follow.

Slowing ecomomic growth still more, to a pace well below the economy's potential, would have some effect on the rate of wage and price increase, but only a small one. Over the past two decades, the rate of wage and price increase has become increasingly insensitive to slack demand in the economy. During the course of the 1948–49 recession, rising unemployment led to a very sharp reduction in the rate of wage increase in manufacturing. Consumer prices stopped rising altogether and actually fell somewhat. In the years since 1949, the responsiveness of wages and prices to economic slack has gradually weakened. In the 1969–70 recession, rising economic slack had no effect on the rate of inflation. What little moderation did occur in the rise of consumer prices in 1970 reflected developments affecting food prices. Moreover, the increase in average hourly earnings in the private nonfarm sector of the economy did not decelerate at all.

In the recession of 1974–75, the improvement on the price front appears to have been due much less to economic slack than to the termination of special factors affecting prices in 1974. Food supplies became more ample, the OPEC oil price increase worked its way through the economic system, and the one-time adjustment of wages and prices after the removal of controls finally ended. From the middle of 1975 until very recently, the underlying rate of inflation, despite several years of very high unemployment, remained in the 6 to 6½ percent range.

Significant reductions in the inflation rate could be accomplished today if we were willing to tolerate massive unemployment for very long periods of time. Such a policy would not only be unacceptable from the perspective of social policy, but also complicate our efforts to curb inflation over the longer run. As economic growth slows below potential, the unemployment rate begins to rise. As high unemployment continues, pressures mount to inaugurate major new Federal programs to provide employment. And as capacity utilization rates fall, business profits are reduced even more than other forms of income. Sluggish growth of sales, low utilization rates, and depressed profits discourage businesses from investments that are needed to increase productivity and to keep the Nation's capital stock growing in line with a rising labor force. We have been through a period like this only recently, and the resulting slowdown in business investment has clearly affected our rate of productivity growth. We do not need another such period. We are far better off to seek policies that avoid a roller coaster of boom and bust.

For these reasons, the administration has recommended an economic posture that will enable us to maintain growth of output near the economy's long-term potential. Accomplishing this objective, however, will require a signficant tax cut next year. Otherwise, increases in social security taxes scheduled under law and the automatic increase in tax burdens that results from inflation will drag heavily on consumer spending and imperil that critical source of strength in the economy. We also need a substantial business tax cut to stimulate investment, both to keep the current rate of economic growth at a satisfactory level and to provide the growth and modernization of capacity required over the long run to deal with the inflation problem.

The Federal deficit for fiscal year 1979 still is very large, even though it has been reduced by $12 billion in the most recent budgetary projections. We must work to bring the deficit down over time as the economy strengthens. The speed with which this can be accomplished, while maintaining satisfactory economic growth, will depend heavily on developments in other sectors. Last year, State and local governments reported an aggregate budget surplus of $30 billion. Moreover, our current account deficit of international payments was $15 billion. In total, the flow of income to State and local governments and abroad was $50 billion greater than the return flow of spending from these sectors back into the income stream. The unprecedented size of these withdrawals put a large burden on the Federal budget to help maintain economic growth. As these huge withdrawals from the spending stream gradually decline, as they are expected to do, it will be possible, and indeed necessary, to move toward a balanced Federal budget in order to meet our desired growth objectives. We expect to make substantial progress in that direction in fiscal year 1980.

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I stated earlier that a significant reduction in business taxes is essential both to continued economic growth and to our anti-inflation effort. I would like to make clear, however, that a large reduction in capital gains taxes, as has been proposed by some Members of Congress, is not an effective substitute for the reductions in business taxes proposed by the President.

Reductions in capital gains taxes are not likely to be an efficient method of stimulating investment. Of all capital gains realized each year, about 60 percent or less can be attributed to the sale of assets that are closely related to productive enterprise. The bulk of capital gains stems from sales of private homes, timber, land, jewelry, art, and similar items. Relative to reductions in the corporate income tax, increases in the investment tax credit, or liberalization of depreciation, capital gains tax reductions are, therefore, a far less effective means of allocating scarce revenue resources toward the stimulation of investment.

It has been asserted that the cut in capital gains along the lines proposed by Congressman Steiger would lead to increases in stock prices as great as 20 to 40 percent, and thus provide a major spur to investment. No one can predict with any confidence the impact of tax reductions on stock prices. But estimates of this magnitude border on sheer fantasy. The total reduction in taxes under Congressman Steiger's proposal, for example, would be about $2.1 billion per year, at current income levels, of which only about $500 million would accrue to holders of common stocks. Five hundred million dollars is roughly *one-half of 1 percent* of the $1 trillion total value of common stock in this country. How an increase in the after-tax income equal to one-half of 1 percent of asset values is supposed to increase those values by 20 to 40 percent escapes me.

Moreover, the argument that capital gains taxes are a particularly onerous disincentive to investment is difficult to accept. Only 10 percent of all Federal income taxes on returns to capital stems from the capital gains tax. Other taxes—including corporate profits taxes and individual income taxes on property income, dividends, and interest—account for the other 90 percent. And while theoretically the *maximum* capital gains tax rate could be almost 50 percent, the *average* rate actually paid in 1976 was only about 16 percent. Even for taxpayers with more than $200,000 in adjusted gross income, the average tax paid on capital gains was only about 27½ percent. Fewer than five-hundredths of 1 percent of taxpayers reporting capital gains paid a tax as high as 40 percent on that income.

Reductions in capital gains taxes of the kind that have been proposed would be of major benefit to a few wealthy individuals. Under the plan proposed by Congressman Steiger, four-fifths of the tax reduction would go to taxpayers with expanded incomes (i.e., adjusted gross plus items of tax preference) greater than $100,000. Some 3,000 beneficiaries of this proposal, with $1 million or more of income, would receive an average tax reduction of $214,000 each. That is an exorbitant price to pay for a tax incentive that would do little to stimulate investment, or to relieve a tax that, when examined carefully, is not all that burdensome.

The issue is *not* whether the economy needs tax reduction designed to stimulate business investment. Such a stimulus is indeed vitally necessary. Rather, the issue revolves around the fairest and most efficient means of doing so. The administration has proposed net business tax reductions of over $5½ billion and total tax reductions on capital income of $7 billion. Analysis of both fairness and effectiveness in investment stimulation indicates that this approach is far superior to the kind of tax cuts incorporated in the Steiger amendment.

OTHER POLICY CONCERNS

My testimony today has focused principally on the macroeconomic policies needed to reach our economic objectives. Macroeconomic policies alone, however, are not enough. Unless they are supplemented with other programs targeted at specific problems, inflation will continue at much too high a rate, and structural unemployment will not be reduced appreciably.

Solutions to these problems do not generally fall under the purview of this committee, so I will keep my comments on them brief. But a few words on the other components of the administration's approach to combating inflation and reducing unemployment are in order.

I have already stated that getting control of inflation is the most critical problem that our Nation faces today. Prudent fiscal and monetary policies are essential to avoid economic overheating, but they are not an effective means of reducing the underlying inflation rate we have inherited from the past. The President's deceleration program is the best vehicle to do this. In the early months of this program, we have received considerable support from the business community. As the year progresses, of course, more and more businesses will face the difficult decisions they

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must take to meet the deceleration standard, and we will be monitoring price developments very closely.

The growth of wage costs must also be decelerated. In particular, we cannot realistically hope to achieve our goals for the economy unless the gap that has opened between the earnings of workers in large unions and workers in the rest of the economy is closed through greater wage restraint on the part of large unions, rather than through faster increases in the wages of other workers in the economy.

We also must press forward with programs to address the problem of structural unemployment. In the President's budget in January, we proposed a series of initiatives to address the needs of the young and the unskilled workers who must be assisted in gaining the skills they need to join permanently the ranks of the employed. Since January, the Labor Intensive Public Works program and the new employment tax credit proposed as part of the President's Urban Initiative offer additional ways to address this debilitating problem. We will have to move gradually if we are not to put too much pressure on the overall economy, but we must not, and will not, turn our backs on those whose chances for employment are still discouragingly low.

The CHAIRMAN. How would you distinguish the Kemp-Roth proposal from the Kennedy-Johnson tax cut and the economic conditions at that time? What are the differences?

Mr. SCHULTZE. Two big distinctions: The Kemp-Roth is a larger tax cut. Second, taking place in an economy with much less slack in it. The Kennedy-Johnson tax cut was smaller. The Kennedy-Johnson tax cut was larger than the cut the administration is proposing now but a good bit smaller than the Kemp-Roth.

Second, it took place in an economy with a good bit more room and slack in it. And finally, it took place in an economy with the rate of inflation running 1½ to 2 percent, where we are dealing with an economy in which you have to walk a much more careful line because of the rate of inflation we are facing. Therefore, I would say for all three of those reasons there is a very large difference between the two.

The CHAIRMAN. Thank you. In your testimony——

Mrs. HOLT. Mr. Chairman, could I ask one question right with the question you just asked about the Kennedy-Johnson tax cut?

What was the GNP then? You say it was a very small tax reduction, but, as I recall it, it was roughly comparable percentagewise.

Mr. SCHULTZE. It was about 2 percent of GNP.

Mrs. HOLT. And what are we talking about here?

Mr. SCHULTZE. We are talking now something that would be just about, when the Kemp-Roth would be fully in effect, just about double that in an economy with much higher inflation and much less slack.

Mrs. HOLT. What is the slack we are talking about?

Mr. SCHULTZE. What I am talking about is excess capacity.

Mrs. HOLT. What is our excess capacity?

Mr. SCHULTZE. We would suggest that perhaps now there might be 4-percent slack. But if you move too quickly to remove it, that would be inflationary. It is the amount of slack and how fast you move to remove it. Don't get me wrong. I do not suggest that we don't need not only the tax cut this year, but in future years additional tax cuts. There is no question of it. What I question is whether or not under current circumstances it is wise to commit ourselves now in law to this phasing in of that size tax cut in this economy. That is my point.

Mrs. HOLT. Thank you, Mr. Chairman.

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The CHAIRMAN. You are saying with the slack in the economy that we are presently at about 83 percent of capacity?

Mr. SCHULTZE. On industrial capacity, that is right.

The CHAIRMAN. And the ideal would be about 87 percent?

Mr. SCHULTZE. Somewhere between 87 and 89 percent; something like that.

The CHAIRMAN. That would be full capacity?

Mr. SCHULTZE. But it is also labor force. There are two parts to capacity; the room you have to expand your employment without putting upward pressure on wage rates and expanding the industrial use.

The CHAIRMAN. On page 3, you say that we must act to promote "a moderate pace of economic growth. To seek a rate of economic growth substantially greater than the growth of the Nation's potential would * * * seriously court the danger of heating up inflation."

And then on page 4, you say, "We are aiming for an overall growth rate of about 4 percent in 1978 and 1979." On page 16, you say, "We must, therefore, follow a course of policy that avoids the emergence of excess demand which would cause prices to rise even faster than they have recently."

How are we doing these things, through tightening monetary policy or reduction of stimulus, reduction of Federal spending? What are the plans of the administration to accomplish this end? Also, bring in the monetary situation and the relationships with the Federal Reserve. What are we doing in this area?

Mr. SCHULTZE. What the administration has proposed, and what is incorporated in the First Concurrent Resolution, very roughly, is a fiscal policy with a tax reduction of a size which would be calculated to keep the economy going as far as budgetary policy is concerned, to put enough additional money in consumer pockets to keep the economy going at that moderate rate.

Compared to recommendations early in the year, the fiscal stimulus that has been recommended has been reduced for the reasons I indicated but not eliminated. So that is No. 1.

No. 2, you have to put it in the context of the fact I mentioned earlier that other taxes are rising, and so we are trying to balance these off to give us the tax reduction, on the one hand, against the tax increases that will occur because of social security and inflation, to give us about the right growth.

Second, the interest rates and monetary conditions have tightened over the last 6 months, and that will tend to hold the rate of growth down some. Our projections are based on the assumption that the current degree of tightness remains roughly the same. I am not trying to call it to a decimal point, but that it remains roughly the same. We think the combination of that would give us this moderate, responsible, satisfactory rate of growth under the circumstances we are now in.

Let me note several things. For example, in the latest midyear budget review in reestimating expenditures in line with current experience and the administration's budget proposals, we come to an expenditure estimate for 1979 of $496.5 billion, I believe it is. That is below the estimate of expenditures contained in the First Concurrent Budget Resolution, not so much because of estimating

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differences, but because there are some policy differences. And so if the full policy of the budget resolution were carried out and estimates remain the same of the spending rate, spending would be slightly higher than what is in the midyear budget review.

But on the assumption of those midyear budget review figures, on the tax side and expenditure side, we think that will be about the right rate of growth.

The CHAIRMAN. Thank you very much. Mr. Stokes?

Mr. STOKES. Thank you, Mr. Chairman.

Mr. Schultze, you cite the fact that unemployment has been reduced from 9.1 percent to its current figure of 5.7 percent. You do not appear to be able to tell us in your testimony, however, the precise factors that have culminated in order to bring about this reduction in unemployment in the economy. At the same time, you cite the fact that unemployment is still very high among our young, our poor, and our minorities. Can you explain for us what factors operate in the economy that would cause this kind of a reduction to take place, and yet, at the same time, has had very little, if any, impact upon unemployment among these three groups?

Mr. SCHULTZE. Mr. Stokes, I will try. We have to admit that we have large areas of ignorance in some of this, but let me try.

First, there has been a reduction in unemployment among disadvantaged groups. The problem, however, is that it was so very, very high to start with; so even after that reduction it remains high. That is No. 1. There has been some reduction but not enough.

Second, one of the points of import of my testimony is that in the reduction of unemployment to date there have been several factors involved. First, the rate of expansion of the overall economy, which generates more jobs. Second, specific programs targeted at those groups of unemployed whose unemployment rate is very high, public service employment, youth employment measures, and the like—that has also been a factor.

In the period ahead we are going to have to rely more on those targeted measures and somewhat less on just simple overall economic expansion because now more and more we have to target our efforts at getting the rate of unemployment lower among groups where that rate remains very high. And we also have, finally, to remember if we really want to make this successful over the long run it can't be just Government hiring. We have to get the private sector more interested in hiring from those groups, and, therefore, among other proposals the President has made this year, was the significant new proposal for tax incentives to employers explicitly to hire from among the disadvantaged, as a step—I don't claim it is going to be the only thing needed over the years ahead—but as an initial step in trying to get this done.

In summary, therefore, you are quite right where we have ended up with respect to unemployment; among black youth, in particular, it is still scandalously high. It has come down some, but it started so very high that even after coming down some, not a lot, we still have a lot of work to do on that, not just through the overall expansion of the economy but by targeted measures.

Mr. STOKES. Referencing the latter part of your reply, I see how the President's urban policy proposal, with built-in tax incentives

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for the purposes of hiring the disadvantaged, might be a vehicle that can be utilized in order to reduce unemployment. I have some difficulty, however, understanding how, if we use the administration's approach of an overall tax cut for business, we can be assured that such a tax cut would be utilized for the same purpose as would tax incentives.

Mr. SCHULTZE. In the first place, it won't, Mr. Stokes, in the sense it is not targeted in the same direction. We have two arrows, if you will, in our quiver. We do need the targeted incentives to hire the disadvantaged, but in the long run we also need for the health of the overall economy an expansion in industrial capacity and productivity, because what we don't want to do is in 1980 run up against bottlenecks that will turn the whole economy down. Therefore, there are two parts, if you will: Incentives to hire the disadvantaged and incentives to expand capacity. We think both are needed, not just one.

Mr. STOKES. On the latter part, what assurance do you have that the tax cut would be utilized for the purpose of expansion of business?

Mr. SCHULTZE. Mr. Stokes, in the sense of legal assurances, none. In the sense of economic analysis, which indicates such tax reductions in the past do tend to stimulate business investments, plenty. But no legal assurance any more than when we cut taxes on consumers we have legal assurance they will spend it. But normal economic analysis tells us that yes, there will be a response, so hence, for all sorts of reasons, we don't attempt to write legal assurances in the law.

The CHAIRMAN. The time of the gentleman has expired. Mr. Mattox?

Mr. MATTOX. Mr. Schultze, I have listened to your testimony, and I have a particular concern about the administration's viewpoint about the tax cut. I think we are in the controversy concerning the Kemp-Roth plan and all these other plans because the administration has steadfastly dug its heels in and refused to take the recommendation of this Budget Committee as to forming a recommendation for a social security tax cuts.

We have increased social security taxes, and it seems to me that an appropriate place to give relief would be in the area that the people most certainly want. That tax cut quite obviously would help both the working people in the community and the businesses that employ people throughout our economy. And would probably be the most helpful thing in the area of unemployment relief.

I am curious as to why we can't seem to get that point across to the administration. I would like to know what your viewpoint is in comparing the social security tax relief with one of these other areas of relief, including capital gains relief.

Mr. SCHULTZE. Mr. Mattox, in the first place, a little history is instructive, I think. You may recall in December the Congress passed, and the President signed, a bill substantially increasing social security taxes in order to finance the social security system.

Second, a reduction in social security taxes now reversing that decision on the basis of considerations of the moment, without embodying it in a major set of reforms with respect to the whole

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long-term financing of social security would, they think, be irresponsible.

It is not that over the long run we don't want to look carefully at the whole financing of that system and whether the route we are going is exactly right. It may well not be, but we don't want to do it piecemeal. We don't want to do it on the spur of the moment because that, in turn, would set a precedent and open up, I think, some really bad possibilities for the future with respect to the long-run financial security of that system.

Therefore, in principle and over the longer term, you have a point. To do it this year in terms of immediate needs on an ad hoc basis, it seems to me to make no sense.

One other point: The Secretary of HEW has appointed a social security advisory committee, which will be coming forth with a major review of that system, both the benefit side and the revenue side. Then indeed it might be time to look at this, but not this year.

Mr. MATTOX. I think the question is, we have seen this problem developing for at least the last 10 years, and it is a question of how long we wait. The administration has taken up the gauntlet in a wide assortment of areas, and it seems that we continue to put off and to delay action that could be taken, and it could be taken relatively quick, because all these studies we are talking about are not that indepth and in detail.

We are hunting for some justification to take some action we know needs to be taken and as long as we are going to give some tax relief and give reduction, it seems to me that the place that gives the greatest stimulus would be in the social security system.

Let me pursue it. Would you agree that the social security tax reduction, or using general revenues to fund some of the social security and reduce the general revenues in some form would be more profitable than some of the other tax recommendations taking place?

Mr. SCHULTZE. If you are asking me to compare the impact of a social security tax reduction with, say, a Steiger amendment, you are asking me to compare apples and peanuts. While I don't want to let it be thought to say I would approve of a reduction in social security taxes this year, as between those two choices, I would prefer that to Steiger, yes.

But they are doing a different thing. I don't think that is the choice, by the way, but if you pose the choice, yes.

Mr. MATTOX. It could be the choice?

Mr. SCHULTZE. I have never heard it put this way until this morning.

Mr. MINETA. Would you yield?

Mr. MATTOX. Yes.

Mr. MINETA. Part of the thrust of last year's legislation was to bring financial stability to the social security system and now that we have done that, shouldn't we consider taking H.I. off the trust fund? Shouldn't we consider taking the H.I. off the payroll tax?

I think it is something significant, and we are not tampering with the stability of the assumed income on the social security system. There are things that don't belong maybe on the social security system, and H.I. may be one of them.

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Mr. SCHULTZE. Mr. Mineta, in terms of taking a fundamental and careful look at the longrun future of the financing of the social security system, I agree with you, and there are all sorts of things that should be looked at and not just on the financing side but the benefit side as well. If you look at disability, for example, benefits have mushroomed. What I am against, and the administration is against, is in the context of a tax reduction for purposes of economic stimulation on an ad hoc basis to make a decision on this without looking at the whole system between now and the year 2000, not just next year, and setting a precedent that every time social security tax rates are about to rise, we cut them back.

So it is kind of a longrun objective. There are all kinds of things that should be looked at. I am not against looking at them all, but they have to be done in an overall package looking at both benefits and revenues and looking at well into the future. I don't think this is the environment, and the administration doesn't think this is the environment, in which to do this.

As I say, the Secretary of HEW has appointed this year a committee to study this indepth, and I don't think we should do it now.

Mr. MATTOX. Well, I think our problem is we are trying to figure out, Mr. Mineta and I, both, what is the environment to take this action, and when that action is going to take place. We continue to say, "Well, we are going to do it next year, or down the road." We have got some stability in the system now, and I know if the administration will get moving and start making the plans that this Congress, the great majority of this Congress, is ready and willing and able to move, particularly in these areas of H.I. and D.I., if we will just take some action on it.

But it is going to take some strong leadership out of you and Mr. Blumenthal and the President to make these actions take place. I think that we could probably end this debate about the capital gains, Kemp-Roth and a lot of these things, if we would go on and do what the American people want us to do.

The CHAIRMAN. The time of the gentleman has expired. The Congresslady from Maryland.

Mrs. HOLT. Thank you, Mr. Chairman. To follow on with this discussion, Mr. Schultze, you said that we do need relief, and I think that is the point we are all concerned about. Is the $20 billion on top of these other taxes that have been put on there going to be relief? We have to look at the whole picture. Is the size of the administration proposal really going to be relief?

Mr. SCHULTZE. Yes, ma'am, I think—well, it will be; that is No. 1. No. 2, everybody would like to cut taxes. We want to cut taxes. The committee wants to cut taxes. The American people want their taxes cut. The question is, How much? The question is, What is responsible by way of the Federal budget deficit and by way of economic policy in the period ahead? So we are not quarreling about basic principle. But I think it is incumbent upon the administration and the Congress to be prudent, to put a significant tax cut into effect, but, because there is a significant tax cut which is right, that doesn't mean one double that size or triple that size or quadruple that size is right.

Mrs. HOLT. Is it really a tax cut if we have added all these taxes and then we are going to give back less than this amount? Along

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that same line, as an ex-director of the Bureau of the Budget, wouldn't it be better to think about a long-term tax reduction over a 3-year period? Of course, I would like to see you thinking along the lines of a reduction in outlays at the same time.

Mr. SCHULTZE. I understand that, and we are.

Mrs. HOLT. As the Kemp-Roth proposes, that we do it over a longer period of time?

Mr. SCHULTZE. Again, obviously reasonable people can argue about the size of a tax cut. One could indeed propose a very large tax cut phased in over 3 years, but then I think it is also incumbent on them to give us at least some broad indications of where they would cut—I don't mean a few billion, but scores, up to hundreds of billions from the Federal budget to match it, and I really don't think—we want to be prudent; we want to pare down the share that Government takes in our economy.

The President has explicitly set that as an objective on expenditures. We want to be realistic about it. You are not going to cut it in half. I don't think anybody wants that. What we are really talking about is giving the American people an important tax cut but not at the same time going so far overboard we give them inflation.

There is nothing, it seems to me, which would be worse than to put money back in the people's pockets through a tax cut and maybe take it away double through higher inflation.

Mrs. HOLT. What I had proposed was to reduce the rate of growth of Government with the hope that very quickly we would see a stabilization occur.

Along that same line, you said in your testimony that the President had instructed Federal agencies in planning their 1980 budget submissions to reduce outlays substantially. What does that mean? Are you asking them to reduce the rate of growth or just saying they have to cut back?

Mr. SCHULTZE. Well, what we do is we have, and we did send to the Congress, a projection of what expenditures would be in 1980 under current programs. Obviously growth in inflation and population adds to Federal expenditures under the social security law, through the automatic indexing of social security and other programs. The defense budget, for example, grows as higher prices come along. So we have an estimate of what those expenditures would be under current programs with no new programs, and what the President said is you have to cut below that and substantially below it. We are not in a position, and won't be until December, to come up with kind of a final bottom line on exactly how much you can do, but let me assure you it will be substantial.

On the other hand, it isn't going to mean expenditures absolutely turning down, because we do have to take care of, as I said, such things as social security indexing, the defense budget, and the like.

Mrs. HOLT. One further question, Mr. Chairman. On the Kemp-Roth, you said $120 billion was the figure you were using.

Mr. SCHULTZE. By 1981, when it is fully in effect.

Mrs. HOLT. It seems to me that is high. The figures I have heard have been something like $20 billion per year. Is that not correct?

Mr. SCHULTZE. Well, it is a 30-percent tax cut on income taxes. If you project out what kind of incomes we are going to have in 1981,

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you can obviously give or take some small amount, and then apply that 30-percent tax cut to the 1981 level of income; its immediate effect would be a cut of $110 billion to $120 billion.

Now, I grant you our gross national product would then increase, and you would get some of that back. So the net effect wouldn't be $100-some billion. What I am arguing against is the fact that you would grow GNP so very much you would get it all back. No way.

Mrs. HOLT. We are not arguing really whether there is a free lunch, but how much it is going to cost us.

Mr. SCHULTZE. In inflation.

Mrs. HOLT. In the unemployment situation, it is dropping rapidly and yet there isn't any great increase in real growth. How do you explain that? Is it that employers are not making long-term capital investments and instead working their capital harder? In other words, are traditional measures that we use valid any more? Can we depend on the measures that we have used conventionally?

Mr. SCHULTZE. Mrs. Holt, I wish I could give you a complete answer to that. In all honesty, I can't. What we do know is that at least what has happened in about the last 9 months indicates that employment has grown relative to the growth in output by much more than would normally be the case. This suggests one of three possibilities. We are overestimating employment; the statistics are wrong. That is very unlikely. We have confirmatory evidence. Second, we are underestimating our output. That may be partly true, but I don't think so. Third, in the last 9 months, the rate of growth in our national productivity is less than we had been having, and I think it may be some of that. What, I am not sure. You do get periods in which these relationships don't stick with historical levels.

The extent to which this is temporary or permanent I am not sure. I think it may be a little bit of both. It does indicate the need to get capital formation and investment growing more strongly. There is no question of that. But I can't give you a statistical answer as to exactly how much that would do. But it does lead in the direction of saying, yes, increased business investment is important.

Mrs. HOLT. Thank you. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentlelady has expired.

The vote on the House floor is final passage. Do you have some time, Mr. Schultze? We have four people here with questions, if we went over and voted we could get you out by about 12:15.

We will stand in recess.

[After recess.]

The CHAIRMAN. The committee will please come to order.

Ms. Holtzman.

Ms. HOLTZMAN. Thank you very much, Mr. Chairman.

Mr. Schultze, I would like to ask you some questions about inflation. I would like to start by expressing my concern about a solution that you propose on page 18 of your testimony, namely, that we could accomplish significant reductions in inflation if we were to tolerate massive unemployment for a very long period of time.

I thought that theory was discredited as a result of our experience under the past administration, when we had enormous unem-

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ployment and rapid inflation. I am surprised to see it being endorsed.

Mr. SCHULTZE. Ms. Holtzman, I never meant that sentence to endorse the concept. I am saying there is probably some level of economic slack, which if you could keep for long enough, might do it. I happen to think it would be very bad, and socially unacceptable, but we do have—let me give you an example. We pulled together eight independent economic studies of what would be the impact on inflation if you wanted to run a policy of economic slack. How long would it take to get how much out of the inflation rate. They all give different answers, but to give you an idea of the range, if you wanted to keep the unemployment rate at 6½ percent, that is a good eight-tenths higher than we now have, for somewhere between 6 and 15 years, you might cut the rate of inflation from 6½ percent to 3¼ percent. I happen to think that is absurd. I am not endorsing it.

Ms. HOLTZMAN. We also had a 10-percent unemployment rate, as I recall, not too long ago, and 7- or 8-percent inflation rate. I am not sure these models or projections that you are talking about bear much relation to reality.

I think our recent history disproved this so-called classical theory about the relationship between inflation and unemployment.

Let me turn, then, to the question of what you think is the cause of the inflation that we are now experiencing and how we are going to deal with it. I don't see anything in this testimony that addresses that, nor have I heard any other solutions. So if you could pinpoint what you think to be the causes of the present inflation, and what the administration is proposing to do about it, it would be very helpful, at least for me.

Mr. SCHULTZE. In the first place, a very short answer which I will elaborate a little on, says the reason for today's inflation is yesterday's inflation. That is, you must distinguish between what started inflation and what keeps it going.

What really got the current high rate of inflation started was a whole series of events in 1973 and 1974 in oil, food, worldwide boom on raw materials, a number of things like that. That got it going.

The burden of part of my testimony, at least, and the burden of a whole chapter in our economic report, is that the structure of our economy is such that once inflation gets going, it tends to perpetuate itself as everybody tries to keep up with past inflation, which makes future inflation continue. It is a price/wage, wage/price, price/wage expectation phenomena. That is not the only thing, but that is a big part of what has kept inflation going despite significant unemployment during the past 2 to 3 years.

Mr. MINETA. Will the gentlewoman yield?

Ms. HOLTZMAN. I will be happy to yield to my colleague.

Mr. MINETA. Thank you. I appreciate that, because I am not sure that the American public thinks that.

Mr. SCHULTZE. No.

Mr. MINETA. All they think of is the fact that the deficit is causing inflation. Unless the administration starts talking about these other influences in a highly visible manner, people focus only on the deficit.

Mr. SCHULTZE. May I respond?

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Ms. HOLTZMAN. I think you should address the question of whether the high deficits we have had contribute to inflation.

Mr. SCHULTZE. Again, unfortunately, there are not many simple things in this world. There are not any simple answers. Let me note what is keeping the inflation going is what I said it was, a kind of momentum, inertia, expectation.

Ms. HOLTZMAN. How long does that last?

Mr. SCHULTZE. I don't have an answer. What we are trying to do through a voluntary program is to gradually nick it down. That is what we are trying to do. Let me also note while the current inflation continuance is not caused by the deficit; we also have to be careful in the situation we are now in not to make it worse by having too large a deficit. It is walking that line that is very difficult.

I agree with Mr. Mineta and Ms. Holtzman—the substance of what you have been saying—the deficit is not why inflation is perpetuating itself, but I have to be candid and say we have to be careful about the size of the deficits that we allow, because we can start it creeping back up again if we overdo the deficit. It is a very careful answer in the sense that yes, the current inflation is not caused by the deficit. We also have to be very careful we don't make it worse by having too big a deficit. It is walking that line that we have to be very careful with.

Ms. HOLTZMAN. What you are telling me, then, is that the reason we how have inflation is because we had some problems 5 years ago in terms of food prices and oil prices, that we don't know how long this inflation is going to last, and that we don't really know what are we going to do about it. What are the administration's policies to deal with this problem?

Mr. SCHULTZE. We have a number of policies. In the first place, if you are saying do we have any sure-fire answer that is going to pull that rate of inflation down to zero quickly, even halve it quickly, no. Given the very stubborn nature of it, given the fact that we don't want to push the economy into a recession as a means of handling it, nor do we want wage and price controls, what we have is a whole panoply of things. These include specific governmental actions, to try to do its bit where it affects prices and where it affects wages, to outline a reasonable, achievable standard of behavior for business and labor and try to get public opinion on our side to put public pressure on them to carry it out, to do everything we can in our statements, and to use the instruments and levers we have to do it. It is not necessarily going to be unsuccessful at all. It has been done other places, other times, not with whopping success, but with some success.

We are not projecting that this is going to get the rate of inflation down overnight. We are saying if we keep at it, we can get the American people to recognize what is involved; we will get some cooperation. For example, in terms of——

Ms. HOLTZMAN. What can the American people do about inflation? You talk about their getting involved.

Mr. SCHULTZE. A number of things. Partly the pressure of public opinion. It is partly the fact that most people are not just consumers; they are also producers; they are also members of labor unions. We think that as you can get people to realize what has to be done,

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it will be easier for us to convince decisionmakers to do it. We are getting some cooperation from business firms. We hope we can get cooperation from both business and labor, not in cutting their wage increases off, but in moderating them. We do want to avoid, as I say, the two dangers of either wage and price controls—they don't work—or running us into a recession. That won't do it, either.

This is a program that does have a chance for success, although we have to keep working at it, and nobody can guarantee it.

Ms. HOLTZMAN. Thank you.

The CHAIRMAN. Mr. Mineta.

Mr. MINETA. Thank you, Mr. Chairman.

To followup on that, essentially I have always heard four ways to control inflation, and the bottom one that is the last resort—wage and price controls. That is something that is on the shelf and, really, no one wants to use, except in short-term periods, in emergencies. So we always seem to come back to jawboning. How effective can we be in jawboning?

If you have labor that is going to be under a 4-year contract, their leaders are going to try to squeeze as much out of that 4-year contract as they can because they are locked in for 4 years. They must try to foresee what the rate of inflation might be, and they have to do something to protect their members. Yet, on the other hand, there are not similar restrictions on the price side. If inflation doesn't slow, businesses can always raise their prices.

Traditional wisdom says that jawboning is the only route to go, but can we rely on that? I wonder whether or not we can dust off wage and price control in some form. I don't know. I don't like it, but maybe traditional wisdom isn't what we need in this day and age.

Mr. SCHULTZE. Let me make a couple of points. First with respect—and there is a real problem—that you are asking, for example, for restraint on the size of 3-year union contracts being signed. They are taking a risk. You have to remember, however, the contracts now have two components. They have a cost-of-living escalator, which doesn't protect fully, but substantially, against changes in prices and a fixed wage component. There is a substantial protection built into the cost-of-living escalator so the question is, Can you bring the fixed components down some?

With respect to wage and price controls, we do have some recent history in the Nixon wage and price controls. What happened is, yes, for about a year and a half they did push the rate of inflation down some, but three things happened. In the first place, as soon as they were lifted, prices rose sharply. Second, they were only on for a year and a half, so it is hard to tell; but you know quite well that with American people who are already complaining about excessive Government regulation, Government regulation of hundreds of thousands or millions of prices is going to add greatly and it will hurt efficiency.

And, finally, the result of the Nixon one was, after it was over, after a year and a half, my recollection of coming to the Congress and talking about extending the old Cost of Living Council with no wage and price authority, you almost couldn't even get that done; people were so fed up.

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I would suggest any enthusiasm for wage and price control is something that lasts only a short period of time, and then the people get fed up, unless there is a war, and that is another matter. We put up with all kinds of things in a war. But in an economy like ours you can't put up with that over a period of time, and you are counterproductive during the period you have it. You might get it down a little bit, but it doesn't work.

Mr. MINETA. On page 19 of your testimony, you talk about requiring a significant tax cut this next year and in the analysis on the Kemp-Roth tax proposal you submitted also, you say there should be a moderate tax reduction in 1979. I am wondering if we can be going after a significant tax cut next year to accomplish the administration's goals in terms of the long term or the moderate tax reduction that you are referring to in reference to the Kemp-Roth tax proposal?

Mr. SCHULTZE. I didn't mean for the adjectives moderate and significant to mean different things. Maybe I should have checked to make sure the adjectives were the same. Let me put it another way. I would think with a $2 trillion gross national product, a $20 billion tax cut is moderate but not insignificant. There is nothing you can draw out of the difference between the adjectives. I think something can be moderate and significant.

Mr. MINETA. On page 3 of your testimony, you mention the pressures which are growing for further protectionism across the globe, and I basically have always considered myself a free-trade advocate, but in the last year I see more and more tariffs, quotas, subsidies, and other kinds of protectionist measures which are being adopted around the world, and they are not going down. From your perspective as an economist, I wonder, are trade restrictions too high in this country? What is your assessment of the steel situation, where we finally came up with a reference-of-steel-price system?

The third area I am interested in is whether or not this wouldn't be the wrong time to be lowering protectionist barriers because of the state of the unemployment and some of the other things that are impacting on our own economy?

Mr. SCHULTZE. First, with respect to steel, let me just take that. The so-called trigger-price scheme, you have to remember that was put in in the context of having on the books a 1974 Trade Act with dumping provisions. Had that been carried out fully without the trigger prices, you would have substantially greater, I think—that was the evidence at the time—substantially greater protection. In effect, the trigger price set up a price reference point based on the most efficient steel producer in the world, Japan.

If the whole spate of cases that were coming up under the dumping laws had been the way we had gone, you would have greater protectionism.

No. 2, the major effort in this area now is in the MTN, the multilateral trade negotiation, in which we are seeking to reduce mutually the barriers to trade, and one of the things we are looking for is a code on subsidies. Distortions to trade come not just on account of the standard quotas and tariffs but also because of subsidies some countries employ, and we are looking, as part of our negotiating business, for improving that substantially.

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So I would say if you asked me the question about removing protectionist barriers, our major effort is not a unilateral change in this but a balanced approach, reflecting not just reduced tariffs and barriers to trade but also reductions in the other kinds of distortions which do come about.

Mr. MINETA. The area I come from is referred to by the business community as Silicon Valley, because it has a large part of the semiconductor industry in it, probably producing close to about 80 percent of the semiconductors in this country. This question of subsidy is an important one because the Japanese Government does much of the research and development in this area of semiconductors, and they license to various companies in Japan the product of their own research and development. Alternatively, we have in San Jose, 50–75 companies climbing all over each other doing the same research on their own, trying to get a foothold into the next generation of whatever advancement there is in the semiconductor industry. Thus, there is severe adverse impact on us and I would hope that the administration will deal with this problem.

I have contacted the International Trade Commission as well as our own Subcommittee on Trade of the Ways and Means Committee, but I would hope that the administration would pursue this because we always seem to wait until an industry is very sick and distressed. I think we should take a look at our economy and various segments of it before they get sick and make sure they don't become distressed.

For example, it was too late to deal with the CB radio industry when it came down to 95 percent of the production being overseas, and there were only something like 1,500 employees in this country by the time the International Trade Commission decided to take it up as an issue.

At that point it was too late to deal with the CB radio industry, and I am afraid if we take this sort of wait-and-see policy on other segments of our industries, that we may be dealing with rather hopeless situations.

Mr. SCHULTZE. I really don't know the silicon industry, but the basic proposition of a mutual, not just a one-sided reduction in trade, and paying attention to the subsidy problem is what we are after.

Mr. MINETA. Very quickly, yesterday Barry Bosworth told the committee that housing has experienced major rates of inflation, which is likely to continue, and he identified many of the housing problems as being on the supply side.

In today's testimony you say, on page 10, "Demand for housing remains strong." Will that demand merely contribute to even higher rates of inflation in the housing sector, and is the housing sector in a demand/pull inflation, as opposed to the momentum inflation we face elsewhere?

Mr. SCHULTZE. First, I guess it is probably true that over the past 2 years the growth of housing has been very large. Since 1976 there has been a 25-percent increase in constant dollar housing outlays. And that has undoubtedly, particularly in the area of lumber and other building materials, led to some demand/pull. I think that is probably true, in the sense we have run up against some supply problems.

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On the other hand, in the year ahead, while we don't think that all housing is likely to collapse, we do expect it to level off and inch down some so the strength of the demand/pull as supply begins to catch up a little should be reduced if it doesn't disappear.

I think you are right; in this area there has been demand/pull inflation. It should be less as housing moderates, and I think goes down some, though not substantially.

The CHAIRMAN. The gentleman from South Carolina.

Mr. DERRICK. I thank the chairman, and Mr. Schultze; we are delighted to have you before us.

I, quite frankly, at this point, have been unimpressed with the administration's manner in dealing with inflation. I have watched your career for many years and have been very impressed with you, I might add. But what is the difference between what the administration is not doing and what President Ford did not do under the WIN program that we all laughed about?

Mr. SCHULTZE. The basic point is that the Nixon and Ford administrations, except the period of price controls, explicitly abjured laying down any standards of behavior for labor and prices.

Mr. DERRICK. The WIN program was not part of the wage and price controls.

Mr. SCHULTZE. I am saying, let me——

Mr. DERRICK. You know, what you have said to me this morning, as far as the administration is concerned is that the administration is not willing to give any strong leadership, or to make any hard decisions. Inflation is tearing this country up; the elderly people and the poor people are suffering daily from it, not to mention most other segments of the population.

But what I get out of your statement, with all deference to you, is that we are trying to have our cake and eat it, too. The only thing I have really heard out of the administration is talk. Why can't we have some leadership from the administration? I mean, why can't we look into areas like prior notice for price increases, and prior notice for wage increases?

I don't think we are making any headway, and I don't see anything, quite frankly, in your statement that indicates that it is going to improve.

Mr. SCHULTZE. Mr. Derrick, in the first place, the administration, if you mean by trying to have our cake and eat it, that the administration is not proposing——

Mr. DERRICK. What I mean by that, if you pardon me a moment, is that you are trying to please everyone and you are not dealing with the inflation problem. I mean you are trying to please labor; you are trying to please business, and no one is willing to make a hard decision.

Mr. SCHULTZE. Let me first note, at least as I read the press, I had not thought labor was that pleased with the anti-inflation program. That is an aside.

Mr. DERRICK. They are not out there picketing.

Mr. SCHULTZE. With respect to prenotification, that is a mirage. We know, on wages, when the bargaining contracts are coming up.

Mr. DERRICK. I am not an advocate of prenotification. I merely threw that out as one of the things that has been discussed. But

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wouldn't it be a way to approach the matter of public pressure that you keep referring to?

Mr. SCHULTZE. Again, I don't see what good prenotification would do. As I say, on the wage side, we know when they are coming up. On the price side we have had good cooperation from industry coming to talk to us.

Mr. DERRICK. You know, the public learns about these wage increases or the significance of them, basically, after the fact. Maybe this would give some time, say, 30 or 60 days beforehand, for this great mystique that we hear about of public pressure to come forward and exert what you are talking about.

Mr. SCHULTZE. Again, I don't want to appear hardheaded; maybe I am——

Mr. DERRICK. Well, I am. You are welcome to be.

Mr. SCHULTZE. What do you get out of prenotification? On one side, the union always comes in with an offer substantially above what it expects to get. What are they going to prenotify, the initial gambit?

On the price side it has not been our problem. We have had some, of course; we can't handle the millions of business firms across the country, but the major concerns are coming in to talk in advance. Hence, rather than create a huge papermill, where we are going to shuffle papers through the Government, whatever the problem with the program is, that isn't it——

Mr. DERRICK. I hear about all these papers and everything. It depends on what side of a particular argument you are on.

May I get to page 7 of your statement where you say, "Our forecast for the rest of 1978 and 1979 takes certain things into account," and if I might say so, I think you are on rather unsteady ground there if you think that the midyear budget review and the tax legislation is going to come about as indicated in there, and obviously the second area, the interest rates already are over the Fed's projected range.

What are you going to do about Mr. Miller at the Fed? He has threatened you, in a sense, if you don't cut back on spending programs, and on the deficit he is going to tighten down on monetary growth so hard that we could go into another recession.

Mr. SCHULTZE. I guess it is a different interpretation. I have seen nothing coming out of Mr. Miller which would suggest that.

Mr. DERRICK. He made a statement last week I will be glad to furnish you with a copy of.

Mr. SCHULTZE. I cannot, in effect, give some specific forecast of what the Federal Reserve will do. I am not trying to. I am saying that in order to achieve the kind of moderate growth that we are after; we think current conditions in the money markets are about right.

Mr. DERRICK. What is the money supply rate right now?

Mr. SCHULTZE. The rate of growth in the money supply?

Mr. DERRICK. Nine percent?

Mr. SCHULTZE. No, the rate of growth that has actually occurred in April and May is significantly larger.

Mr. DERRICK. 11.9 percent?

Mr. SCHULTZE. It was higher in May and has come down in June.

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Mr. DERRICK. And all the projections we made were based on what, 5 or 6 percent?

Mr. SCHULTZE. A range of 4 to 6½ percent.

Mr. DERRICK. Of course, a third item, with all deference to you, is kind of a hope and prayer that everything works out.

Mr. SCHULTZE. It is more than a hope and prayer, Mr. Derrick. There is some hope in it, that is true, but it is more than a hope and prayer.

Mr. DERRICK. I hope there is some prayer in it, too.

Mr. SCHULTZE. Yes, sir.

Mr. DERRICK. You say that the higher rate of inflation in the first half of the year, which was fed by a number of special factors, which you see easing during the second half. That is a hope. And that the underlying rate of inflation does not accelerate in 1979, and I suppose that is another hope combined with a prayer. But what I am trying to get to, Mr. Schultze, is that seems to me to be a rather weak base to start from.

Mr. SCHULTZE. In the first place, to go through the three of them, if you are telling me that the kind of expenditure restraints—the round number $20 billion tax cut we are talking about the Congress isn't going to pass—I don't see anything to indicate these aren't ballpark numbers.

Mr. DERRICK. We have cut substantial amounts out of outlays in the appropriations process in the last several weeks.

Mr. SCHULTZE. In which case, fine, sir.

Mr. DERRICK. So you agree with that.

Mr. SCHULTZE. Yes, sir.

Mr. DERRICK. Mr. Bosworth told us yesterday we should not cut back on spending.

Mr. SCHULTZE. No, sir. Let me again note that in order to come up with the expenditure numbers which we are now projecting, the Congress will have to come in with budget outlays somewhat below the First Concurrent Resolution, so we welcome that. That is my understanding of the way the numbers rack up.

Mr. DERRICK. Let me comment briefly on a couple of other things. You know, when you folks up there were peddling the minimum wage, you said it was not inflationary. Yet now we hear in all of the testimony that comes from the administration that this is part of the reason for the inflation.

Mr. MATTOX. If the gentleman will yield, I believe that tomorrow, having had the opportunity to look at a certain portion of advanced text from Mr. Miller, he is going to suggest possibly that we delay the 1979 minimum wage increase because of the inflationary impact.

Mr. DERRICK. My point is, and I thank you, Mr. Mattox, but my point is that is it, or is it not, inflationary? As I said, when you were peddling it, it was not inflationary, and I think, and I would stand to be corrected on this, that the same thing was true of the social security payroll tax increase.

Mr. SCHULTZE. Mr. Derrick, I didn't testify on the minimum wage, but my recollection is that we did indicate that it would, by its nature, add to costs and prices; that it would be a modest amount, and the point is that in 1979 the increase in the minimum wage is much smaller than this year and only slightly out of line

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with the average growth in wages. It is a little larger, but not much.

But I would have to go back and review the testimony, but we clearly indicated it would add to costs and prices, and it would not be a huge amount.

Mr. DERRICK. I did not get it from you, and certainly don't want to suggest that I did, but that was not the information I received when it was being peddled.

Let me ask you one other question, and I will wind it up. Could you cite for me maybe one or two things that you would consider as hard decisions that might displease a few people that the administration is willing to make to deal with inflation?

Mr. SCHULTZE. Well, let me just indicate, obviously such hard decisions as they come along we are willing to make them, but let me give you three examples of some we have done. First——

Mr. DERRICK. I would prefer to know some you anticipate.

Mr. SCHULTZE. I understand that, Mr. Derrick, and just as soon as the administration reaches those decisions, you will know. I wanted to give you some indications of the kinds of ones we have already made.

Mr. DERRICK. All right, sir. Thank you.

Mr. SCHULTZE. First, we did indicate that the President would recommend to the Congress a 5½-percent increase in Federal pay rather than the probable 7½ percent which would come along if the simple formula were allowed to go into effect. Second, we did lift the quota on meat imports. Third, the President did indicate that he would use his veto on an excessively expansionary farm bill, as a consequence of which we didn't get one. That was a decision with some difficult political consequences that we have heard about.

Mr. DERRICK. I wouldn't be too quick to take all the credit for not getting it.

Mr. SCHULTZE. I am not. In all of these, let me put it this way, in every one of these, certainly the first and the third, we need the cooperation of the Congress, because my recollection is that the Congress has a chance to override our 5½ percent, and we need Congress cooperation, and on the farm bill we, of course, needed it, too, but, on the other hand, there also were some tough political decisions for the President to make.

Mr. DERRICK. I voted against the farm bill and agreed with the President on it.

I would ask you if you could submit to me in writing the differences that you see between the Ford WIN program and what the administration has done to date—back to my original question.

Mr. SCHULTZE. I will submit it in writing.

[The information referred to above follows:]

PRESIDENT FORD'S WIN PROGRAM AND PRESIDENT CARTER'S APPROACH TO INFLATION

The differences between President Ford's WIN program and President Carter's approach to inflation are significant and substantial. The WIN program called for a tax surcharge, regulatory reform, action against restrictive business practices, energy conservation, and voluntary restraint in private sector wage and price decisions.

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The WIN program, of course, was ill-timed. Rather than inflation, recession and unemployment very quickly became the principal concerns of the administration and the American people. But the program suffered from deeper flaws as well.

First, it recommended a tax increase—at a time when economic growth had already ceased—to control an inflation that was no longer being aggravated by excess demand. The lesson of 1970—that a world recession would do little or nothing to slow inflation—was overlooked.

Second, it approached the inflation problems we faced too narrowly. It did not recognize the need to address longer range structural difficulties in the economy. By contrast, the administration's program calls for tax incentives to stimulate business investment, and for a broad range of jobs programs designed to increase the supply of skilled workers as the economy moves toward high employment.

Third, the President's program addresses directly some of the most important sources of inflationary shocks. We have, with the Congress, established a grain reserve of more than 40 million metric tons to provide a buffer against future worldwide crop shortages. Compared with the previous administration's regulatory efforts, the Regulatory Analysis Program established by the President and chaired by CEA marks a significant step toward recognition of economic concerns in regulation through efforts to adopt cost-effective regulations.

Finally, the WIN program's efforts to obtain wage and price restraint was too vague for business and labor to understand. The administration has put forth a specific standard to guide the behavior of business and labor in making price and wage decisions. That is, the rate of wage and price increase this year should be less than the rate of increase, on average, in the past 2 years. While this is a flexible standard, designed to take into account the differing situations among industries and firms, it is a standard that in each particular case has clear-cut meaning for workers and employers.

Mr. SCHULTZE. Somehow we got interrupted on my one major point on that which is that if you go back and look at it, there is a difference. We have laid out an explicit standard for behavior of wages and prices in terms of decelerating from the last 2 years' average. The WIN program wanted nothing to do with the Government saying anything about what should happen to wages and prices. We do have a voluntary program with a standard of behavior, realizing it can't be one number for everything.

The WIN program was talking about consumers buying cheaper cuts of meats and everything. This is quite explicit.

Mr. DERRICK. Let me make this comment, if I may. I say this, that is my President up there on Pennsylvania Avenue, and I want to see him succeed for a number of reasons, some of them selfish and some of them not. I yield to Ms. Holtzman.

Ms. HOLTZMAN. I thank the gentleman for yielding.

The CHAIRMAN. The gentleman's time has long since expired, but go ahead, Ms. Holtzman.

Ms. HOLTZMAN. I am interested in whether or not you consider a vigorous antitrust enforcement part of an anti-inflation policy, and, if so, how do you explain the recent actions taken by the Justice Department with respect to approving mergers in the steel industry and elsewhere?

Mr. SCHULTZE. Ms. Holtzman, over the longer pull, vigorous enforcement of antitrust obviously is important. Second, the consequence of that is not that every merger is bad. Quite frankly, I don't happen to be an expert on that particular case, the steel one you are talking about, so I can't discuss that in detail. It is perfectly, it seems to me, consistent, and, in fact, necessary, to have an antitrust program which is, on the one hand, vigorous but doesn't run on the presumption that every merger is bad. There is no necessary contribution. I am not familiar enough with the case to discuss it.

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Ms. HOLTZMAN. I don't know whether or not Mr. Derrick has an opinion on this, but it would seem to me if we are talking about the hard decisions, somebody's toes have to be stepped on. I think that antitrust policy is one of the areas in which the toes have not been stepped on, and which inflation is going to continue to exist.

Mr. SCHULTZE. I agree you can't do it without stepping on toes. I do suggest the way to do it is not finding every toe to step on, but finding the right toes.

The CHAIRMAN. Part of the problem with wage and price controls is that they are not popular, and every administration and everyone in Government seems to abjure them as a solution. Would we discount wage and price control absent a war, and in a peacetime situation, would we abjure it if the unemployment rate went into double digits?

I wonder if we might not think about wage and price controls under that type of runaway inflation? That being the case, isn't it a good idea for Presidents to have built-in standby authority on wage and price controls such as we had up until I think President Ford asked Congress to take them away?

Mr. SCHULTZE. Mr. Chairman, I don't think so for two reasons, or three reasons. In the first place, if you look at the current circumstances and foreseeable circumstances, in the first 6 months of this year, inflation going into double-digit figures has been basically food prices. We had virtually double-digit figures because of food prices, and that is the one area we know you cannot put on price controls.

No. 2, standby wage and price controls are an invitation to use them when they shouldn't be used.

No. 3, the very process of getting that is going to cause anticipatory price increases. So on all three grounds I don't think so.

The CHAIRMAN. You say the standby feature of it would be an invitation to——

Mr. SCHULTZE. Conceivably could be an invitation to premature use. And in the process of getting them, you have the anticipatory price increases, and finally for reasons I indicated substantively, literally, what they lead to is the kind of economic situation in which they can't work.

The CHAIRMAN. Thank you. Mr. Regula.

Mr. REGULA. From what you are getting from your friends, I think you should be looking to some of us on the other side of the aisle; to wit, your friends are suggesting that the tough decisions ought to be made by the administration on the anti-inflation measures as I listened to the questions. Does it strike you that maybe the Congress should make some tough decisions on budget matters in reducing outlays and would that be a help on solving the inflation problem?

Mr. SCHULTZE. Without for a moment wanting to suggest that the Democratic majority isn't interested in that, of course it would help.

Mr. REGULA. I have been interested in yesterday's testimony and also today, that people have alluded to inflation as being the No. 1 problem, and yet I find very little being said about the deficit as a cause of that problem. On a scale of 1 to 10, where would you place the deficit as part of the contributing factor to inflation?

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Mr. SCHULTZE. Mr. Regula, I can't answer that question when phrased that way. If I can answer it slightly differently, that is as I answered earlier in the question of Mr. Mineta, the kind of momentum and inertia inflation that is a hangover from the past is not a problem with the deficit. On the other hand, we do have to be very careful that we don't have a deficit which heats up inflation, and, on the other hand, we also have to be careful we don't put the brakes on so hard we start raising unemployment.

Mr. REGULA. Do you think the present deficit heats up inflation?

Mr. SCHULTZE. I think we have already scaled it back by over $10 billion. Not at the level we are talking about, no. I think we are going to have to work to get those expenditures down to that level, and we should work, and if we can find additional economies, we will, but, as an important factor in heating inflation now, no.

Mr. REGULA. The next thing, I keep hearing there has to be a tradeoff between unemployment and inflation, and yet I look back in the 1950's and 1960's; I think we had very low inflation rates, in the 1- to 2-percent range and also low unemployment, but I also note that we had very low budget deficits; in fact, we had surpluses in some of those years. It probably averaged out from 48 to about 62 to around zero or only a slight deficit. Is there any correlation, and what was unique about that period that we could have both low inflation and low unemployment?

Mr. SCHULTZE. In the first place, we started with low inflation. In fact, if you look at the inflation record in recent years, in terms of it heating up, except for food prices if we started with low inflation we would have had low inflation now. That is No. 1. It isn't that inflation has heated up recently except for mainly the food price increases.

The second proposition, there are two things which have occurred, which have helped to raise that budget deficit from an economic standpoint. In the first place, if you look at the total governmental sector—Federal, State, local—State and local governments are running about a $30 billion surplus. The net governmental deficit, as a proportion of our GNP, is about the lowest in the world, literally. It is about one-fourth of the German; it is about one-sixth of the Japanese. You can't measure central governments alone because the relationships are so different.

That fact is importantly different from the 1960's and in order to get recovery going, there was more of a deficit involved in the Federal Government because there was a big surplus in the State and local governments.

Mr. REGULA. In light of what you say, and in light of the fact there is a $30 billion surplus out there, what would be your reaction to suggesting that we cut some of the antirecessionary measures out of the budget such as revenue sharing as a billion, public service jobs, which, in effect, replace many of the local budgets, temporary public works, which they could be doing themselves, and let them use their $30 billion and thereby pull $10 billion out of our deficit?

Mr. SCHULTZE. In the first place, you have to look at these grants-in-aid programs on their own merits one by one. No. 2, it is clear, just reading the newspapers, and looking at what is happening, that State and local governments are now in the process of

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reducing taxes. I think that is good. I am not sure I would want to get in the way of that.

Mr. REGULA. On another subject, you had discussed at great length the Kemp-Roth and had the figures about what it would take in the increase in the gross national product. Would, in fact, Kemp-Roth passage result for all practical purposes in indexing the tax code?

Mr. SCHULTZE. I would have to look at the magnitudes, Mr. Regula, and I would be glad to give that to you on the record whether it would be more or less than that. I am not sure. Let me note, however, that what would really disturb me, indexing or no indexing, is committing ourselves now to that kind of a tax cut, that large a tax cut over 3 years, indexing or no indexing.

Mr. REGULA. Would you favor indexing?

Mr. SCHULTZE. No, sir, I don't think so. Let me indicate two reasons for it. Obviously, again, reasonable people, it is not a subject in which it is way out of the ballpark, but it seems to me there are good reasons for not indexing. In the first place, if you begin to think about indexing the tax code, there are some parts where you could do it easily. But in order to keep any kind of fairness and distortions from this, you really would want to index as much as you could of the whole code, and then you get to the problem of indexing complicated businesses. You can index the tax brackets; that is easy. But the whole business of business taxation, depreciation, how do you treat interest, which is a very difficult problem on indexing, that is No. 1. No. 2, given the fact that the world as a whole is in an era in which inflation is much higher than it used to be, I think it is useful to have a system which isn't indexed so you can make decisions year-by-year or every 2 years as the Congress can, as to exactly how much taxes should be reduced in terms of economic circumstances. You give that flexibility away when you index. I don't want to pound the table, but it seems to me indexing does have real difficulties, and those are two of them.

Mr. REGULA. You mention in the testimony that to offset the impact of Kemp-Roth we would need $500 billion GNP growth to recover those taxes. If we look at the history of the last 3 or 4 years, we will have that as a result of inflation, so it would seem to me it would be a wash.

Mr. SCHULTZE. No, sir. I mean you would have to have whatever we are going to get plus another $500 billion.

Mr. REGULA. So you are saying the $500 billion would have to be in addition to the $500 billion that probably, based on past history, will result from inflation?

Mr. SCHULTZE. Yes, sir, and growth. I am talking about an extra $500 billion.

Mr. REGULA. I was interested in your testimony in the First Budget Resolution. You mention that perhaps we have made it too attractive not to be employed, and that we should look at some of those programs that do result in people getting substantial sums of money without working. Would you still feel that way, and is anything being done in the administration to evaluate whether that should be a subject for consideration by the Congress as well as the administration?

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Mr. SCHULTZE. Well, it wasn't since the time of my last testimony, but, in any event, one of the major elements of the welfare reform program we proposed precisely went to that, in terms of the marginal tax rates on welfare recipients and in terms of jobs as opposed to straight welfare, precisely along those lines. I think that had been done before my testimony. I don't remember exactly what I said, but that was certainly consistent with it.

Mr. REGULA. One last question: You discussed at length the capital gains this morning in the Steiger proposal. How would an approach appeal to you that would allow a rollover of capital gains into another investment and be deferred for tax purposes until such time as it was taken out for spending purposes, such as is the case with homeownership at the present time.

Second, it would have as a feature thereof an indexing that would allow for consideration of inflationary impact on that investment so you wouldn't be, in effect, taxed on inflation increase in value. Third, my idea that would then tax whatever net resulted at ordinary rates for tax purposes?

Mr. SCHULTZE. Mr. Regula, there is no way in the world I could respond to that off the top of my head; I would be glad to give you a response for the record. The indexing problem is really a difficult one, when you start to look at what that would imply.

With respect to the rest of it there is no way I can answer it from the top of my head. I will be glad to give you an answer in the record.

[The following information was received for the record:]

INDEXATION OF CAPITAL GAINS

Indexation of capital gains for inflation—so as to provide for tax of only real capital gains—appears intuitively attractive. However, indexation of only one party of the tax system would be inequitable. Inflation affects incomes and wealth in a variety of ways. For example, interest rates on long-term corporate bonds are now around 9 percent. The largest part of this return is an inflation premium. We should not lessen the inflation effects on taxes paid on capital while leaving inflation effects in the burden of taxes on other sources of income. On the other hand, indexation of the whole tax system would be enormously complicated.

Postponement of taxation of capital gains if the proceeds are reinvested—and taxation at ordinary income tax rates when the proceeds are not reinvested—would also be undesirable. If taxes on capital gains were deferred because the funds were made available for investment purposes, equity would require that a deferral of taxation in all other forms of income that are saved, rather than being spent for consumption. We do need measures to stimulate more investment in our economy but I believe there are better ways to accomplish that purpose—such as those proposed by the administration that directly affect the rate of return on capital.

The CHAIRMAN. Thank you very much, Mr. Schultze, you have been most helpful and informative, and we apologize for keeping you so late, but it was worthwhile. Thank you.

The committee is in recess until 2 o'clock, when we will have Mr. Blumenthal.

AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order.

Our first witness this afternoon is Hon. W. Michael Blumenthal, Secretary of the Treasury.

It is a pleasure to welcome you on behalf of the committee. It is always a pleasure to visit with you and to hear from you.

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As you know, we are holding hearings in anticipation of developing the Second Concurrent Resolution on the Budget for Fiscal Year 1979.

All but three of the appropriation bills have passed the House and are under consideration in the Senate. We are meeting our schedule for enactment of the spending bills. However, as you well know, tax policy is not yet decided, and that is probably the understatement of the year.

We would like your recommendations as to the size and composition of the proposed tax cut. We would also like your evaluation of the economic and budgetary impact of Congressman Steiger's proposal to cut the capital gains tax, and of the Kemp-Roth proposal to cut individual income taxes by one-third, and to reduce the corporate tax rate by 3 percentage points over a 3-year period.

We are all facing the very difficult task of keeping the recovery going and reducing inflationary pressures. We would welcome any suggestions you have as to how to accomplish this task.

Again, welcome to the committee. We are looking forward to your testimony. You may proceed as you wish.

STATEMENT OF HON. W. MICHAEL BLUMENTHAL, SECRETARY OF THE TREASURY

Mr. BLUMENTHAL. Thank you very much, Mr. Chairman, and distinguished members of the committee.

I, too, welcome the opportunity to appear before you and to address myself to the general issues that you have raised in the context of the administration's mid-session review dealing with the general economic situation as it relates to unemployment and inflation and growth and with particular emphasis on our tax policies.

I believe other administration witnesses appearing before you, Mr. Chairman, have in some detail commented on the general economic situation. I, therefore, will not do so.

I have summarized my views in the prepared remarks, which I would like to submit to you for insertion in the record, and confine myself to making some general comments.

I would say, by way of introduction, that I agree with my colleagues that growth in the economy for the first half is likely to average around 4 percent in real terms. We do not see much difference for the second half and going into next year, assuming the tax cut that I will talk to in more detail is approved by the Congress and monetary policy is not unduly tightened further.

I am also of the view that there is no recession in sight, based on the data that are available to us. The balance between production and sales is good. There are none of the real danger signals that normally herald the advent of a recession that we can detect.

There are no great inventory imbalances that we can detect, so the situation is relatively good.

We obviously are pleased by the recent substantial reduction in the unemployment figures and by the addition of some 2 million new jobs in the last 6 months.

I think this does underline the great resilience and strength of the U.S. economy and of a free market economy, and certainly employment has increased more rapidly than we have anticipated.

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I think one of the elements, however, that somewhat lessens the pleasure we can take from that substantial reduction to a 5.7-percent rate of unemployment clearly is the fact that productivity has not been increasing in the United States at nearly the rate at which we require it.

Related to that is the fact that investment in plant and equipment has not been increasing to the extent to which we require it. And I think herein lies part of the explanation for the rapid increase in employment, but it is also one of the problems we face as we deal with inflation and other matters.

As my testimony indicates, at this stage in previous expansions investment had exceeded its previous peak by substantial margins. This is not now the case, and it is a worrisome thing.

We are devoting less than one-tenth of our real output to investment in new plant and equipment, which is a smaller share than in previous periods, and certainly if we are to remain competitive in the world markets and a free market economy we will have to do something about that.

The tax program, to which I will speak in more detail, Mr. Chairman, therefore, is significant in that it seeks to address itself importantly to that particular goal.

There is another area that is disturbing, and that is the imbalance that exists in our foreign trade. We do need a better balance to maintain a stable economy, and even though we have seen some improvements in recent months with regard to the export-import picture, particularly with the increased export of farm goods and some of our manufactured goods, our imports are still much too high. Moreover, high rates of inflation, if we cannot control them, would further accentuate the trade imbalance. Clearly that is a disturbing factor.

It underlines the importance of the President's energy program to stem the import of foreign oil into the United States. It also makes it important to bring about stability in the dollar so that general international markets will be stabilized and trade can be carried on at high levels.

I think in all of these factors inflation is a key, Mr. Chairman. That is why the President, for some time now and particularly in his April 11 anti-inflation statement, has emphasized this as one of his greatest preoccupations.

We have had much too high rates of inflation in recent months. Partly this has been due to food prices, and that factor should abate. Partly it has been due to wages, particularly nonunion wages and wages of smaller unions that have been catching up with the larger wage settlements that have been made in the past. And partly I think it is due to the fact that productivity has not been increasing, as I said earlier.

The budget policies of the administration are framed with these problems in mind, and they do indicate a strong emphasis by the administration on the tightest possible fiscal program, particularly for 1979 and beyond.

Outlays for 1978 at $452 billion are some $11 billion less than the figure that we projected in January, due in part to spending shortfalls and in part to a deliberate policy on the part of the administration to hold spending down wherever possible.

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For 1979, as you know, we now project outlays at $497 billion, which is $4 billion less than January, and the increase that is implied in this number is some $5 billion less than this year's increase over the previous year.

We are alert to the opportunities for further cuts, as you are aware. The President has indicated that if these are possible, we certainly should try to effect them in order to reduce the deficit in the budget as much as possible, as quickly as possible.

We now anticipate a slightly smaller deficit of $48½ billion for 1979, down some $12 billion from the January figure, and we certainly think that if that number can be further reduced it would be highly desirable.

In that same regard we have also revised our tax program in order to favorably impact the deficit and, therefore, inflation. That program in its revised form differs from the President's original program in the following respects as far as 1979 is concerned:

First, we have eliminated the recommendation for the repeal of the tax on telephone services and to reduce Federal unemployment insurance tax rates.

Second, we have recommended that the amount of proposed individual income tax reduction be reduced and, third, we have included a modest amount to reflect the startup costs of those elements of the President's urban initiatives that would be implemented through tax credits.

The total tax program has been revised to reduce it from $25 billion, and the effective date has been postponed from October 1 of this year to January 1, 1979, so that the total fiscal year 1979 cost would be under $15 billion.

The tax program does reflect importantly, Mr. Chairman, our emphasis on business tax reductions. We have looked not only at the overall total, but at the sum total of taxes on business and on capital. For it is clear that these taxes have an economic impact on incentives, on profitability, on incentives to invest, and so forth.

It is for this reason that we have recommended, and continue to recommend, a cut in the corporate tax rate. We want that to be as large as possible because we are concerned that it is this tax which is clearly the most important one as far as business is concerned, and needs to be reduced.

It is for this reason that we have recommended a liberalization of the investment tax credit because we believe that creates important incentives for business to invest more and to create new jobs.

It is also for this reason, Mr. Chairman, that we have opposed the recommendations for a substantial reduction in capital gains taxes of the kind recommended by Congressman Steiger and of similar proposals.

The reason simply is that that kind of reduction, which would involve $2.4 billion in the case of the proposal made by Congressman Steiger, and well over $1 billion in other proposals that have been made, would clearly imply a reduction in other kinds of business taxes which we believe will do more good.

Second, the particular proposals that have been made involve giving back tax revenues to a lot of people who would not be using them for productive investment in business. Thus, such reductions would not do much good for capital accumulation, for venture

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capital, or for the relief of the average American who has to pay capital gains taxes when he sells his residence.

It is these features we have particularly objected to, and it is for these reasons we have preferred to concentrate as much as possible on the kind of business tax relief that has been proposed and that is inherent in the President's program.

The President, therefore, is recommending a tax program which is directly dovetailed to the kind of economic problems we face, which gives relief to individuals in the low- and middle-income groups, where the impact of inflation and of higher social security taxes is greatest, and which relieves the total load of Government taxes on business so as to increase investment. The President's program does this in a responsible way, by targeting as much of the reductions as possible where it will do the most good, and by doing it in a fair way so that the benefits do not accrue in a regressive manner rewarding primarily those with the higher or highest levels of income, and not having needed revenue available for relief of middle-income and low-income groups.

The 1980 budget, which is now under discussion within the administration, upon the President's instructions, is intended to show a substantial reduction from the deficit figure that we now project for 1979 and, as I indicated, even for 1979 we would be satisfied with a lower rather than a higher figure. Therefore, fiscal restraint, a balanced budget, the anti-inflation program, and a tax program that is targeted to do the most good is the administration's approach to dealing with the existing economic problems.

Mr. Chairman, I will be happy, in answering questions, to deal with other elements of the tax program as they may relate to the proposals made by Congressman Kemp and Senator Roth and to any other aspect of the tax policy which you or your colleagues may be interested. Thank you very much.

[The prepared statement of Mr. Blumenthal follows:]

Prepared Statement of Hon. W. Michael Blumenthal

Mr. Chairman and members of this distinguished committee, I am pleased to have the opportunity of discussing with you this afternoon the results of the administration's mid-session budget review, particularly as they relate to the future course of the economy and the President's program for reducing inflation and unemployment. As you requested, I will also discuss the economic implications of the proposed changes in the size and timing of the President's tax program. Information about each of these issues should be helpful in the committee's consideration of the Second Concurrent Resolution on the Budget for Fiscal Year 1979.

Your review comes at a time when the economy is settling down to a more reasonable rate of growth, after the clearly unsustainable pace in early spring when the economy was catching up from the winter weather and the coal strike. While figures for the second quarter are still several days away, it appears that economic activity was fast enough to bring the rate of expansion in real GNP over the first half of the year to about 4 percent.

We expect a pace close to this to continue over the balance of the year and, given some success in containing inflation without further intensification of monetary restraint, and given enactment of the administration's revised tax program, there is no reason to expect marked deviation from this pace in 1979.

Admittedly, it is unusual to anticipate growth to continue into the fifth year of an economic recovery. But we have been fortunate in avoiding some of the excesses that in past recoveries have forced the economy to pause and often to reverse direction. Production and sales have been kept in good balance; we are not suffering from inventory imbalances that often have been the cause of production cutbacks and swelling unemployment rolls. Indeed, the unemployment rate has dropped

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sharply this year, from 6.4 percent last December to 5.7 percent in June; 2 million new jobs have been created in the past 6 months.

Although our forecast is for continued economic progress at a sustainable rate somewhat in excess of the economy's longrun potential—appropriate for an economy still operating with some slack in utilization of its plant and labor resources—we cannot afford complacency. There are significant risks in the economic outlook, most of them on the downside. We will not be able to achieve or maintain a satisfactory rate of growth unless we encourage a faster rate of investment in new productive facilities, unless we restrain inflation and unless we redress the serious imbalance in our foreign trade.

To increase productivity and offset rising labor costs, and to create jobs for the future, we need to create the tools of production at a faster rate. Real business fixed investment has lagged in this recovery. At this stage in previous expansions, investment had exceeded its previous peak by a margin of almost 18 percent; at present, investment has barely reached its prerecession peak. We are devoting less than one-tenth of our real output to investment in new plant and equipment, a smaller share than in the late 1960's and early 1970's, and well below the share needed to insure the rate of capital formation necessary to support a full-employment economy in the 1980's.

The need for accelerating capital formation in this country is well documented. The slowing in the rate of growth in our capital stock parallels the slowing in the growth of productivity, and is a major contributor to the inflationary pressures from which we suffer. In the past 4 years, our manufacturing capacity has increased at an annual rate of less than 3 percent, down 1½ percentage points from the growth rate in the postwar period through 1973. Similarly since 1973, productivity growth in manufacturing has fallen by almost 50 percent as compared to its average for 1948–73.

This need for enlarging our capital stock is addressed in the tax proposals submitted by the administration, which would directly encourage capital formation by increasing the after-tax profitability of business investment. It is essential, for both short- and long-term needs of the economy, that we move rapidly to establish effective incentives for business outlays for new plant and equipment.

Another potential obstacle to achievement of the projected growth path of the economy is the imbalance in our foreign trade. To be sure, there are some encouraging signs of improvement in our foreign trade picture, as we shake off the effects of winter weather and as our exports increasingly respond to changed foreign exchange relationships. The rise in our exports in recent months is welcome. But much of the increase is in agricultural exports; our exports of manufactured goods are improving very modestly. At the same time, our imports of manufactured products have been rising very rapidly. And oil imports, while below last year's rate, still represent the major element in our trade deficit. Until we act decisively to reduce oil imports, and to improve the competitive efficiency of American industry by encouraging new investment, progress in correcting the trade imbalance will be painfully slow. Hence, it is essential to enact the tax measures proposed by the President, including the removal of subsidies that encourage oil imports and lower the cost of energy below its true replacement cost.

Finally, our ability to maintain growth depends heavily on our ability to contain inflation. Our progress on this objective continues disappointing—the latest consumer price data indicate a third month of increase at double-digit rates. Of course, food prices are chiefly responsible for the unpleasant developments, but there is hope for some moderation as increased supplies reach the market.

But the underlying rate of inflation—even after discounting the contribution from volatile food prices—is still running at an unacceptably high rate. And the continued rise in wages, as smaller unions and the less-organized workers try to catch up with the large increases achieved by the more powerful unions, threatens to keep up the pressure on price levels, particularly in light of the poor performance of productivity.

The persistence of inflation is the major threat to achieving the goals of adequate economic growth and increased employment opportunities. Inflation impacts adversely on real incomes and on consumer confidence and willingness to spend, and on interest rates and mortgage credit availability. It deters business investment, and foreshortens the time-horizon in making capital outlay decisions.

The administration's budget proposals are carefully framed to avoid exacerbating inflationary pressures. Outlays for the current fiscal year are now projected at $452 billion, some $11 billion less than was estimated in January. This reduction is the result primarily of smaller-than-planned spending by Government agencies, and we have, as a matter of deliberate policy, refrained from any effort to force spending to

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the original higher levels. For fiscal year 1979, we now estimate outlays at $497 billion, $4 billion less than our January estimate, and implying an increase for the 1979 fiscal year which is $5 billion smaller than for the current fiscal year. Moreover we are aggressively seeking areas in which spending can be reduced further. It is our belief that improvements in efficiency are possible which would permit us to deliver the desired level of public services at less cost to the taxpayer.

Even with a tax cut, it is expected that Federal revenues will rise more than projected outlays. As a result, the estimated budget deficit for next fiscal year, at about $48½ billion, is moderately below that expected for fiscal year 1978, and some $12 billion less than was estimated in January. This scaling back in the size of the fiscal year 1979 deficit reflects the delay and reduction in the proposed tax cut as well as somewhat lower outlay projections.

The revised tax program differs from the President's original program for calendar year 1979 in three respects:

1. The January budget proposal to repeal the tax on telephone services and to reduce the Federal unemployment insurance tax rate would be deleted.
2. The amount of proposed individual income tax reduction would be reduced.
3. A modest amount is included to reflect the startup costs of those elements of the President's urban initiatives that would be implemented through tax credits.

The size and composition of the proposed tax reductions reflect the very high priority that the President places on encouraging business investment, increasing productivity, and fighting inflation.

The calendar year 1979 cost of this revised tax program is estimated to be about $20 billion. Since the effective date for the program would be January 1979, rather than October 1978 as initially proposed, the fiscal year 1979 cost would be under $15 billion.

The decision to reduce the size of the tax cut, while reflecting our willingness to be flexible and responsive to economic developments, does not mean that we are ready to abandon other objectives such as tax equity. The administration, therefore, continues to support its program for long-overdue reform of our unfair and complicated tax laws.

These new budget outlay and revenue recommendations reflect a careful balancing of the need to keep the economy on a steady growth path with a recognition of the importance of containing inflationary pressures. President Carter is determined to use the full powers of his office, including the veto, to ensure that spending increases and tax cuts stay within the limits of his budget proposals. Moreover, he is determined to move toward a balanced budget as fast as economic conditions permit.

The fiscal posture depicted by the 1978 and 1979 estimates in the Mid-Session Review is what we believe to be sufficient and appropriate to support economic growth at the moderate rate now anticipated through 1979. At the present stage of the recovery, and because of the threat to continued economic growth that would be precipitated by a further acceleration of inflation, this degree of budgetary restraint is essential. To depend too heavily on monetary restraint risks distorting the composition of growth and eventually aborting the expansion. Even the present degree of monetary restraint is already being reflected in a tightening in mortgage markets and declines in indicators of future residential construction activity.

In view of the need for continued inflation restraint, and the need for an appropriate balance between monetary and fiscal policies, it is surprising that there is serious advocacy in Congress of massive tax reductions, reductions that would increase the Federal deficit by incredibly large amounts over the next few years. Instead of working toward budget balance, as does the President's program, large tax reductions such as those proposed in S. 1860 and H.R. 8333 (Kemp-Roth) would, on the basis of the analyses submitted by their advocates, increase the deficit by $12 billion in the first year and by $38 billion by the time the full round of tax reductions was completed.

We do not quarrel with the proposition that tax reductions can, in an underemployed economy, stimulate economic activity and thereby ultimately return some of the foregone revenues to the Government. But massive tax reduction in an economy already suffering from inflationary pressures is sheer waste. We do not have the financial or physical resources to absorb such stimulus without adding to inflationary pressures, and whatever benefits might be envisioned would be quickly negated by the rise in prices and in interest rates.

Advocates of major tax reductions frequently cite the success of the Kennedy-Johnson tax reductions in support of similar action now. What is overlooked, in these presentations, is the difference in the economic environment between that of the early 1960's and that in which we live today. In the early 1960's, inflation was

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running at less than 2 percent per year; this year we fear that the Consumer Price Index will rise by more than 7 percent.

In the early 1960's, the Federal deficit averaged only $5 billion; even with exceptional restraint, the deficit for this fiscal year and next will average almost 10 times that. Interest rates currently are already double the levels prevailing at the time of the Kennedy-Johnson tax cut. To impose on our financial markets the burden of massive increases in an already large deficit would result in either inflationary expansion of credit or—more likely—a preemption of financial resources that would curtail private spending and investment. There is no basis in the evidence of previous tax reductions that capacity and productivity would increase sufficiently rapidly to accommodate the increased demands flowing from such large, abrupt reductions in taxes.

The administration tax and budget program is designed to lower the burden of taxation and unleash the forces of the private sector. But it is of a magnitude appropriate to the needs and capacity of the economy. As in most things in life, moderation is a virtue; too much of a good thing will produce economic indigestion, not improved economic health.

The CHAIRMAN. Thank you very much, Mr. Secretary.

I tend to agree with you that the tax cut should be in the area or in the magnitude that you have recommended, and the revised figure that President Carter is speaking of, which I believe is about $20 billion on an annual calendar year basis, about $15 billion on a fiscal year basis in the first year.

Let's talk about the realities of taxes as we approach an election in 3 months and as we approach a Congress which is going to try to get out of town for that election somewhere around the first of October.

The realities suggest that rightly or wrongly there is very strong sentiment for change in the treatment of capital gains taxation. There is some sentiment on the minority side for a larger tax cut a la Kemp-Roth. You could address yourself to that, too. But for the moment let's stick to the capital gains treatment of income.

There seems to be very real support for change in that area, and it seems to me that it is not enough to point out the inequities of the proposal or even the threat of a veto. I think we have to either come up with alternative proposals or some other suggestions to counteract this.

Now, I think you know this and I think the administration knows it, and I think you have been thinking about it. I know they are thinking about it here in the appropriate committees of the Congress, and I think what we need from you is a recommendation, a proposal, one that will be more equitable than the present capital gains proposals before the Ways and Means Committee.

Would you address yourself to that or, to be even more blunt, what is your alternative proposal from the administration? Our time is running out.

Mr. BLUMENTHAL. Let me deal with your blunt question with a blunt answer, Mr. Chairman.

The administration does not have and will not have an alternative proposal to deal with the question of capital gains taxes. The administration has put forward a tax program to the Congress and to the appropriate committees. We have adjusted the size and effective data to conform with the emerging economic realities. For reasons I have indicated, it does not include reduction of capital gains taxes. We will not make a proposal.

On the other hand, I think it is important to understand why the particular proposals that we have seen come from the Congress are

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unsatisfactory and why the President has spoken out so strongly against them.

First of all, because the size of these capital gains tax reductions is large, $2.4 billion in the case of Mr. Steiger's proposal, clearly if we are to keep the deficit under control, if the total size of the cut is not going to be greater than $20 billion or $15 billion as some people in the House Ways and Means Committee are suggesting, then that $2.4 billion has to come out of somebody's hide.

We don't believe that it ought to come out of the individual tax cuts, and we don't really believe that we should take it away from the other business taxes which also impact business and restrict the incentive to invest. Therefore, size is a factor.

The second factor clearly is the regressive nature. I think a proposal that puts a very large portion of the total reductions into the pockets of those who have very high income, some 80 percent of the $2.4 billion going to those who earn more than $100,000 a year, clearly is inequitable and unfair.

It is not only inequitable and unfair, but it also does not stimulate investment in the same way it would if the cuts were given to the broad cross section of middle income taxpayers who want an incentive to invest, possibly in the stock market or in some other productive activity.

Third, it does not offer anything different for the homeowners from what we have recommended. Homeowners do have a problem. Tens of millions of Americans have homes and when they sell them inflation accounts for some of the gain and they don't want to be taxed on it in the same way as they have been in the past.

The fourth reason why we have opposed this is it does not, in our view, sufficiently address itself to the problem of stimulating venture capital, equity capital, and capital accumulation. As I have said in my remarks, the need to increase productivity, to increase investment, to stimulate venture capital, and to promote capital accumulation exists strongly in the U.S. economy.

In a program such as that which Mr. Steiger has proposed, in which a lot of the benefits go to the land speculators, go to the commodity speculators, go to the people who realize capital gains on jewelry, on paintings, or what have you, you are wasting a lot of valuable Treasury resources that ought to be applied to really help business invest.

It seems to me, it is significant that the President has not said he will not accept anything in this area. But he is not going to make that proposal and the administration is not going to make it. If the Congress is intent on doing something about capital gains, then in the context of the general program which the President has put forward, and which we consider to be sound, some recognition should be taken of the factors that I have cited. A program that is more limited, that can be accommodated within the $20 billion cut, that is more progressive, that benefits the average homeowner, that creates an incentive for venture capital and capital accumulation, certainly, as Secretary of the Treasury, I would want to look at it very closely and would be much more inclined to recommend it to the President.

I cannot tell you what the President would say. I think it is significant he has not said he will not accept anything in this area.

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The CHAIRMAN. What you are saying is you certainly would be receptive to suggestions from up here that would be more equitable in nature and carry out the purposes that you have just outlined there?

Mr. BLUMENTHAL. That is my view, Mr. Chairman.

The CHAIRMAN. When you speak of better ways of stimulating investment and venture capital, are you talking about reduction of rates and different treatment of accelerated depreciation and investment tax credit and those traditional areas? Is that what you had in mind?

Mr. BLUMENTHAL. We have, of course, a proposal on investment tax credit before you and I know that the business community is very interested in that. No; I was referring to the fact that one of the arguments made in favor of a reduction in capital gains tax rates, which I hear from Wall Street, I hear from the business community, I hear from the investing community generally, is that it may be helpful to channel more money into equity markets.

Clearly, there has been a deficiency of capital going into equity markets, the debt equity ratios of corporations are high, and it would be desirable to channel more capital into equity markets. Additional capital raised in this way can be used to create more jobs and increase productivity.

Particularly, people have said that the venture capitalist, who has to take risks, is dissuaded from putting his money into such kinds of ventures because the tax at the end, if he does hit the jackpot, is too high. I really had in mind, if there are going to be proposals from the Congress on capital gains, focusing them on those areas that are particulary directed toward these kinds of purposes rather than spreading them across the board and giving them to those who, (*a*) really don't need it, and (*b*) won't invest it in productive facilities.

The CHAIRMAN. In pointing out the need for fiscal restraint you note a massive tax reduction would increase the Federal deficit by incredibly large amounts over the next few years. Supporters of the Kemp-Roth proposal have suggested that the Treasury made similar kinds of estimates at the time of the Kennedy-Johnson tax cuts, estimates of revenue that they say turned out to be wrong.

Could you lay out for us the Treasury's estimates of revenues on a unified basis for period 1963 to 1968? If you could give us those for the record and probably just comment on them now.

Mr. BLUMENTHAL. Yes. I will take you up on that, Mr. Chairman. I don't have it with me. I will submit it for the record.

[The following information was received for the record:]

ESTIMATED REVENUES OF UNIFIED BUDGET RECEIPTS

Actual unified budget receipts rose $54 billion from 1962 to 1968. For this same period Treasury estimates reported in the budgets predicted a $52 billion increase. In both 1963 and 1968 (after adjusting for the proposed surcharge which was delayed until fiscal year 1969) the level of receipts were, in fact, overestimated by Treasury. For the 6-year period, 1963 through 1968 the average estimating error was 4.6 percent. These errors ranged from a low of less than three-fourths of 1 percent for 1965 to a high of nearly 8½ percent for 1966.

Attached are two tables which explain these calculations in more detail.

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ESTIMATED AND ACTUAL GROWTH OF UNIFIED BUDGET RECEIPTS, 1963–68

[In billions of dollars]

	Fiscal year—						Cumulative 1963–68
	1963	1964	1965	1966	1967	1968	
Actual growth of receipts [1]	6.9	6.1	4.2	14.0	18.7	4.1	54.0
Treasury estimates of the growth of receipts [2]	13.4	3.9	4.7	5.3	16.7	[3] 8.3	52.2
Treasury estimates according to Congressman Kemp [4]	—2.4	—5.2	—13.3	—20.0	—23.7	—24.4	—89.0

[1] Calculated as the year-over-year increase in actual receipts measured on the unified budget concept. Source: "The Budget of the United States Government" for fiscal years 1964–70.

[2] Calculated as the difference between receipts estimated 18 months prior to the end of the fiscal year and those estimated at the same time for the fiscal year in progress, measured on the unified budget concept. Source: "The Budget of the United States Government" for fiscal years 1963–68.

[3] Estimates for 1968 have been adjusted to exclude the proposed income tax surcharge which did not take effect until fiscal year 1969.

[4] Statement of Congressman Jack Kemp. Source: "Congressional Record," Apr. 6, 1978, page H2579.

Note: Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, June 27, 1978.

COMPARISON OF ESTIMATED AND ACTUAL UNIFIED BUDGET RECEIPTS, 1963–68

[In billions of dollars]

	Fiscal year—					
	1963	1964	1965	1966	1967	1968
1963 budget (January 1962)	113.5					
1964 budget (January 1963)	105.4	109.3				
1965 budget (January 1964)	[1] 106.6	111.3	115.9			
1966 budget (January 1965)		[1] 112.7	114.6	119.8		
1967 budget (January 1966)			[1] 116.8	124.7	141.4	
1968 budget (January 1967)				[1] 130.9	150.3	158.6
Actual receipts	106.6	112.7	116.8	130.9	149.6	153.7
Estimating errors:						
Estimate made 18 months prior to year end minus actual receipts	+7.0	—3.4	—0.9	—11.0	—8.1	+4.9
Error as percent of actual receipts	+6.5	—3.0	—0.8	—8.4	—5.4	+3.2

[1] Denotes actual level of unified budget receipts.

Note: Details may not add to totals due to rounding.

Source: Office of the Secretary of the Treasury, Office of Tax Analysis, July 14, 1978.

Mr. BLUMENTHAL. Let me comment on the Kemp-Roth proposals, generally.

I think that analogies are always risky. They are particularly risky in economics, as we well know. And in this particular instance the simple analogy to the early or mid-1960's is not only risky but it is exceedingly faulty and just plain wrong, in my judgment.

The conditions under which we are operating are entirely different. Let me give you a few of the differences and I think you will get the flavor of the reasons why we are most skeptical that you can look at the 1963–65 situation and say the same thing would happen in 1978.

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From the fourth quarter of 1962 to the fourth quarter of 1963, the Consumer Price Index increased by only 1.4 percent. During the past year, unfortunately, we are looking at a consumer price increase of almost 7 percent. And we expect it might be over 7 percent for the next year.

We looked at a prime rate in 1963 of 4½ percent. On July 7, 1978, the average prime rate was 9 percent. We had a deficit in the Federal budget in the fourth quarter of 1963 of close to zero, virtually a balanced budget. We are operating now with a deficit of over $50 billion. We are operating today at 84 percent of industrial capacity and higher in some critical sectors. Operating rates were lower during that period.

Moreover, we have seen a number of major factors changing in the economy. Employment population ratios are much higher today than they were then. Labor force participation rates are much higher today than then. So we are operating in an inflationary environment with very different statistics, very different utilization rates, and it simply is not plausible, therefore, to say that the same relationships, the same impact that occurred in 1963 through 1965, would occur again, under the very changed circumstances that exist in 1978.

What happened in 1964 was that the demand was impacted considerably and given that the supply was available, inflationary pressures did not result. There is no evidence at all that what we are facing now is a lack of demand, that we substantially need to stimulate demand. There is also no evidence that, in the short run at least, the kinds of tax cuts proposed would stimulate an expansion of supply and productive capacity in the way suggested.

The fact is that the claims that have been made by the proponents of Kemp-Roth that it would bring forth greatly increased effort on the part of individuals and business, and that these increased efforts would raise economic activity, expand capacity, and bring in more revenue for the Treasury, are assertions not backed by any empirical evidence that we can lay our fingers on. So, I think, Mr. Chairman, it is for this reason that we are most dubious.

Now, even the studies that have been commissioned by Mr. Kemp——

Mr. SIMON. Would the chairman yield?

The CHAIRMAN. Let him finish.

Mr. SIMON. Excuse me, if I could, I hate to interrupt because I agree with your general thrust of what you are saying on Kemp-Roth. But, everything you say, when you say there is no need to stimulate demand and everything, suggests to me that maybe our colleagues from Texas and Ohio on Ways and Means may be correct in saying we should not have any tax cut other than a simple extension of the tax cut we have had previously.

Mr. BLUMENTHAL. I will address myself to this if you will, sir.

We have names and labels for all of these things, I guess that is Vanik-Pickle; at least in the House Ways and Means Committee it is Vanik-Pickle. I don't know what it is on the Budget Committee, and I will be happy to comment on that part of it, which is the other wing.

Mr. SIMON. Excuse me. All right.

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Mr. BLUMENTHAL. The final point I wanted to make is that even the studies that have been commissioned by Mr. Kemp himself show that in the first 3 years, what we would have would be a larger deficit. That is unavoidable, because even if these favorable consequences ensue, they would ensue over a longer period of time. So certainly his own studies indicate the deficit in the first year would be increased by $12.4 billion and in the third year by some $37.9 billion. In addition, these studies show that at least 1 percent would be added to the inflation rate. And as my colleague, Charles Schultze, has indicated to you, he thinks that 1 percent is probably on the conservative side, and I agree with him in that regard.

So we certainly would be operating, therefore, with a $60 to $70 billion deficit the first year and a larger one in the next year.

There is no empirical evidence that we can put our finger on which indicates that under the circumstances in which this economy is operating today all of that will be washed out by people working harder and more people coming into the labor force. Bear in mind we already have very high participation rates.

Since demand is not going to be stimulated in the same way in which it was in the early 1960's the same effects cannot be expected. Even the study by Norman Ture, which uses a model of the type suggested by Mr. Laffer, who is one of the economist fathers of this approach, as I understand it, indicates that even after 10 years, the revenues of the Treasury, would be down, compared to present levels, by $43 billion.

Mr. Chairman, I can elaborate on it further, but I think under those circumstances we simply do not think it is responsible to ask for those kinds of cuts unaccompanied by spending cuts.

Now, if the proponents of it would indicate that the Congress were willing to vote spending cuts of some 34 percent over the next 3 years to match the 34 percent tax reduction, then I think we would clearly at least have something where the two sides fit. I don't know whether that would be a desirable policy, but at least the two sides would fit. In this case the two sides really don't fit.

The CHAIRMAN. The two sides might fit, but it would create some problems.

Mr. BLUMENTHAL. I think it would. Mr. Chairman would you like me to respond to the idea that there should not be a tax cut at all?

The CHAIRMAN. Fine.

Mr. BLUMENTHAL. I think, as I indicated in my opening remarks, sir, our best estimates indicate the need for a tax cut. I have to hasten to add that these are estimates and, of course, we can be wrong. Unfortunately economics is not sufficiently precise and with all of the computers in the world we really cannot say this with 100-percent precision but, as best as we can tell, our analysis indicates that a $15 billion cut in fiscal year 1979 and a $20 billion cut for the full calendar year of 1979, will give us a growth rate in this country of a little over 4 percent. That kind of growth rate is somewhat in excess of the long-term sustainable rate of growth. I would say even we need about 3½ percent or so of real growth just to stay even.

Without a tax cut there would be an effective increase in taxes on lower and middle income Americans in particular, who are

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impacted by inflation and by higher social security taxes, and we don't think that is fair.

The President's goals of getting Federal spending down to 21 percent of GNP, and keeping Federal taxes as a constant or slightly reduced percentage of personal income would not be possible. We could not achieve it. We would, in fact, be increasing taxes that are paid by lower and middle income Americans, and we don't think that is fair.

Also, we do believe, as I said earlier, that we need to provide incentives for business to invest and to create more jobs for the future and to maintain growth at 4 percent or so. Therefore, having no tax cuts at all, I believe would go too much in the other direction. It's the wrong way to balance the budget. We need to balance the budget by keeping spending under control and getting it down and not by effectively raising taxes on the average American.

The CHAIRMAN. Thank you. Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman.

I have not been at the Budget Committee for awhile, and I am pleased to note we have abandoned the 5-minute rule during my absence, because I have a lot of questions which I would like to ask.

The CHAIRMAN. We have not abandoned the 5-minute rule, Mr. Conable, but we are going to give you equal time.

Mr. CONABLE. First of all, Mr. Secretary, I am sure you are not aware of it, but I would like to call to your attention a recent study of Martin Feldstein on the impact of a 25 percent maximum capital gains rate on the probable amounts of capital gains claimed in 1973, the last year for which firm figures were available to him. It's a very interesting study. It indicates generally that there would have been three times as many capital gains claimed in 1973 at the 25 percent rate as there were at the rate which then obtained.

You know, I am sure if I were in the administration I would be very much concerned about inflation and thinking about the various components of our present rate of inflation and I am sure you do look at that list.

I have made a list of seven components and I would like your assessment. I don't ask that you try to quantify what each is contributing to the rate of inflation at the present time, but I would like your assessment of which ones you think are most necessary for us to deal with if we are to get our rate of inflation back to a manageable prospect for the country. Let me list them.

First: Fiscal and monetary policy, including the problems of deficit.

Second: Food and fuel price increase, special problems of that sort.

Third: The decline of the dollar abroad, and its impact on imports and exports, and the related issue of protectionism, reducing competition within our American market and permitting some industries to raise domestic prices as a result of the decline in the competition.

Fourth: The mandated expenses, such things as safety requirements, environmental consequences, Davis-Bacon and so forth.

Fifth: The increases in the minimum wage, social security taxes, the total burden of taxation. You will note many of these items

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have to do with Government, and so we can deal with them directly in one way or another. But I realize there are other factors besides that.

Sixth: The problems of industrywide bargaining and large wage settlements, which is going to be a serious problem next year. It is a problem now because industrywide bargaining obviously does not need to be reflected in changing competitive concerns among the components of that industry.

Seventh: The shortfalls in investment and ultimately in productivity and supply, which are also, I think, a long-term concern and may have some impact in the future, particularly if we get into demand-pull inflation instead of cost-push.

Now, looking at these seven items, can you tell me which ones you think are most critical at this point, which ones are the largest and most serious components now and for the immediate future at this rate of inflation? I don't ask for your solutions, I would just like to get some idea of what you think we ought to really focus on the most.

Mr. BLUMENTHAL. Mr. Conable, I see now why you asked for equal time. I am going to have to ask for equal time, too, because the answer to that question, if I were to do even minimal justice to it, would cause me the severe wrath of the chairman in taking up his time.

Mr. CONABLE. The chairman is a very agreeable man, very patient and extremely kind to members of the minority who ask long questions.

Mr. BLUMENTHAL. I thought you were including me as a member of the minority.

First of all, let me say I think your list probably could be expanded somewhat to include other factors.

Mr. CONABLE. I don't claim to be an economist, sir.

Mr. BLUMENTHAL. But taking those seven as you listed them, I would say I fully agree with you, all seven of them are important factors. It is difficult to single any one out.

I would hazard the hypothesis that, one, fiscal and monetary policy is probably the key to it, although it alone will not do the job. The point being that, in my judgment, we cannot succeed in reducing inflation if we do not follow very careful and conservative fiscal and monetary policies at the present time. Not only is the Government clearly a big factor in the overall economy but also the Government sets the tone, hopefully, the Government provides signals for the rest of the economy, and has much to do with the general level of confidence or lack of it. Therefore, fiscal and monetary policies are critical. And I would say we are partners in this in the executive and legislative branches, for obviously we both share the responsibility for how we come out on this.

I think, second, is the importance of the shortfall investments. Let me ask you one further question. Are you talking about the most critical factors, the ones with the largest need in terms of the immediate impact?

Mr. CONABLE. Well, what ought we be focusing on more than others?

Mr. BLUMENTHAL. All right. I think shortfalls in investment, productivity, and supply I would put very high up on the list.

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Now, that does not have an immediate impact, obviously, but it does have one 3, 4, 5 years down the road. If we don't take the leadtime and do it now we will be in a worse fix 2 or 3 years from now than we are today. We certainly will have continuing inflationary problems unless we deal with the need to increase our productivity and our capacity. So I would assign equally high priority to that. That is, of course, what the tax debate is all about.

I would say that the question of fuel imports, decline of competitiveness and protectionism are other very important issues. There we have some countervailing pressures that I think we need to take into account. The program to develop greater self-sufficiency in energy, to encourage conservation of energy, clearly has some shortrun inflationary impacts. We cannot get away from that. That is a cost I think the economy and all of us have to bear.

I think in the medium and longer run it actually is anti-inflationary for various reasons you well understand, but it does have an inflationary impact. Yet I would concentrate on it because it tends to lead to greater stability of the dollar and, therefore, helps the trade environment. Fighting protectionism, which is highly inflationary, and promoting exports in particular, in my judgment, are also critically important to this anti-inflation effort.

Now, all of these other things, minimum wages, social security taxes and taxation I put under fiscal policy really. I subsum them under that. I don't believe you can isolate these. Certainly the social security taxes and taxation is part of the fiscal policy, and minimum wage is also important. I would not put it——

Mr. CONABLE. They become elements of cost quite apart from the impact on fiscal policy.

Mr. BLUMENTHAL. Sure, they are. They are elements of cost but, on the other hand——

Mr. CONABLE. That is why I put minimum wage with those rather than isolating that. I meant to look at that apsect of it. I realize fiscal policy is something, too.

Mr. BLUMENTHAL. Finally, I wouldn't call it industrywide bargaining, I would list union wage policies and business practices.

Mr. CONABLE. Business practices obviously are involved. They are going to take a tough line if they know they can pass it all on because there is no competitive pressure on them to absorb any part of it.

Mr. BLUMENTHAL. In other words, under six I would have wage policies and business practices. Clearly, these two things fit together.

Mr. CONABLE. You left out mandated expenses.

Mr. BLUMENTHAL. Yes, we are beginning to work on this. I think that is very, very important and it seems to be terribly difficult to do anything about it. Anything the Congress can do in that area.

Mr. CONABLE. It is not unrelated to shortfall investments. Many of these things are interrelated and perhaps artificially isolated in my list.

Mr. BLUMENTHAL. I would say in conclusion, sir, that I would place an attack on mandated expenses, on inflationary, ineffective, mandated cost increases, and there are plenty in the U.S. economy and every corporate executive can give you chapter and verse on it, of highest importance to this country.

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In my judgment the President has his hands tied in this area. The Congress is under great difficulty in this area and we better address ourselves to it sooner rather than later.

So I would say I put that high up on the list. I put it together with shortfalls in investment because that takes time, too, but unless we attack those two things, we won't have it better 3, 4 years from now.

Mr. CONABLE. Thank you, Mr. Secretary. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much. The time of the gentleman has expired. The Chair recognizes Mr. Mineta.

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

Mr. Secretary, it is good to see you and I hope your father is having a good time in San Jose.

On page 5 you speak of inflationary pressures of wage increases, and concurrently, to follow up on this question that my colleague from New York had, labor is being criticized as a major impetus in the continuation of inflation. What has been the actual wage experience in the entire economy? Which groups within the labor force have gained the most? If we engage in the traditional policies of demand restraint to deal with inflation, which groups do you think will be possibly thrown out of work?

Mr. BLUMENTHAL. Mr. Mineta, I don't have the exact figures before me. I think in a period of almost certain recession which follows high inflation, it is the average worker who suffers most from the lack of employment, higher unemployment really impacts him, and I think the experience of the middle seventies indicates that real wages do not keep up in that situation with the increases in the cost of living.

So the worker, everybody gets the short end of the stick to some extent, but labor in particular. For that reason I think labor has a particular stake in making sure that inflation does not get out of hand. For the extent to which it does lead to recessions, which it always does, there will be great suffering.

My impression is, as I recall the figures, and I would be glad to submit them—I don't have them at my fingertips—that is exactly what has happened in the period in the middle seventies, that real wages did not go up, they declined in fact for a period of time and that the wage settlements that were agreed to were not sufficient to make up for that kind of loss.

Recent wage settlements have been higher partly to make up for that shortfall and perhaps because there has been a tendency to try to get ahead of that. Now what we are seeing is that smaller union and nonunion wages are also rising quite significantly to catch up with the larger union wage settlements that have been made.

I am not one who puts the blame on wage settlements, just as I don't think it is fair to put the blame on business and say it is anticompetitive practices of business that are causing this inflation. I am persuaded that in a complex economy such as ours, it is all of these factors interacting and, importantly, and you notice I put it No. 1 on Mr. Conable's list, fiscal and monetary policy of the Government. That has to lead the way.

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But then we can't succeed unless there is an understanding that in the long run if you increase wages more than productivity, you are never going to ratchet this thing down.

Mr. MINETA. In that wage-price spiral, in that momentum inflation, where do you jump in? Where do you step in to try and decelerate that?

Mr. BLUMENTHAL. Well, the problem is, I think, what we are dealing with are sort of self-fulfilling prophesies, if you will. The President's deceleration standard that he talked about in his April 11 speech——

Mr. MINETA. Is that the 5½ percent?

Mr. BLUMENTHAL. No, the 5½ percent is the Government workers part of it. The President said he wanted to keep increases in Government pay to no more than 5½ percent, which is lower, which is deceleration from the previous year.

He said he hoped that if he took action to have a tight fiscal program, if he kept Government pay increases to 5½ percent, if he froze the pay of Government executives, if he got the deficit down more quickly and put a tight rein on Government spending, if he did all of these things, then we could get inflation to subside somewhat. But we need more, we also need deceleration in wages and prices. If simultaneously business and labor would commit themselves to accept wage and price increases at a less rapid rate than the average of the previous 2 years, then prices would increase less rapidly. They wouldn't need as large an increase, they would be no worse off and we would bring inflation down.

If, however, one side said it doesn't trust the other, it is not going to happen, I better get in and get mine quick and early, the other side will have to do the same and we will be invalidating what we are trying to do.

He felt he was taking the first step with this program and was saying to business and labor, you had better do the same thing or it will fail. That is the philosophy behind a deceleration standard which is voluntary, because we don't believe in inflexible wage and price controls. If labor and business will agree to wage and price increases which are less than the average of the previous 2 years, if they are willing to do that, we will all be better off. But that is easier to say than to do. That is the philosophy behind that approach.

Mr. MINETA. It seems to me prices and wages have really been inflexible, downward.

Mr. BLUMENTHAL. They are more rigid than they have been in past periods. We find a higher rate of inflation associated with a given level of unemployment than used to be the case in the early and midsixties, for example, which is why comparisons with that period are so difficult to make. There is that rigidity, it takes longer, there is longer leadtime. Therefore we need greater patience, yet we seem to have less, not more, these days. We look at last month's figures and try to make policy instead of giving it enough time, looking ahead a little and waiting over a longer period.

Mr. MINETA. One effect of inflation is to increase the revenues of the Federal Government automatically because of the progressive nature of our tax structure. There are a number of proposals

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before Congress to remove that inflationary basis by indexing the code for the effects of inflation. Do you think that the inflation-induced revenue is substantial and do you think moving to index the Tax Code would be wise?

Mr. BLUMENTHAL. I believe it would not be wise, Mr. Mineta. Our problem, and one of the sources of the rigidities that we have in our economy at the present moment is that a large portion of payments received by individuals is already indexed, too large a portion is indexed.

Mr. MINETA. Cost of living benefits?

Mr. BLUMENTHAL. Yes; they are indexed. The Finance Minister of Brazil, where indexing has become a way of life because they have had rates of inflation which I hope we will never see in this country, said if there is one thing you want to avoid doing, one thing above all, is to get yourself caught on this kind of indexing. For then you write in a rate of inflation and you are never able to get rid of it.

We have a form of informal indexing which I think is much better and that is, if you will permit me to be so bold as to suggest, the U.S. Congress. The U.S. Congress every couple of years, or maybe each year, considers tax legislation and when you look at the curve of tax reductions that have been voted, you see in fact that they have been steady reductions to take account of the moving into higher tax brackets.

I think that is a more flexible device because at least it provides the opportunity, whether the Congress takes it or not, and I sometimes regret you don't take it more, to adjust a system in an anti-inflationary way and allocate these revenues in an effective manner.

If it is done mathematically and mechanically, you have robbed yourself of that option. As long as you make sure you don't follow the advice of those who say don't cut taxes, because then you really would put people in higher brackets, but you cut them enough to take account of inflation and do it in a flexible manner, you are indexing effectively in a better way than if you did it mechanically.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Ohio, Mr. Regula.

Mr. REGULA. Thank you, Mr. Chairman.

Mr. Secretary, you mentioned earlier that you might be part of the minority. After reading your statement and listening to your response to Mr. Conable, I would welcome you.

I particularly congratulate you on the statement, and I don't think it has been made in the hearings thus far, that "to depend too heavily on monetary restraint risk is distorting the composition of growth and eventually aborting the expansion." I hope all will pay heed to that.

You mentioned the trade imbalance and at the same time your concern for protectionism. On page 3 you say, "Unless we redress the serious imbalance in our foreign trade," and you mention this a couple of times. How do you deal with the dichotomy involved here? Of course, unless we have some restraints, that is, protectionism, if you will, the trigger price mechanisms, et cetera, we run the risk of this flow in an environment of free trade but perhaps not fair trade. Second, of course, the fact that $5 billion in interest

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payments on the national debt are flowing out of the country to foreign investors is another element in the imbalance of foreign trade. How do you propose to deal with this seemingly contradictory situation?

Mr. BLUMENTHAL. Let me deal with the last point first and then come to the main point which you raise which I think is a very real one.

I am not particularly worried about interest payments on U.S. debt to foreigners for two reasons. One, it means that the foreigner is investing in the United States and I want more of that. I think that is good for the U.S. economy, it is good for our balance of payments, in fact, and it is certainly good for jobs and in every way, shape or form.

I should also add that what we earn from abroad is quite a bit greater than we pay out anyway. So we are doing well in that area and I wouldn't want to restrict it or cut it down.

I think the basic issue you raise is very important because obviously in a world which is not free, as far as trade barriers are concerned, you can't have one country, even one as large as the United States, that practices a certain kind of policy without taking seriously into account what happens to jobs in this country if other countries don't do the same thing. The fact is that no country, including the United States, really practices a policy of open trade completely.

You mentioned trigger prices. We have all kinds of restrictions on agriculture and other commodities. Other countries have the same thing.

I think that we have to be cognizant, and it is politically unrealistic to expect anything else, that there are individual situations, in which protection and relief to individual industries for limited periods needs to be provided while we bargain with other countries to make sure that we get an equal deal for our exports and while we adjust internally in those individual circumstances where a particular group is suffering.

That does not in any way deny the validity of the basic concept that protectionism hurts everybody and overall you try to get the level of protection down. The whole history in this regard of U.S. policy since the end of the war, on a bipartisan basis, regardless of who has been in office, has been to subscribe to the notion that protectionism a la the 1930's hurts us all. I am happy to see that we are making progress again in Geneva to bring protection down for all countries, but we were also talking about a safeguard clause at the same time.

That is one of the things we have to negotiate, so that we all have the right, in isolated instances, to have time to make adjustments and to protect people's jobs in individual circumstances.

Mr. REGULA. Thank you. You make quite a point of capital formation and I think accurately so. It is a serious problem and you, of course, question the proposals that are pending on the capital gains tax.

How would the idea of allowing reinvestment of any capital gain in another type investment, and not taxing it until such time as it is used as a spending—until you took out your profits and, second, as part of this, allowing an indexing of any capital gain that would

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result from simple inflation so that the tax would be paid at ordinary rates but it would only be paid on money that is being used to spend and also that represents real dollar profit to the individual?

Mr. BLUMENTHAL. This kind of a rollover provision, as it has been called, which we do have in the code for housing—if you buy another house in 18 months or less—has been looked at carefully by us, as has the second idea that you put forward of indexing so as to adjust the sales price for inflation, the idea being you don't tax inflation.

Mr. REGULA. As I understand, many countries have no capital gains tax.

Mr. BLUMENTHAL. Well, you have to be very careful about that one, Mr. Regula. For example, the Germans are always cited as having no tax on capital gains, which is true. But what people don't point out is they have something in its place, which is worse. They have a wealth tax and the difference between a capital gains and a wealth tax is in capital gains you only tax the gains when you realize them. In the wealth tax, each year they come around and look at the net worth, on paper, and tax both the unrealized and realized gain. That is worse.

I always say to people when they cite Germany as the shining example, do you really want us to propose to the Congress that we substitute a wealth tax for a capital gains tax.

In Japan the situation is more complicated for they have a system that taxes capital gains at ordinary rates for all but stocks and those they don't tax at all.

I think you can't compare specific aspects of a particular tax system with any other. You have to look at the total tax structure. Then you come up with one conclusion, which I think most Americans would be shocked to realize, and that is that taxes in this country—we complain because they are so high—are lower by any measure than in most other developed countries in the world. That is something for us to be proud of, but also to be concerned that we don't lose it, because if we did, we might be in the same fix as some of the countries that have allowed their tax rates to go so high.

Quickly on the rollover, we have looked at that. I really think that dealing directly with homeowners, perhaps extending the benefits that they already have, dealing in a more targeted fashion by offering incentives to people who want to invest in venture capital and risk their money, are better ways. It is again a question of alternatives. If we use the money for one thing, we don't have it for another.

One of the reasons it is a better way is that my colleagues in the Treasury tell me it is exceedingly complicated to have these rollover provisions. We would have to come and ask you for a rather large increase in an appropriation for more revenue agents because, bear in mind, we would have to trace through each transaction, not just for houses but for whatever other purpose, trace through each particular taxpayer reinvestment. Was it the same money that was reinvested, how long was it held. Imagine, 10, 20 years out what kind of records you would have to keep.

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In terms of tax administration, it becomes a practically impossible problem for us to solve, and we feel we have other ways of doing the same thing but doing it better.

Mr. REGULA. One quick question. You make quite a point of productivity. You don't speak to it in terms of the governmental sector which takes a good chunk of money. Do you think Civil Service reform would enhance productivity in the governmental sector?

Mr. BLUMENTHAL. I am almost embarrassed that you ask me these questions, sir, because it almost seems as if I have fed them to you, which I haven't, I hasten to add.

Certainly for anyone coming from private industry into the Government, and having the responsibility for administering or attempting to administer a department of 125,000 people, there is nothing that is more discouraging than the present set of impediments on executives, and on the President ultimately, in managing things efficiently and in providing for greater productivity. Let me give you one example in that regard.

The Treasury recently proposed a very small simplification in the management structure of certain Internal Revenue offices. The sum total of that reorganization—I hope these numbers are right, they are about right in order of magnitude certainly—would have involved the reduction of slots to the tune of 242. That is 242 out of 80,000 people in the Internal Revenue Service, with an annual saving of about $7 million. While $7 million is but a drop in the bucket for the total Federal Government, it is a way to make things more efficient. We would have gotten more efficiency by making the system simpler.

I think as a Member of Congress you can imagine the kind of problems we ran into. In certain particular offices it meant the reduction of six job slots but not people who would lose their jobs. They might be transferred or go through attrition. It wasn't 242 people unemployed, but 242 people transferred or absorbed through attrition.

The comments from Members of Congress, who shall be nameless here, as to "What are you doing?" "What are you doing to my district, four jobs, six jobs?" were tremendous. There were threats that our budget would be impounded or that other terrible retribution would be visited upon us, resolutions introduced. That is one of the ways in which we have to struggle to get greater productivity in the Government.

Civil Service reform, which allows the transfer of people, which provides incentives, which makes management of people in the Government move into the 20th century and move within shouting distance of what is done in industry, is very important and I hope you all support the President's program in that regard.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Ohio, Mr. Stokes, is recognized.

Mr. STOKES. Thank you, Mr. Chairman.

Mr. Secretary, my first question deals with the administration's capital gains tax approach. When we consider the present unemployment picture and acknowledge the fact that there has been some overall general reduction in the unemployment rate, and, at the same time, we know that the young, minorities, and the poor

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are experiencing an extraordinarily high rate of unemployment, in fact, an intolerable rate, it just seems to me that the capital gains tax approach actually enhances or encourages capital growth at the expense of the marginal labor market. Wouldn't it be better for us to try and take an approach where you would have encouragement or enhancement with reference to growth in the labor market?

Mr. BLUMENTHAL. Well, Mr. Stokes, I think that one should say in all fairness that those who have proposed capital gains tax relief have argued that by providing greater incentives to invest, you create more jobs, and I think if it is under certain circumstances that may be true. I carefully say under certain circumstances, not under all circumstances, and not in all ways. Some of the ways proposed would not do so. I think there is some truth in that.

Clearly, however, if the resources that are used for that purpose—and that is the point I made at the beginning of my remarks in answer to the chairman's question—are taken away from lower- and middle-income people, or from other kinds of tax reduction that are really job creating, as for example, targeted job tax credit, clearly you would have the kind of problem on your hands that you are referring to.

That is why how we spend that $20 billion is important if we want to use tax relief to create the maximum number of jobs, and to target them to the areas where we have the highest levels of unemployment. Even last month, black unemployment was still at 11.9 percent and teenager unemployment still at 14.2 percent. So while we are happy about the 5.7 percent overall rate, we are not at all happy about these other numbers.

That is critically important, and I agree we have to be very careful and not rush in and hurt these kinds of factors that we also want to improve.

Mr. STOKES. I would also question whether the venture capital approach, which you spoke of with reference to Mr. Regula's question, wouldn't be more efficient if targeted to small businesses rather than to business straight across-the-board. Wouldn't it have a greater impact?

Mr. BLUMENTHAL. I think there is a valid argument that can be made, sir, that the venture capital typically is a small businessman. The great developments in this country, I am sorry to say, having come out of a very large company, are not typically made by very large companies. They are made by small people who have an idea and develop it if they can raise the capital, and that is a problem now.

So if you provide an incentive for venture capital, a good portion would go to smaller companies anyway. I would say also that a job is a job is a job. I don't really care if in the city of Detroit or Cleveland, or wherever, whether an additional job is created by a small or large company, as long as it is created. And if we find through business tax reductions the best possible way of creating additional jobs in those areas, where unemployment is still high, I will be very happy.

Mr. STOKES. I have one further question. In your formal testimony you mention the administration's continued support of tax reform. Given the short time that Congress will be in session with

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an October adjournment presently scheduled, what realistically is the administration's thoughts for tax reform in this Congress?

Mr. BLUMENTHAL. Mr. Stokes, the administration has its proposal before the Congress. It has not changed that proposal with respect to the reforms, both to make the system simpler as well as to make it fairer. We hope, and the President is very anxious, to have the Congress enact the maximum of those reforms—all of them, if possible.

I recognize that time is getting short. It is, therefore, urgent that the House and then the Senate, get on with the consideration of a tax bill. We have not pulled back from that, and we will be working actively to convince the Congress to adopt the maximum number of the reforms that have been suggested, because we believe that they are fair and, incidentally, provide revenue, additional revenue, which can be used more productively and more effectively if it were available to us.

Mr. STOKES. Thank you, Mr. Chairman. Thank you, Mr. Secretary.

The CHAIRMAN. The gentlelady from Maryland.

Mrs. HOLT. Thank you, Mr. Chairman.

Mr. Secretary, I apologize for not being here to hear your statement.

Mr. Bosworth testified yesterday before the committee, and I don't want to misquote him, but I think he said there was no correlation between budget deficits and inflation. This statement disturbed me. While it may have been historically true at some time, don't you believe that the huge deficits, both in relative and absolute size that we have had back to back, are a contributory factor in inflation?

Mr. BLUMENTHAL. I haven't seen the precise statement which Mr. Bosworth made. I would say if he stated flatly that budget deficits are not correlated with inflation, I would disagree with him. I think that is clearly not true. Mr. Bosworth is a very able economist. He probably qualified that statement in some way.

Mrs. HOLT. That is why I don't want to misquote him.

The CHAIRMAN. If the gentlelady would yield—I don't think Mr. Bosworth said it flat out. It was part of a broader statement where he was talking about the many causes of inflation and that it wasn't correct to say that large deficits are the only cause.

Mrs. HOLT. I withdraw the question then, and I will reword it.

Do you think that there is a correlation between budget deficits and inflation and, really, that they force the Fed to pursue a more expansionary policy? And even more than that, it seems to me that it is the confidence of the people.

Now when we offered our first budget resolution, I offered an amendment that would have held our spending—I was trying to hold it to current services because I felt that would be real leadership—to labor, to everybody else, to say, "OK, Government is going to try to do its part," and I think that is where we really should start, is to establish some kind of appropriate growth My second question: What do you think an appropriate growth rate is? Or am I right in my attitude about that?

Mr. BLUMENTHAL. Mr. Conable earlier gave me a list of seven possible, or in his judgment likely, causes of inflation, and I indi-

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cated to him that while I accepted each one of those seven as being a contributory factor, probably he and I could agree on two or three additional ones at least. I think therein partly lies the answer to your question.

Inflation is caused by many factors; therefore, an attack on inflation must address itself to all of these. I think then, in that context, answering your question specifically, in a period in which the economy is operating at a high level of capacity—which it is, relatively speaking now, with rates of unemployment that have been dropping, with industrial capacity that is not at maximum but that is high—a deficit of the size that we are having is a contributing factor in my judgment.

You can't measure it by a $3 billion or $5 billion difference either way, but clearly if we did not have the $48.5 billion deficit, if we were in balance, that would be better for inflation.

There is a second factor quite apart from the numbers, which is the psychology you referred to. I think that the signal that is sent, as you correctly stated—to the business community, to labor, to the financial community and to the international community—from a balanced budget, as against a $50 billion deficit, is clear.

Furthermore, I also agree that two large deficits back to back make it that much worse. I think, therefore, that the President's strong commitment as a candidate, reiterated again and again, that he will be working hard to move that deficit down and bring the budget into balance, is very significant.

I have sat in enough budget meetings now with him and with my colleagues to have a clear appreciation of the difficulties on doing it quickly. His control over the budget is not as large as some people well might think; a lot of mandated programs really are outside of his control. Nevertheless, I think it has to be done, spending reductions need to be carried out. If we were in a very slack economy, my answer would possibly be somewhat different, but we are not.

Mrs. HOLT. Do you think it would be disruptive if we tried to reduce the growth rate of Government? Wouldn't that be a good approach, to say we are going to reduce it 1 percentage point this year, or hold it to current services and try to continue that for 3 or 4 years and, hopefully, at the end of that time that we would have reached a stable situation?

Mr. BLUMENTHAL. I think that the President's approach, which allows spending to go up less rapidly than the GNP and makes Government a smaller share of the total, is the correct approach. As he has pointed out, Federal Government spending has risen to close to 23 percent of GNP, but he wants to gradually bring it down to 21 percent by 1981.

If we can accomplish that, if the Congress would help us, I think we would achieve the goal that you have in mind.

The CHAIRMAN. The time of the gentlelady has expired.

We have a vote on. We have two gentlemen here who have some questions to ask, and we can do it if we stick to the 5-minute rule. Mr. Pike.

Mr. PIKE. Mr. Chairman, in view of the fact I was so late, I will pass.

The CHAIRMAN. Thank you. Mr. Latta.

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Mr. LATTA. Thank you, Mr. Chairman.

I am sorry, Mr. Secretary, I was detained in the Rules Committee, getting out grist for the mill next week and didn't get to hear all your testimony. I have just a couple of short questions.

Since the unemployment rate is dropping so rapidly, and we all are pleased with that, as you indicated on page 2, and 2 million new jobs have been created in the past 6 months, do you really think we need 725,000 public service jobs in our budget for fiscal year 1979?

Mr. BLUMENTHAL. I think so, Mr. Latta. As I pointed out a moment ago in response to a question by Mr. Stokes, even with a 5.7 average, we have 14.2 percent of teenagers, 11.9 percent of black workers unemployed. This particular program is not one that stimulates the economy generally but it is focused on particular groups in which the level of unemployment is high.

I don't have the statistics here, but if we looked at unemployment in the inner cities, for example, where this program is also concentrated, you would find much higher rates than the average. On the other hand, for example, the unemployment rate for adult men is down to 3.9 percent, which is a much better number. So we still need these public service jobs in order to deal with these particular groups and do so on a focused basis, which is much better than general stimulation.

Mr. LATTA. Well, it seems to me, though, that in this time when employment is increasing so rapidly it would be a good time to bring these people into the mainstream, if we possibly could, rather than putting them on public service jobs and keeping them there.

Mr. BLUMENTHAL. Well, the problem is that there is great rigidity in doing that. In 1975 when we had 8.5 percent unemployment on the average, we had 13.9 percent unemployment for black workers. In 1977 we had reduced 8.5 percent to 7 percent, and we still had 13.1 percent black unemployment. Very little improvment.

Now we are down to 5.7 percent overall, but are still at 11.9 percent black unemployment. The same thing with teenagers—it has dropped from 18 or 19 percent to the lowest in a good many years—14.2 percent. These groups just don't respond with general economic activity as we would expect and want them to.

Mr. LATTA. Mr. Secretary, I read in the paper this morning about an Ullman-Jones approach now. It seems like the chairman of the Ways and Means Committee is endorsing the Jones approach on capital gains tax. Does that indicate that the administration is changing its position?

Mr. BLUMENTHAL. No; it does not, Mr. Latta. The President did indicate in his last press conference that for the reasons I have laid out for this committee in some detail, he did not feel he could accept either the Steiger or the Jones approach to capital gains.

Mr. LATTA. How high do you think he could go?

Mr. BLUMENTHAL. He hasn't said that he will go anywhere as far as that issue is concerned. On the other hand, he also has not said that he will not go somewhere. As long as it meets the criteria that I have suggested, which is my own analysis of the situation—there may be a change, but it depends on what other proposals are made.

Mr. LATTA. I have several questions, but one particularly affects my district. Since we have Sylvania in my district—and you are

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familiar with what recently happened by virtue of the Supreme Court decision on imports from Japan—we had a similar situation which hit the television industry very hard a year ago when the President intervened after the Federal Trade Commission had made a decision.

These two acts hit the television industry very, very hard and I can see a lot of employment going overseas as well as a lot of dollars, and when our balance of trade is as it is today, it would seem to me that the administration should be changing its position on these imports. Is there any chance in the foreseeable future that the administration might recognize that we have a problem here and might change its position?

Mr. BLUMENTHAL. I think the administration does recognize that where there are particular problems, particularly those that are of a transitional nature, that some relief is indicated.

In the case of television, some voluntary arrangements, if I remember correctly, were entered into with some countries a year ago. I don't believe that the administration is likely to change its position on the basic question of whether or not the indirect taxes that are rebated by some exporting countries are countervailed in the United States, which is what the Supreme Court decision was about. That is a system that has been in effect for decades and we think there is good justification for not countervailing those.

But where there are particular problems the President has—with due consideration to inflation and unemployment—taken action from time to time and I am sure he would consider doing so again.

The CHAIRMAN. Thank you very much, Mr. Secretary, for taking the time to be with us and giving us the informative material which you have, and the benefit of your views. Thank you.

Mr. BLUMENTHAL. Thank you, Mr. Chairman.

The CHAIRMAN. The committee stands in adjournment until tomorrow at 10 o'clock.

[Whereupon, the hearing adjourned until Thursday, July 13, 1978, at 10 a.m.]

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ECONOMIC OUTLOOK AT MID-SUMMER

THURSDAY, JULY 13, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:30 a.m., in room 210, Cannon House Office Building, Hon. Robert N. Giaimo, chairman of the committee, presiding.

The CHAIRMAN. The committee will please come to order. Our witness this morning is G. William Miller, Chairman of the Board of Governors of the Federal Reserve System.

Mr. Miller, it is our pleasure to welcome you on this, your first appearance before the House Budget Committee. We truly welcome you and are delighted to have you here. We look forward to cooperating with you and the Federal Reserve System in the coordination of monetary and fiscal policy, not only in the months ahead, but also in the longer run.

We are, of course, interested in your forecast of the future path of the economy and your opinion as to the size and composition of the tax cut that will be included in the second budget resolution. We are also interested in what course you think monetary policy should take over the next 12 to 18 months. We are all faced with the very difficult task of continuing the recovery from the 1975 recession and at the same time reducing the rate of inflation. We would certainly welcome any suggestions that you have as to how we accomplish this.

As you know clearly better than anyone else, the conduct of monetary policy is of the greatest importance, not only to this committee, but to the country as a whole, and we wish you well in your new position and your new undertaking.

Welcome again to the committee. You may proceed as you wish.

STATEMENT OF HON. G. WILLIAM MILLER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

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

Mr. Chairman and members of the committee, I do appreciate this opportunity to make my first appearance before your Budget Committee and to convey to you the view of the Federal Reserve on the state of the economy as well as the economic policy issues facing us.

Mr. Chairman, with your permission, I would suggest that the prepared text I have submitted be included in the record, and that perhaps, just to aid the discussion, I will hit its highlights. Then we can turn our attention to the questions that you have in mind.

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The CHAIRMAN. Without objection, we will include your statement in the record and you may highlight it.

Mr. MILLER. Thank you.

The economy is now in its fourth year of expansion and, fortunately, unemployment has been substantially reduced. However, the Nation is beset by an unacceptably high and recently accelerating rate of inflation, and budget deficits continue large for this stage of the expansion. It is essential that longer term policies be structured to confront these problems.

Economic growth, though uneven so far this year, has been on the whole satisfactory. We had a zero growth rate in the first quarter, and will probably show a real rate of growth of 8 to 9 percent in the second. The average rate of growth is satisfactory, but its unevenness has caused certain problems.

The vigor of employment growth is one important measure of the underlying momentum of the economy. The addition of 2¼ million jobs so far this year has pushed the unemployment rate substantially lower, and you will find in the materials I submitted, a chart that shows how we have moved along in reaching this objective. The unemployment rate does remain unacceptably high, particularly for minorities and youth, but we can be encouraged by the progress to date.

[Charts referred to may be found at the end of Mr. Miller's prepared statement.]

Mr. MILLER. Recent data indicate some slowing in the extremely rapid growth of overall activity during the spring rebound. Economic expansion will be reasonably well maintained in the near term, but will certainly drop below the high level in the second quarter.

Sustaining the economy will be a number of important segments. Consumer demand remains strong. You recall that we have had recently a very satisfactory rate of automobile sales. Some of the purchases by consumers, however, may have represented buying in anticipation of future price increases and, to that degree, there may be some distortion in quarterly economic activity. However, surveys indicate a continuing relatively high level of consumer confidence, so we can expect this segment of the economy to continue to be supportive of expansion.

The business sector should also continue to be a source of support. Inventory policies are such and inventory conditions are such that we can expect to see moderate increases in spending for inventories. We also have survey information that would indicate continued moderate increases in capital spending.

In contrast, residential construction will probably cease to be a source of support for the economy. Housing has been operating at a relatively high level, a satisfactory level, but with credit markets what they are we can expect some slackening, although certainly not the kind of downturn that would indicate a recession.

On balance, the evidence suggests further moderate growth in aggregate demand over the near term, sustaining one of the most durable expansions of the postwar period. But the longer term outlook is clouded by the price situation. So far this year, consumer prices have risen at over a 10-percent annual rate as compared with about 6.8 percent in the same period in 1977.

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The food sector has been particularly disturbing and has contributed significantly to inflation, but prices outside the food area have also moved up sharply recently and are continuing to fuel inflation.

We expect some relief later this year from the slowing of food price increases, but with the economy moving into a period of heavy collective bargaining, the intensified inflation is likely to be reflected in larger wage adjustments and more rapid increase in labor costs.

Turning to interest rates, in the last year or so, private and governmental credit demands have risen, putting considerable upward pressure on interest rates. At the same time, the recent and expected inflation has also been an extremely important factor underlying the increase in interest rates contributing to money and credit demand and conditioning the stance of monetary policy. Obviously inflation increases the volume of credit necessary to finance any given level of economic activity. Individuals have to borrow more to acquire houses, cars, and other durables. In the business sector, the rise in the dollar volume of spending on inventories and fixed capital, a significant portion of which represents rising prices, has outstripped internal funds generation, producing a marked increase in borrowing.

In addition to the direct effect of rising prices on credit demands, the prevalent expectation that the rate of inflation will remain high, if not accelerate, has always increased the demands for goods that require financing. The volume of borrowing has been strengthened by existing homeowners withdrawing part of their rising equity in the housing stock, and this, too, has contributed to the upward pressure from increased credit demands.

Borrowing has contributed to worrisome distortions in the financial positions of consumers and businesses. As to consumers, the consumer and mortgage loan repayments have now risen to a near record level as a percent of disposable income. You will find in the material I submitted, a chart showing that almost 20 percent of disposable income is now committed to servicing these debts. Thus far, households have handled this situation well, but it is a cause for concern, requiring careful watch.

In the business sector, the pattern of financing has similarly begun to cause concern. An increasing share of business credit requirements have been handled through short-term borrowings, especially at banks, and this has added to the pressure.

While one would expect strong credit demands as a normal counterpart of a healthy and growing economy, a significant, and I am afraid expanding, share of recent credit growth is both the direct and indirect result of inflation. Moreover, mounting inflation expectations raise the specter of possible speculative excesses leading to shortrun explosion of credit and output and subsequently to recession. The Federal Reserve's firming of monetary policy has been designed to minimize the possibility of such an undesirable outcome.

In the presence of strong credit demands, the worsening of inflation, and the Federal Reserve's efforts to contain excessive monetary expansion, market interest rates have risen significantly. Most short-term rates have increased about 1 to 1½ percent since the

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beginning of this year. This rise in market interest rates has been accompanied by slower growth of savings in banks and thrift institutions. As a result, growth rates of the broader monetary aggregate, M_2 and M_3 have remained within the Federal Reserve's longrun ranges.

The slower rate of growth of savings has threatened to retard the housing industry. Therefore, the Federal regulatory agencies recently took action to increase the competitiveness of bank and thrift deposits subject to regulatory ceilings in order to maintain the flow of credit to housing. Two new savings instruments were authorized effective June 1, and the early evidence indicates this has helped significantly in sustaining flows of funds to thrifts and money for the housing industry.

The persistence of a large Federal budget deficit at this advanced stage of our economic expansion is another disturbing problem. During the last recession, large deficits were both a consequence of and a reasonable policy response to the underutilization of our productive resources. Developments this year, however, suggest that the Federal Government should be moving with deliberate speed to rein in its compensatory policies. The level of private sector activity has risen markedly over the past several years, and there now appears to be much less usable slack in the economy and much less need for Federal deficits to sustain the economy.

Positive steps are thus in order to lessen the Government's competition with the private sector for resources. The Federal Government has a constructive role to play in moderating the ups and downs in economic activity. In the present circumstances, a damper on further expansion of Federal expenditures would help to assure a continued, sustained, long-term economic growth.

In my view, the task of reducing the Federal share of GNP should begin now. I believe we should strive to reduce the Federal Government's share of GNP from more than 22 percent at present to 20 percent or so over the period of 5 to 7 years. As you will note in chart 6 submitted to you with my testimony, this kind of reduction would merely return us to the share of Government activity that existed in the early 1960's. It would, therefore, be a very reasonable undertaking.

Moreover, private capital investment should be encouraged directly by offering incentives to businesses to expand their stock of plant and equipment. Capital accumulation is the chief engine of long-range growth, of labor productivity, and rising living standards. Yet, depreciation guidelines and the resulting deductions have not approached actual replacement costs in periods of inflation. Present depreciation tax laws should be liberalized. For example, businessmen could be permitted to use a shorter writeoff period for machinery, equipment, and structures.

A larger share of GNP must be devoted to capital investment. It will not be enough simply to reach the investment proportion of 10½ to 11 percent of GNP that has characterized past periods of prosperity and low unemployment. In my opinion, the Nation must set an ambitious goal of, say, 12 percent of GNP for an extended period, a level that would support increased growth and increased productivity and help to reduce inflation.

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Establishment of a high-growth, low-inflation economy would be facilitated by extensive reform of costly Government regulations. In this connection, the President's recent Executive order to improve the regulatory process is encouraging and deserves full support and cooperation.

In the same vein, it is important that we consider alternatives to those programs that tend to limit competition and raise prices. Notable examples are import controls, price supports, the Davis-Bacon and Walsh-Healy Acts. In addition, it seems appropriate to consider deferring the increase in the minimum wage that is scheduled for January 1, 1979, given its implications for cost and for youth employment opportunities.

It is my belief that a reduction of budget deficits and restructuring of taxes to help investment, along with prudent monetary management by the Federal Reserve, should, over time, lead to an economy that enjoys sustained growth, price stability, and a sound dollar.

Thank you very much, Mr. Chairman.

[Testimony resumes on p. 162.]

[The prepared statement of Mr. Miller follows:]

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PREPARED STATEMENT OF HON. G. WILLIAM MILLER

Mr. Chairman and members of the Committee, I appreciate this opportunity to meet with you to convey the views of the Federal Reserve Board on the state of the economy as well as on economic policy issues facing the nation.

The economy is now in its fourth year of expansion and unemployment has been substantially reduced. However, the nation is beset by an unacceptably high and recently accelerating inflation, and budget deficits continue large for this stage of the expansion. It is essential that longer-term policies be structured to confront these problems, while supporting continued growth.

. . PACE OF GROWTH MAINTAINED RECENTLY

Economic growth, though uneven so far this year, has been on the whole satisfactory. As you know, the severe weather and the coal strike temporarily halted over-all expansion during the winter. However, with the subsequent surge in activity--illustrated in the first chart--growth of real GNP in the first half appears to have averaged about a 4-1/2 per cent annual rate, close to the average pace over the first three years of the present expansion.

The vigor of employment growth is one important measure of the underlying momentum of the economy, and indicates that business has confidence in the sustainability of the expansion. The addition of 2-1/4 million jobs so far this year has pushed the unemployment rate substantially lower--as illustrated in the lower panels of the chart--

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and supported brisk growth of personal income. Almost all groups of workers have benefited from improved job opportunities, though the unemployment rate remains unacceptably high for minorities and youth.

. . AND THE NEAR-TERM OUTLOOK APPEARS FAVORABLE

Not surprisingly, recent data indicate some slowing from the extremely rapid growth of over-all activity during the spring rebound. Even so, the fundamental determinants of final demand suggest that economic expansion will be reasonably well maintained in the near term.

In particular, consumer demand remains strong. Auto sales continue at extremely high rates following the turnaround that began in March. Some of the surge in durable goods purchases appears to have represented buying in anticipation of further price rises. Gains in retail sales outside the automotive area have moderated somewhat recently, but this was to be expected following the extremely rapid sales pace of February and March. With surveys indicating a continued high level of consumer confidence, sustained moderate growth in income should support further expansion of consumer outlays over the near term.

The business sector also should continue to be a source of support to activity. Inventory policies have been conservative over the past several years, and businesses have in general thus avoided the imbalances that interrupted previous expansions. Various investment surveys, as well as data on equipment orders and construction

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contracts, suggest moderate increases in capital spending over the balance of this year.

In contrast, it appears likely that residential construction will cease to be the source of support that it has been in this expansion. While housing activity currently remains at a high level, mortgage markets have tightened considerably and it is likely that residential construction will begin to slacken in coming months. And growth in State and local government outlays is likely to remain modest. These jurisdictions have pursued relatively conservative spending practices and this reluctance to accelerate spending seems unlikely to change, especially in light of tax relief mandated by Proposition 13 in California and the possibility of similar actions elsewhere. But our net export position, which has deteriorated over the past two years, should improve somewhat over the next year. Imports are likely to rise at a slower pace. At the same time, exports should pick up if activity abroad increases as expected and as the changes in exchange rates which have occurred over recent months improve the competitive position of U.S. goods.

. . INFLATION CONTINUES AS OUR BASIC PROBLEM

On balance, the evidence suggests further moderate growth of aggregate demand over the near term, sustaining one of the most durable expansions of the postwar period. But the longer term outlook is clouded by the price situation. During the first three years of the

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expansion inflation rates were very high by historical standards, and there has now been a further acceleration of price increases, as shown in Chart 2. So far this year consumer prices have risen at a 10.2 per cent annual rate, as compared to 6.8 per cent in 1977. A key element in the price surge this year has been the adverse developments in the food sector, as meat production has been constrained by an ongoing reduction in the nation's cattle herds. However, prices outside the food area have also moved up sharply recently. Retail prices of nonfood commodities and services rose at an 8 per cent annual rate during the first five months of the year--up appreciably from the 6-1/2 per cent rate in 1977.

We can expect some relief later this year from a slowing of food price increases. But with the economy moving into a period of heavy collective bargaining, the intensified inflation is likely to be reflected in larger wage adjustments, and a more rapid increase in labor costs. These costs also will be boosted early next year by additional mandated increases in social security taxes and in the minimum wage. The continued interplay of wage and price rises, coupled with the legislated cost increases, makes it difficult to anticipate much relief from underlying inflationary pressures over the next year.

. . RISING INFLATION AND RISING INTEREST RATES ARE TWO SIDES OF THE SAME COIN

In the last year or so, private and governmental credit demands have risen, putting upward pressure on interest rates.

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At the same time, the recent and expected inflation also has been an extremely important factor underlying the increase in interest rates, contributing to money and credit demands and conditioning the stance of monetary policy. Obviously, inflation increases the volume of credit necessary to finance any level of economic activity. Individuals have to borrow more to acquire houses, cars and other durables. In the business sector, the rise in the dollar volume of spending on inventories and fixed capital, a significant portion of which represents rising prices, has outstripped internal funds generation, producing a marked increase in borrowing this year.

In addition to the direct effect of rising prices on credit demands, the prevalent expectation that the rate of inflation will remain extremely high--if not accelerate--has also increased the demand for goods requiring financing. As noted earlier, the extremely strong pace of automobile sales recently appears to have reflected consumer attempts to beat expected price rises. Home sales may have been similarly buoyed by the perception that waiting can only result in having to pay higher prices later. Such purchases have contributed to record instalment debt financing and to substantial additions to mortgage debt. The volume of borrowing also has been strengthened by existing home owners withdrawing part of their rising equity in the housing stock, partly to finance major expenditures and to otherwise maintain living standards in an inflationary environment.

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Borrowers appear to be counting on the general rise in nominal incomes that accompanies most inflations to help service their growing debt burden. This, in fact, has been a major ingredient in the upward pressures on interest rates. Borrowers are willing to pay higher interest rates because they expect that their future debt burdens will be eased by rising nominal incomes; meanwhile lenders seek higher interest rates in order to protect their real position.

. . CURRENT BORROWING LEVELS IMPLY FUTURE RISKS

Moreover, such borrowing has contributed to worrisome distortions in the financial positions of consumers and businesses. For example, the ratio of consumer and mortgage loan repayments to disposable income is now at a near record level (Chart 3). Thus far, households have apparently been able to service this debt with little problem. Recently, however, delinquency rates have edged higher, although they remain well below previous peaks. Nonetheless, the level of household indebtedness is of concern, since it may constrain future spending, and could give rise to more widespread financial difficulties--especially if the rate of income growth were to slow.

In the business sector, the pattern of financing has similarly begun to cause some concern. An increasing share of business credit requirements recently has been met through short-term borrowing, especially at banks, and businesses have slowed their accumulation of liquid assets. As a result of these changes in the composition

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of business assets and liabilities, corporate liquidity has deteriorated recently, although balance sheets remain in considerably stronger condition than they were in 1974 (Chart 4).

. . RESPONSE OF MONETARY POLICY

While one would expect strong credit demands as a normal counterpart of a healthy and growing economy, a significant—and I am afraid expanding--share of recent credit growth is both the direct and indirect result of inflation. Moreover, mounting inflationary expectations raise the specter of possible speculative excesses, leading to a short-run explosion of credit and output, and subsequently to recession. The Federal Reserve's firming of monetary policy has been designed to minimize the possibility of such an outcome.

In the presence of strong credit demands, the worsening of inflation, and the Federal Reserve's efforts to contain excessive monetary expansion, market interest rates have risen signficantly further. Most short-term rates have increased by 1 to 1-1/2 percentage points since the beginning of the year and long term bond yields have followed much the same pattern, as illustrated in Chart 5. The rise of market interest rates has been accompanied by slower growth of savings and small-denomination time accounts at banks and thrift institutions. As a result, growth rates of broader monetary aggregates--M-2 and M-3--have remained within the Federal Reserve's long-run ranges.

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The slower rate of growth of savings and small-denomination time deposits has threatened to retard housing activity. Therefore, in an environment of rising interest rates, the Federal regulatory agencies have recently taken action to increase the competitiveness of bank and thrift deposits subject to regulatory ceilings in order to maintain the flow of credit to housing. Two new savings instruments were authorized effective June 1--a variable-ceiling, six-month certificate, with weekly ceiling rates tied to yields on newly issued Treasury bills, and an eight-year certificate carrying ceiling rates of 7-3/4 and 8 per cent for banks and thrifts, respectively. The limited available evidence suggests that these new instruments, especially the defensive six-month certificates, are playing a significant role in helping to sustain net deposit inflows to thrift institutions, even as market interest rates have risen further.

. . CONTINUED HIGH DEFICITS A MAJOR PROBLEM

The persistence of large Federal budget deficits at this advanced stage of our economic expansion is a disturbing problem. Businesses and households have had to compete for funds in credit markets with the public sector, whose borrowing this year has continued at a high level.

During the last recession, large deficits were both a consequence of and a reasonable policy response to the under-utilization of our productive resources. The Federal government cut taxes and increased the size of public employment and other spending

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programs. Continued large Federal deficits were justified well into the recovery period, since the expansive impact of Federal fiscal policy was offset in part by sizable budget surpluses by States and localities, together with an increasing foreign sector deficit, both of which drained purchasing power away from the private sector of the economy. Developments this year, however, suggest that the Federal government should be moving with deliberate speed to rein in compensatory policies. The level of private sector activity has risen markedly over the past several years, and there now appears to be much less usable slack in the economy. Moreover, the over-all surplus of States and localities appears likely--in the wake of Proposition 13 in California and related developments--to be swinging back toward balance.

. . WE MUST REDUCE GROWTH OF FEDERAL EXPENDITURES

Positive steps are thus in order to lessen the government's competition with the private sector for resources. The Federal government has a constructive role to play in moderating the ups and downs in economic activity. In the present circumstances, a damper on further expansion of Federal expenditures would help to assure a continuation of sustained long-term economic growth.

In my view, the task of reducing the Federal share of GNP should begin now. A careful, systematic review must be undertaken to reduce or eliminate those Federal programs that are ineffective or that have outlived their usefulness. We also need to recognize the limits on government resources when considering alternative spending proposals.

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I believe that we should strive to reduce the Federal government's share of GNP from more than 22 per cent at present to 20 per cent or so over a period of five to seven years. As can be seen in Chart 6, such a reduction would not fully return the government proportion to that of the early 1960's.

As spending is brought under tighter control, government will become less prominent as a borrower in credit markets. A lower government profile will facilitate the flow of credit to the housing sector where it is becoming scarce, and to the business sector where it can be put to use in rebuilding our currently inadequate stock of fixed capital.

. . MEASURES NEEDED TO ENCOURAGE INVESTMENT

Moreover, private capital investment should be encouraged directly by offering incentives to business to expand their stock of plant and equipment. Capital accumulation is the chief engine of long-range growth of labor productivity and rising living standards. Yet for an extended period, the nation's tax policies have not provided adequate incentives for business investment. In particular, depreciation guidelines and the resulting deductions have not approached actual replacement costs in periods of inflation. Present depreciation-tax laws should be liberalized. For example, businessmen could be permitted to use a shorter write-off period for machinery, equipment and structures. Careful consideration also should be given

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to present laws that tax corporate profits twice--first at the firm and then at the stockholder level.

Given the neglect of investment which has eroded the nation's capital stock, as well as the need to accommodate to the reality of scarcer and more expensive energy, a larger share of GNP must be devoted to capital investment. It will not be enough simply to reach the investment proportion of 10-1/2 to 11 per cent that has been characteristic of past periods of prosperity and low unemployment. In my opinion, the nation must set an ambitious goal of, say, 12 per cent of GNP for an extended period--a level that would support increased growth and productivity.

. . STRUCTURAL REFORMS ARE ALSO NECESSARY

Establishment of a high-growth, low-inflation economy would be facilitated by extensive reform of costly governmental regulations. Regulatory activities in the health, safety and environmental protection areas may not always achieve the desired outcome at minimum costs, and they need to be reviewed with that thought in mind. Similarly, market- and price-regulation programs should be carefully reexamined to ensure that their benefits outweigh their costs. In this connection, the President's recent executive order to improve the regulatory process is most encouraging and it deserves the fullest possible support and cooperation.

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In the same vein, it is important that we carefully consider alternatives for those programs that tend to limit competition and raise prices. Notable examples are import controls, price supports, and the Davis-Bacon and Walsh-Healy Acts. In addition, it seems appropriate to consider deferring the increase in the minimum wage that is scheduled for January 1, 1979, given its implications for costs and for youth employment opportunities.

To conclude, it is my belief that a reduction of budget deficits and restructuring of taxes to help investment, along with prudent monetary management by the Federal Reserve, should, over time, lead to an economy that enjoys sustained growth, price stability and a sound dollar.

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Chart 1

CURRENT ECONOMIC INDICATORS

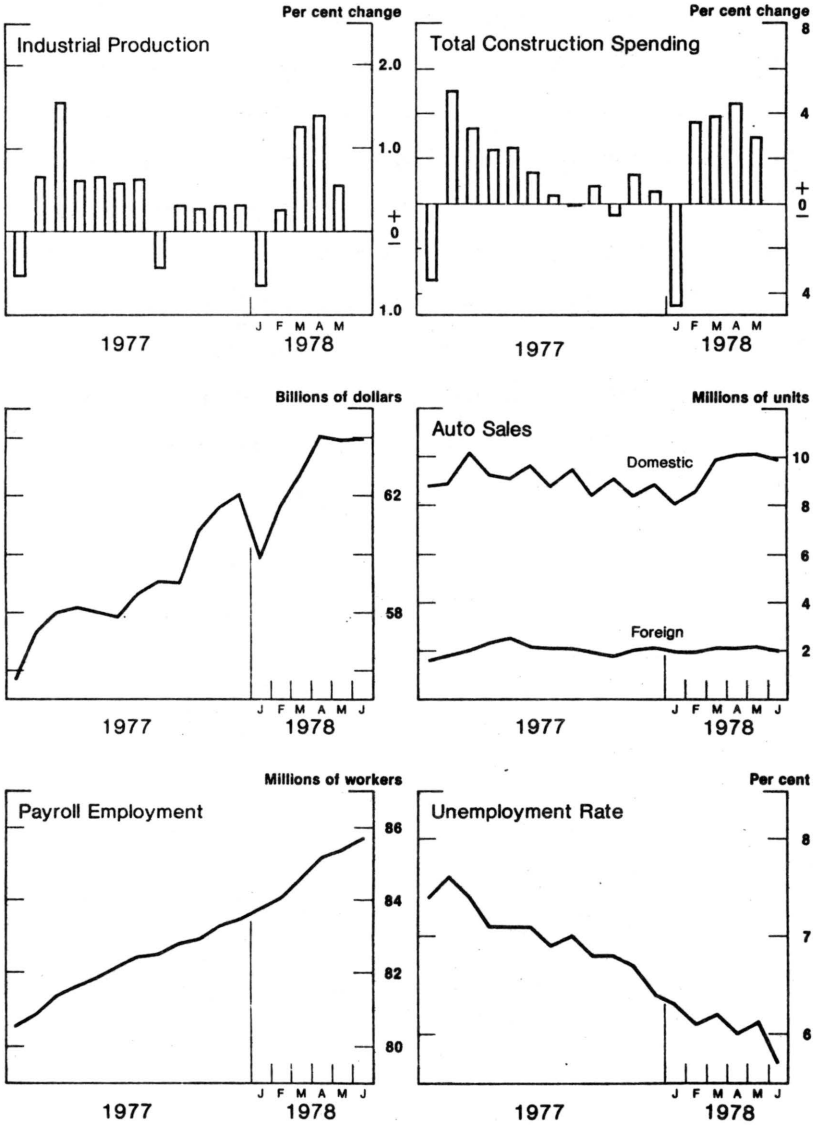

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Chart 2

MEASURES OF AGGREGATE INFLATION

PERCENTAGE CHANGE FROM PREVIOUS PERIOD, ANNUAL RATE

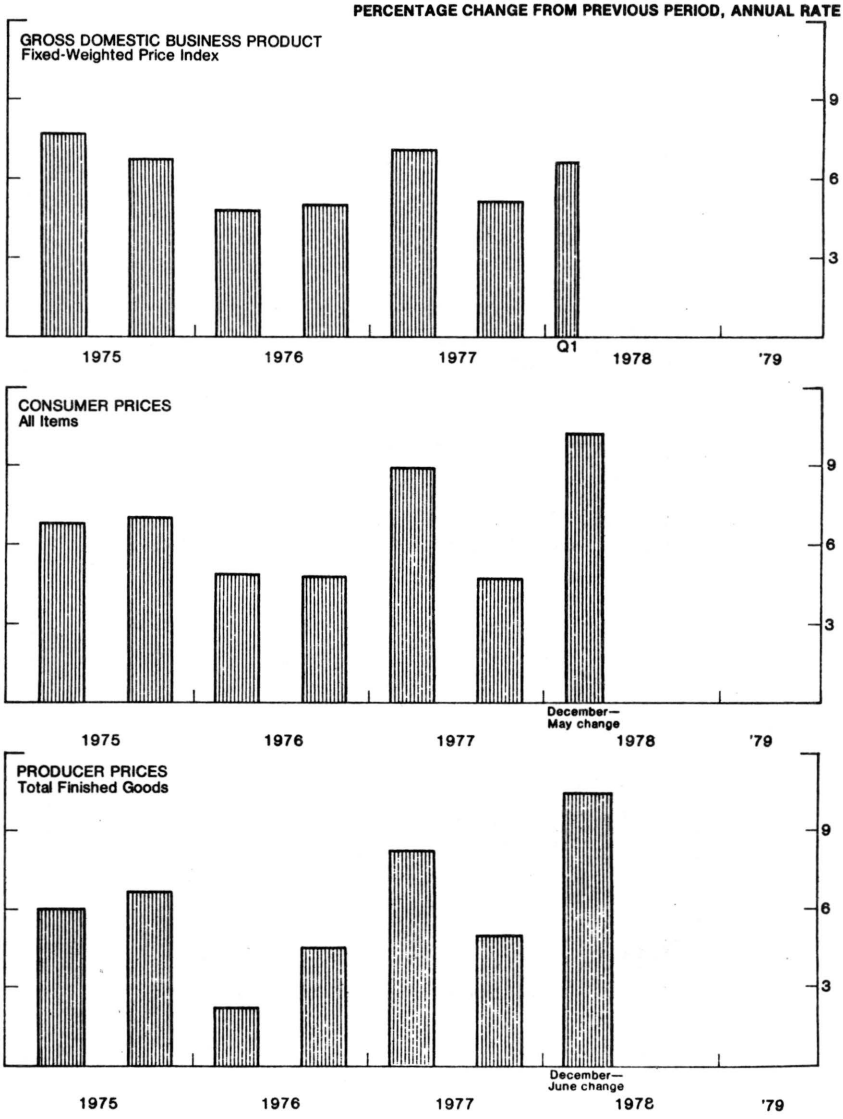

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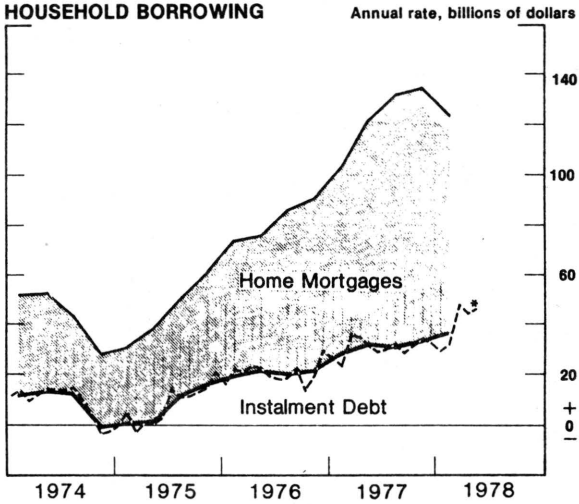
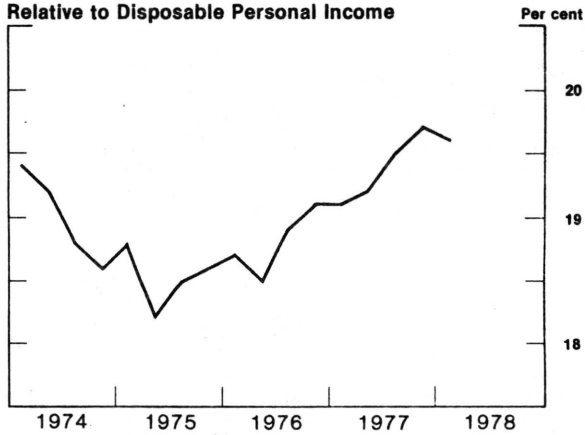
Chart 3

HOUSEHOLD BORROWING



HOUSEHOLD DEBT REPAYMENTS
Relative to Disposable Personal Income



* Monthly net change in amount outstanding of Total Consumer Instalment Credit.

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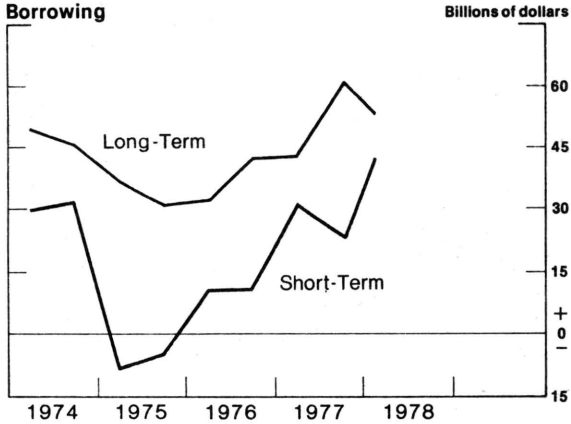
Chart 4

CORPORATE FINANCE



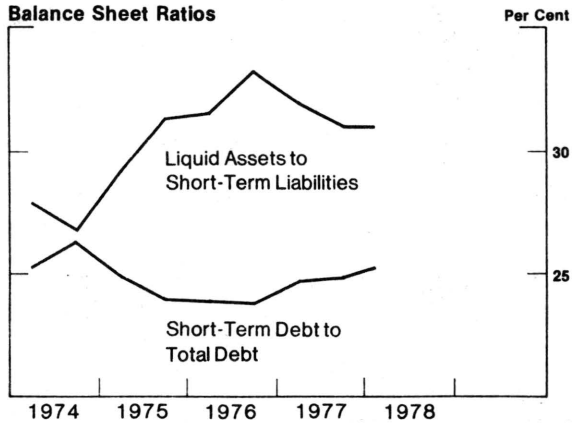


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Chart 5

INTEREST RATES

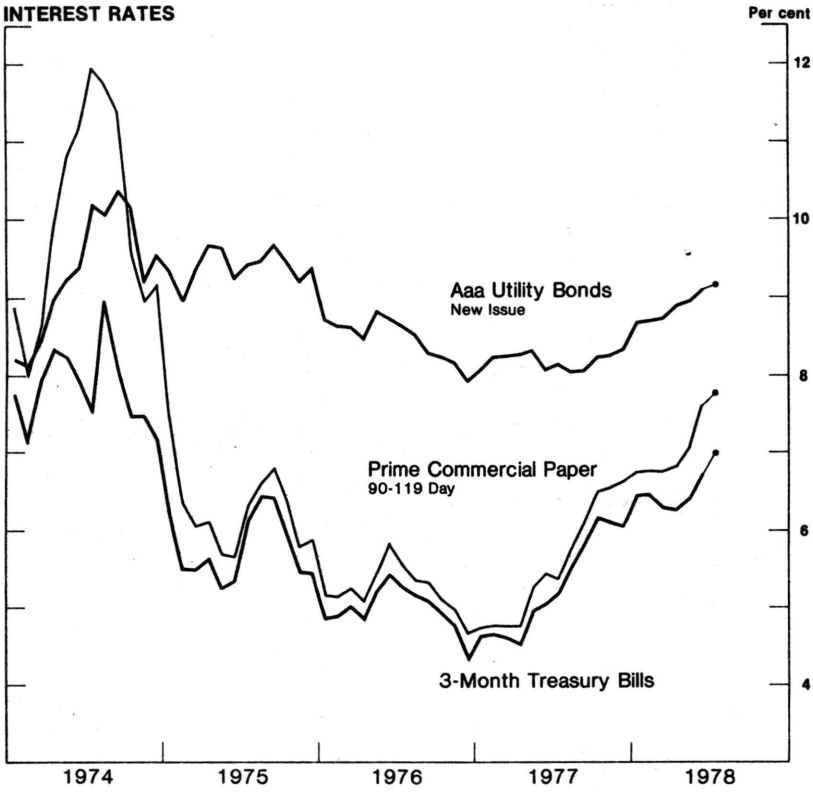

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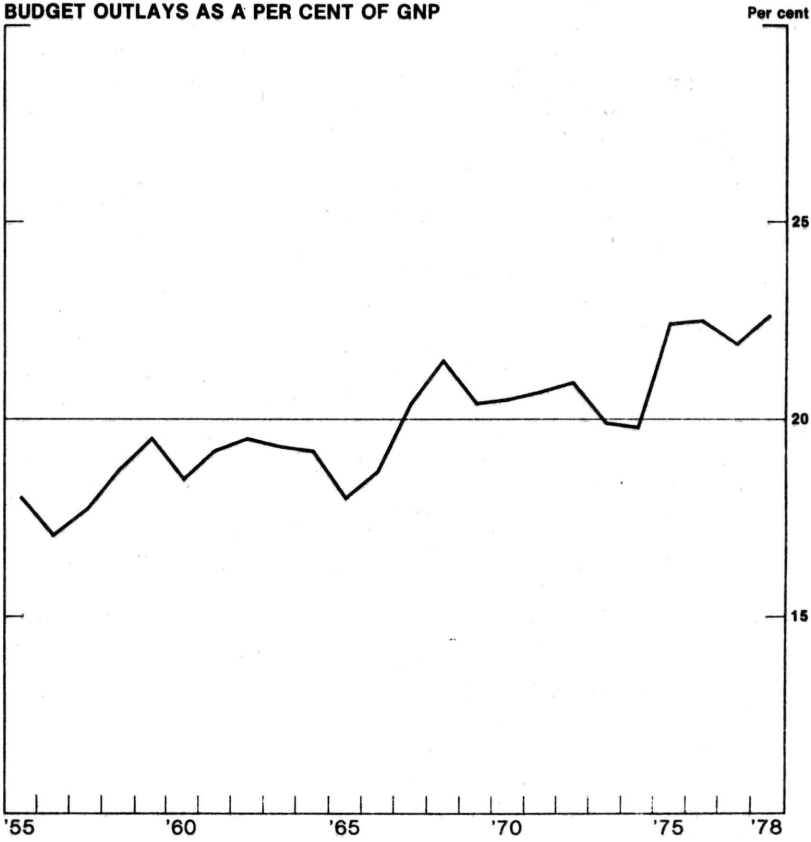
Chart 6

BUDGET OUTLAYS AS A PER CENT OF GNP



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The CHAIRMAN. Thank you very much, Mr. Miller.

Mr. Miller, next weekend, the Economic Summit will convene in Bonn, Germany. What do you expect the results of that meeting will be, and what should or could come out of such a meeting?

Mr. MILLER. Over the last dozen years, Mr. Chairman, the world has developed toward increasing interdependence among all nations—certainly an increasing interdependence among developed nations. Economies are linked together. So it is important that there be a procedure and a mechanism by which the heads of state and heads of government of the leading industrial nations can keep in close touch and learn the implications of their own economic policies and actions as they affect the whole world and the welfare of all countries.

So these meetings over the last few years, I think, have been an encouraging development. However, it is a mistake, in my opinion, to expect that each and every year, just because the pages of the calendar have been turned for 12 months, that any major new initiatives or major new developments are in order.

The summit this year should be looked upon as an opportunity to update the trends of the past year, to become acquainted with the internal considerations that are influencing the economic policies of major nations, and to continue to seek ways to harmonize and to reach a confluence of interest.

It would be unrealistic to expect the leaders of our governments, at this point, to come up with some all-embracing solutions. This is a time to consolidate; it is a time to harmonize; it is a time to understand. I don't believe that it is a time when we should expect major new initiatives.

The CHAIRMAN. You said in your statement:

> Private capital investment should be encouraged directly by offering incentives to business to expand their stock of plant and equipment. Capital accumulation is the chief engine of long-range growth and rising living standards.

And then you address yourself to some of the tax policies to bring this about, specifically changes in the depreciation tax laws, a liberalization thereof. There is a pretty broad recognition that we have to encourage and develop greater incentives to business to invest, and one of the arguments, as you well know, favors changes in the treatment of capital gains taxation. Would that accomplish the desired result?

Mr. MILLER. There have been a number of proposals in Congress for liberalizing—reducing—capital gains taxes. In my judgment, these would not have an efficient or direct impact on capital spending by businesses. I could list several kinds of tax policies that would result in a more direct stimulus to business fixed investments, and we might look at the merits of each.

One is a reduction in corporate taxes, increasing cash flow to corporations. The trouble with this particular solution is that there is no assured link between a lower tax rate and spending for capital investment. A lower tax rate means more cash flow, but the cash released could be used for inventories, for dividends, for higher profits, and not necessarily for spending.

A second method is subsidized interest rates, which we have seen in revenue bond financing. This approach does give an incentive for investment, but is not really the right solution, long term, and

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therefore not the solution for a massive change in capital spending plans.

A third possibility is the investment tax credit, or higher rates of depreciation.

The investment tax credit is a very useful method of increasing cash flows and creating greater incentives for investment by reducing the risks that go with investments when there are unknown and unsure markets and unknown and unsure costs. But the investment tax credit is also a forever-reduction of taxes. So it can never be recaptured.

On the other hand, faster depreciation is a very efficient way to stimulate capital investment. It is directly linked to investment; there is no reduction in Federal revenue unless there is an investment. And once the investment is made and the writeoff takes place, then, of course, all that faster writeoffs do is defer taxes. The businessman recaptures his capital sooner and reduces his risk, but once he has recaptured his capital he keeps paying taxes. Therefore, the Treasury gets more for its dollar by deferral than it does through an investment tax credit.

So a higher rate of depreciation is one of the most efficient systems, and I am hopeful that Congress, in looking at the tax package that is now being shaped, will give this method a good deal of consideration. I know that so far the preference has been to reduce corporate tax rates; I don't object to that in principle, but I would point out that there is no direct linkage between that reduction and stimulating investments.

When we go to something like capital gains taxes, of course, the linkage is a very remote one. Capital gains taxes relate to the sale of capital assets. But the ownership of stock in a corporation and the profit accumulated by investors when the stock goes up doesn't generate any cash for the corporation to invest. Nor does it generate any incentive for investment even if, with resulting better market prices, the corporation has an incentive to issue stock to raise capital. When a corporation raises capital, it may raise it for all kinds of activities, not just for capital spending. Moreover, any effects of capital gains reductions are delayed.

Of all the choices, the one that I would recommend to you for highest priority consideration is a very substantial acceleration in the writeoff of productive assets. This is the kind of incentive we have utilized in periods of emergency in the past, when a 5-year writeoff during the war created a tremendous stimulus.

The CHAIRMAN. Thank you. I am going to recognize Mr. Fisher.

Mr. FISHER. Thank you, Mr. Chairman. I listened most attentively to what you had to say, Mr. Miller, on the merits of different ways of stimulating investment of capital formation, and I tend to agree with what you say.

What would you think of a combination of some reduction in the corporate income tax rates combined with a faster writeoff of depreciation, and some improvement in the investment tax credit? This would put the corporations in better cash position to elect to invest more if they wish, rather than declare dividends or doing something else, and would also give them the favorable situation of a faster writeoff or a higher investment tax credit.

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Mr. MILLER. Congressman Fisher, let me just back off a minute and put the problem in context. I would like to be responsive. I think your thoughts are very sound, but I would like to develop them a little.

The first point is to recognize that, given the condition of the economy and the priority to reduce the Federal deficit, we have to limit the tax reductions that are made. So first we have to decide how much we think we can afford; and certainly a tax reduction, effective next January 1, of between $15 and $20 billion—of about $18 billion, say—is reasonable. How much of that should go to individuals—to relieve the increasing burden of inflation, payroll taxes and the progressivity of the income tax brackets—is important and debatable; perhaps two-thirds of it should go to that use.

But if one concludes that there is $5 billion to $7 billion that could be allocated to business, then the question is how best to allocate it. I have no objection to a judicious allocation, balancing those tax policies which directly intensify investment and those which help corporations that are not in the productive sector of the economy; and we must recognize that those corporations too, need help.

I think that what you are talking about is a very sensible, balanced approach. I would want a very good part of that business allocation to go toward helping investment, because I am convinced that the next leg of development has to be investment to sustain growth in this economy.

We have been underinvesting for so long. The Japanese invest over 20 percent of their GNP in business investments, the Germans 15 percent. We invest 8 or 9 percent. My suggestion is that we get up to 12 percent; we have been up to 11 percent in some periods. People say we are investing 9 percent and that getting to 12 percent would be an enormous jump; it wouldn't in relative terms. And if what we are speaking of is new investment in lieu of budget deficits or in lieu of too much personal consumption that does contribute to inflation, I think it is a very healthy alternate way to go. I would commend the thought you have in mind with your suggestion.

Mr. FISHER. Could I continue, Mr. Chairman?

The CHAIRMAN. Yes.

Mr. FISHER. This all makes great sense to me, and I am delighted to hear your thoughts on this subject. With my colleagues on the Ways and Means Committee, for some weeks now I have been advocating $15 billion, $18 billion, in tax cuts, most of which would come in the rates but reserving a fair chunk of it for more direct stimulation on investment by way of credit and accelerated depreciation, and I have thought the ratio ought to be about 2 to 1, two parts for the relief of individuals to one part business, which is a much more favorable ratio to business than the total tax collections from individuals and businesses would have, which would be what, 5 or 6 to 1.

And this seems to be a good way to recognize really the current and long-term need for stimulating investment, so you come down to exactly what is the best way to do it, and I am delighted that we seem to be in some agreement here.

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I am hoping that we can put together a tax cut package, the general magnitude of which would offset the automatic tax increases that result from inflation and, to some extent, the social security tax increase, which will take another jump in January, and incorporate considerable stimulation to all kinds of business and, at the same time, not go too far so that the macro, the overall, will be inflationary.

This is a difficult balancing act and my sensing, apparently like yours, is that the total magnitude is in the $15 billion to $20 billion range, with a good chunk of that for as direct and meaningful business investment stimulation as we can do, and I am much attracted to this combination of business tax cuts on the corporate rate, plus a further favorable treatment directly of investment through either or both the investment tax credit and better rules for depreciation.

Are there any other ways that you can think of that we could pinpoint a stimulation to new equities, even venture-type equities, beyond what we have talked about so far? Could you carve out some kind of preference for new equities, or equities in new corporations, or what are your thoughts along that line? You have had immense experience in the business world and in venture companies.

Mr. MILLER. That is right. I have been involved in venture companies. Congressman Fisher, let me say that the judgmental calls that need to be made in fiscal policy and monetary policy right now are as difficult as we are apt to see, because we are in a very difficult period. The judgments we make this year will set the stage for many years to come, so I take very seriously the matter of seeking a better coordination between monetary and fiscal policy and, in seeking this coordination to be willing to suggest things in the fiscal area that I think would be in harmony. What you are suggesting is exactly on the right track.

In answer to your question, there are many, many ways to carve out initiatives that aid new businesses. I always hesitate, however, to begin to segment our tax structure, because it feeds a tendency to overmanage and to interrupt the natural adjustment process that should take place. I suppose my preference is that we begin to think in terms of where this Nation wants to go, in economic values over a 5- or 7-year period and to make sure we are not just thinking of 1-year policies. A policy of cutting back the Federal deficit, balancing the budget by 1982, and reducing the Federal Government's component of the GNP over 5 or 7 years—gradually, so that it doesn't create a problem—makes sense.

I thought the stimulation of capital investment was timely this year. I think that next year would be the time to look at special incentives for venture capital. We don't want to get running ahead of ourselves; and we should take these policies seriatim, make them work consecutively to sustain the objectives we want to accomplish.

I have talked, as you know, about a model economy, how it should look in 5 or 7 years. If we think that way, we can begin to make policies that fit in year after year toward our achieving the desired goal. So I don't want to duck your question, but I think it would be better to put off consideration of any segmented effort to help venture businesses until next year. Let's get about using the

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limited resources of $15 billion or $18 billion or $20 billion this coming fiscal year to rifle-shoot at the problems.

Mr. FISHER. I have tried to think of some way of defining a special preference for venture capital investment and haven't had too much luck with it. If you and your associates have your minds on this and devise any way of doing this, I would certainly like to know.

Mr. MILLER. There are many, many policies that could be adopted. For example, for newly incorporated enterprises of certain sizes, you could certainly go back to a more favorable capital gains tax rate. Or you could do what was done by the SBA; that is, if one invests in a small business which shows a capital appreciation, one takes a capital gains treatment. If the business shows a loss, one takes an ordinary income loss. That was the SBA way to stimulate small business investment. Such opportunities are still around, but the climate hasn't been too ripe for getting those kinds of businesses going. That is why I am so anxious to curb the inflationary forces and get the investment cycle started, because I think that will create the climate in which small business will prosper and new enterprise start out.

Mr. FISHER. Just one more question. Of course, there is much interest now in changing the capital gains tax, and you have already talked some about it, and I am interested in that. The difficulties with the so-called Steiger proposal, as I see it, are that by going back to the pre-1969 treatment, it rather effectively guts or eliminates the minimum tax, which, for all its difficulties, has been placed in the law; it has been there for awhile; it has been expanded rather than contracted some since it was started, and it symbolizes something, and that gives me a problem.

But more to the point of this discussion, it does seem to me, as it apparently does to you, that there are better ways of changing business taxes to stimulate investment than the kind of treatment of capital gains that is being so much talked of.

I wish there was some way we could really focus attention on changes in business taxes that would have the best chance of stimulating investment, and it does seem to me round about, indirect, and not likely to be very successful if you stimulate investment by reducing capital gains that individuals receive, most of which isn't in equity markets anyhow, in securities, and even much of that would be reinvested in very much the same kind of thing.

If you have any further thoughts on the relative merits of these different ways of stimulating investments, I would like to have them.

Mr. MILLER. I would be glad to submit them. I agree with what you say. Our limited ability to respond by cutting taxes should be dedicated to those areas where we get the most results for the least loss in revenues. I am not opposed in any way, philosophically, to reducing the burden of taxes on capital or reducing the burden of double taxation of dividends from corporate profits. I have no philosophical problem with these approaches.

[The information requested above follows:]

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EFFECTIVE WAYS OF STIMULATING INVESTMENTS

As my prepared statement and my response to the Chairman's questions indicate, I believe the most direct and efficient stimulus would be a substantial shortening of the writeoff period for productive assets. One way to do this would be to standardize the depreciation period and permit businesses to writeoff machinery and equipment in 5 years and structures in 10 years. If that seems too large and costly at this time, all writeoff periods could be shortened proportionately by widening the permissible asset-depreciation range, say from 20 to 25 percent.

Even without the need to stimulate investment, however, some shortening of writeoff periods would probably be appropriate, in order to conform the service lives allowed for tax purposes to economic service lives. In recent years, the economic service lives of many types of equipment and structures have been significantly shortened by technological progress, the increase in the relative price of energy, and the raising of environmental standards. The time has probably come to take another look at the useful-life guidelines that underlie present writeoff periods, and the Congress might want to ask the Treasury to undertake a new study to see what liberalizations to tax service lives are needed.

Mr. MILLER. But I do have a commitment to putting things in priority, and I am convinced that these approaches should not be the priority at this time. I have no objection to looking at them as they can be fitted into a long-term plan in which we keep our other objectives in order—in which we do work toward a balanced budget with full employment, toward getting the inflation rate down, and so forth.

Incidentally, the tax reduction policies to relieve individuals and provide equity are important. But individual Americans will benefit greatly from a program that stimulates investment, because such a program will stimulate jobs and stimulate productivity gains, which will reduce costs and reduce prices. Along with the equity considerations of relieving them of the tax burden, that would do more for Americans than almost anything else we could accomplish.

Mr. FISHER. Thank you.

The CHAIRMAN. The gentlemen from South Carolina.

Mr. DERRICK. I thank the chairman. Mr. Miller, we are delighted to have you with us this morning.

Mr. MILLER. Thank you, Mr. Derrick.

Mr. DERRICK. In reading some of your recent statements, I'd say you have made some hard decisions.

Just to digress for a moment, I will tell Mr. Fisher that last night, I read his "Dear Colleague" letter on reducing inflation, and you have some very good points.

Mr. Miller, I have three areas I would like to address myself to. What is the growth rate in M_1 at the moment?

Mr. MILLER. So far this year—from the fourth quarter of last year through the second quarter of this year—the growth rate for M_1 has been 7.6 percent. From the first quarter through the second quarter of this year it has been 9½ percent. The second quarter showed quite a strong growth, higher than we would like. We had high nominal activity in the second quarter for reasons I mentioned, and M_1 did break out quite strongly.

Mr. DERRICK. I notice in your statement that you say M_2 and M_3 long-term projections are pretty much fitting in there. What are those?

Mr. MILLER. Let me give you the ranges for all of the aggregates. For M_1 our range recently has been a 4- to 6½-percent rate of

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growth. Last year, the rate of growth was 7.9 percent; this year, on average, it is running close to 8, which is above our range, and worrisome.

As to M_2, the growth rate range has been 6½ to 9 percent; and on M_3, 7½ to 10 percent.

We have been unable to stay in the range on M_1, I think, for reasons of higher inflation and higher nominal activity, and also because of some technical problems with tax collections in April, when there was some delay in processing. We had an unfavorable M_1 situation.

Mr. DERRICK. In view of the GNP growth rate and rising interest rates, what do you see over the next 12 months on interest rates? I am very concerned about the construction industry, because we could get into a situation somewhat like that we experienced in 1974. Do you see this as a possibility? How long do you see interest rates remaining at the levels they are now?

Mr. MILLER. I see interest rates rising. The possibility of a credit crunch is a great worry, and something we are working hard to avoid. Since my 4 months in Washington, the Federal Reserve has tended to react rather promptly to the growth in aggregates and tried to act prudently and in advance so as to avoid the necessity of facing tougher issues; the sooner one gets started, the easier it is.

But we face a dilemma. Unless the American public is alerted to the dangers of inflation, we will never get effective anti-inflation programs. But once they are alerted to the dangers, there is anticipatory buying against inflation which leads to increased credit demands and works against what we want to accomplish; more credit demands have pushed interest rates up. Temporarily we have had to suffer from upward pressures on interest rates in order to mobilize the fight against inflation.

My hope—and I cannot give you a promise—my hope is that we are nearing a time when those anticipatory purchases will be over, that, with the second quarter of catchup we are past this bulge and that the pressures will begin to abate. The actions being taken by Congress to reduce the fiscal stimulus will help us, and, as the year progresses, I hope we will find that we are at or near the top of the interest rate cycle and that we can begin to be under less pressure. That doesn't mean we will see interest rates drop much, but if we can top out——

Mr. DERRICK. I am concerned about the interest rates, but, of course, I am also probably as much concerned about the availability of credit in this area.

Am I to understand, I don't want to put words in your mouth, that you see a slackening of that upward pressure during the last part of this year?

Mr. MILLER. Congressman Derrick, I personally see some slackening of the pressure. Let me be clear about this, because I don't want to be misunderstood: I did say I worried about a credit crunch, but I see nothing in the immediate future—in the foreseeable future—that would cause the unavailability of the capital necessary to maintain the proper rate of growth in the economy, the rate of growth we are all anticipating.

My view is that under these circumstances the right plan is to aim for a 3½- to 4-percent rate of real growth—not try to achieve

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more because we would begin to run into these pressures. We also want to avoid falling below that rate because then we would create the potential for a recession and that would be counterproductive.

Mr. DERRICK. I thank you very much. I have two other areas. I notice you join with many of us in Congress in feeling that something needs to be done about the deficit, and it is one of the major causes of inflation. Would you suggest that this deficit be decreased by a cutback in spending or are you suggesting that it be done by raising taxes?

Mr. MILLER. There are only two choices, as I have pointed out many times. To spend less, or to collect more. Those are the only choices, unfortunately.

During this current planning cycle for fiscal year 1979 we must try to do both. But because of the difficulty at this late stage of making very large inroads in cutting spending, it is necessary to curtail our aspirations for lowering taxes. The 5- or 7-year plan that I outlined should focus on reducing spending, and thereby reducing the deficit, and thereby, in effect, releasing opportunities for spending decisions and investment decisions to be returned to the private sector rather than made by the Government.

Mr. DERRICK. Mr. Miller, I thank you very much, and I am in complete agreement with you on what you said so far. As far as I know, every witness that has appeared before this committee in the 4 years that I have been here is in agreement with you.

Now we come to the next question. Would you advise us where you think we should cut this spending, specifically?

Mr. MILLER. I have hesitated to interject myself into spending priorities for the Nation, which I think is the responsibility of the Executive and the Congress.

Mr. DERRICK. I understand that that is our mandate but we are asking for advice.

Mr. MILLER. My advice is that what is needed at this stage is not so much to find one little nugget that would reduce spending—that is probably impossible—but to undertake a comprehensive management effort and to concentrate on doing everything better and more efficiently. We should concentrate on agreeing not to initiate new programs that will lead to further funding requirements and on not doing what we have done in the past; that is, starting programs that seemed inexpensive but ended up as an expensive package.

I am not prepared at this stage to suggest the dismantling of any major programs. I would ask your willingness to defer my comments on that. I would rather see us concentrate on what I consider to be the first phase of a reduction in Federal expenditures, which requires that we do things better and more efficiently. I can guarantee you, that in any enterprise as large as the Federal Government substantial savings can be made if we go to work on it.

Mr. DERRICK. Mr. Miller, I quite agree with you, and I think most people do. The hard decision, as you well know, comes down as to where you do it, and, as I recall an article in a national publication about you recently, you said that the problem with inflation is that no one is willing to make those hard decisions, and if you decide that there are any major programs that need to be

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dismantled or would be worth taking a look at, I would appreciate it if you would advise the committee and me—and I say that in all seriousness—I would be delighted to know what your thoughts are.

Mr. MILLER. I would be pleased to do so.

[The information requested above follows:]

EVALUATING COST-EFFECTIVENESS OF GOVERNMENT PROGRAMS

Most Government programs provide benefits to some members of the public. The question of whether specific programs are cost-effective requires a careful evaluation which the Congress and the Executive are in a far better position to make than I am. But even without program-by-program evaluation, effective steps can be taken to curb increases in Federal spending.

A cap on Federal pay increases, such as the administration has proposed, is a necessary discipline, since it sets an example to State and local government workers as well as to workers in the private sector. In addition, a modest across-the-board cut in spending programs of about $5 billion could undoubtedly be absorbed without major detriment to the effectiveness of Federal programs. Such a reduction would equal only about 1 percent of total spending. It is true that some programs lend themselves to being cut back more easily than others—the so-called "uncontrollable" outlays. But even if a $5 billion cut this fiscal year were concentrated entirely in the relatively controllable program outlays, the reduction would total less than 4 percent.

And efforts should be undertaken to trim the growth of relatively "uncontrollable" spending in future years. When grants to other governments or entitlements to individuals are authorized, it is of vital importance to consider the future consequences of such acts. Such concern today can prevent a large increase in "uncontrollable" spending later on.

Mr. DERRICK. May I jump to one last area. Could you give us a few comments on your analysis of the Kemp-Roth proposal?

Mr. MILLER. Yes, sir. I feel that the kind of approach that I have just been outlining would be far preferable to legislation that reduces revenues but is not linked up to a reduction in spending. If we make a commitment to reduce taxes and reduce the collection of revenues in today's climate, with today's rate of inflation and today's level of deficit, we are certainly going to create a much larger Federal deficit over the period of implementing this legislation, regardless of what can be done in reducing spending, during that time. The result is going to be highly inflationary and work against everything we are trying to accomplish.

The more sensible plan is the one I have been trying to promote; that is deciding where we want to be in 5 to 7 years, beginning a reduction in Federal expenditures, and as we reduce them, cutting taxes to give back the dividends to people and to businesses. We should not legislate tax reductions in advance, because next year, after taxes will already have been cut, the Congress may not be willing to make the hard decision to cut expenditures.

Mr. DERRICK. I gather from what you say that you think the Congress should make the hard spending decisions first, and then if that works out, the easy tax decisions?

Mr. MILLER. The easy decision is to give people money. The hard decision is to cut down the spending so that you release the money that permits you to declare a dividend.

I want to read from yesterday's New York Times. I was taken by this article by Felix Rohatyn and his experience in trying to help in New York City. This paragraph is right on the point you are talking about. He says:

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There is no place for statesmanship in government today because the political cost of statesmanship is too great. Most of the meaningful decisions required from government today are unpleasant. They involve vocal, powerful, competing interests. They involve living up to overcommitments made by previous officeholders unwilling to face facts in their own time and place. My role as Chairman of the Municipal Assistance Corporation was symbolic of the failure of government as well as pointing to the increasingly important role to be played by the private citizen.

I agree with what he is saying, and then again I don't agree: I think there is a place for statesmanship now because the political cost of not facing these issues is too high.

Mr. DERRICK. Do you believe that the Kemp-Roth proposal would result in substantially larger deficits and therefore be inflationary?

Mr. MILLER. Yes, sir. I think it would be unwise to adopt that legislation at this stage. Its basic premise cannot be ignored; that is, that when and as Government spending is cut, the return of resources to the private sector would be desirable. But the decisions to cut spending should be made first and the decisions to reduce taxes later.

Mr. DERRICK. I thank you for your very candid answer.

The CHAIRMAN. The time of the gentleman has expired.

We all want to have the chance to question the witness, and if we would all stay as close as we can to the 5-minute rule——

Mr. MILLER. Perhaps my answers have been too long, Mr. Chairman.

The CHAIRMAN. No; your answers are excellent. It is just the desire of the members to ask you all kinds of questions, but I am going to ask the members to try to cooperate a little more, and I don't say that now that I am ready to call upon the minority side. Mr. Regula from Ohio is recognized.

Mr. REGULA. Mr. Chairman, I am tempted to say amen to all we have heard this morning. I want to compliment you, Mr. Chairman, on a thoughtful blueprint for statesmanship for this congressional body. I am going to insert in the record today a copy of your remarks. I hope every Member will read them. I am only sorry that the entire Congress isn't here this morning, and I might add I hope you will send a copy over to the White House, also.

I think you stated so beautifully what needs to be done in this country.

I do have a couple of questions. I suppose I am a bit biased in that several months ago I introduced a tax bill that provides for accelerated rates of depreciation, and I agree completely with what you have outlined. Let me back up and ask if you think that tax changes should be targeted to achieve specific objectives, that is, capital formation, rather than just a broad-based type of cut?

Mr. MILLER. Yes; I think that at this point most of our fiscal actions need to be targeted. Otherwise, I think the linkage between the general flow of cash and its consequences as far as what we need in the economy at this time are too remote. We need far better linkages; we don't have the time to let a system work its way through in a more general way.

Mr. REGULA. Given that background, what would be your reaction to, in terms of depreciation, allowing the businessman to make the judgment if he wants a 1-year writeoff, 2, or 5, or whatever, because, in the final analysis the tax receipts will be the same? They just may not come in the same year.

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Second, absent that, what is your reaction to a 1-year writeoff for any Government-mandated nonproductive equipment; and, third, at least some type of credit for interest, perhaps the first $100 of interest on savings, tax-free as a means of inducing greater savings?

Mr. MILLER. The best system for depreciation, in the long run, would be to leave it optional, as you suggest; write off assets anytime you want. I would be cautious, however, and remind you that if we are going to limit our tax reduction to $15 billion or $20 billion on January 1—and if only one-third of it is going to be allocated to business—we want to be sure that a proposal along your lines would be phased in so as not to impact against our budget objective.

But in principle, I agree with you. Actually, once you get over the hurdle of an optional writeoff, then depreciation is a one-time adjustment; you have only deferred the tax, you haven't forgiven it. It works extremely well.

You might want to consider linking optional depreciation with a requirement that any public corporation write off its assets for purposes of reporting to shareholders the same way as used for tax purposes; then you would have a real discipline. It would cause businessmen to act for shareholders like they do for Uncle Sam. I would be in favor of that, but I expect it would not be very popular with business executives.

As to the second suggestion—writeoffs for Government-mandated nonproductive equipment—I would think that if you are going to have an optional writeoff period, you could start with mandated pollution control equipment—allowing a 100-percent writeoff in 1 year or over 20 years, but a writeoff only once. As to nonmandated investments, at this stage I would favor a 5-year writeoff, and observe the revenue effects and then see when you can afford to liberalize more.

I am a little reluctant at this stage to recommend your suggestion as to savings. I am not opposed to it philosophically, but at the moment it would complicate achieving our priorities. We should make these other adjustments first and let them work through the economy and see what happens to savings. We are coming to a period when I think savings are going to increase. We may not want to draw that much out of the other activities of the economy, so I would be cautious on that one.

Mr. REGULA. Thank you.

You state in your testimony that net exports should improve somewhat next year. How much, if any, do you attribute this to the depreciating dollar? Obviously, the dollar has been depreciating in relationship to the German mark and the Japanese yen, thus far without any appreciable improvement in our trade balances.

In your opinion, have world markets become so integrated that exchanges in depreciation are no longer an effective means of securing permanent improvement in our trade balances?

Mr. MILLER. Exports do pick up as a result of exchange adjustments; we have seen this in connection with the Canadian dollar and with the Italian lira. The first effect of the decline in the dollar is to work against us, but then, in due course, there is an

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opportunity for exports to pick up, and I believe that will happen to a degree—to a degree.

Another factor that will influence the growth of our exports is the relative growth rate of our economy as compared to other industrialized economies. We have been working our way out of the great recession of 1974-75 at a much more rapid rate than the rest of the world. Now we are coming down to a sustainable rate—hopefully in the 3½- to 4-percent range—and some other countries are coming up a little. This converging of the relative rates of growth is going to help us on exports. We will be importing less and sending out more relatively speaking.

The final thing that is important to increasing our exports—and my own recommendation—is that we start a major export drive, so that over a period of a number of years we build our exports up from 7 percent of GNP to 10 percent. That will give us the absorptive power to help other nations by buying more of their goods, and will also get us out of the deficit position; it would help the dollar enormously.

To do that we have to change our emphasis. We in the United States have not been international traders. A small amount of our GNP reflects trade, nothing like many other countries, because we have never felt the need to develop the marketing.

Elimination of relief under section 911, a congressional action, which was postponed recently, would increase the cost of maintaining Americans abroad to service and support U.S. sales. It would be a step in the wrong direction. If we penalize Americans for going overseas, how are we going to get salesmen or technicians overseas? We have to change our attitude and become oriented and organized for exporting. Once we do, we can be good exporters.

Mr. ROUSSELOT. Would you yield?

Mr. REGULA. Yes.

Mr. ROUSSELOT. Would you suggest the Ways and Means Committee repeal that outright now?

Mr. MILLER. I think the sooner that matter is settled, the better.

Mr. ROUSSELOT. We are hearing from a lot of companies that they are losing employees over the whole thing.

Mr. MILLER. The cost is so great, that the customer won't absorb it. To maintain a $20,000 employee overseas costs $100,000. The customers won't pay that.

Mr. ROUSSELOT. Thank you for the comments. Thank you for yielding.

Mr. REGULA. To what extent have the recent budget deficits, which for peacetime recovery years have been unprecedented in relative and absolute magnitude, hampered your ability to pursue an anti-inflationary policy without causing unacceptably large increases in interest rates or are you going to be required to substitute monetary policy when you should not be, to overcome the erroneous fiscal policies of this Congress?

Mr. MILLER. Too much of the burden over the last 12 years has been placed on monetary policy. Monetary policy has its limitations if other considerations are such that monetary policy is left as the only balance wheel against inflation, the ultimate consequence is to bring about distress and difficulty. I think it is high time—and it is encouraging to see trends in this direction—for

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fiscal policy to carry far more of the burden. That is beginning to happen, and I am pleased and commend Congress for the steps it has already taken. But I am sure more needs to be done, as was mentioned in the discussion with Congressman Derrick.

Mr. REGULA. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Mattox.

Mr. MATTOX. Mr. Miller, I am pleased to hear your testimony today. I know it is kind of like the preacher sometimes preaching to all the good church members. Some of us have been saying some of the things you have said with regularity.

I think from being out visiting with the business community—I am from Dallas, and visiting with those folks—frankly they are scared to death of the Fed. They are literally scared to death that the Fed is going to continue to tighten the screws on the economy and cause some serious problems in the future.

If you walk out there and talk to the business community, say what troubles you and what is keeping you from investing, there are two answers to it. It is not the tax policies ordinarily, not those things. They say first that inflation has us scared to death. We don't know what is going to happen to the price of our products, and then the other one is that we don't know what is going to happen to these interest rates. We don't know whether to invest now, or not invest; we don't know when we do invest if the Fed is going to put such a clamp on the economy it will kill all the demand for our products and then send us into a deep recession.

And I know that you are on kind of the horns of dilemma. I have heard you describe the need for increased capital investment and increased spending in that area. And, at the same time, the Fed appears to be tightening up the interest rates, or at least attempting to cause interest rates to gradually keep up, in an effort to try to slow the economy down at the same time. I don't understand exactly how you can suggest that we need the big capital spending and, at the same time, cause interest rates to go up which, in effect, is probably the one thing that kills off capital spending. The businessman will not spend because he thinks money is too expensive, and it is so much more difficult to make a profit when the money is expensive.

Mr. MILLER. In the past, the Federal Reserve has been the whipping boy in hard times; it was easy to point to the Federal Reserve as the guilty party in times of economic downturn. It is easy to point to the Federal Reserve because if it is the only game in town, it is left to try to fight inflation alone. This can only be done by restraining the growth of the monetary aggregates so as to slow down an overheated or inflationary economy. The side effects, unfortunately, can lead to difficulty for a time.

That is why we have been arguing so strongly for more coordination, to relieve the burden on the Federal Reserve. As to the level of interest rates, we are concerned. We are not pleased by high interest rates, but they are the natural consequence of the overall economic policies that the United States has been following. One thing that causes higher interest rates is inflation. Long-term capital, throughout the 25 years that I have been around in business, has cost about 3 percent in real terms. Add to 3 percent the rate of

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inflation and you pay the total. If inflation is 7 percent, it takes an interest rate of 10 percent to get a real return of 3 percent for the investor. And if you don't give a real return on money, capital will fly and you won't have it. Unfortunately inflation makes it expensive to attract capital to invest. Any nation that has tried to hold interest rates down in the face of inflation has seen capital leave the country, or go into gold; it won't go into investment because it would be taxed away. The capital would be taxed away.

The old saying is that, in time of inflation people are interested not just in the return "on" their principal, but in the return "of" their principal. They don't want to see it come back with less purchasing power than they started out with. In addition, an economy that is not only growing in real terms but in nominal terms takes more money to finance because of inflation. So we have, suddenly, a growth in credit demand to finance the same level of fiscal activity, and that increase of credit demand means that there is not enough money around in banks or sources of capital, so interest rates go up.

The Federal Reserve, in trying to restrain the forces that will inevitably lead to higher inflation rates, does have to do some tightening which does cause some of the increase in the short-term interest rates.

The Federal Reserve, has faced this terrible dilemma since I have been in Washington. If it should say, "Well, in the face of these conditions we better keep interest rates low," and if we should print enough money to do that, business people would be happy for 6 or 8 or 9 months, but then the economy would see double-digit inflation and the interest rates would be far higher, and there would be nothing the Federal Reserve could do. There is not enough money to prevent us from getting into severe difficulties if we try to take that path.

If, on the other hand, we are responsible and prudent and lean against inflation, yes, interest rates do go up and people do worry about it. But it is the bitter medicine that we must take as a consequence of actions over the past 12 years that have put us in this terrible position. We didn't finance the war in Vietnam; we put on wage and price controls that didn't work; we let the international monetary system break down; we didn't have an energy program, the oil boycott was able to work against us, and we have experienced a fivefold increase in energy; we had Watergate, with its aftermath, with nobody trusting Government or other institutions. Everything broke down or deteriorated.

Now we have to build ourselves back. We have to face the music, take it like it is, pay the price for our past sins, and sin no more.

Mr. MATTOX. I appreciate what you are saying, but the problem is——

Mr. MILLER. I am from Texas, but not all sinners come from Texas.

Mr. MATTOX. Over at the Federal Reserve, you must be tearing yourselves apart because of these inconsistent areas of logic. It is impossible for us to be demanding the kind of increase in industrial growth and increased real growth in our economy, and, at the same time, making the business community scared to death by the increasing of the interest rates. I mean it is just not possible.

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But I think the point, if there would be a point to be made, is that this Congress is operating right now with not much change in attitude from where we were 2 or 3 years ago. We still have accelerated public works programs that we had in the 1979 budget. We have the countercyclical money in there; we have the revenue-sharing money in there; we have the title VI public employment type activity at the rate of 725,000 people; we are still pursuing the course of pushing the economy forward very rapidly, as rapidly as we can, without causing even more substantial deficit.

It would be easy for us to bring the economy in control if we cut back on those programs—into a more balanced situation. But, at the same time we are pushing those goals, the Federal Reserve is putting the screws on, putting the brakes on, raising interest rates which, in effect, appears that we are getting back in some degree, to the same place the Congress was in with Arthur Burns, when the Fed was taking exactly countervailing action from what the Congress was taking, about the time we were in our serious recession.

Mr. MILLER. I think there is more compatibility now, though, between Congress and the Federal Reserve than I would have expected.

Mr. MATTOX. I agree with that, let me assure you.

Mr. MILLER. Let me remind you, Congressman Mattox, that we saw a rather interesting phenomenon this year. The Federal Reserve acted promptly and forcefully to tighten the money supply, and to tighten the economy in the face of inflationary forces, and the stock market went up. That has never happened in recent times. So while you may be hearing from worried businessmen, the judgment of the market was that the actions of the Federal Reserve were positive and were ones which could be reflected in a willingness to spend and invest.

Mr. DERRICK. Will the gentleman yield?

The CHAIRMAN. I am going to have to really advise the gentleman that his time has expired, at least three times.

Mr. MATTOX. Mr. Chairman, it seems to me we may be pointing up the fallacy of the committee process when you have a man of the ability and character of our witness when the members of the committee are limited to asking 5 minutes of questions. Even all of our combined logic and reasoning should indicate that we probably should destroy the committee system and find a better approach to managing the Government, because it is surely evident to me we are accomplishing very little.

The CHAIRMAN. That may well be, but your other colleagues eagerly are awaiting.

Mr. MATTOX. I understand entirely. I am saying maybe that is the reason the Government is not working very well.

The CHAIRMAN. It probably is one of the reasons.

Mr. MILLER. You know, my plan to fight inflation is to ask Congress to pass a law to ban air-conditioning in Washington. That would clean out Washington in the summer, and there wouldn't be any mistakes made.

The CHAIRMAN. The gentleman from Ohio, Mr. Latta, is recognized for 5 minutes.

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Mr. LATTA. It is a pleasure to have you before the committee this morning. I agree with a lot of what you said and especially when you say that the Fed has been playing the only game in town, and I fully understand what you mean by that statement. It has been the only real restraining influence on inflation that we have had here.

I am pleased, having followed your actions since you have been in office, to say that I believe those restraining influences will continue at the Federal Reserve, and I commend you for carrying on those policies.

Mr. MILLER. Thank you.

Mr. LATTA. I note a few places in your testimony where you differ with the administration. Maybe you can convince the administration to adopt your policies. For example, on page 10 you say, "I believe that we should strive to reduce the Federal Government share of the GNP from more than 22 percent at present to 20 percent or so over a period of 5 to 7 years." The administration's position is 21 percent, and that little variance there, between 22 and 21 percent, will mean about $25 billion a year.

Mr. MILLER. Currently. It will mean more later.

Mr. LATTA. I wonder if you couldn't bring your tremendous influence to bear at the White House to see if we couldn't cut back $25 billion.

Mr. MILLER. I appreciate your confidence in my influence at the White House. I will certainly carry the message.

Mr. LATTA. On that same page, you have a couple of other suggestions that I wish you could influence Mr. Ullman on the Ways and Means Committee to adopt, where you say, "Present depreciation tax laws should be liberalized. For example, businessmen could be permitted to use a shorter writeoff period for machinery, equipment and structures." They should have done that a long time ago. They shouldn't have to wait for you to come up here and tell them to do it.

I wish you could use your influence on that committee to get that done because I think it would help tremendously, and you go on to say, "Careful consideration also should be given to present laws that tax corporate profits twice, first at the firm and then at the stockholder level."

We have heard that preached around here for a long time. You shouldn't have double taxation on dividends, but nothing ever seems to be done about it. Hopefully, when you get before the Ways and Means Committee—and I am sure you will in the future, and you probably have been in the past—but convince them to do something about that.

Do you think your prospects for convincing them are good or bad?

Mr. CONABLE. Even before you answer, you have convinced me.

Mr. MILLER. There are a lot of good ideas in Washington and the time is ripe for some of them, I think.

Mr. LATTA. You make another good one on the last page. I don't know why you waited until the last page to make it. "In addition, it seems appropriate to consider deferring the increase in the minimum wage that is scheduled for January 1, 1979." I agree with you 100 percent. I voted against that increase for the very reason you

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are saying it shouldn't be increased on January 1, 1979, because it was inflationary. But downtown and here in the majority of the Congress, they thought, boy, this is a good thing to do.

Mr. MILLER. May I address myself to that for a moment, Congressman Latta?

Mr. LATTA. Surely.

Mr. MILLER. I am sure the change in the minimum wage was enacted in good faith and with goodwill and without any expectation that the consequences would be what they have turned out to be. Let me first point out the consequences this year. I am not sure you all know what has happened this year.

The rate of wage increases in the first half of this year was over 8 percent. And with the increase in the minimum wage, the increase in the social security payroll taxes, and the unemployment insurance tax, the increase in total hourly compensation in the first quarter of this year was 13½ percent. This year the effect of the minimum wage will be to add about one-half of 1 percent to the rate of inflation.

We are going to have another dose of that increase on January 1, 1979, and it is going to add another one-half percent to inflation next year. If we make no other changes, the mandated increase in the minimum wage and in payroll taxes on January 1, 1979, will increase the projected hourly compensation from 8 percent to 12½ percent in that quarter. The increase in the minimum wage will add one-half of 1 percent to inflation next year.

Now is there anything that could cut one-half percent off the rate of inflation easier than facing up to the effect of that minimum wage increase now and deferring it for a couple years? It does not help people to give them something with one hand and take it away with the other by putting on this cruel tax of inflation that hurts everybody. A few people are affected by the minimum wage; everybody is affected by inflation.

This is something that could be done now. It would be statesmanlike; it would be courageous. It would not be popular, but it is time for some unpopular things like that to be done.

Mr. REGULA. Would you yield?

Mr. LATTA. I would be happy to yield. I want to thank you for a tremendous statement.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Florida, Mr. Lehman.

Mr. LEHMAN. Thank you, Mr. Chairman. I have a tendency to talk about subjects I actually see and experience in the district I represent. For instance, just a few years ago, downtown Miami was kind of a disaster area, but today, all the stores on Flagler Street are rented and rents are going up. Burdine's, the big downtown department store, is renovating and enlarging, and the recently completed Omni complex downtown is running several years ahead of expectations. Even the 50-year-old boomtime dwellings on Miami Beach, are being sold now for the first time in a number of years.

This is the result of people coming from other countries to buy our bargains. People come from Latin America and elsewhere into the Miami area and load up. You can see them going out with huge cartons of American-made goods.

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Our inflation may be bad, but compared to inflation in the rest of the world, ours is not that serious. My question is, are we really dealing in a reality, and how much effect can our own domestic fiscal or tax policy really have on our inflation unless we can get a handle on rising costs outside this country?

We existed in a fairytale world of low-cost goods we could get cheap from the developing nations. We are not going to get them cheap any more, so are we really deceiving our people in saying that what we do with interest rates and other Federal policies can give us a handle on inflation?

I guess what I am trying to ask is can what we do in this country have a significant effect on inflation if we can't control inflation beyond our borders, as evidenced by the circumstances I see in my own area?

Mr. MILLER. Thank you, Mr. Congressman. I want to respond at some length and probably take more time to answer than I should.

We cannot be complacent about inflation. We cannot allow ourselves to believe that a rate of 7-percent inflation is acceptable or tolerable. I will give you a couple of examples of why we cannot.

In the first place, we are not just any nation in the world. We are a nation whose production represents 30 percent of the production of the whole world. If this great country should erode and destroy its values, the effect on the whole world would be enormous and the probability of instability and tension and war could be increased. We must have a stable economy; we must have price stability; we must achieve all of the economic objectives we believe in.

I have been telling this year's university graduates what inflation means to them. The people who are graduating this year are highly motivated, well trained, and determined to take a constructive role in our society, but they are not familiar with inflation and deflation because they are young and they haven't had the experience. What has happened in the last few years has been bad, but if the current rate of inflation continues until these young people reach age 65, then the dollar they hold today will be worth less than a dime at that time. We just can't let that happen.

I will give you another example. In the 16th century, Spain was the greatest beneficiary of the discovery of the New World. Massive amounts of gold were introduced into Spain from America, giving unearned purchasing power that drove up prices 1,000 percent and built the most elegant society that Europe had ever seen. But Spain didn't invest anything; it consumed everything. And by the 17th century, Spain was, economically speaking, barefoot.

The United States in the 20th century has built the most affluent nation the world has ever known, with the highest standard of living for the most number of people. But it has discovered the printing press and unearned purchasing power. If we continue to consume and continue to put too little back—not enough to maintain the productive capacity to sustain ourselves—we will run the risk of being barefoot in the 21st century. We have to face up to these issues.

Mr. LEHMAN. I just wanted to find out how much control over our own destiny we really have in this effort because of the effect

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on the rest of the world. No matter how hard we try, can we really do it?

Mr. MILLER. Yes, sir, we can do it. We really can. Some figures have just been passed to me regarding experience in some of the major countries. Japan, for instance, suffered 22-percent inflation in 1974; this year their rate of inflation is far below ours, but it was 22 percent just a few years ago. England had a very high level of inflation, 24 percent in 1975; they are now down to the same rate of inflation as the United States. From 1975 to 1978 they have brought down the rate of inflation to the same level as ours.

Mr. LEHMAN. There is hope.

Mr. MILLER. There is plenty of hope.

The CHAIRMAN. The time of the gentleman has expired. Mr. Rousselot.

Mr. ROUSSELOT. Thank you, Mr. Chairman.

I appreciate the Chairman's testimony and many of these comments that he has made since then in answer to questions.

Right before us now is the finalization of a budget resolution relating to 1979, and you mention in your testimony that we must reduce the growth of Federal expenditures we have projected for 1979 in our First Budget Resolution, and you mention that we need to control that increase in Government expenditure.

Some of us have advocated, but we have not been a majority, a closer restraint on those increases in immediate expenditures, as you know. There is a real difference of degree as to what that should be. If you were able to have a heavy input to this committee, what would your judgment be as to what the increase in Federal expenditure should be for 1979 percentagewise? It is going to be, under the 1979 resolution, between 10 and 11 percent. What would you suggest, since you put such heavy emphasis on restraining the increase in Government expenditure?

Mr. MILLER. The original proposal was for spending of about $500 billion. I think you are now talking about around $496 billion under the current resolution; am I correct?

Mr. ROUSSELOT. That is OMB's latest estimate.

Mr. MILLER. Ideally, I would like to see that reduced another $10 billion. But I must be honest with you; I don't think that is practical given your timetable. If you could keep that resolution at around $490 billion, that would be another major contribution.

Mr. ROUSSELOT. $490 billion?

Mr. MILLER. In spending, yes, sir.

Mr. ROUSSELOT. But preferably another $10 billion.

Mr. MILLER. You asked me what I would prefer if I were the ruler of the universe.

Mr. ROUSSELOT. As you know, Mrs. Holt and Mr. Fisher had a similar suggestion, and we voted on this in this committee and lost by one or two votes, so maybe we can reintroduce that idea and do better this time.

Mr. MILLER. A combination of the changes in the tax program, and some changes in spending would go a long way in the right direction.

Mr. ROUSSELOT. I appreciate your suggestion, and I appreciate your being candid. I appreciate that you said idealistically. Maybe we idealists can try again.

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You also related very heavily in your statement to the issue of controlling the growth of Federal expenditures, and the issue of the measures needed to encourage investment because the Federal Government has been, as you have stated, one of the main competitors in the marketplace for money as we refinance old debts or finance new debt. That is not a brandnew theme, as you know. To what degree do we as a Government, need to reduce our competition in the marketplace for money? You made some specific suggestions.

Mr. MILLER. When I took office at the Federal Reserve, the economic plan for fiscal year 1979 involved a budget deficit of $60 billion and off-budget borrowing of $12 billion for a $72 billion presence of the Federal Government in markets. I believe that the plan now is shaping up to be around $60 billion; maybe it could be squeezed more.

Mr. ROUSSELOT. Especially if there are further shortfalls on the expenditure side.

Mr. MILLER. Yes; if you put further caps on spending. The $12 billion reduction is a very substantial step in the right direction, and I must say I have great admiration for even that accomplishment. I know the difficulties; and I give great credit for what has already been accomplished. If more can be done in fiscal year 1979, I would welcome it.

But the schedule I would like to see is a reduction in the deficit to below $50 billion in fiscal year 1979; to below $40 billion or about $35 billion the following year; to below $20 billion or about $17 billion the next year; and to achieve a balanced budget with full employment in 1982.

That kind of program makes sense to me. I don't believe we can solve our problems with erratic motions. We can't suddenly cut $50 billion. We have to start the right trend and move the throttle with some gentleness. This jerking around does shake up the passengers. It is time we went on a steady and constant course. That is the better way to do it. The market will adjust better; it will give greater assurance that the mechanisms are in place. That is the timetable I would recommend.

Mr. ROUSSELOT. Do you think we should target for a deficit of $40 billion in 1979?

Mr. MILLER. To get down to $45 billion would be, I think, quite satisfactory. If you try to get below that, you are going to have a more rapid——

Mr. ROUSSELOT. That, of course, is what the Holt-Fisher amendment attempted to do. I appreciate your comments.

The CHAIRMAN. The time of the Congressman has expired. The gentlelady from New York.

Ms. HOLTZMAN. Thank you, Mr. Chairman, and welcome to the committee, Mr. Miller. I want to ask you about two matters. The first has to do with reduction in Government spending and the other with increased interest rates.

I take it that the increase in interest rates was designed to prevent an increase in the amount of money in the economy and thereby reduce inflation. But, of course, raising interest rates, itself, is inflationary. I would like to get some idea from you as to

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when you think the action that was taken by the Fed to raise the interest rates will result in a reduced inflation?

Mr. MILLER. One of the problems the Federal Reserve has, Ms. Holtzman, is the difficulty of timelags; what we do isn't seen at the time and by the time it cycles through it is forgotten.

If the Federal Reserve were to supply additional reserves to the banking system and create more credit or money, short-term interest rates might thereby be lowered. It is not at all sure that long-term rates would be lowered. They might be higher, because of the expectation that the result of all that credit would be inflation. Capital to be loaned for a long period of time would tend to be unavailable; it would tend to sit on the sidelines waiting.

While the short-term effect of the Federal Reserve's tightening and restraining is to bias interest rates up, its long-term effect—over 18 months, or over a 3-year period—is to bring down the inflation rate.

It is that long lag that makes it so hard for us to get people to appreciate how we work and why it is so important we don't put action off. If we continue to validate inflation, it will look good for me for 6 months, but I know what damage I will do to the economy by that sort of process after 2 years.

Ms. HOLTZMAN. I see, so the results of the efforts that have been taken by the Fed in raising interest rates will be seen in approximately 18 months to 3 years?

Mr. MILLER. And, of course, interest rates, as I mentioned before, are influenced not just by what the Federal Reserve does, but by the general demand for credit that is in turn influenced by the rate of inflation which requires more money to finance the same level of activity, and so forth.

Ms. HOLTZMAN. I would like to turn now to the issue of Government spending. I am concerned that when we talk about inflation we do not fall into cliches, and that is why I want to raise with you two points that I don't think you touched on.

The first is that not all Government spending is equally inflationary. For example, without making any value judgment, military spending is, per se, inflationary. We may, of course, be willing to pay their price, but, by definition, this type of Government spending creates inflation.

Second, the loss of dollars abroad, and the failure to return those dollars to the United States, resulting in an enormous negative balance of payments, also creates inflationary pressures.

I would like you to address these two items as contributing factors to the inflation we are now experiencing. It is easy to pick on the minimum wage, as a prime cause of inflation because it has always been a subject of controversy, and it has always been easy to pick on Government spending in general. But I would like to have a sense that we are thinking through the larger picture, that is, the extent to which the loss of American dollars abroad is creating inflation, and the impact of these enormous military expenditures which are, by definition, inflationary. We may be willing to pay the price, but I don't see anybody measuring the inflationary impact of them as we are measuring the impact of the minimum wage.

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Mr. MILLER. Let me talk about the balance-of-payments problem first, if I may. There are two levels of concern about the value of the dollar. One is over short-term movements that relate to confidence, speculation, market actions; these can be generated by forces that do not necessarily show a fundamental problem.

The long-term value of the dollar is determined by more fundamental issues, and there are two fundamental situations that have worked to cause a decline of the value of the dollar. One is inflation. Relative inflation against other countries puts us in a position where the dollar has less purchasing power and therefore has to be worth less than some other currency that hasn't been eroded by inflation.

The second issue is our balance of current account payments, which you mentioned. We have to have a balancing inflow of capital to make up for that, which can have a very inflationary impact.

The decline of the dollar since last September will produce an increase of about 1 percent in this year's rate of inflation. So I am absolutely with you that we must address the balance-of-payments problem vigorously; we need to do that.

Ms. HOLTZMAN. I take it from your figures that this inflationary impact is greater than that caused by the minimum wage?

Mr. MILLER. The minimum wage adds half a percent. The minimum wage can be changed by an act of Congress. You can't change the balance of current accounts without a much more massive program. You have to get an export drive going, dismantle some of the inhibitions to exports, and so forth. I am for attacking those problems, as I tried to point out, and I have been advocating a national policy to increase our exports.

Minimum wage action could be taken immediately and would not hurt people. It hurts people more to tax them through inflation which takes away their resources. But I don't want to make value judgments about these things either.

I am trying to say that in the last analysis the welfare of all Americans is affected more by inflation than by almost anything else. I mentioned what would happen to college graduates this year, what would happen to the values that surround their lives; what would happen would be dreadful. We all do have tough decisions. We should attack all of these problems.

I had a chance before to single out where to cut Government spending, and I said I would submit some ideas; I feel this is a congressional prerogative. I agree with you that not all Government spending is inflationary and that not all Government spending cuts can take place at once because, as I mentioned, too erratic a change creates a drag on the economy. You would get recession, and if you get recession, that will create high unemployment, which will create deficits, which will give us another kind of inflation. That is the peculiar thing about our economy now.

The theory used to be that if you moved into low economic activity and recessions you would get a cutback in inflation. We found that isn't true; our transfer payments have just about offset that effect so we have to find other ways to curb inflation. That is why I have tried to emphasize that the policy of the Federal Reserve is to walk through a narrow tunnel, a narrow valley

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where, on the one hand, we can't allow the economy to grow so fast as to unleash more inflationary forces and, on the other we can't afford the heavy restraint that would produce a recession.

The judgmental problems are so difficult right now. We must make better calls than we have ever made in order to work through this period.

The CHAIRMAN. The time of the gentlelady has expired. The gentlelady from Maryland.

Mrs. HOLT. Thank you, Mr. Chairman.

Mr. Chairman, on the amendment that I offered to the First Concurrent Resolution, I made an effort to limit the rate of growth of Government, and one of the big things that I was concerned about there is the confidence. I think you have mentioned it two or three times this morning, "shaking up the passengers," and I think if we are going to get anybody, labor, management, anybody else to realize that we are serious about inflation, that we have to provide the leadership. So the amendment was almost permitted to pass when it got to the floor, and I think that means that the majority of the American people want to see it happen.

Now, the thing that I would like for you to elaborate on for me is this confidence factor. There is some authority that the surge in the second quarter could have been anticipatory buying. Would you comment on that, how these things affect it?

Mr. MILLER. Yes; I would be delighted to, Congresswoman Holt. The second quarter growth was somewhat influenced, I believe, by anticipatory buying of durables, of large ticket items. With the expectation of inflation, families made purchases earlier, financing them because of the availability of credit sources.

On the other hand, the second quarter was not characterized this way entirely. It also reflected a catchup from the first quarter in which, because of the winter and the coal strike, we had zero real growth.

Confidence is hard to measure. In my limited experience in Washington, I have noted that when there is a nationwide sense of greater fiscal discipline, coupled with prudent monetary discipline, confidence is created. This is true whether confidence is measured by the Michigan poll or by some business survey or by what markets actually do and how people vote with their money. The sense that we in the Government are going to act positively to curtail inflation generates a sense of confidence.

That is why the things we are talking about today are so important. Not only are they important intrinsically, but they are important in demonstrating that, having created the problems that we have over the past dozen years, we also have the fortitude and the willingness to start changing policies with some perception of where we are going and a commitment to stick with it. You cannot solve problems built up over a dozen years by policies taken over 3 months.

But we have to start to show constancy and purpose and determination over time. Then I am sure confidence will rebound, and conditions will allow us to use inflation in a positive way, as the common enemy against whom we can all rally. When we unify this Nation through a common purpose with our self-interests all aimed

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against the same target, we can do wonders. That is why I am sure we can win.

Mrs. HOLT. Do you think it would be effective to legislate a cap on Federal outlays, a percentage of GNP, except in the case of national emergency? Do you think that would ever work?

Mr. MILLER. I don't object to the discipline. But I am skeptical of long-term, legislated caps because I believe that the world is too complex, and this sounds like too easy a solution. I would rather have us announce a program, a plan—like the model economy I have been talking about—and then be sure each Congress fits its action into that plan, but does not get locked in. You just can't measure this year what next year will be like.

Mrs. HOLT. Sort of like a Budget Committee setting aggregates based on the econometric models that we see.

Mr. MILLER. Yes.

Mrs. HOLT. Thank you.

The CHAIRMAN. The time of the gentlelady has expired, and I might add I got the message.

Mr. MILLER. I thought there was a message there.

Mrs. HOLT. Thank you.

The CHAIRMAN. The gentleman from New York, Mr. Conable.

Mr. CONABLE. Thank you. Chairman Miller, welcome to the committee. I am sure you have been welcomed many times today, as many of us find your testimony refreshing.

Let me ask you, I have heard it said that the old traditional measures of M_1 and M_2 are not necessarily all that accurate at this point, and that the economy cannot be understood except in terms also of the vastly expanding long-term credit, where people seem to be willing to commit themselves despite the high interest rates to a considerable obligation that would not have been taken on in more traditional times. Is there something to that?

Mr. MILLER. Yes; there is. Once you develop a certain tolerance for it, inflation is, I suppose, like other habits in life——

Mr. CONABLE. It is not only a tolerance; it is a sophistication that leads people to believe they should go ahead and commit themselves no matter how high the interest rate, because it is going to be worse in the future. Isn't that it?

Mr. MILLER. It is more than that. It is the feeling they should commit themselves not only because it is going to be worse in the future, but also because if they believe inflation is going to persist, they see they can pay back their debt in depreciated dollars. The psychology works the wrong way, and that is why I mention the fact that, when we fight inflation we have to fight this tendency of perpetuating it. That is why I think all the techniques that index and accommodate inflation are wrong; they make it a heads-I-win/tails-I-win situation. When any individual is indexed for inflation, this creates an enormous incentive to overborrow; you know you are protected because you will have more income to pay back your loan—and in depreciated dollars. Or if you end up without inflation, you win that way too. So it is an unsatisfactory situation for curbing inflation.

I don't want to get into your question about M_1 and M_2 until we have more time to explore it. But, briefly, we are seeing changes in payment mechanisms, and we do have in times of inflation, the

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tendency for more sophisticated cash management and greater velocity in money; this creates certain new phenomena for us to deal with in monetary policy. I know you are aware of all these things.

Mr. CONABLE. I wanted to get your view as to whether or not we really did need some statistical review of this whole area.

I would like to ask you, also, sir, if we are doing enough to sustain the value of the dollar abroad? There is a general feeling that somehow we have a unilateral policy to depreciate the dollar; it will help us sell our exports abroad; it will increase the cost of imports in our market and solve some of our trade problems.

Some of our trading partners are accusing us of deliberately fostering this. We counter by saying, "Go ahead and debase your own currency; deflate and maybe you will succeed in more of our goods." And that is kind of crazy advice to be giving people like the Germans and Japanese, who have been managing their economy better than we have. Are we doing what we can? We really can't afford the Russian roulette of debasing the dollars abroad when so many dollars are being held there. We could have a dollar panic. From your view as a central banker, have we propped the dollar enough, or are we running some very unacceptable risks?

Mr. MILLER. Congressman Conable, let me go back to the basics for a moment. I would like to put to rest any thought that a depreciated dollar has any value to the United States. That idea is false.

Mr. CONABLE. There is some value, but there is a lot of risk, too.

Mr. MILLER. You know, the dollar is the principal currency for trade and investment in the world; it is the principal reserve asset. So a decline in the value of the dollar disrupts international trade, which hurts the United States; a declining dollar disrupts international investments, which hurts the United States; a declining dollar increases the cost of imports and reduces the competition from imports and causes inflation in this country, which is against the interest of the United States.

Every aspect of a declining dollar works against the interests of the United States. We have to say that loud and clear to everyone. I say it to every foreign central banker and every Government official who comes to see me. Believe me, we are not interested in devaluing the dollar at the Federal Reserve; we are not. We are interested in seeing a strong and stable dollar. It has to be in the U.S. interest to do that.

Now, are we doing enough? We have been taking some bridging actions, and the dollar now has about the same value it had 4 months ago, when I arrived here. That doesn't prove anything; it could drop or go up tomorrow. These are temporary actions, but I think we have been forceful in taking them and, to a degree, effective. The only way to do enough is to get our house in order by bringing down inflation and balancing our trade deficits. We don't have to solve the problem overnight, but we do have to start the trend in the right direction. If we turn down the trend on inflation and start to reduce the foreign account deficit, I can assure you the dollar will strengthen. And if we continue on those trend lines, the dollar will again be an asset with the preeminence it needs to have if we are to create stable conditions for trade, investment, and for the prosperous development of the whole world.

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Mr. CONABLE. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired.

Chairman Miller, I want to thank you for what I consider to be an outstanding performance by you in coming up here and being candid with us, and so informative and helpful and educational. You really have been. And it is refreshing, and it is very helpful.

You said somewhere along the way today that we are paying for the sins of the past, and we are. And I want to assure you that I have been trying for some time to sin less, and I am going to try even harder, and I am going to try to persuade some of my colleagues that we have to do less sinning if we are to get our economic house in order.

Mr. CONABLE. Mr. Chairman, we could go on sinning, but it hasn't been much fun, either.

The CHAIRMAN. I think the gentleman is right.

Thank you, Chairman Miller, and come back again.

Mr. MILLER. Thank you very much, Mr. Chairman. I have enjoyed the session and appreciate the courtesies you have extended to me.

[Whereupon, at 12:20 p.m., the committee adjourned, to reconvene at 10 a.m., Monday, July 31, 1978.]

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ECONOMIC OUTLOOK AT MID-SUMMER

MONDAY, JULY 31, 1978

HOUSE OF REPRESENTATIVES,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 10:45 a.m., in room 210, Cannon House Office Building, Hon. Robert N. Giaimo, chairman of the committee, presiding.

The CHAIRMAN. The committee will please come to order.

The gentleman from Texas.

Mr. MATTOX. Mr. Chairman, prior to our actually getting started in the hearings today, if I might, I would like to submit for the record two sections of material, one being a statement by me that deals with the subject of indexing the Federal structure as a method of insuring stability when the prices of goods, particularly oil and food are controlled artificially through the market system.

The statement that I am submitting was prepared with the assistance of Dr. Tom Dernburg, who is the economist of the Joint Economic Committee. I would ask unanimous consent for its inclusion in the record.

The CHAIRMAN. Without objection, the gentleman's statement will be included in the record.

Mr. MATTOX. I have already sent copies to each of the members' offices, and I would be glad to provide others.

The second thing I would like to submit is a short article that deals with and is somewhat critical of the CETA public works program. The purpose of submitting this is because——

The CHAIRMAN. Will the gentleman yield?

Mr. MATTOX. Yes.

The CHAIRMAN. I notice this article says "CETA: $11-Billion Boondoggle." You say somewhat critical?

Mr. MATTOX. Mr. Chairman, as you well know, I have been somewhat critical of the administration's CETA program. I think it is going to be difficult for us to continue to fund the program that has the kind of irresponsible administration taking place in it that this one does, and I am submitting it for that purpose and for consideration. I am sure that there are many articles that have been written on the fine things that have taken place in CETA. This particular one deals with problems dealing with CETA. I would ask unanimous consent for the article to be included in the record.

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

[Testimony resumes on p. 195.]

[The material referred to above follows:]

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Economic Stability and Inflation Indexing of the Individual Income Tax

(Submitted by Hon. Jim Mattox)

I am pleased to have the opportunity to submit this statement on the inflation correction, or indexing, of the individual income tax to the House Budget Committee.

Indexing of the income tax is an idea whose time has come. A properly indexed tax system can eliminate many of the legitimate complaints about the inequity of our tax system, and it can also contribute to the growth and stability of our economy. In my judgment, indexing of the income tax will prove to be both good politics and good economics.

In the past discussions of indexing have been dominated by ideology. I am, however, hopeful that henceforth we can discuss the issue on its economic merits. Conservatives have tended to favor indexing of the income tax because this slows the rate at which progressive taxes run up Federal revenues and permit the Government to increase its claim over real resources. Liberals, of course, have opposed indexation for precisely the same reason. History—with considerable assistance from Congress—has declared this debate a draw. Since 1950 total Federal revenue has averaged 19.1 percent of GNP. It has exceeded 20 percent of GNP only in 1968, 1969 and also in 1974 when that was exceedingly harmful to the economy. The Federal Government's share of the Nation's income has shown virtually no tendency to increase.

The reason for this stability is that Congress has granted periodic tax relief in a manner that offsets the tendency for the progressive income tax to increase the Federal share of national income. Consequently, I believe it is fair to say that the issue has less to do with the relative size of the public sector, than with the question of whether it is better for the economy if tax relief is granted on a piecemeal basis, or whether it is better for relief to occur automatically. In a subsequent part of my statement, I shall indicate why the latter is to be preferred. First, however, I wish to explain the mechanics of the indexing scheme. It can, I believe, be accomplished quite simply and with virtually no administrative complexity.

A correctly indexed progressive income tax would permit average tax rates for individuals to change when real income changes, but not when a rise in money income is offset by a rise in prices. The appropriate way to effect this is to widen bracket limits, exemptions, standard deductions, and tax credits at a rate equal to the rate of inflation. In this way the real values of these categories are held constant and this prevents an individual from moving into a higher bracket if his money income increases no faster than prices.

In addition to the foregoing changes, appropriate inflation correction of the individual income tax should include a redefinition of some items of taxable income that are distorted by inflation. An obvious example is the taxation of nominal capital gains; a practice that is unfair, wasteful, and injurious to capital formation. Certainly a homeowner who has held his property for over 20 years ought not—as at present—have to pay a capital gains tax on that part of the gain that stems from general inflation. Similarly, small savers have suffered greatly from the practice of taxing nominal interest. These savers do not have access to the full scope of the capital market. They are likely to be restricted to saving deposits and similar instruments whose nominal yields are held down by law. When the inflation rate rises above these controlled interest rates—as happened in 1974 and is happening again—these savers suffer an erosion in the real value of their savings and, to add insult to injury, they must pay taxes on the nominal interest they earn. The appropriate way to deal with this problem is to tax only real interest. This is computed quite simply by subtracting the inflation rate from the nominal interest rate. If the resulting real rate is negative, the taxpayer should be permitted to reduce his taxable income by the amount of his loss.

Once these simple reforms are enacted the average aggregate rate of income tax will no longer vary with the inflation rate. The question to which I wish to devote most of the remainder of my statement is whether such neutrality with respect to inflation is desirable from the point of view of economic stability. Will our economy be more or less resistant to the effects of shocks? Will our economy be more or less inflation prone?

The conventional view has been that progressive taxation of money income contributes to the stability of the economy. During inflation the disproportionate rise in taxes in the unindexed system slows the growth of disposable income and consumer spending and thereby helps to moderate inflation. Conversely, progressivity, causes tax yield to fall disproportionately more rapidly than personal income when eco-

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nomic activity declines. This prevents disposable income from falling less than would otherwise be the case, and this helps to hold up consumer spending.

The conventional view would not be subject to dispute if real and money income always moved in the same direction, as would be the case if inflation were always the product of excessive demand. And if this were always the case I would not be an advocate of income tax indexing. But recently we have learned that inflation can also come about from restrictions on the supply side. The chief shocks that come to mind, of course, are the very sharp increases in world food and oil prices that occurred in 1973–74. Such supply restrictions tend to raise prices and at the same time they tend to reduce output. If the response to these supply shocks is a restrictive monetary-fiscal policy, the decline in output will be that much greater, while almost no headway will be made against inflation since there is very little that domestic policy can do about prices that are determined by external conditions or acts of nature.

Despite the inappropriateness of such policy it is exactly the sort of policy that was pursued in 1974, and this is a major reason why the recession of 1974–75 was the worst since the Great Depression of the 1930's. To be sure, some of the restrictions that occurred in 1974 was the direct produce of conscious policy decisions. But in addition, considerable damage came about automatically because of the operation of our unindexed income tax during a period of acute stagflation.

To illustrate, here is what happened between the fourth quarter of 1973 and the third quarter of 1974, the period during which most of the damage was done. Real GNP fell at an annual rate of 3.2 percent. However, because of the inflation rate of 11.1 percent (as measured by the GNP deflator) money GNP increased 7.6 percent and personal income rose 9.4 percent. Personal income is the tax base of the individual income tax. Its rapid increase, combined with the progressivity of the income tax rates, caused revenue from the income tax to rise 15.8 percent. The result was that the ratio of income tax receipts to personal income rose from 11 percent to 11.5 percent during this period—a period during which real output and real wages were falling.

This did incalculable harm to the economy. It meant that our income tax acted as an automatic destabilizer rather than the automatic stabilizer that conventional wisdom and the economics textbooks have led us to expect. An automatic stabilizer causes the ratio of the tax to its base—the aggregate tax rate if you will—to fall when real income falls. But in 1974 the opposite happened. Had the income tax been indexed, the aggregate tax rate, instead of rising to 11.5 percent, would, in fact, have fallen to about 10.9 percent. Thus, this experience shows that indexing is the difference between an income tax that is an automatic stabilizer all of the time, and one that is an automatic stabilizer only some of the time.

As I noted earlier, Congress has granted tax relief so as to keep Federal receipts roughly constant as a proportion of GNP. However, in the 1974–75 period this relief did not come until March 1975, at which time the recession had already touched bottom. Clearly it would have been better for tax relief to have come earlier. One trouble with discretionary policy is that it often does not get put in place until after the damage has been done. Indexing of the individual income tax would help to avert this problem; and that is perhaps the most important economic argument in favor of it.

I know of no responsible economist who would claim that the economy would not have been better off in 1974–75 had the income tax been indexed. Nevertheless, there are those who regard that episode as a special case, and also those who feel that indexing will eventually add to inflation because they think it will, on balance, imply lower taxes than the present system.

Economic events are nothing but a series of special cases. I therefore see no reason for risking another debacle of the 1974–75 variety when this can easily be avoided by constructing a neutral tax system. Furthermore, indexing does not necessarily imply lower taxes as seems obvious from the unwritten law that Congress almost always holds taxes below 20 percent of GNP. But beyond these conventional considerations, there is good reason to suppose that indexing of the individual income tax may actually reduce inflation. There are two reasons for this; and I wish to comment on them briefly.

First, our conservative friends have been telling us that high marginal rates of taxation tend to reduce work effort, or what most economists call labor supply. Most students of this issue would concede that this is the case, but there is considerable dispute about its quantitative importance. Whatever the extent of the response, a reduction in labor supply in response to higher taxes implies an upward push of wages, a consequent rise in prices, and a reduction in employment. In conventional economics tax increases reduce total demand and this lowers prices and employ-

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ment. But if the tax increase is also accompanied by an upward wage shove, the employment reduction will be accentuated (since both the tax and the wage push effects work in that direction), while the price effects tend to offset each other and may, on balance, produce more inflation.

This argument has been propounded by a number of contemporary economists, and if it is valid, it means that the unindexed tax system may act as an automatic mechanism that generates both higher prices and higher unemployment. Inflation carries taxpayers into higher brackets. The resulting reduction in real take-home pay leads to an attempt to compensate for the loss by higher wage demands. The higher wages are then pushed forward into higher prices. Both the higher taxes and the higher prices reduce consumer real disposable income and therefore consumer spending. They therefore reduce production and employment. The result, then, may be a built-in mechanism that worsens stagflation. That is to say, it automatically contributes both to a higher rate of inflation and a higher rate of unemployment.

Indexing is sometimes viewed as a concession to inflation. It is important to note, however, that in European countries—where there has been considerable experience with attempts to slow inflation through incomes policy—indexing of the income tax is viewed as an indispensible ingredient of a successful incomes policy. I do not know if we will wish to adopt definite wage-price guideposts in the future. However, in case we do, it is important to be aware that the success of such a program is likely to be impaired by our present tax system. For example, a Kennedy-type guidepost policy which permits wages to rise at the rate of productivity growth, implies a freezing of the relative shares of income that go to wages and profit. But if rising income puts taxpayers into higher brackets, their after tax income will rise less rapidly than the growth of productivity, and when that happens the incomes agreement will very likely break down and aggressive wage demands will resume.

What I am suggesting is that the Government's own tax policy may undermine the wage restraint program that the Government itself is attempting to foster. To put the point differently, an agreement to fix the relative income shares between business and labor is not enough. The Government also has to play the game fairly by agreeing to hold its relative share constant. Rising marginal tax rates are incompatible with that requirement.

I cannot promise that we will have less inflation if we index the income tax, but I certainly believe that the arguments presented here make this a strong possibility. That indexing would help to protect the economy from the impact of supply shocks is not subject to dispute.

There remains one objection that we hear in the Congress and that is that indexing would deprive the Congress of the pleasure and political reward of granting periodic tax reduction. Considering the time and agony that has gone into the current debate over taxes, I wonder if tax cutting really is a pleasure. Some time ago Congress decided to forego the pleasures of providing semi-annual increases in social security benefits by replacing this ritual with an indexing scheme. This has removed a source of friction and I daresay that indexing of the income tax might have the same effect.

Nevertheless, let me address this issue by closing with some quantitative estimates of the cost of an indexing scheme if that were to be initiated in 1979. In this calculation I assume, as in the Wharton May 30 forecast, that personal income will rise 12.3 percent in 1979 and that consumer prices will rise 7.3 percent. Revenue from the personal income tax is estimated at $197.5 billion for calendar year 1978, so that with the usual assumed responsiveness, of taxes with respect to personal income of about 1.5, revenue would rise by $35.5 billion. Of this total $13.9 billion would be attributable to real growth, and $21.6 billion would be due to inflation. In the indexed system the portion due to inflation would be directly proportional to the rise in the price level and would come to $14.4 billion. Thus the net budget cost of indexing the individual income tax would be only $7.2 billion in calendar year 1979.

It is extraordinary how much can be brought at such low budget cost. Revenues still will rise progressively with respect to increased real income, and Congress therefore still has plenty of room to cut taxes. However, with an indexed system, Congress will have to address itself to the issue of how to raise real growth, and it will no longer be able to finance programs through revenues produced by inflation. That, in addition to what I have said earlier, ought to be plenty of incentive to cut back or eliminate many of the congressional and administration actions that directly add to inflation. Government ought not to have a stake in inflation.

In closing, I believe that inflation indexing of the individual income tax is no longer a partisan issue and should not be treated as such. Indexing will help our economy and it will help to defuse some of the more irresponsible tax proposals that are presently before us. If I interpret the supporters of Congressman Steiger, and of

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Congressman Kemp and Senator Roth correctly, their chief concern is with the effect that inflation has had on tax liabilities. My proposal attacks that problem directly, fairly, responsibly, and in a manner beneficial to the economy.

CETA: $11 Billion Boondoggle

(By Ralph Kinney Bennett)

(This Federal plan to help the hardcore unemployed has become a grotesque Lazy Susan of programs that are rife with waste and mismanagement as funds are dispensed in everything-for-everybody style.)

What have your Federal tax dollars been doing lately? Just take a look.

In Chicago, they paid a young man $750 a month to teach inner-city youth how to slap various parts of their bodies rhythmically and become "human drums."

In Salem, Oreg., they financed the construction of a steel-reinforced concrete rock, 30 feet high and 60 feet across, on a small island in the Willamette River. It will be used for practice by rock climbers.

In Miami, Fla., they paid for a "nude sculpting workshop" in which naked men and women ran hands over one another's bodies. (This was to help them discover that they had "both male and female qualities.")

In Atlanta, Ga., they paid the former leader of the Black Panther Party, an avowed Marxist-Leninist, $475 a month to, as he says, "keep an eye on city, county and State governments and their jiving of the masses."

In Ventura, Calif., they enabled 101 people to count the dogs, cats and horses in the county. And in Pinellas County, Fla., they paid 22 "outreach workers" to go door to door and find people to add to the food-stamp rolls.

The U.S taxpayer, somewhat inured to Federal boondoggles, might well greet body drummers and animal enumerators with sighs of resignation. But these examples deserve a closer look because they and hundreds like them have been financed out of a single Federal law, the Comprehensive Employment and Training Act, known as CETA.

Enacted in 1973, CETA was supposed to funnel Federal money to state, county and local governments to provide unskilled or low-skilled workers with public service jobs in health, education, law enforcement, sanitation and the like. The jobs were to be useful to both the public and to the individual hired. And they were to be temporary—to give the disadvantaged the initial training needed to find productive employment, generally in the private sector.

But during the 1974–75 recession, Congress persuaded the Ford administration to go along in transforming CETA into an everything-for-everybody unemployment cure. House Education and Labor Committee Chairman Carl Perkins (D., Ky.) assured restive colleagues that "this is just a temporary emergency bill to get us through the next few months until we go to work on more durable long-term solutions."

Scandal-pocked.—This assurance was quickly lost in the administrative shuffle. An initial $3.8-billion effort to put the Nation's most desperate people to work became a grotesque Lazy Susan of programs, dispensing $11.4 billion in the past fiscal year. Quite obviously, some Americans have been helped through this massive outpouring of tax dollars. But, with scandal rife and payrolls clogged with would-be artists, political activists and college-educated professionals, the program has degenerated into an unfortunate joke on the genuinely disadvantaged.

Local governments began openly subsidizing payrolls with CETA money to the point where 15, 25, 30 percent and more of their employes are now drawing Federal paychecks. The Wall Street Journal notes that the spending for jobs "is in fact a system, now well advanced, for transferring the fiscal burdens of the nation's cities to the federal government." And Rep. Jim Mattox (D., Texas), a supporter of the original CETA concept, admits the program now "runs the risk of becomming an elite Peace Corps in our own country," dispensing jobs that bear no relationship to the needs and abilities of the hardcore jobless.

CETA programs have become so pockmarked with scandal that the Department of Labor has instituted a 200-man permanent investigation unit to probe abuses such as these:

Choice jobs.—In Chicago, while mailbags full of applications from the genuinely unemployed piled up beneath their desks, job "screeners" handed out choice $7,000- to $9,000-a-year CETA jobs as political plums. The jobs went to applicants who had letters of recommendation from city aldermen. In Baltimore, loose eligibility guidelines resulted in CETA jobs going to the wife of a State supreme court judge, the daughter of a U.S. Court of Appeals judge, the son of the vice president of a large

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brewing company, the son of a city public works superintendent, and the son of a member of the Maryland House of Delegates.

Ghost employes.—In Atlanta, a CETA administrative employe credited thousands of dollars' worth of work hours to nonexistent workers, then pocketed the money herself. Other CETA "workers" were found to be drawing two paychecks for two different public service jobs and showing up at neither one. In Cincinnati, a private employment agency "filled" 79 nonexistent jobs for which it received $47,250 in CETA funds from the city.

Lax administration.—In Buffalo, N.Y., one of the cities hardest hit by unemployment, Federal investigators and a grand jury have been trying to follow the trail of millions of dollars in the mismanaged CETA program that has been marked by sloppy auditing, ineligible participants, nepotism and illegal political activity. In East St. Louis, Ill., administrative costs for each CETA job ran to $17,872—five times the national average of $3,761. In New York City, $500,000 in expenses for a summer youth program was unaccounted for. Many employes sat around all day doing nothing. One group of youths supposedly training to become recreational supervisors, was paid to play softball each day.

But these scandals, so characteristic whenever there is a massive influx of loosely audited Federal money, are only a sideshow to the real problem: CETA has become so far removed from its legislative intent that it constitutes a fraud on taxpayers and—most poignantly—on the disadvantaged whose hopes for lasting, useful employment it has falsely raised.

CETA junkies.—The administration boasted last March that it had created 425,000 new CETA jobs in less than a year. The jobs, scattered through tens of thousands of local projects, consumed more than $8 billion in tax money. (Some of this money is returned to the Treasury, of course, in income tax payments.) By contrast, tax-producing jobs in the private economy increased by 440,000 in a single month—November 1977—during the same time period. And a closer look at those 425,000 new CETA jobs reveals that they have very little net effect on the unemployment picture.

The big reason for CETA's less-than-sparkling record on job creation is the fact that many cities, towns and counties absorb CETA funds into their existing payrolls to relieve local tax pressure and balance budgets. It has been estimated that CETA finances four existing jobs for every new one it creates.

Philadelphia's Mayor Frank Rizzo brags that he makes "maximum use" of CETA-paid personnel to "hold down" locally funded costs. Twenty percent of the New York City work force is CETA-paid. CETA paychecks go to 32.8 percent of the city employes in Buffalo; 25.8 percent in Hartford, Conn.; 22.8 percent in Newark, N.J. In many cases, local governments have dismissed employes, then hired them back as CETA employes. "The cities are addicted to the CETA narcotic," says Rep. Barber Conable (R., N.Y.).

A recent study by the Brookings Institution indicates that Federal funds, mostly CETA will amount to at least half as much money as that raised through local taxes in Philadelphia, Detroit, Baltimore, Cleveland, Buffalo, St. Louis, and Newark. Instead of directly assisting the hardcore unemployed, CETA money is replacing local funds.

Ballerinas on the dole.—CETA true impact on hardcore unemployment is further distorted by the fact that it has evolved into a kind of Federal job fair in which the individual desires of some take precedence over the real needs of many. The low-skilled worker who can't get his foot in the employment door in wealthy Montgomery County, Md., may be somewhat bewildered to find that CETA funds are paying nine young women $145 a week to take ballet lessons full time (they give occasional benefit performances for county residents).

And the ballerinas, like the young body drummer, are not isolated CETA "arts" programs are funding at least 10,000 men and women—many of whom have left jobs in the private economy—to paint, sculpt, make movies, create street theater, play guitar, weave and make pottery at public expense of more than $75 million a year. It seems that CETA money is waiting for anyone resourceful enough to tap into it in the name of performing some kind of "public service." So in Los Angeles, "Gay Community Services" secured $640,000 from CETA to provide, among other services, information "about gay lifestyles and gay people's problems."

Training hoax.—Beyond the matter of dubious job funding lies a further dispiriting problem for the low-skilled jobseeker. CETA if funding thousands of "high entry" jobs that obviously demand skills marketable in the private economy. Many cities augment the $10,000 CETA maximum pay to create white-collar jobs paying $15,000 or $20,000 a year. In Washington, D.C., the city council amassed one of the country's largest council staffs, paying 56 of its 126 employes with CETA money.

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With CETA funds, Northumberland County, Va., hired a retired Navy captain to be sanitary district administrator.

With such jobs absorbing much of the CETA money, job training—which could best help the hardcore unemployed—has been relegated to a relatively minor status. In fiscal 1977 CETA devoted a mere 1.5 percent of its $11.4-billion budget to on-the-job training.

In New Hampshire, Joseph Zellner, deputy commissioner for employment and training, laments, "We've been saturated with money earmarked for public service but little for providing lasting jobs for the unemployed." Thus, he says, businesses in the State are having a hard time finding takers for advertised jobs in carpentry, construction, clerical and other skills, while non-tax-producing, public-sector jobs in the State continue to expand.

CETA jobs, no matter how dubious or frivolous their value, are plainly attractive. The pay is high (CETA workers make $10,000 a year picking up junk from vacant Philadelphia lots), and the work is often not demanding (one summer CETA day-camp program in New York had six workers caring for four children). As economist David Meiselman notes in a penetrating study of public sector jobs, "More unemployment results as workers wait longer and search longer for preferred public sector jobs rather than take private sector jobs."

New approach.—Despite the rising evidence of the program's inefficacy as a cure for unemployment, the Carter administration plans to maintain the present CETA jobs level at 725,000, pouring an additional $6.2 billion into the program in fiscal 1979 while trying somehow to fashion ways to more precisely target funds for the hard core jobless. But more and more Congressmen are wondering if this is the answer. Says Congressman Jack Kemp (R., N.Y.), "An expanded CETA is going to further slow the proven ability of the private economy to produce real jobs. What's needed is not additional billions in Federal spending but tax cuts that will guarantee business expansion and the creation of permanent, tax-paying jobs."

Perhaps, as the CETA program becomes more entrenched, we should all listen to the small voice of experience from the town of Boston, N.Y. (pop. 8,000), which sought to dip into the CETA trough, then realized its mistake. Town officials wrote President Carter:

"The Boston Town Board certainly wants to see unemployment rates reduced, but we want to see permanent improvements which increase our Nation's productivity and increase our gross national product. The Board would appreciate your support and action to terminate the [CETA] program and begin constructive programs to create permanent work positions in the private sector."

The CHAIRMAN. Today we intend to conclude testimony on the Second Budget Resolution for Fiscal Year 1979 which will set a binding spending ceiling and revenue floor for the fiscal year beginning this October 1.

While I have already announced the chairman's recommendations for the Second Budget Resolution, the committee will only work its will upon them later this week. I want to assure today's witnesses that the Budget Committee has made no final decisions as yet and that my own recommendations are not inflexible. The recommendations, or chairman's mark, are in effect a starting point for the committee when it begins marking up the second resolution on Wednesday. We hope to order the resolution reported this week and bring it to the floor of the House about August 15.

I will be recommending to the committee outlays of $490.4 billion, revenues of $446.8 billion, and a deficit of $43.6 billion. The recent acceleration of inflation has made it imperative to reduce the Federal deficit. My recommendations would reduce it by $17 billion from the $60.6 billion proposed by the President last January.

Our witness this morning is Dr. Rudy Oswald, research director of the AFL-CIO. We welcome you to the Budget Committee, Dr. Oswald. I notice you have Robert McGlotten with you. Will you both come up to the witness table.

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We are interested this morning in hearing your comments on the present direction of the Nation's fiscal policy. We would particularly like to know what tax policy you think the Congress should adopt.

As you know, last Thursday the Ways and Means Committee reported out a tax package totaling $16 billion on a calendar year basis. But several substitute proposals are likely to be in order on the floor. We would be interested in your assessment of the Kemp-Roth and Fisher substitutes among others.

Dr. Oswald, you may proceed as you wish.

STATEMENT OF DR. RUDY OSWALD, RESEARCH DIRECTOR, AMERICAN FEDERATION OF LABOR AND CONGRESS OF INDUSTRIAL ORGANIZATIONS, ACCOMPANIED BY ROBERT M. McGLOTTEN, LEGISLATIVE REPRESENTATIVE, AFL-CIO

Dr. OSWALD. Mr. Chairman, I appreciate this opportunity to present the AFL-CIO's recommendations on the congressional budget for fiscal 1979 and also on those tax matters that you mentioned.

We urge this committee to support a budget that clearly and unequivocably reflects the needs to stimulate the U.S. economy and to put the Nation and its people back to work. And we urge this committee to reject counterproductive, across-the-board budget cuts that will cripple job-creating programs and offset any beneficial effects from a tax cut.

There is still a long way to go to a healthy, full employment economy. Although the Nation is into the fourth year of a slow, halting economic recovery, the danger of slowdown and recession hangs over the U.S. economy. Industry is operating at only 84 percent of capacity. Interest rates are high. The prime rate, now at 9 percent, has risen nearly 50 percent in 14 months. Tight money is slowing housing and investment by local government and small business investment.

Unemployment is still high. Although the official June unemployment figures show improvement as the result of targeted programs to provide jobs, especially for teenagers, by the AFL-CIO's more comprehensive measure—which includes workers too discouraged to look for jobs and workers forced to work part time because full-time jobs are not available—there are still more than 8 million workers suffering unemployment and serious income loss.

This Nation must generate 4 million new jobs a year for the next 4 years to provide work for the currently unemployed and for those who will be joining the work force.

Against this background, we want to state that we are willing to support budget cuts where new data and new information and new estimates from the Congressional Budget Office or from the administration clearly indicate that existing appropriated funds will not be spent.

We want waste and fat cut out of the budget but we don't want existing people-oriented and job-creating programs crippled under the guise of budget cutting.

We are deeply concerned about proposals to cut the budget in some arbitrary manner without regard to the specific impact of such cuts and without regard to the Nation's need for continuing economic stimulation, without regard to the need for maintaining

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and expanding job-creating programs, and without regard to the need to maintain essential social programs.

If the House Budget Committee should agree to proposals for across-the-board budget cuts, it will be abdicating its own functions and prerogatives.

The House Budget Committee has an important role in the budget process. This role involves making decisions on specific, detailed components of the total Federal budget, with the right to propose specific cuts and specific increases in the budget. To give up this powerful decisionmaking prerogative is to abdicate power and to acquiesce in the erosion of the role and the power of the Budget Committee.

The administration in its Mid-Session Review of the Fiscal Year 1979 Budget and later in testimony to this committee has been cutting back its projections for economic growth and it has cut back its proposed tax cut stimulus and it has cut back projected Federal outlays for fiscal year 1979 by $4½ billion.

The chairman's own economic projections and recommendations are for a cut of $8.4 billion in spending for 1979.

The 4 percent growth rate set by the administration as a goal for 1978 and 1979 is too low. Higher levels of real economic growth are needed to create andequate number of jobs, to get more economic utilization of productive capacity, to break inflationary supply bottlenecks, and to generate additional Federal tax revenues.

Unfortunately, slow growth means less Federal tax revenue. Citibank's publication, "Economic Week," recently pointed out that a shortfall of 1 percent in the rate of GNP growth from the Government's estimate would cut some $10 billion from the Government's tax receipts.

It is clear, therefore, economic stimulus along the lines urged by the AFL–CIO would actually increase job-creating economic growth and would increase Federal revenues and thus would do more to reduce the Federal deficit than the proposed budget cuts.

About three-fourths of the fiscal year 1979 Federal budget is relatively uncontrollable. Social security, veterans programs, public assistance, commodity support programs, interest payments on the Federal debt, revenue-sharing commitments, and payments in fiscal year 1979 for contracts made in earlier years are all uncontrollable. It is almost impossible to make any significant cuts in these areas of the budget.

Defense spending makes up about half of the remaining portion of the budget and so-called discretionary domestic social programs make up the remainder of the budget. These include education, health, employment and training, child care, services for the elderly, vocational rehabilitation, housing and other such programs.

A 2 percent cut in a $500 billion Federal budget translates into a $10 billion budget cut. Cuts in the defense budget pose problems of national security. Nondefense cuts will fall on domestic social programs.

In effect, what may have started out as an effort to cut 2 percent across-the-board on all parts of the Federal budget would end up as a cut primarily applied to people-oriented and job-creating programs which have the greatest potential for stimulating consumer buying power and jobs and output of goods and services.

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Congress should maintain and expand labor-intensive public works and public service employment programs, and youth, housing, and urban assistance programs for the Nation's major cities, where inner-city unemployment remains at crisis levels.

The application of a 2-percent-across-the-board cutback on Federal budget spending—or any other flat across-the-board cutback—would impose seriously disproportionate cuts on the so-called "discretionary" people-oriented education, health, and job-creating programs of the Federal Government.

The AFL–CIO is deeply concerned about the danger of budget cuts offsetting beneficial effects from tax cuts. A preoccupation with reducing the fiscal year 1979 budget deficit by cutting Federal spending does not make sense in the present state of the economy. It would actually be counterproductive.

This is one key reason for the AFL–CIO tax-cut proposal. We want to get more money into the hands of low- and middle-income families whose spending gives the biggest stimulus to the economy. This, presumably, is a goal the administration shares. This is a goal we believe Congress shares.

We are calling for enactment of a fair and responsible $11 billion individual income tax cut, to be accomplished simply by increasing the present $35 per person general tax credit to $150.

Such a measure would provide its greatest relief to low- and middle-income taxpayers and large families—those groups hardest hit by the inflated costs of the basic necessities of life—food and shelter. Based on the Labor Department's budget for a moderate income family of four, food cost increases amounted to $335 a year or almost $90 per person over the past year. Under our proposal, the typical family of four would receive a tax cut of more than $400.

Such a tax cut would be easy to understand as well as equitable. It would cost about $11 billion during fiscal year 1979. Most taxpayers would receive a reduction and 83 percent of the benefits would go to those with incomes of $30,000 a year or less—85 percent of all taxpayers. Many lower income taxpayers would be removed from the tax rolls.

I would like to interject, Mr. Chairman, in terms of your earlier comments that a proposal by Mr. Corman comes closest to our proposal, and Mr. Fisher's proposal is also a step in that direction, over the proposals recommended by the Ways and Means Committee last week.

We believe such action is needed because:

There is widespread agreement that a tax cut of reasonable proportions is needed to avert a recession in 1979.

Starting January 1, the social security payroll taxes will increase draining an additional $7.4 billion out of the economy.

Three provisions of the current income tax law, including the current $35 tax credit, will expire December 31 and, in the absence of any relief, taxes would increase by $9 billion next year.

Taxpayer discontent and frustration cannot be ignored. However, many of the tax-cut proposals being put before the Congress and the American public are clearly unfair and would make a mockery out of the need for tax justice and heighten taxpayer resentment.

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While we support a tax cut to strengthen the economy and cut the burden on low- and middle-income workers and consumers, that cut must be fair and maintain a balance between the need for consumer purchasing power and essential public facilities, services, and programs.

The Roth-Kemp tax cut proposals meets none of these tests. It would hamstring social and economic progress, fuel inflation and make a mockery out of the need for a tax justice. Nearly 44 percent of the Roth-Kemp tax cut would go to taxpayers with income over $30,000—only 12 percent of all taxpayers.

Slashing individual and corporate income taxes would cost the Treasury, after 3 years, $122 billion a year—more than the country now spends for all national defense needs.

Such a permanent, inequitable, and drastic cut of the Government's income is frightening.

Unfortunately—in spite of the clear need for a fair and responsible tax cut to stimulate private consumer spending, and in spite of the clear need for maintaining and increasing Federal outlays to boost public and private spending—the Carter administration is behaving in a confused and contradictory manner on basic fiscal policy.

It is clear to us that the economy need both kinds of stimulus—the stimulus of tax cuts and the stimulus of at least current levels of Federal spending. The $11 billion tax cut proposed by the AFL–CIO will help avert recession.

Full employment—without inflation—can be achieved by balanced, healthy growth in the private sector, supported by effective job-creating Federal policies and programs. Like all Americans, we are concerned about inflation. American workers, along with retirees, suffer more than anyone else because of inflation.

But the right solution to inflation is appropriate anti-inflation programs targeted against the real causes of inflation—not arbitrary, indiscriminate budget cutting aimed simply at reducing the size of the Federal budget deficit.

We want a workable anti-inflation policy that deals with the real sources of inflation—not wage pressures but supply shortages, idle productive capacity, high interest rates, and actions of foreign oil-producing countries. Food, fuel, home mortgage costs, and medical care are the principal causes of today's inflation.

Reducing unemployment and stimulating economic growth are the keys to fighting inflation. Unemployment means lost income and lost consumer buying power, lost business sales, high overhead costs, and low levels of investment in new, more efficient and productive plant, machinery and equipment.

The AFL–CIO urges action in these specific areas of major inflationary price pressures:

AN IMMEDIATE REDUCTION IN INTEREST RATES, PARTICULARLY FOR HOME MORTGAGES, AND THE ALLOCATION OF CREDIT TO SOCIALLY NECESSARY INVESTMENT

The recent actions of the Federal Reserve Board in returning to the discredited policies of tight money and high interest rates threaten the entire anti-inflation program. High interest rates push up costs throughout the economy.

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CONTINUED EMPHASIS ON JOB-CREATING PROGRAMS TO REDUCE THE LEVEL OF UNEMPLOYMENT

Unemployment is inflationary, since idle workers are not producing goods and services. Increased production, brought about by higher employment levels, will reduce unit costs and the wasteful costs of maintaining unused plant and equipment.

ESTABLISHMENT OF RESERVE STOCKPILES AND EFFECTIVE EXPORT CONTROLS ON AGRICULTURAL COMMODITIES AND OTHER RAW MATERIALS IN SHORT SUPPLY

We recognize the fact that the family farmer is not responsible for food price increases. Taking the profit out of commodity speculation would increase the return to the farmer and reduce the price to the consumer. We believe that the Government should assert some measure of control over food exports to assure stable prices to both the farmer and the consumer, and over the export of other raw material in short supply, such as lumber.

CONTINUED REGULATION OF NATURAL GAS

While we have long supported increased development of domestic energy sources, we believe that deregulation of natural gas would only add to the price consumers pay without increasing supplies and would be severely inflationary.

ENACTMENT OF A HOSPITAL COST CONTAINMENT PROGRAM

An effective program which holds down rapidly escalating medical costs—without placing the burden on the wages of the low-paid hospital workers whose wages are not responsible for medical cost increases—would reduce one of the most inflationary pressures. An effective program is necessary to hold down physician fees—another major factor in medical cost inflation.

Mr. Chairman, the AFL–CIO is very much concerned about the continuing needs for economic stimulus and job creation to maintain the momentum achieved in reducing unemployment. We share the views of Secretary of Labor Ray Marshall who recently warned against the danger of overoptimism about the current unemployment situation this way:

> There are those who are now saying that unemployment has declined so much that we no longer need a large-scale public service jobs program.
>
> This is a very dangerous misconception.
>
> I say to you today that I do not believe that we can keep unemployment under 6 percent over the next year without a full-scale public service jobs program.
>
> Any ill-advised cuts in the CETA program run the risk of destroying the progress we have made in putting America back to work. Cutting CETA is tantamount to saying that 6.0 percent unemployment is full employment.

We share those quotations and views expressed by Secretary of Labor Ray Marshall.

This warning from the Secretary of Labor correctly points to the need for further economic stimulus from the Federal budget.

In conclusion, therefore, we urge this committee to approve a fiscal year 1979 Federal budget that will stimulate balanced, healthy economic growth aimed at full employment without inflation. We urge this committee to reject proposals for across-the-board budget cuts. And we urge you to maintain basic people-

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oriented and job-creating domestic programs which add to the Nation's social and economic welfare.

Thank you, Mr. Chairman.

The CHAIRMAN. Thank you very much, Dr. Oswald.

On page 4 of your statement you say that the AFL–CIO is deeply concerned about the danger of spending cuts offsetting benefits which would otherwise result from any tax cuts. Then you present the AFL–CIO tax cut proposal and you say you want to get more money into the hands of low- and middle-income families whose spending gives the biggest stimulus to the economy. You set that forth as a goal we all should share.

Given today's economic conditions, with inflation raging the way it is, and with stimulus already built into our fiscal program, is it the wisest thing in the world to have additional stimulus in the shape of tax cuts designed primarily to increase consumption?

Dr. OSWALD. Mr. Giaimo, the projections of nearly all economists is for a slowdown in the second half of this year. The growth rate in the first half of this year was much slower than anticipated. In the first quarter of the year it actually declined and the second quarter the growth rate was 7 percent, which for the first half of the year leaves us at a growth rate of less than 4 percent.

Projections for the second half of the year are for an even slower rate of growth than for all of 1979, much slower. If we don't have some stimulus, we will have substantially increasing unemployment, and it will be starting not from a rate of unemployment of 4.8 percent as existed in 1973 when we went into the 1975 recession. But we are now at 5.7 percent unemployment officially, a higher unemployment level than we have had in any period except in recessions previous to this time.

The CHAIRMAN. One of the major controversies raging over the nature of tax reduction legislation is whether or not the reduction should be designed to provide stimulus via increased consumer spending or increased productivity through the encouragement of investment activity and capital formation. As you know, there is considerable opinion in the favor of encouraging investment activity and investor confidence. Would you specifically address yourself to this approach and give us your thoughts on it?

Dr. OSWALD. I would just like to comment that the best way to get new investment is to get increased consumer spending and demand in the economy. Part of the more rapid growth in the second quarter of this year also came about as a result of very rapid growth in business investment, which grew at a 15 percent rate without new tax stimulus for business.

Business is going to invest if it has an opportunity to make goods that will be sold rather than on the basis of new tax cuts. The tax cut proposals that are being considered really give disproportionate cuts to the wealthy in our society and would give no guarantee at all that there will be more investment forthcoming.

The CHAIRMAN. Thank you. Mr. Mitchell.

Mr. MITCHELL. Thank you, Mr. Chairman.

I am generally supportive of your statement with regard to reducing unemployment. However, I want to speak to the issue very briefly, if I may.

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I know that there is a strong feeling that the private sector should supply a disproportionate number of the jobs in this country, and I think that is right. I also realize that there are mounting criticisms against the Government's attempts to create jobs, but in your statement you indicated some of the developments which I think justify the Government's role in job creation, particularly in the absence of private sector jobs. If I may, let me emphasize one or two additional points.

Chairman Miller of the Federal Reserve Board testified before the Banking Finance and Urban Affairs last week. In his testimony he indicated that for fiscal year 1979 the real growth rate would probably be somewhere between 3½ and 3¾ percent, not 4 percent, and obviously this estimate of economic growth is not conducive to the private sector increasing its employment efforts.

In addition, high interest rates tend to depress the private sector's efforts to create more jobs.

Chairman Miller has indicated that he expects those rates to prevail throughout fiscal year 1979.

I know as well as you that there are numerous attempts being made to slash programs contained in the budget. But if you take those first two factors, the lack of real growth for 1979, and the fact that higher interest rates will prevail for most of fiscal year 1979, it is difficult to expect the private sector to produce enough jobs to substantially reduce unemployment.

Therefore, I would argue further and support your position. Initially, we inadequately funded all of these employment programs. Consequently, it is not enough just to maintain them at their fiscal year 1978 levels, especially in light of the two conditions that I mentioned earlier. Clearly, the burden must fall on the Federal Government to step up its efforts to stimulate the economy and to fight joblessness.

I have no specific questions. But I think that the members of the Budget Committee understand the problem of unemployment in its full context and I hope that they would not slash our jobs programs.

Mr. Chairman, as you know, I didn't mention black unemployment. I won't. I wouldn't do that. I think that the black unemployment problem has been abandoned. We have decided to use blacks as pawns in the game of economic expendiency.

My remarks were for the general good, the general well-being of the country. Thank you, Mr. Chairman.

The CHAIRMAN. Thank you. Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman.

Good morning, gentlemen. It is nice to have you before us. Thank you for your testimony.

I would like to ask if you think productivity is a problem. It is, of course, bound to be a major concern of labor. But doesn't productivity have something to do with the increase in real wages that you can get for your people in a period, particularly in a time of inflation when otherwise it just becomes a matter of trying to keep up with inflation, unless you can increase your productivity? Obviously, you are going to have to use pressures of collective bargaining to try to get a bigger piece of the pie, and it is much easier if

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you can point to increased productivity. How do you think we can achieve that?

I note only macroeconomic suggestions here, increased stimulus for greater consumer spending. Do you think that is the way to get more investment?

We have been doing that for a long time, and our productivity has gone down. I think since I have been in Congress 14 years, we have stimulated the economy roughly 28 times, and despite that effort—you can always say, well, we haven't done enough, I suppose—but despite that effort productivity has sagged.

How do you think we can deal specifically with this issue, other than by trying to encourage that very ephemeral and volatile condition, consumer confidence and consumer demand?

Dr. OSWALD. Mr. Conable, we did have our most rapid periods of productivity growth in the 1960's, at the same time that we had a long period of rapid economic growth. We have had big drops in productivity as a result of the recessions that have taken place in the 1970's. We had actual declines in productivity during the 1970–71 recession, and substantial declines again in the 1974–75 recession, and so much of the problem of the slowdown in productivity in the 1970's is related to the poor overall economic performance. That is the reason that we have been urging stimulus for the economy to put the economy back on a general growth path.

If we have sustained economic growth, then we will have greater productivity, but if 1979 is the start of a new recession, then we will have substantial drops in productivity again, and even more severe inflationary pressures.

Mr. CONABLE. But do we not have a very high level of consumer spending now? Is it not as a matter of fact unusually high, given this rate of inflation?

Dr. OSWALD. Consumer spending has been the force that has kept the economy going currently in terms of the recovery. Last quarter there was also a substantial boost in business investment, but there have been substantial reductions in the Federal purchase of foods and services, which has weakened the recovery, but it has been consumer spending that has played the most important role in the continuation of the recovery.

Mr. CONABLE. You think that is the only ingredient then, something that we ought to admittedly have at a fairly high level now, the only ingredient that we can use to increase productivity is to further stimulate the economy?

Dr. OSWALD. If we do not continue to stimulate the economy, we will have a substantial likelihood of a recession in 1979. The projections made by nearly the whole range of economic forecasters, who are basing their projections on the stimulus of a tax cut of approximately $15 billion for fiscal year 1979, are still projecting growth rates of less than 4 percent.

Mr. CONABLE. Is your major objection to the Ways and Means bill that it gives disproportionate benefits to the well-to-do via the reduction in capital gains rate?

Dr. OSWALD. The bill provides for a reduction in capital gains rate and a reduction of tax rates which give disproportionate benefit to the higher income recipients.

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Mr. CONABLE. I realize the AFL–CIO has a major involvement in public employee unions, and that for that reason maintenance of a high level of Government services is in your interest, but you do not feel that productivity in the private sector is of comparable importance at this point, that it at least should have structural rather than macroeconomic interest of the sort that the Ways and Means Committee has proposed apparently?

Dr. OSWALD. Mr. Conable, we feel that the Ways and Means Committee proposal would not stimulate productivity. What it would do is give large tax breaks to the wealthy, who may or may not invest that money, who may spend that money in the United States or may spend it abroad or may not spend it at all, whereas if you gave——

Mr. CONABLE. If they do not spend it all, you think they will put it in the bank somewhere and only build houses with it?

Dr. OSWALD. They may put it in gold or diamonds.

Mr. CONABLE. Or municipal bonds?

Dr. OSWALD. But if you give the majority of the tax cut to the majority of the people, which you would not do under the Ways and Means bill, then you would have real stimulus for the economy, and you would at least distribute the tax cut equitably among the American taxpayers.

Mr. CONABLE. It seems to me, sir, that the position your organization has taken has resulted in very heavy taxes for the working people, declining productivity, and therefore uphill work in trying to get better wages in an expanding economy I really think it is time for us to try something else.

I must acknowledge that I am not sure we have the right answer, but I think that it has been pretty well demonstrated that the course you are advocating has not been the right answer, and what we have had so far has been just a mindless application of an unsuccessful formula for macroeconomic stimulation.

I do not expect any agreement with that statement.

Dr. OSWALD. It worked very well in the 1960's.

Mr. CONABLE. That is when we had a war on.

Dr. OSWALD. Before the war there was also very rapid economic growth. As you may recall, in the early sixties there was a rate of productivity growth of over 3 percent a year, 3.4 percent a year on a 5-year average in the early sixties, between 1960 and 1965, and that growth in productivity came about through expansion of the private economy, through overall economic stimulus.

Mr. CONABLE. Thank you, Mr. Chairman.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Texas, Mr. Burleson.

Mr. BURLESON. I will pass, Mr. Chairman, thank you.

The CHAIRMAN. The gentleman from New York, Mr. Pike.

Mr. PIKE. Thank you, Mr. Chairman. Dr. Oswald, how long have you been with the AFL–CIO?

Dr. OSWALD. I have been with the AFL–CIO for 20 years.

Mr. PIKE. How long have you been their research director?

Dr. OSWALD. For 2 years. Nat Goldfinger had been research director for many years prior to that.

Mr. PIKE. Do you ever recall a time when the AFL–CIO was not advocating greater Government spending for creating jobs?

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Dr. OSWALD. Mr. Pike, the proposals vary according to the economic——

Mr. PIKE. Well, do you ever recall a time when they were advocating something which in my judgment would be anti-inflationary, such as cutting back on Government spending?

Dr. OSWALD. Mr. Pike, in terms of Government spending, we have urged increases in taxes in the sixties, when there was the expansion of the Vietnam war.

Mr. PIKE. But then you had a huge increase in Government spending.

Dr. OSWALD. Yes, and we asked for increases in taxes to offset that.

Mr. PIKE. Right, but have you ever asked for less Government spending?

Dr. OSWALD. We have asked for less Government spending for specific programs, and I think that is also what we are asking you to do now, to look at specific programs.

Mr. PIKE. But like anyone else, you say do not touch ours, and all I am trying to say is, it just seems to me that in good times or bad, inflationary or not inflationary, economy booming or recession, you are always advocating the same thing.

Dr. OSWALD. No, that is not true.

Mr. PIKE. Well, I have only been here 18 years, so I cannot say what you have been doing over 20 years, but in my 18 years that is all I have ever heard the AFL–CIO advocate.

Now you say we are in the fourth year of a recovery from the bottom of a recession. Without going back to the sixties, and without going back to the early seventies, what has happened to productivity during those last 4 years? It has gone down, has it not?

Dr. OSWALD. No. Productivity increased very rapidly in 1976, less rapidly in 1977, and if growth does not continue in 1978 at a substantial rate, we will not have substantial rates of increase in productivity this time.

Mr. PIKE. Do you consider the programs which you are advocating, CETA, for example, to be efficient programs as far as productivity is concerned?

Dr. OSWALD. Let me just go back and give you the numbers on productivity as reported for 1976 and 1977. The output per manhour in the private sector grew at a rate of 4.2 percent in 1976, and at 2.6 percent in 1977. In terms of CETA, obviously the very important goal of providing people with skills has been an important contribution of the whole CETA program.

Mr. PIKE. Oh, yes, but you are talking about a goal. I am asking, are the programs productive programs? Do they show high productivity, or do they show very low productivity?

Dr. OSWALD. They show that they do provide workers without skills new job training, in order to be able to fulfill the needs of our society, and one of the basic elements by which we get productivity growth is by having a trained work force that is skilled.

Mr. PIKE. I will simply say you are talking about the great goals that we attribute to these programs. It is my personal judgment that their efficiency rating, the productivity of the programs themselves, is very, very low.

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You say that the real sources of inflation are "not wage pressures but supply shortages, identical productive capacity, high interest rates and actions of foreign oil-producing countries," and you use as your next example food. Is there a supply shortage in food?

Dr. OSWALD. There is a supply shortage of certain foods. Beef prices have increased 30 percent since last October.

Mr. PIKE. So have the prices of all the rest of the food, not as rapidly as the beef prices, but they have all increased. Is not food one of the few things in America we have really a huge surplus of? It is our largest export, is it not?

Dr. OSWALD. And some of the exports may well have contributed to the increase in price in the first half of this year. The export of food has gone up by $1.7 billion in the first half of this year.

Mr. PIKE. The farmers tell us that they cannot even make it without (a) exporting, and (b) huge price increases, but you are listing food as the chief cause, or you are listing it as the prime example of inflation.

Dr. OSWALD. It is very clear in looking at Consumer Price Index that in the first half of this year food prices have increased 17 percent at an annual rate.

Mr. PIKE. I agree with you.

Dr. OSWALD. More than doubled.

Mr. PIKE. And despite the fact that we have food coming out of our ears?

Dr. OSWALD. I would like to point out a recent study by UNCTED of what they claim is a major reason for some of the increases in the price of both food and raw materials. They say it is because of control of a few large corporations over food and raw material processing. They use an example of cotton, where they say that 15 corporations worldwide control the price of cotton. They do not blame it on the farmers but rather they blame it——

Mr. PIKE. They may well be right, but it seems to me that there is no more competitive industry in America than agriculture. We have only 3⅓ automobile producers in this country, but we have tens of thousands of food producers, so I just do not think you can blame it on a food cartel.

Dr. OSWALD. But there are claims that certain corporations have cornered the commodities futures market for particular items and have influenced the price that farmers receive.

Mr. PIKE. You have gone from food to cotton?

Dr. OSWALD. No. You also have commodities futures in wheat, soybeans, and hogs.

Mr. PIKE. I hear what you are saying. I do not buy it but I hear it.

The CHAIRMAN. The time of the gentleman is expiring. It has expired. The gentleman from Texas, Mr. Mattox.

Mr. MATTOX. I am interested in the statement that you made, Dr. Oswald. I have heard your statements concerning the AFL–CIO position on the general tax cut issue. I would be interested in knowing whether you have continued to maintain your overall position and the position that was taken in the Budget Committee in the first resolution of asking for a reduction in social security taxes or a conversion of general revenues to social security taxes as

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a means of giving stimulus to the economy, and also tax relief to the working people of the country.

Dr. OSWALD. Mr. Mattox, we still support that, and support Mr. Giaimo's proposal, for the Second Budget Resolution.

We find the part of the proposal of Mr. Fisher for his alternate tax proposal as a very important means of trying to move in that direction.

Mr. MATTOX. Do you have any reason to believe we are going to move in that direction?

Dr. OSWALD. Mr. Mattox, I am afraid that it seems that the Congress recently has not been paying much attention to most of the American people, at least if I read what has happened with the bill that was reported by the Ways and Means Committee, because only a very few wealthy individuals would get most of the money, and unless we stop fooling people in terms of who gets the benfits from these tax cuts, we are going to wake up and find that the American people are aware that the tax cuts are going to the wealthy and not to them.

Mr. MATTOX. How many members does the AFL–CIO have nationally?

Dr. OSWALD. It has 14 million members.

Mr. MATTOX. It seems that with the combined role of the AFL–CIO and the other working people out in the country, that we could bring about a democratic tax proposal, a democratic tax program, rather than one Mr. Ullman has ushered forth through the Ways and Means Committee.

Dr. OSWALD. I would hope so.

Mr. MATTOX. I am a little concerned. I honestly am. I am concerned about the Democratic platform and the actions of that committee.

Let me take a statement and move forth with it. I am interested in knowing your general assessment of the countercyclical program. You know that program is in serious trouble in the Government Operations Committee. I have reason to believe that the subcommittee considered that and very well may opt to strike the program, which is worth about $1 billion, I think $800 million. I would be interested in knowing what you think about that action.

Dr. OSWALD. When we testified on the First Budget Resolution, we spoke strongly in behalf of that policy. We are very much concerned that the tax system be equitable, and the countercyclical program operate in a way that really brings about a much more equitable tax system, because Federal taxes are raised on a much more equitable basis than the property taxes that are the basis for many local governments, so the countercyclical program is a means of providing funds in a much more equitable manner.

Mr. MATTOX. Do you think those funds are actually being provided to the cities of the country in an equitable fashion?

Dr. OSWALD. Mr. Mattox, we have been somewhat disturbed with the allocation of funds, and I think the question is not to scrap the program but to improve the allocation formula.

Mr. MATTOX. The thing that concerns me is if we keep bringing forth these programs, and as we bring them forth we recognize that these programs are not doing what we intend for them to do, and we recognize that the allocations are not proper, and we are

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not stimulating right and we are not doing this and not doing that, but for some reason we cannot ever seem to disassemble them or make them work right. I bring you to the issue of the CETA program.

I have studied the CETA program rather closely in the last year. I think this is probably your child, it has probably been your child more than any other group; you've been more responsible for it than any other group, and the approach of attempting to get at the hardcore unemployed has totally escaped that program. I say totally and I mean totally, because I think that the program has not done anywhere near what you originally conceived that you would like for it to do.

I understand that your approach is, let's reform the program and let's try to make it work right. Well, it appears pretty obvious that we cannot make the program right at the level of 725,000 jobs, because we cannot seem to administer it, and I agree with Ray Marshall's statements. They are great statements, but his department is supposed to be administering that program, and it is a disaster, so why should we give any great credence to that approach?

But assuming we cannot with 725,000, would it not be sensible to maybe step that program back to say 600,000 or even 500,000 and see if we can administer at a somewhat lower level to make it work? Then if we can make it work at that level, then maybe expand it to a greater and greater level. Is that not sensible?

Dr. OSWALD. Mr. Mattox, Mr. McGlotten has worked on CETA for many years.

Mr. MATTOX. I know he has.

Mr. PIKE. It is his child?

Mr. MCGLOTTEN. Mr. Mattox, let me first of all say that in terms of the problems that the CETA program has had, I think first of all we have to look at the history of the CETA program. It was enacted in 1973. Title II was public service employment at approximately 150,000 jobs at that particular time, and it was running very, very well.

In 1974 when the bottom fell out of the economy, we put on a title VI to increase the authorization to deal with the unemployment problem. In 1975 in June we increased it a little bit more, and in 1976 we still increased it a little bit more.

I am saying all that to say that during times of high unemployment we increased the number of jobs to deal with the unemployment problem. As a result of trying to deal with that problem, I think many of the prime sponsors who were out there, and I do not believe that mayors and county officials have any more knowledge of manpower problems than the Labor Department does, but at that particular time there was an increase and they tried to do the best they could do.

As a result, there were some abuses, but I think if you look at the program overall, you will find that the benefits have outweighed the abuses. I think less than 2 percent of the amount of job slots in the program have been found to be somewhat abusive, dealing with the question of substitution, nepotism, and that kind of thing.

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Mr. MATTOX. I think that depends on how you define those things because I do not agree with any figure like that. I can go out and count by hand and find the 2 percent easily.

The CHAIRMAN. The time of the gentleman is expiring.

Mr. MATTOX. Is expiring?

The CHAIRMAN. Go ahead, complete your question.

Mr. MATTOX. I think I have probably already made the point that I am trying to make. The thing about it is, I think you will agree that the program is not operating the way that we would really like for it to operate. I think that is a fair assessment. I do not think there is anything unfair about it. It just seems that to accept responsibility for having these kinds of programs, and for the good of the community it would be best for us to, when they are not working exactly the way we want them to, is, instead of keep charging forward, regroup and try to make it work a little better, rather than having to get to the point where we have it just destroyed entirely rather than just try to rebuild it.

Mr. MCGLOTTEN. If I may just respond just for a couple of seconds, Mr. Chairman. Let me say to you, since the buildup, Mr. Mattox, and since they have changed the eligibility criteria, and I think looking at the present figures, most of the criticism that I knew that Members of Congress have comes from a study that was taken in 1974 and 1975, not in terms of the buildup, when you went from 310 to 725,000 jobs.

You know there is the increased participation of the AFDC recipients, more unemployed people of 15 weeks or longer. I think there have been a tremendous amount of changes that have taken place in 1977–78.

Mr. MATTOX. I agree, but most of the criticisms I have are still valid ones, and they have not changed. I have a feeling they have gotten a heck of a lot worse.

The CHAIRMAN. The gentleman from Ohio, Mr. Latta.

Mr. LATTA. Thank you. Gentlemen, it is always good to have you testify before the committee and give your viewpoints. I commend you on your suggestion on page 2 where you are willing to support tax cuts or budget cuts. Would you be more specific? Everybody is against waste in Government. Where would you cut?

Dr. OSWALD. Mr. Latta, the chairman in his proposal for the Second Concurrent Resolution has noted some $8.4 billion in tax cuts, which reflect a number of cuts in various areas, as well as some increases, where either various agencies will not be able to spend what has been allocated, where there have been changes in legislation since the First Concurrent Budget Resolution, or where there have been Appropriations Committee actions which lead to such reductions.

We feel that such tax cuts reflect specific changes that have taken place between May and the end of July. We feel that such cuts are the sort that obviously the Budget Committee should be looking at.

Mr. LATTA. May I interrupt you there? My quesiton was directed toward budget cuts, what is cut out of the budget in addition to the ways you mentioned.

Dr. OSWALD. That is an $8.4 billion cut.

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Mr. LATTA. Those are largely shortfalls. What we are saying is, the agencies did not meet their spending goals and therefore you have a shortfall.

The CHAIRMAN. Will the gentleman yield?

Mr. LATTA. I will be happy to yield.

The CHAIRMAN. Some of it is shortfall, with much of it in the defense category, which would seem to indicate that defense is getting more money than can be spent each year. Some of it, I think about $3 billion of it, is the result of reductions recommended by the Appropriations Committee in a number of different programs. Some of it stems from a delay in initiatives requiring legislation that was intended to get on the books this year, such as the urban policy package. So I think the shortfall is a mix. I think that is basically what he is trying to say.

Incidentally, there are some increases to offset the reduction, because of legislative reforms which Congress for one reason or another has not or will not enact—wage reform, hospital cost containment, social security et cetera.

Mr. LATTA. I knew the chairman's answer. I wanted the witness' answer.

Mr. PIKE. Point of order, Mr. Chairman. You talked Mr. Latta right out of all his time.

The CHAIRMAN. I know I did.

Mr. LATTA. I take it back. I want to be specific because it is important to know what you have in mind when you talk about budget cuts. For example, you probably read and heard about the waste in HEW that GAO found—$7 billion. An effort was made when the HEW bill was on the floor to just cut out half the waste. Let me ask you this: Did your organization support that amendment?

Dr. OSWALD. Mr. Latta, we did not support the amendment.

Mr. LATTA. What in HEW would you want to cut out?

Dr. OSWALD. Mr. Latta, we do support all efforts to try and assure that the programs teach those people for whom the programs have been intended, and we support actions that assure that waste does not take place in a program. We don't think that you get at the waste by just arbitrarily setting a limit on the money for the Department of HEW.

Mr. LATTA. Apparently you don't want to give me, or give the committee, specifics about budget cuts that we are all looking for. Let's move on to something else.

You talk about high interest rates. Everybody is against high interest rates, but can we agree that with a one-half trillion dollar budget in 1 year that this might add something to inflation and consequently raise interest rates because Government has to go out and borrow so much? Treasury is going to go this week again with a sale for some refinancing and they are going to be selling Treasury notes for something like 8⅝ percent, a very high figure for long-term notes, and just what we are talking about that drives up interest rates that you are against.

Dr. OSWALD. Mr. Latta, the drive up of the interest rates is not because——

Mr. LATTA. Of the Government's spending.

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Dr. OSWALD [continuing]. Of the movement into the market of the Government as much as the rediscount rate set by the Federal Reserve Board. By pushing up the rediscount rate, it has forced up interest rates across the board.

Now that is an appropriate policy if you are fighting a sort of inflation that is based on an overheated economy, where you have an overabundance of consumer demand and a shortage of supply, such as existed right after World War II. Then people had money to spend. They had savings during World War II and you had a shortage of goods. At that time, high interest rates would cool down the economy and would have the effect of curtailing the inflation.

Today, a high interest rate only adds to the inflation and is built into the cost of the deficit here; it has gone up $1 billion in the new mark of the chairman.

Mr. LATTA. It really doesn't affect the interest rates when the Government has to go out and borrow, say, $45 billion or $50 billion to finance the debt; that doesn't affect interest rates?

Dr. OSWALD. Not as substantially as the level of the rediscount rates that are established by the Federal Reserve Board.

Mr. LATTA. Let me go on to page 5.

Dr. OSWALD. Mr. Latta, if I may go on—interest rates fell in 1975 when we had a deficit of over $60 billion, but we had a big recession at that time, so just the level of borrowing of the Federal Government itself is not the primary determinant of the interest rate.

Mr. LATTA. I see where you want export controls on agricultural commodities; is that correct?

Dr. OSWALD. We would like the Government to have a role in the export of agricultural commodities, such as the Canadians do in terms of wheat, and as you recall, in the 1972, 1973, 1974 period, the large export of wheat to Russia was a primary cause of some of the price increases that took place at that time.

Mr. LATTA. You probably realize—one more question, Mr. Chairman—that we have a serious balance-of-payments problem in this country, and if you are going to cut down on exports of agricultural commodities, how is that going to affect that problem? Isn't it going to complicate it and make it worse?

Dr. OSWALD. Mr. Latta, if we are paying toward the balance-of-payment problems with an inflationary food policy, then we haven't accomplished anything; and I would like to bring to your attention the fact that agricultural exports did increase substantially in the first half of this year, at the same time that we had a 17-percent increase in food prices in this country; and we think that you do have to look at both of them together.

Mr. LATTA. You have to look at the farmer, too. There are a lot of them in this country that have to live, too.

Dr. OSWALD. We have been very supportive of programs to aid farmers, but some of the gains of the exports have not been going to farmers. As a matter of fact, in the 1973–74 wheat deals with Russia and China, it was shown that most of the benefits did not go to the farmers but rather to a few large corporations.

Mr. LATTA. A lot of the benefits went to the longshoremen who were striking; they got what they wanted.

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The CHAIRMAN. The time of the gentleman from Ohio has expired. The gentleman from Illinois, Mr. Simon.

Mr. SIMON. Thank you, Mr. Chairman.

I agree with much of what you have to say. In response to suggestions of my colleagues on the productivity area, it does seem to me—and this is in partial response to my colleague from New York—that where Government programs hit at structural unemployment—and we recognize that we are just not going to let people starve; we are either going to pay them for doing nothing or pay them for doing something—it just makes infinitely more sense to pay people for being productive.

There are major deficiencies with CETA. I think the major deficiency being that we still view it as a temporary thing and we have not really viewed unemployment—structural unemployment—as a permanent phenomenon in our society; and I think it is—and you and I agree on some of the things, some of the features that ought to be in the program; but I think that is one thing.

The second thing is, if we are really aiming at increasing productivity, then the cuts by the Ways and Means Committee—meaning no disrespect to that committee—ought to be in the area of depreciation allowance, speeding that up, rather than the capital gains area.

I happen to agree with the importance of interest rates. My present inclination, frankly, is to support the Vanik-Pickle approach, because if we can reduce the demands—and I think my colleague from Ohio is correct—if there is less demand from the Federal Government for borrowing, that is going to have a healthy effect on interest rates; plus I have had some conversations with one of the members of the Federal Reserve Board and I think it is likely that if we reduce that deficit another $16 billion, there will be a reduction in interest rates in the Nation, and that can stimulate the economy more than any additional $15 billion or $16 billion in tax cuts.

I am just curious. If you face the situation where we end up with the program that emerged from Ways and Means—and, incidentally, as I read the statements and recalling a meeting with the chairman of the Senate Finance Committee—what may emerge from the Senate Finance Committee may be appreciably worse than what came from Ways and Means. But if I have to face a situation of what emerged from Ways and Means and Vanik-Pickle, it seems to me Vanik-Pickle is going to do more to help the economy of this Nation than what emerged from Ways and Means. Am I correct or incorrect in that assumption?

Dr. OSWALD. We think that what emerged from Ways and Means is clearly an inequitable program that provides most of the tax relief only to the wealthy, and we are in perfect agreement that that would be a disastrous move by this Congress in terms of equity in our society.

The Vanik-Pickle amendment would provide no stimulus whatsoever to the economy; it would offset the approximate $9 billion drag that would occur from policies that expire at the end of this year.

We still have about a $7 billion drag from the increase in social security. We would hope that there would be more of a move

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toward the Corman or even the Fisher-type alternative than the one that was reported by the Ways and Means Committee.

Mr. SIMON. But I am not sure I agree with you when you say it would be a drag. If, in fact, it ended up reducing interest rates, couldn't it be that that would stimulate the economy as much as what has emerged from Ways and Means?

Dr. OSWALD. Mr. Simon, the interest rates will not automatically come down if the Federal budget deficit is $37 billion, or $43 billion as put forth in the chairman's proposal; it can come down if the Federal Reserve Board will stop increasing the rediscount rate.

Mr. SIMON. It could, but you would recognize that the probability of that happening would increase tremendously?

Dr. OSWALD. Not for a $6 billion or $7 billion reduction in the amount that the deficit is up or down.

Mr. SIMON. Let me then get back to my question which didn't get answered, if I may, and I understand your reason for reluctance to answer. Faced with a choice of Vanik-Pickle or what emerged from Ways and Means, which would you vote for?

Dr. OSWALD. Mr. Simon, the reason I haven't answered it more directly, is that this is one of the things that the executive council of the AFL–CIO will itself be reviewing because of our concern with the inequitable proposal that has come from Ways and Means.

The executive council will be meeting a week from today and may take a formal position that answers your question. I would prefer not to answer it more directly at this point.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from California, Mr. Mineta.

Mr. MINETA. Thank you, Mr. Chairman.

Dr. Oswald, I appreciate your testimony here today. On page 4 you indicate "a preoccupation with reducing the fiscal 1979 budget deficit by cutting Federal spending does not make sense in the present state of the economy." Then at the bottom of the page you also say,"Taxpayer discontent and frustration cannot be ignored." It seems to me somewhere we have to be dealing with that whole issue and that that is what we are attempting to do in the Second Budget Resolution.

Then on page 5, at the bottom, you deal with some of the causal factors about inflationary pressures, and I am wondering, can you get into some more specifics about how we can deal with these inflationary pressures.

Dr. OSWALD. Mr. Mineta, on the food side, which in the first half of this year I had indicated had been increasing at a rate of 17 percent on an annual rate, we need to have policies that assure that such things as the commodities futures market is operating in a way to provide farmers with adequate funds and assurances of a fair return without causing severe inflationary pressures of its own.

Mr. MINETA. Price support programs?

Dr. OSWALD. In terms of price support programs, they should be programs that provide farmers with a fair return, with maybe some maximum, as has been considered a number of times and has not passed the House, so that rather than unlimited supports for any particular farmer, that the price supports have a limit in terms of the amount that any particular farmer might receive.

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Mr. MINETA. How do we deal with sugar, for instance, where it is about 68, as a rule, what the farmers are getting, and yet the cost of production for the farmer is up around 11 cents, and as I understand it, there is a bill in Agriculture to have a support program at roughly 16 cents, how do we deal with that in terms of looking at the farmers' plight and at the same time seeing what kind of inflationary pressures that kind of a bill in Agriculture would add?

Dr. OSWALD. Mr. Mineta, we have tried to review the sugar price bill and at this point we haven't finished that review; so I cannot give you a clear answer on that bill, but we share the concern that you mentioned.

Mr. MINETA. What about fuel, should the President impose import limitations, quotas?

Dr. OSWALD. We would rather have import quotas than the proposal he once made, of an additional surcharge on foreign oil. We have said before that if the need is to have some sort of a rationing system, that rationing is better than an inflationary proposal which would raise the price.

For many people in our society, the car is a necessity to get to and from work. We support policies that do not raise energy prices but that will lead to conservation, and we have long supported programs that would lead to the development of new energy sources so that we won't have such a severe dependence on oil imports.

During the first half of this year we did import some nearly $2 billion less in oil than we did in the first half of 1977, and I think that some of the benefits of the Alaskan oil have begun to appear, and I hope we get even more benefits from natural gas from Canada shortly.

We are distressed with the moves to deregulate natural gas, for example, which we feel would only result in a price increase and would not lead to more natural gas being produced.

Mr. MINETA. Dr. Oswald, I appreciate the statement you presented here today. Thank you.

The CHAIRMAN. The time of the gentleman has expired. Does the gentleman from New York seek recognition?

Mr. PIKE. Yes, Mr. Chairman.

Dr. Oswald, your tax proposal is a $11 billion tax cut for individuals; is that correct?

Dr. OSWALD. Yes; assuming a start in January in 1979, $11 billion would be in the fiscal cost.

Mr. PIKE. What was the total amount of your tax cut?

Dr. OSWALD. We have only made a proposal in the area of individual tax cut.

Mr. PIKE. So there was nothing for corporations or for businesses in your proposal?

Dr. OSWALD. We have not made any recommendations for a tax cut for corporations or businesses.

Mr. PIKE. Was that to be a refundable credit?

Dr. OSWALD. No; it was to be just to increase the current $35 tax credit to $150. It would not be refundable, but its distributional aspects would be such that most of the benefits would go to those with income below $30,000.

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Mr. PIKE. Mr. McGlotten, you said that the criticism of the CETA progam is based on an old study, 1974, 1975 study. Isn't that the period in which you said that the CETA program was working well?

Mr. MCGLOTTEN. No. I indicated that that was the period of growth in the CETA program and I suspect that many of the abuses——

Mr. PIKE. What was the period when they had 150,000 CETA jobs?

Mr. MCGLOTTEN. That was in 1973.

Mr. PIKE. Wasn't the 1974 study based on the 1973 program?

Mr. MCGLOTTEN. No. The 1974 study was based on title Vl which came into existence in December of 1974. If you remember, this was close to Christmas, when we decided to do something about the high unemployment rate.

Mr. PIKE. Right. If the program worked well at 150,000 jobs, doesn't that sort of take you to where Mr. Mattox was trying to take you?

Mr. MCGLOTTEN. No, because at the time of the buildup, what happened, it worked well in 1973 and part of 1974 under title II which dealt specifically with the whole question of structurally unemployed. When it got involved in a kind of cyclical unemployment, it was just hard to define who was structurally unemployed and who was not structurally unemployed.

Mr. PIKE. I agree that is a problem. I would also agree there are people who are structurally unemployed, but defining is a real problem.

You have come out against cutting waste in Government spending, which is not a new breakthrough on anybody's part, but don't you think that the concept of saying that you are going to cut the budget only where the departments have not spent the money is about the most wasteful motivation you can think of? I can't think of anything which is more likely to get departments to spend money than the concept that the budget is going to be cut if they don't spend the money.

Dr. OSWALD. Mr. Pike, Congress continuously reviews programs that are administered by various agencies, as you well know.

Mr. PIKE. I served for 14 years on the Armed Service Committee. I have watched how Congress has kept a hawk eye on defense spending and cut it to the bone year after year, just as they did this year. Please go ahead.

Dr. OSWALD. There are some programs that are curtailed and there are some that are expanded. I think that is an appropriate role at this particular point.

Mr. PIKE. Yes, but Congress almost always expands defense programs. Isn't that a fair statement? Do you really think Congress' oversight of spending programs amounts to a hill of beans?

Dr. OSWALD. Congress does attempt to do, I think——

Mr. PIKE. Congressmen like to get elected.

Dr. OSWALD. But the means is not to approach defense problems by some arbitrary number that just is selected out of a hat and say that we are going to take care of our defense needs by arbitrarily cutting an agency by $10 billion. I think that is a real problem.

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Mr. PIKE. The constituency of each congressional committee is such that whoever is reviewing the programs wants to increase the program that it is reviewing.

Mr. Mattox, I resent your coaching the witness.

Mr. MATTOX. I have been trying to help you. We can't seem to get our point across.

Mr. PIKE. Mr. Chairman, I yield back the balance of time that I do not have left.

The CHAIRMAN. The time of the gentleman has expired.

We want to thank both of you for testifying and responding to the questions here today. Thank you very much.

The Chair recognizes the gentleman from California, Mr. Mineta, for an inquiry.

Mr. MINETA. Thank you, Mr. Chairman.

I know that tomorrow, under the suspension calendar, we are going to have H.R. 12972, dealing with the SSI for the handicapped. The concern that has been raised with me is whether or not within the budget resolution there is enough to accommodate the will of the House should it pass this bill by its two-thirds majority tomorrow; and so I would like to inquire of staff about the possibility of making sure that the amount necessary for this bill is included and that there is enough room in the budget resolution for H.R. 12972, recognizing that we don't work on the line item. I am just wondering within the gross amounts for the program——

The CHAIRMAN. If the gentleman will yield, this matter was brought to my attention today too, and I would like to work this out as best we can, to make sure that we don't jeopardize this program's chances by excluding it in the Budget Committee's deliberations during markup.

Part of the problem, is that Ways and Means did not see fit to accord the legislation high priority in its March 15 302 allocation. Since then, however, they have reported out a bill and it is coming up on the floor tomorrow.

I think there is a lot of merit to this legislation, and I think we should encourage its passage. I think it needs encouragement.

I am sure we can find a way this week, as we markup, to make certain that it is accommodated, even though, as you know, we don't line item.

Mr. MINETA. I appreciate the assurances of the chairman, and this will be, I think, a subject we can take up Wednesday when we start marking up the Second Resolution.

The CHAIRMAN. Right.

Mr. MINETA. Thank you very much.

The CHAIRMAN. Let me remind everyone that we are meeting at 1 o'clock for an early warning briefing. At 2 o'clock we will have the Director of OMB followed by the Chamber of Commerce representative.

The hearing stands adjourned until 2 o'clock.

AFTERNOON SESSION

The CHAIRMAN. The committee will please come to order.

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Today we intend to conclude testimony on the Second Budget Resolution for Fiscal Year 1979, which will set a binding spending ceiling and revenue floor for the fiscal year beginning October 1.

While I have already announced the chairman's recommendations for the Second Budget Resolution, I want to assure today's witnesses that the Budget Committee has made no decisions and that my own recommendations are not inflexible. The recommendation or chairman's mark will serve merely as the starting point when the committee begins marking up the Second Resolution on Wednesday. We hope to order the resolution reported this week and to bring it to the floor of the House about August 15.

I will be recommending to the committee outlays of $490.49 billion, revenues of $446.8 billion, a deficit of $43.6 billion. That deficit is $17 billion below the $60.6 billion deficit presented by President Carter last January.

Our first witness this afternoon is James T. McIntyre, Jr., Director of the Office of Management and Budget. Welcome to the Budget Committee.

As you can see, we have taken seriously the recommendation you made last week to the Senate to reduce expenditures. The outlays are considerably below the $496.6 billion estimate of July 6. Even $490.4 billion may be on the high side, if reductions are made in the course of floor consideration of the two remaining appropriation bills—defense and foreign aid.

As we markup, we will be looking for additional ways to reduce expenditures. We would appreciate any suggestions you have along those lines, Mr. McIntyre.

The Ways and Means Committee, as you know, reported out a $16 billion—on a calendar basis—tax reduction last Thursday. In contrast to most tax bills, this one will have a rule which will permit the consideration of several substitutes. We would like your opinion of the Kemp-Roth and Fisher substitutes.

With that, Mr. McIntyre, we welcome you again to the committee. We have enjoyed working with you and your able staff throughout the year, and we look forward to further cooperation in bringing this budget deficit down—hopefully to a balanced budget within a very few years.

You may proceed as you wish, Mr. McIntyre.

STATEMENT OF HON. JAMES T. McINTYRE, JR., DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET, ACCOMPANIED BY BOWMAN CUTTER, EXECUTIVE ASSOCIATE DIRECTOR FOR BUDGET; AND CAREY P. MODLIN, DEPUTY ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. McINTYRE. Thank you, Mr. Chairman. I am pleased to appear before this committee as you conclude your hearings on the Second Budget Resolution for Fiscal Year 1979.

I have with me today Bowman Cutter, who is Executive Associate Director for Budget, and Pete Modlin, who is in our Budget Review Division.

On July 6, we issued the Mid-Session Review of the Budget, revising budget estimates for 1978, 1979, and subsequent years. I will discuss these estimates briefly.

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I would urge the committee to be and continue to be rigorous in the review it undertakes as it prepares the Second Concurrent Resolution, with the objective of producing a resolution that calls for lower spending. Budget restraint is appropriate now. It is consistent with both the economic outlook and the need for increased governmental efficiency, which spending restraint will encourage.

1978 AND 1979 BUDGET ESTIMATES

In the table entitled, "1978 and 1979 Budget Totals" in my prepared statement, our 1978 and 1979 revisions show lower Federal spending and lower deficits than were projected in January. The fiscal year 1978 deficit is now estimated at $51.1 billion, $10.6 billion less than the January budget estimate. This decrease can be attributed almost entirely to a lower estimate of Federal spending. Our current estimate of the deficit for 1979 is $48.5 billion, $12 billion below the January budget. This decrease reflects: The change in administration tax policy to delay the proposed tax cut and to reduce it from an annual rate of $25 billion to $20 billion; intensive administration efforts to constrain 1979 spending; and a shortfall of Federal outlays in a number of categories from the January budget.

ECONOMIC ASSUMPTIONS

I should like, first, to discuss briefly the economic assumptions that underlie the Mid-Session Review estimates. I will not go into detail on this because Chairman Schultze has already testified on this. The economic outlook for calendar years 1978 and 1979 shows higher inflation, lower real growth, and less unemployment than were forecast in January. The rate of inflation is now predicted to be about 7 percent during 1978 and about 6½ percent during 1979. These figures are above the January budget assumptions by about 1 percentage point for 1978 and one-half percentage point for 1979.

The rate of real growth is less than was forecast in January by about one-half percentage point in both 1978 and 1979. Despite this lower real growth, the expansion in employment and the decline in the unemployment rate are expected to equal or exceed earlier expectations. Progress on the employment front this year has been considerably greater than we had anticipated.

RECEIPTS

Receipts in 1978 are now estimated at $401.2 billion, about the same as estimated in January. Receipts in 1979 are estimated to be $448.2 billion, almost $8 billion above the January budget estimate. Changes in legislation since January add almost $10 billion to 1979 receipts, while revised incomes and technical reestimates reduce receipts in 1979 by about $2 billion. With respect to legislation, the delay in the effective date of the administration's tax reduction and reform proposals from October 1978 to January 1979, and the reduction in the size of the tax cut from an annual rate of $25 billion to $20 billion, increases 1979 receipts by $11 billion. Delayed enactment of the President's energy tax proposals reduces 1979 receipts by about $1 billion.

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OUTLAYS

Our estimates of outlays for 1978 have been reduced by $10.8 billion since the January budget, to $452.3 billion. For 1979, a thorough review of planned outlays and actual spending experience has enabled the administration to reduce spending estimates by $4½ billion below the January budget to $496.6 billion. A table showing the outlay changes since January is attached to my statement.

Examination of actual spending thus far this year indicates that most agencies have fallen below the spending plans consistent with their January estimates. It is clear that the tendency of agencies to overestimate spending for the current year—which has caused shortfalls in all but one year since 1970—has continued. Our 1979 outlay estimates are based upon, among other things, experience to date in 1978, not on a completed year. In the light of the record of shortfalls in recent years, we cannot say with any degree of assurance that further shortfalls will not occur in 1979. During the past year, OMB has worked with Federal agencies to improve the quality of their estimates. We think these estimates have improved, but the revisions incorporated in the Mid-Session Review demonstrate that vigorous efforts to improve them further must be continued.

Our current estimate of spending in 1979—$496.6 billion— is $2.2 billion below the First Budget Resolution. Moreover, our estimates include $1.4 billion in outlays for energy rebates to offset proposed new energy taxes. These outlays, which do not affect the deficit, are not included in the First Resolution. Adjusting for this difference, the current administration outlay total is actually $3.6 billion below the resolution. Virtually all of this difference represents policy increases implicit in the resolution.

BUDGET AUTHORITY

The current estimate of total budget authority in 1978 is $503.8 billion, about the same as in January, and $2.1 billion above the March estimate. Most of the change since March is due to the increased authority required for disaster relief and loans, and reestimates of trust funds receipts and interest. Since January, our estimates of 1978 budget authority have been above the Second Resolution and the CBO scorekeeping estimates because of technical estimating differences.

Our current estimate of budget authority in 1979 is $571.4 billion, $2.4 billion above the January estimate and $4.9 billion above the March estimate. Increases in budget authority for the urban initiative, water resources, and other programs are partly offset by the elimination of the allowance for contingencies and revisions in the estimates for several trust fund receipts.

Even though the First Budget Resolution for 1979 assumes discretionary budget authority increases for many programs, the resolution is $2.6 billion below the administration total. One reason for this is the fact that the resolution rejects or reduces several items that require relatively large amounts of budget authority, such as the municipal bond option and forward funding for certain education and health programs. In most cases, these cuts have virtually

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no impact on the size of the deficit in 1979 and will do little, if anything, to hold down the deficit in future years.

THE LONG-RANGE BUDGET OUTLOOK

As required, this Mid-Session Review also presents longer range budget estimates. I want to stress, and stress strongly, that the estimates for fiscal year 1980 and beyond do not represent the actual totals to be published in the President's 1980 budget that we will send to the Congress early next year. I think the current estimate of 1980 outlays is unacceptably high. I think the current estimate of the 1980 deficit is unacceptably high. Between now and the end of the calendar year we will work to get those numbers down—both the spending number and the deficit number. I think, and I have told the President, that it is imperative that we continue to strive for more fiscal restraint.

CONCLUSION

In conclusion, I would like to reiterate my belief that it is imperative that there be a general tightening down on all Federal spending that is not mandatory.

I say this for two reasons. First, restraint in 1979 spending would represent an appropriate fiscal policy in an economy in which unemployment has declined more than had been expected and in which prices are rising rapidly. Such restraint would show that the Federal Government is serious about our anti-inflation program, and would permit a better balance of fiscal and monetary policies. In addition, it would be an effective means of encouraging increased governmental efficiency.

Second, as I noted earlier, the budget outlook for 1980 is disturbing. It is already clear that spending in 1980, which under current programs and administration proposals would approach $550 billion, is going to have to be pared back very significantly. It is by no means too early to begin dealing with this problem.

Thus, the message I want to leave with the distinguished members of this committee today is that the administration is ready and willing to work with the Budget Committees, the Appropriations Committees, and others in the Congress to limit the growth in Federal spending. I believe that by a combination of tighter estimates, eliminating the discretionary spending increases over the President's budget implicit in the First Resolution and in some of the bills currently pending before the Congress, and perhaps even an across-the-board cut, we could achieve a substantial reduction in 1979 spending.

As I stated last week, it is my belief that a target of total outlays in the neighborhood of $491–$492 billion for a cut of about $5 billion would be an appropriate objective of such an exercise.

Mr. Chairman, I was pleased when you announced last Friday that you are recommending to this committee that the Second Concurrent Resolution set $490.4 billion as the appropriate level of outlays for 1979. When adjusted to take into account the energy tax rebates, of $1.4 billion, your figure is virtually identical to the target the administration is suggesting—in the neighborhood of $491 billion to $492 billion.

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As our difference on the energy tax rebates illustrate, we are not likely to agree in every detail on the composition of the total, but our closeness on the appropriate total for outlays is very encouraging.

I look forward to working with this committee and with others in the Congress to maintain the budget discipline that the total requires, and I am convinced that strict discipline will be required, for it is doubtful that the desired total can be achieved without some program reductions.

Mr. Chairman, as you know, we have a close working relationship with your committee staff in this effort, and we will continue to pursue this effort.

That concludes my prepared statement, Mr. Chairman. I would be happy to answer any questions you might have.

[The prepared statement of Mr. McIntyre follows:]

PREPARED STATEMENT OF HON. JAMES T. MCINTYRE, JR.

Mr. Chairman and members of the committee, I am pleased to appear before this committee as you conclude your hearings on the Second Budget Resolution for Fiscal Year 1979. On July 6, we issued the Mid-Session Review of the budget, revising budget estimates for 1978, 1979, and subsequent years. I will discuss these estimates briefly.

I would urge the committee to be rigorous in the review it undertakes as it prepares the Second Concurrent Resolution, with the objective of producing a resolution that calls for lower spending. Budget restraint is appropriate now. It is consistent with both the economic outlook and the need for increased governmental efficiency, which spending restraint will encourage.

1978 AND 1979 BUDGET ESTIMATES

As shown in the following table, our 1978 and 1979 revisions show lower Federal spending and lower deficits than were projected in January. The fiscal year 1978 deficit is now estimated at $51.1 billion, $10.6 billion less than the January budget estimate. This decrease can be attributed almost entirely to a lower estimate of Federal spending. Our current estimate of the deficit for 1979 is $48.5 billion, $12 billion below the January budget. This decrease reflects:

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1978 AND 1979 BUDGET TOTALS

[In billions of dollars]

1978

	President's budget			Second resolution
	January [1]	March [1]	July	
Receipts	401.3	401.4	401.2	397.0
Outlays	463.1	454.4	452.3	458.25
Deficit	−61.8	−53.0	−51.1	−61.25
Budget authority	503.9	501.7	503.8	500.1

1979

	President's budget			First resolution
	January [1]	March [1]	July	
Receipts	440.5	440.7	448.2	447.9
Outlays	501.0	500.2	496.6	498.8
Deficit	−60.5	−59.5	−48.5	−50.9
Budget authority	569.1	566.6	571.4	568.85

[1] Revised for accounting changes. Earned income credit payments in excess of an individual's tax liability, formerly treated as income tax refunds, are now classified as outlays. In addition, the budget estimates now include activities of the exchange stabilization fund that were formerly off-budget.

Economic assumptions.—I should like, first, to discuss briefly the economic assumptions that underlie the Mid-Session Review estimates. I will not go into detail on this because Chairman Schultze has already testified on this. The economic outlook for calendar years 1978 and 1979 shows higher inflation, lower real growth, and less unemployment than were forecast in January. The rate of inflation is now predicted to be about 7 percent during 1978 and about 6½ percent during 1979. These figures are above the January budget assumptions by about 1 percentage point for 1978 and a one-percentage point for 1979.

The rate of real growth is less than was forecast in January by about one-half percentage point in both 1978 and 1979. Despite this lower real growth, the expansion is employment and the decline in the unemployment rate are expected to equal or exceed earlier expectations. Progress on the employment front this year has been considerably greater than we had anticipated.

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incorporated in the Mid-Session Review demonstrate that vigorous efforts to improve them further must be continued.

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THE LONG-RANGE BUDGET OUTLOOK

As required, this Mid-Session Review also presents longer range budget estimates. I want to stress, and stress strongly, that the estimates for fiscal year 1980 and beyond do not represent the actual totals to be published in the President's 1980 budget that we will send to the Congress early next year. I think the current estimate of 1980 outlays is unacceptably high. I think the current estimate of the 1980 deficit is unacceptably high. Between now and the end of the calendar year we will work to get those numbers down—both the spending number and the deficit number. I think, and I have told the President, that it is imperative that we continue to strive for more fiscal restraint.

THE BUDGET OUTLOOK, 1979–1983

[In billions of dollars]

	1979	1980	1981	1982	1983
Receipts	448.2	507.3	580.0	651.3	720.5
Outlays	496.6	549.4	591.3	631.0	671.5
Surplus or deficit (−)	−48.5	−42.1	−11.3	20.3	49.0
Budget authority	571.4	625.2	680.6	728.8	768.8

Note.—The budget details for 1980 and 1981 do not reflect budget or fiscal policies desired by the Administration for those years.

CONCLUSION

In conclusion, I would like to reiterate my belief that it is imperative that there be a general tightening down on all Federal spending that is not mandatory.

I say this for two reasons. First, restraint in 1979 spending would represent an appropriate fiscal policy in an economy in which unemployment has declined more than had been expected and in which prices are rising rapidly. Such restraint would show that the Federal Government is serious about our anti-inflation program, and would permit a better balance of fiscal and monetary policies. In addition, it would be an effective means of encouraging increased governmental efficiency.

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Thus, the message I want to leave with the distinguished members of this committee today is that the administration is ready and willing to work with the Budget Committees, the Appropriations Committees, and others in the Congress to limit the growth in Federal spending. I believe that by a combination of tighter estimates, eliminating the discretionary spending increases over the President's budget implicit in the First Resolution and in some of the bills currently pending before the Congress, and perhaps even an across-the-board cut, we could achieve a substantial reduction in 1979 spending. It is my belief that a target of total outlays in the neighborhood of $491–$492 billion for a cut of about $5 billion would be an appropriate objective of such an exercise.

Mr. Chairman, as you know, we have been working with your committee staff in this effort, and we will continue to pursue this effort.

That concludes my prepared statement, Mr. Chairman. I would be happy to answer any questions you might have.

Enclosures.

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CHANGE IN BUDGET OUTLAYS, 1978 AND 1979
(in billions of dollars)

	1978	1979
January estimate 1/	463.1	501.0
Policy changes	-0.5	0.8
Reestimates:		
Department of Defense-Military	-1.5	---
Energy, natural resources, environment, and transportation	-2.0	0.2
Benefit payments for individuals:		
Unemployment benefits	-0.2	-0.4
Other	-1.5	---
Other:		
International financial programs	-0.9	-0.5
Net interest	-0.6	---
Offshore oil	-0.5	-0.5
Other	-1.0	-0.4
Subtotal, Reestimates	-8.2	-1.6
March 13 estimate 1/	454.4	500.2
Policy changes:		
Urban initiative	---	1.0
Farm bill	---	0.5
Other program changes (net)	0.2	1.2
Contingency allowance	---	-1.4
Subtotal, Policy changes	0.2	1.3
Reestimates:		
Department of Defense-Military	-1.8	-3.0
Energy, natural resources, environment, and transportation:		
TVA power marketing	0.2	0.6
Other	-1.5	-0.9
Benefit payments for individuals:		
Unemployment benefits	-0.4	-0.3
Other	-*	-0.7
Other:		
International financial programs	0.8	-0.1
Net interest	0.5	-0.1
Local public works	0.7	---
Farm price supports	-0.4	-0.5
Other	-0.3	0.1
Subtotal, Reestimates	-2.2	-4.9
Current estimate	452.3	496.6

1/ Adjusted for accounting changes.
* $50 million or less.

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CHANGE IN BUDGET AUTHORITY, 1978 AND 1979
(in billions of dollars)

	1978	1979
January budget estimate 1/	503.9	569.1
Policy changes:		
Higher education initiative	---	1.2
Other program changes (net)	-0.4	1.1
Contingency allowance	---	-1.3
Subtotal, Policy changes	-0.4	1.0
Reestimates:		
Municipal bond option	---	-1.8
Other	-1.7	-1.8
Subtotal, Reestimates	-1.7	-3.5
March estimate 1/	501.7	566.6
Policy changes:		
Urban initiative	---	5.9
Water resources initiative	---	0.8
Veterans pension reform	---	0.5
Energy rebates (delay in enactment)	-0.3	-0.5
ConRail	---	0.4
Federal pay cap	---	-0.3
Other program changes	0.6	1.1
Contingency allowance	---	-1.7
Subtotal, Policy changes	0.3	6.1
Reestimates:		
Disaster relief	0.9	---
Military sales trust fund	0.8	-0.2
Social security and medicare trust funds	0.3	1.0
Unemployment trust fund and receipts	-0.8	-1.9
Net interest	0.5	-0.1
Other	0.1	*
Subtotal, Reestimates	1.8	-1.2
Current estimate	503.8	571.4

1/ Adjusted for accounting changes.
* $50 million or less.

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The CHAIRMAN. Thank you very much, Mr. Director.

In view of your spending reestimates, and in view of the review of the economic situation that you have recently undertaken, and taking cognizance of the heavy pressures from inflation, would you comment on the wisdom of having a tax cut, whether it should be of perhaps a somewhat smaller size, and what the composition of that tax cut should be.

Mr. MCINTYRE. Mr. Chairman, the administration is on record in support of a tax cut. In fact, we have recommended that the Congress consider a tax cut of $19 billion, with the approximate distribution about one-third corporate and two-thirds personal. I think that a tax cut is desirable. As I testified before this committee earlier this year, I think it is desirable for several reasons.

I think it is desirable, first of all, to keep the economy moving forward strongly and to provide a small amount of fiscal stimulus to keep our economic growth healthy.

Second, I think, it is important to overcome the additional taxes that come into effect automatically in January of 1979 through the social security laws, and also to overcome and help make up for the loss of expendable income by virtue of people moving into higher income tax brackets as a result of inflation.

The answer to your question is yes, I think a tax cut is needed. I think that a cut in the neighborhood of $20 billion, is appropriate, and this is the administration's position on the tax cut.

The CHAIRMAN. You would be concerned, would you not, with substantially larger tax cuts contributing to inflation?

Mr. MCINTYRE. Yes, we certainly are concerned about proposals that would include substantially more than the $20 billion tax cut the administration has recommended, particularly at this time, in which we are seeing increased pressures on inflation, and particularly since there is such concern about the size of the Federal deficit, and the effects that that deficit might have on inflation.

The CHAIRMAN. Now that the enactment of welfare reform appears unlikely this year, does the administration support interim fiscal relief in fiscal year 1979 as proposed in different versions by both the Committee on Ways and Means and the Senate Finance Committee?

Mr. MCINTYRE. Mr. Chairman, our proposals on fiscal relief are linked to enactment of welfare reform. Fiscal relief would be a program that we could support, but only on the assumption that the two are linked.

As we move toward welfare reform, we should keep in mind the basic objectives—the increase in work incentives, tying the jobs and the cash payment elements, and also consolidating some of the Federal programs—as well as the link to fiscal relief that I referred to earlier.

The CHAIRMAN. Thank you very much. Mr. Latta.

Mr. LATTA. Thank you very much, Mr. Chairman. It is good to have you here, Mr. Director. You mentioned some cuts, and we are all interested in cuts. The question is, where? Have you any suggestions, specifically?

Mr. MCINTYRE. Well, I have made several suggestions about the way to go about achieving these cuts. The President has submitted to the Congress a budget that reflects his priorities. In that budget

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the President did submit some changes in programs that are being debated, for example, health and hospital cost containment and some minor cuts in the social security area.

Mr. LATTA. What kinds of cuts in social security?

Mr. MCINTYRE. There are some minor changes in the benefits. I could get you a list of those, Mr. Latta.

Mr. LATTA. Will submit that for the record?

Mr. MCINTYRE. Yes.

[The information referred to above follows:]

PROPOSED SOCIAL SECURITY CUTS

1. *Restriction of retroactivity in claiming benefits.*—Reduces the permissible retroactivity from 12 months to 3 months. Estimated savings in 1979—$121 million.

2. *Month of initial benefits.*—Benefits would begin in the month in which applicants met all requirements throughout the month rather than within the month. Estimated savings in 1979—$138 million.

3. *Minimum benefit provision.*—Eliminates the $121.80 minimum benefit for persons coming on the rolls after December 1978; denies cost-of-living adjustment in minimum for those already on the rolls. Estimated savings in 1979—$60 million.

4. *Maximum student benefits.*—Repeat of earlier submission to limit social security benefits for students over age 18 to the BEOGS grant. Estimated savings in 1979—$117 million.

Mr. LATTA. Thank you.

Mr. MCINTYRE. You know, my feeling at this point is that we should work cooperatively with the Appropriations and Budget Committees and others in the Congress to seek some agreement on the areas where reductions are possible, and where the spending estimates can be tightened generally. We have also recommended that the discretionary increases over the President's request be changed, and that we move back toward the President's request. If necessary, if after this cooperative effort we still need to make some changes, we may want to consider across-the-board cuts to achieve any additional reductions. This is nothing novel. The House has already recommended this in several bills.

I think this is the responsible way for us to proceed because it focuses on trying to cooperate with the Congress and to reach agreement with the Congress. It strengthens and supports the congressional budget process by working within the process. It offers a way to generally tighten Federal spending without disrupting Federal programs.

Mr. LATTA. How about impact aid? Is the administration recommending anything in this area?

Mr. MCINTYRE. We have recommended that you go back to the President's budget. The House is some $200 million above the President's request. We would certainly like to see that moved back toward the President's request.

Mr. LATTA. Let me say I concur. You know we have had every President since President Eisenhower making the presumption we never seem to make much effort here in the Congress to get it cut back.

These enormous shortfalls, as you indicated when you were here previously, are a problem. You indicated that perhaps you are making some headway, but we still have about a $6.5 billion problem right now, as you have indicated. I just wonder what went wrong that we are off that much.

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Are we overappropriating in various areas? Should we take a look at that if we are overappropriating and cut them back?

Mr. McINTYRE. Mr. Latta, it is very difficult. If I knew the answer to the shortfall problem, I would remedy it. I don't mean that in a short sort of way. I really mean if I could find the answer, I would try to do something about it. What we have done is we have tried to monitor the shortfall for the last several years to determine if there are any patterns in the shortfall. There are many reasons for it. Agencies do overestimate. That is one reason. Sometimes we have difficulties in getting funds obligated because of contractual negotiations or something happens in the process and we are unable to obligate the funds, or get the contracts signed as rapidly as we thought. Sometimes there are natural occurrences such as the cold weather that have some deterrent effect upon spending patterns. I don't have a specific answer. All I can tell you is that we are concerned about it in OMB. We are going to continue to work hard to try to get the estimates more reasonable and more in line with what actual expenditures are.

Mr. LATTA. I was disturbed, as I am sure every Member of Congress was disturbed, about the $7 billion that GAO found in waste in HEW, and I just wonder what action, if any, OMB took when this announcement was made. Did you make any type of investigation or give any thought to perhaps reducing the amount that they were requesting in fiscal year 1979, saying, "Look, you have $7 billion that they found in waste; we're going to cut you back."?

Mr. McINTYRE. First of all, I think that that was a report of the Inspector General of HEW that estimated there was as much as $7 billion in waste. But the answer to your specific question is that I did ask my staff to look into this report; and I believe Mr. Cutter can give some light on what the staff has actually done.

Mr. LATTA. Would you repeat that name, please?

Mr. McINTYRE. Mr. Cutter, who is here with me right now.

Mr. CUTTER. Congressman, the difficulty with being able to proceed directly to action from that report was that it was, in fact, an estimate; it looked at procedures in the entitlement programs and estimated that there was as much as $7 billion in waste. It didn't go down account by account and say "There is *x* millions of dollars in waste here," and say "Why?". The estimate was made from a look at how the Federal Government makes payments and on what terms and how State governments make payments and on what terms in the entitlement programs.

The difficulty with going through and simply taking out $7 billion in the appropriation and our recommendation for the appropriation is that those are entitlement programs and by law whatever payment is required is going to be made. Therefore, what we really have to do is look at the procedures and change them where we agree that, in fact, they lead to waste.

What we have at OMB, what we have been doing and what we are strengthening as a result of that report and our own general perception that there is such a problem, is what we have called quality control programs in the general area of entitlements.

One of the major problems with the budget—and I am sure you have heard this before—is that 57 percent of it is uncontrollable by

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law; 57 percent of it stems from entitlement programs in which a class of beneficiaries and set of benefits are defined and the number of beneficiaries is multiplied by the nature of the benefits to get the payment.

In a program like that, program structure never gets looked at as closely as, for example, you, the Budget Committees and the Appropriations Committees, look at more discretionary programs. Therefore, procedures tend to develop over time which are simply inappropriate. What we have tried to do and are trying to do cooperatively with HEW in our quality control programs, is to do a careful statistical analysis of the methods by which payments are made and the nature of the payments, in order to come to some determination about precisely how a program operation can be changed.

That is a long answer to a short question, but the point is that I think there was an estimate based on a sense about procedures, and we are trying to define with some precision where those procedures are inappropriate.

Mr. LATTA. Thank you very much.

Mr. MCINTYRE. Can I make one positive statement about things we are doing that I have been involved in with the Secretary? We have taken some specific steps with the Secretary to eliminate fraud and waste in the student grant and loan programs. I think you are probably aware of this effort.

Mr. LATTA. I am.

Mr. MCINTYRE. And we have been working with the Secretary in that effort.

Mr. LATTA. May I ask one more question? Have we gotten down the number of people who are making in excess of $40,000, working for the Government, who are in default on their loans?

Mr. MCINTYRE. I don't have that information, but I think the Secretary probably does. I can check it, if you desire.

The CHAIRMAN. The gentleman from Texas, Mr. Mattox.

Mr. MATTOX. Mr. McIntyre, I have been, I would say, rather critical of the countercyclical programs that we have had, and I have been looking at, and I have asked to have prepared for me a memo on the administration's program that they are developing to take the place of countercyclical—the Supplemental Fiscal Assistance Act.

Looking at it, I am somewhat concerned because it would indicate to me that the program the administration is pushing is moving even more drastically in the direction of general revenue sharing, most difficult at best to administer, and using to a great extent estimates, and it appears to me that we are going to be providing—if we do carry this program forward—benefits to 26,211 local governments, which is about 70 percent of all the general-purpose, local government entities in the entire country.

That is about 9,000 more than are getting countercyclical aid today, and the allocation formula relies very heavily on the unemployment rates; and those unemployment rates are available for only about 5,000 of the local entities, which would indicate that the rest of them are going to be general-estimate-type formulas.

When you look at the per capita division that exists and that is provided, when a city like New York City, I understand, is going to

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get about, I believe it is, one-fifth of the entire benefit out of the entire program, that kind of worries me. I understand that there are several things to be concerned about, and I am just curious if it wouldn't be better for us just to kill this program, kill countercyclical, and move on to a program that provides health care benefits and educational benefits and provides some other direct beneficial-type aid, rather than just doling this money out to many local municipalities that have surpluses and States that have surpluses, particularly in light of our $40 million or $50 million deficit?

We don't have anything to be doling out. Why don't we cut back? You can't share. It is difficult to share a deficit. We continue to do it. So if the administration is legitimatly interested in cutting this budget, how much can we cut back in this countercyclical if we just kill it off?

Mr. McINTYRE. Mr. Mattox, first of all, the administration feels strongly that the supplemental fiscal assistance program is a desirable program.

Mr. MATTOX. Why?

Mr. McINTYRE. I will tell you in just a moment. In fact, we looked at it very carefully as we studied the urban policy and developed our recommendations for the urban program. It makes a change basically from a general approach to one in which local governments in distress benefit from this program. We thought that this was a change the Congress also was in favor of; the fact that it does benefit those local governments that are in distress seems to be an important aspect.

Mr. MATTOX. Let me interrupt. Do we have 26,000 local governments that are under stress or under strain?

Mr. McINTYRE. I don't have the number of local governments that would qualify under the provisions of the program, but there are a lot of local governments in this country.

Mr. MATTOX. Yes, sir, I understand there are, and on the basis of the memo that I have developed, it appears that we are talking about a much greater area of giving benefits than would otherwise be justified.

Dallas, Tex., the city I am from, which is not eligible for countercyclical, manages to get some money under this program that you are developing and I know Dallas has a very substantial budget surplus, and it would seem to me that when you start talking about local municipalities that are in distress, you have your formulas mixed up some way or other.

Mr. McINTYRE. I don't know the unemployment rate for Dallas.

Mr. MATTOX. It is one of the lowest in the nation; it is lower than full employment, based on the figures that exist, that your office uses; so it seems to me that we have some problems. If we legitimately want to cut this budget and want to balance it, rather than hanging this money out for everybody that would like to have a little piece of it, we ought to get on about some fiscal integrity.

Let me ask you one other question that deals with this area of CETA. We have not been able to administer 725,000 CETA jobs under title VI, public service jobs. We have just not been able to do it. If we can't administer it, and it is pretty obvious that we can't, why is it that the administration is not seeking to cut that program back a little bit, so that we can get it under control, maybe

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cut it back to 500,000 jobs or 600,000 jobs, so maybe we could administer it?

You know if we can't administer a big program, maybe we can cut it back and get a little better handle on it. Wouldn't that be a better thing and maybe save us a billion or two?

Mr. McINTYRE. My position on the number of public service jobs authorized by CETA is that at this particular time the recommendations of the administration seem to be reasonable; however, if the unemployment rate should continue to drop, and if the drop that we have seen in the past month should prove to be a permanent-type drop, as opposed to an aberration, then I personally would be willing to review the public service employment program.

Now I recognize that the Secretary of Labor in a speech last week indicated that he thought that it was important to continue at the current level of 725,000 jobs. What I am saying is that I, as the Director of OMB, would personally be willing to reexamine that number should we continue to have substantial improvements in the unemployment rate.

One thing that I think we often overlook is that we have been extraordinarily successful in getting the unemployment rate down over the past 19, 18 months.

Mr. MATTOX. I agree with you.

Mr. McINTYRE. I think the Congress, as well as the administration, can take great pride and should take great pride in it, Mr. Mattox.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Virginia, Mr. Fisher.

Mr. MATTOX. Mr. Chairman, may I submit one more question for purposes of the record and just ask one more for the purpose of the record?

The CHAIRMAN. You are well over the 5-minute rule.

Mr. MATTOX. I understand. I will submit it in writing, if the Chair would like.

The CHAIRMAN. No. Go ahead.

Mr. MATTOX. I know your office has moved, and is in the process of moving, to evaluate the usefulness or lack of usefulness of the major regional councils established around the United States. For purposes of the record, I wish that you would provide me, or the committee, with some indication of what the possibilities are of either doing away with those councils or making them effective, and what kind of budgetary expenditures it calls for to continue to maintain those regional councils.

Mr. McINTYRE. Mr. Chairman, if I may make one point about that, we would be glad to provide the committee with that information. It will not be completed probably for, I would say, 30 to 60 days at least. As soon as it is completed, I will see that you get a copy, and the other members of the committee.

Mr. MATTOX. Thank you.

[At the time printing the information referred to above was not received.]

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The CHAIRMAN. Mr. Fisher.

Mr. FISHER. Thank you, Mr. Chairman.

I would like to inquire into the reasons for the drop in estimated outlays in fiscal year 1979. In Janaury when we started off, the estimate was $501 billion and now it is $496.6 billion, around $5 billion less. I guess the chairman's mark shows——

The CHAIRMAN. $490.4 billion.

Mr. FISHER. I haven't seen the details, $490.4 billion. There is kind of a downward trajectory here as the different estimates and marks and so on have come along. I would like to understand in some detail what makes that up.

Mr. MCINTYRE. Mr. Fisher, let me direct you to the Mid-Session Review publication. Table 4 of that publication has the details. Some of the highlights of that include reestimates in the Department of Defense and in the Department of Energy; and then there are some reestimates in the benefits payments area. If it meets with your approval, rather than going through the details, we have them on a table in our Mid-Session Review and I will be glad to go into any further details you might desire.

Mr. FISHER. Is all of the drop to be accounted for by reestimates, that is, shortfalls in spending? Is there anything in addition to that in the picture?

Mr. MCINTYRE. I believe that most of it—I hate to use the all-inclusive word "all", but most of it is reestimates on the outlay side now.

Mr. FISHER. Do you think you have taken into account fully the assumption you make about inflation in the cost that the Government has to pay? Would you expect that to go up as compared to what we now have before us?

Mr. MCINTYRE. You have hit on a subject near and dear to my heart, Mr. Fisher. Some people feel that we ought to automatically adjust all Federal programs to take into account inflation. I think that is a circular argument, because once you start recognizing inflation for all discretionary programs in the Federal budget, it almost becomes a self-fulfilling prophecy.

I, personally, feel you ought to budget based on what you can afford to spend, and that then produces great efficiencies in the agencies.

Mr. FISHER. I quite agree with you on your general statement about built-in escalating factors. It is a self-defeating kind of process; but still and all, you have to make your estimates of inflation in order to put down numbers here for outlays, and given the recent rapid increase in costs and it strikes me that you may be on the low side on this account; and it also strikes me, just looking at these figures that, as is typical, not only while you have been Director but for a long time, we underestimate the shortfall, and I would probably take a small bet that even these figures underestimate what is likely to happen.

So these two factors offset one another somewhat. My speculation is that the shortfall will lower the outlays more than the inflation will raise them, compared to what is here. I would be interested in your comments on that.

Mr. MCINTYRE. Based on the most recent evidence, we could probably expect the inflation rate to be higher than the midsession

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estimates indicate. I think Chairman Schultze indicated that over the weekend. He said he felt that based on the most recent evidence—which we did not have, as you know, until last Friday—it appears that the pressures on inflation are even more than we could anticipate in the midsession review.

Mr. FISHER. If you get any further thoughts on this general subject, I would like to have them anytime.

One final question: In your testimony you talk about different ways of restraining the increase in outlays, and as the last possibility you mention even the possibility of an across-the-board cut. Could you enlarge a little on that? How far across the board, and across the board of what programs? Would they be the all others but the 57 percent of entitlements that you mentioned a moment ago?

Mr. MCINTYRE. Seventy-five percent.

Mr. FISHER. Or 75 percent by the time you count other things? Or would they include some of the entitlement programs? The entitlement programs themselves in terms of outlays depend considerably on the state of the economy and the outlook for inflation and everything else.

You are not entitled to unemployment compensation unless you are unemployed. You are not entitled to full social security benefits unless you fully retire, up to a certain age, and so the so-called entitlement programs are not as rigid and fixed as a lot of people think.

The agricultural programs, many of them, are entitlement programs but they hinge on the price of farm products, the number of people who apply for food stamps and so forth. So I am inviting you to extend the notion of an across-the-board cut from just the more narrowly defined and discretionary programs and extending the concept to include some of what you would call entitlement programs.

Mr. MCINTYRE. Mr. Fisher, I would like to know how to do that legally, because if an individual is entitled to a social security benefit, then we must pay him the benefits.

Mr. FISHER. I must say, one point could come out of increase in efficiency—it is a bit ham-handed and clumsy—or out of fraud and abuse, or some combination of these things. I might want to argue that another 1 percent, or another 1 percentage point, could come out of just the tiniest readjustment of some of the basic assumptions of inflation, employment, unemployment, productivity.

The CHAIRMAN. The time of the gentleman has expired.

Mr. FISHER. I realize that and I end on this note, and invite other responses.

The CHAIRMAN. Mr. Conable.

Mr. CONABLE. Thank you, Mr. Chairman. Welcome, Mr. Director, back before the committee. I guess we are going to see a lot of each other over the years.

Mr. MCINTYRE. I hope so.

Mr. CONABLE. I am not terribly impressed with savings that come about as a result of reestimates. You get a certain sense of loss of control as you find you have planned wrong; but I realize one of the most volatile items is the rate of inflation, and it has an impact both on revenue and on expenditure.

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Are there any rules of thumb you can give us on that? You have estimated still a 7-percent rate of inflation which, I think, is sanguine in the extreme, and I am wondering, if it is 8 percent, will we be worse off in terms of what we have to pay for Government goods and services or will we be better off because a 1-percent inflation rate increases the revenues by 1.4 percent or something like that? What kind of rules of thumb can you give us for judging these things as we try to go through our own estimates and find a pretty volatile set of circumstances on which to predict?

Mr. McINTYRE. Mr. Conable, I understand that we have given some of those rules of thumb before, and I would be glad to supply them for the record.

[The following information was supplied for the record:]

GUIDANCE IN ESTIMATING EFFECTS OF HIGHER INFLATION ON THE BUDGET

Higher inflation increases outlays, but it increases receipts by a greater amount. Tax collections rise almost immediately as a result of inflation, in large part due to our system of withholding. On the outlay side, however, longer timelags generally exist, even for programs for which automatic cost-of-living adjustments are provided by statute.

The effects of a higher rate of inflation depend critically on timing: When the higher rate begins and how long it remains higher. Our rough calculations are that if the rate of inflation (as measured by the GNP deflator) is 1 percentage point higher beginning the first quarter of calendar year 1979 and continuing through 1981, the effects in the last 9 months of fiscal year 1979 would be rather small—about a 0.4 percent increase in receipts and one-quarter of 1 percent increase in outlays. In fiscal year 1980, the effects would grow to about 1.5 percent higher receipts and 0.9 percent higher outlays. In fiscal year 1981, the effects would amount to about 2⅓ percent higher receipts and 1½ percent higher outlays. Applying these percentages to budget estimates in our Mid-Session Review of the Budget yields the following dollar magnitudes for this 1 percent inflation rate differential:

ESTIMATED EFFECTS ON THE BUDGET OF 1 PERCENT HIGHER INFLATION RATE BEGINNING 1979:I

[In billions of dollars]

	Fiscal year—		
	1979	1980	1981
Receipts	+1.7	+7.7	+13.7
Outlays	+1.2	+5.1	+8.9
Deficit	−0.5	−2.6	−4.8

One "rule of thumb" these estimates suggest is that they effect of a higher rate of inflation on outlays for any given year will be only on the order ot two-thirds as great as the effect on that year's receipts.

Mr. McINTYRE. In general, I would like to say that inflation affects the Government differently, just as it does individuals, because it depends on what goods and services you buy and how much inflation affects those goods and services, but my understanding is——

Mr. CONABLE. There is a big impact for a medical program, for instance. There is a big impact for defense spending, but less for some of the other items.

Mr. McINTYRE. I am informed that in one rule of thumb that has been generally used is that in general inflation affects revenues more than——

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Mr. CONABLE. It has a long-term impact because it buys so many of them under contract and has direct control over such things as wages. Well, your Mid-Session Review shows that the budget authority went up by a total of $7.1 billion and outlays went up by $2.1 billion as a result of changes due to policy initiatives. Do you have any breakdown as to which of these initiatives were caused by Executive changes and which by legislative changes? In other words, to what degree is the Congress responsible for that and to what degree is the President? I assume the Congress takes the lion's share, in fact, particularly with respect to entitlement programs; is that so?

Mr. MCINTYRE. The budget authority that I was referring to in my testimony was primarily those that the administration had recommended.

Mr. CONABLE. I see. The recommendation by the administration, you assume, results in that kind of an increase?

Mr. MCINTYRE. $2.4 billion above the January estimate.

Mr. CONABLE. $2.4 billion in outlays?

Mr. MCINTYRE. No; that is budget authority.

Mr. CONABLE. I am talking about those that were due to policy initiatives and not due to simple reestimates.

Mr. MCINTYRE. What I am giving you is basically a net figure for budget authority.

Mr. CONABLE. You are up and down, if you are talking about reestimates, but the changes due to policy initiatives are up in both cases. You're talking about fiscal year 1979 now?

Mr. MCINTYRE. That is correct; fiscal year 1979. There are some policy changes that relate to the urban initiatives—water resources, education. There is a detailed table, table No. 7, on page 16 of the Mid-Session Review.

Mr. CONABLE. Fine. Thank you.

Mr. MCINTYRE. It gives that list of changes.

Mr. CONABLE. Thank you for pointing that out. I wanted to take a look at it.

One thing that concerns me, as I listen to presidential rhetoric anyway, he is talking about how we have to get tough on spending during fiscal year 1980, and I agree with that. I think it is obvious that we are going to have to lean very hard on the growth of Government; but what about fiscal year 1979? We are still up here in the condition where we can influence the course, and I am somewhat concerned about that.

I wish the President would talk about that to as great a degree as he seems to be talking about 1980. I realize you are starting on 1980 now and that is an obvious place to focus, but I don't think it is too late in fiscal year 1979, and we would like all the help we can get, if policy initiatives are driving us up at this point, and then the President says something about how serious we are about 1980, and that is the only reason I was asking that particular question.

The CHAIRMAN. The time of the gentleman has expired. You can respond.

Mr. MCINTYRE. Mr. Conable, I would welcome the opportunity to continue to work with this committee and the Appropriations Committees to attempt to get the 1979 spending down. In fact, my

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recommendations require that we work together to get the number down to the $491 billion to $492 billion range that we are talking about.

I am trying to recall if all of these policy changes were mentioned to the committee earlier in the year when the January budget was discussed or not. I know that the urban initiative program was mentioned to the committee. I know that the education program was mentiond to the committee. I think we discussed water resources—I am not absolutely certain, but I believe that we did.

Mr. CONABLE. That has been subject to some negotiation, I think.

Mr. MCINTYRE. I believe we mentioned that we would be recommending some new initiatives for the Congress in that particular area.

So the point is that most of these policy initiatives were discussed earlier this year when the January budget was debated. It is not something that we sprung on the Congress. It was not an afterthought, after the budget was prepared.

Mr. CONABLE. I greatly appreciate my chairman's patience.

The CHAIRMAN. The gentleman from Maryland, Mr. Mitchell.

Mr. MITCHELL. Mr. McIntyre, you propose an across-the-board cut for fiscal year 1980. How much, what percentage?

Mr. MCINTYRE. I am not proposing an across-the-board cut for fiscal year 1980.

Mr. MITCHELL. 1979?

Mr. MCINTYRE. Or 1979. I am suggesting that if we cannot achieve our objectives to reduce the spending to the $491 billion to $492 billion range, then we may have to resort to an across-the-board approach to help get to that amount.

Mr. MITCHELL. I am glad this issue has been cleared up for me. Honestly, this practice of across-the-board cuts, this Proposition 13 syndrome, is very discouraging.

I think the Budget Committee in general has done a pretty good job each year of reducing the deficit and I think it is nonsensical to resort to disruptive across-the-board cuts. Why not let the Budget Committees continue their work of gradually cutting back on Government spending? In that connection, I want to help you a little bit, if I may.

Since we have already abandoned the fight against unemployment, we have dropped that fight altogether, why don't we isolate the manpower training programs which have a high incidence of blacks and other minorities and merely cut them? That would be consonant with the general abandonment of the minority unemployment problem.

Mr. MCINTYRE. Who is we? The administration has strongly supported minority training programs, an expansion in Federal purchasing from minority businesses, and minority participation in the Federal Government's programs.

Mr. MITCHELL. Oh, I am making a collective "we", the Congress and the administration too, because we are maintaining present levels over suggestions of cutbacks in public service and CETA.

I just want to be helpful and suggest that we can painlessly reduce the Federal budget and then the admiration and love of the minority black community.

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The CHAIRMAN. Would you yield? Is that in the nature of a question?

Mr. MITCHELL. The nature of a suggestion. I thought that would be helpful.

Mr. MCINTYRE. We would probably reject that suggestion, Mr. Mitchell.

Mr. MITCHELL. I hope you can persuade some of the Members of the House and this committee to also reject it.

One other question, Mr. McIntyre: The Department of Defense accounts for about 31 percent of your shortfall in spending in 1978; yet, throughout your testimony and your written statement, you refer to lower spending. You refer to the matter of agencies estimating their budget requests. Enlighten me just a little bit. Isn't that the function of the Office of Managment and Budget, to see to it that these gross overestimates, such as in the case of the Department of Defense, do not occur?

Mr. MCINTYRE. Absolutely; it is one of our jobs. I have, since I have assumed the directorship, pursued this very vigorously, Mr. Mitchell. I want to try to get the shortfall out. I think we have some initiatives that we have underway right now that you, from the tone of that question, might find interesting. It certainly is our job and we are pursuing it vigorously.

Mr. MITCHELL. Good. I wish you a great deal of success, because each year that I have been on the Budget Committee it has been the Department of Defense which has been the gross, flagrant culprit in terms of overestimating and thereby causing the resultant shortfalls in spending.

In the President's urban initiatives, there were several things the President suggested—the General Services Administration program for locating Federal facilities in cities, formation of an urban interagency coordinating council, and the design of improved urban data and information system.

Could you give me a progress report on those three? There were seven major items. I won't list all of them. Could you give me a progress report on any of those three? I think that these three initiatives are primarily under the jurisdiction of the administration.

Mr. MCINTYRE. The three were the——

Mr. MITCHELL. The General Services Administration program for locating Federal facilities in cities, the formation of an urban interagency coordinating council, and the design of an improved urban data and information system—those three out of seven.

Mr. MCINTYRE. I can tell you from my own personal knowledge the Interagency Coordinating Council has been created and is operating.

Mr. MITCHELL. Who heads that up?

Mr. MCINTYRE. Mr. Watson, of the White House staff.

Mr. MITCHELL. A good man.

Mr. MCINTYRE. We agree on something.

Mr. MITCHELL. My time has expired. Just slip me a note.

Mr. MCINTYRE. I will get you a report on the other two. In fact, I can get you one on all seven.

[The information referred to above follows:]

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URBAN DATA TASK FORCE

The first meeting of the Urban Data Task Force was held on June 22, 1978. Assistant Secretary of the Department of Housing and Urban Development, Donna E. Shalala, chaired the meeting and attendees included representatives from Commerce, EPA, HEW, Justice, Interior, Transportation, Treasury, and HUD. At the meeting the Task Force approved a preliminary work program consisting of three tasks: 1. The development of a priority set of urban indicators; 2. The development of an expanded set of more comprehensive urban indicators; and 3. The identification of State and local government data needs.

Assistant Secretary Shalala's staff, in cooperation with the staff of the Office of Federal Statistical Policy and Standards of the Department of Commerce, is currently concentrating on the development of the priority urban indicators. That work includes both developing an inventory of urban data sets currently collected by the Federal Government and working with the various Federal departments to identify their urban concerns.

Preliminary results will be presented to the task force at its second meeting scheduled for September. Work on the other two tasks is proceeding as outlined in the work program.

GENERAL SERVICES ADMINISTRATION PROGRAM FOR LOCATING FEDERAL FACILITIES IN CITIES

This program has been reviewed within the administration and the President is expected to sign an Executive order on Federal Space Management within a few weeks. This order will encourage the location of Federal facilities on a priority basis in cities whenever such location is not inconsistent with agency missions.

The CHAIRMAN. The gentleman from South Carolina is recognized under the 5-minute rule.

Mr. DERRICK. Thank you, Mr. Chairman.

The CHAIRMAN. That is not directed to you. That is directed at the committee.

Mr. DERRICK. Mr. McIntyre, I have a couple of observations to make, and then a couple of questions.

The observation is that when you folks were up here peddling the social security program and the minimum wage increase, you kept telling us that it was not inflationary. Now we hear the administration cite the minimum wage increase and social security as part of the reason we are enjoying a double-digit inflation right at this moment.

My question is, and following up on what Mr. Mitchell said, do you know of any conscious agency overestimates that have been brought to your attention?

Mr. MCINTYRE. Not in the sense of deliberate, no.

Mr. DERRICK. That is exactly what I mean.

Mr. MCINTYRE. I do not know of any deliberate overestimates. Do you know of any?

Mr. DERRICK. No, I don't, but I am not the head of the OMB either. Have you satisfied yourself reasonably well that there aren't any?

Mr. MCINTYRE. Deliberate in the sense of premeditated, sat down and, "Well, we are going to——

Mr. DERRICK. With malice aforethought.

Mr. MCINTYRE. I am not sure there are any that were deliberate, with malice aforethought, but let me make some general observations. I think that there is a tendency in the agencies to be sure that they have sufficient funds to carry out their programs. I think that there is some concern that if they don't estimate a little on

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the high side, they might come up short toward the end of the year and not be able to carry out their programs or objectives.

Mr. DERRICK. I call that conscious overestimating.

Mr. MCINTYRE. No, I don't think it is sitting down and deliberately saying, "Well, we know we are not going to spend this much, but we are going to request it, anyway." I think what the agencies try to do is try to be sure that they have sufficient funds to carry out their responsibilities. I would say to you also that these figures are reviewed by your staff, too, and the CBO, as well as by OMB.

Mr. DERRICK. Mr. McIntyre, you and I come from the same part of the country. Are you going to tell me that you don't think there is any conscious overestimating, or that you can't find any?

Mr. MCINTYRE. What goes on in people's minds, Mr. Derrick, neither you nor I will ever really realize; but, again, just for somebody to sit down and deliberately try to fool OMB and fool Congress, I don't think so.

Mr. DERRICK. Are you telling me that when someone makes an overestimate to try to cover themselves, and comes to this Congress and tells us consciously that they need more money than they know that they are going to need, that that is not malice aforethought?

Mr. MCINTYRE. I am not suggesting that they know that they are not going to need that much.

Mr. DERRICK. They are either abusing their statutory power or they are incompetent, and there really isn't a whole lot of difference as far as I am concerned. I would like to see OMB get on this, because I have a strong feeling that there is a great deal of it going on based on the figures that we see.

Anyway, let's get to the next question. When we prepared the First Budget Resolution, you folks told us that we were going to have a midyear savings of about $463 million of outlays because of changes in social security and the AFDC program. We took that into consideration in the First Budget Resolution, and it was only on July 20 that you transmitted the social security proposals, and we haven't heard anything about AFDC yet. How in the world can we work with you folks if you aren't going to get legislation over here in time for us to consider it?

Mr. MCINTYRE. I assume that you are talking about the proposals to change programs and thereby save some money?

Mr. DERRICK. That is right. In the President's budget they amount to $453 million in outlays and we cut them down on our first budget to $200 million.

Mr. MCINTYRE. I share your concern about the lateness of some of the proposals getting to the Congress. When I found out that the proposals were not up here, I immediately got on the telephone with the Secretary and instructed him to get those proposals prepared and up here. I assume they are all before the Congress.

Mr. DERRICK. Let me just hit on one other brief thing here, and you have touched on it several times already.

Of course, you understand, I know that 75 to 77 percent of this budget falls into what we call uncontrollables, so when you are asking for a $5 billion cut, what you are suggesting—unless you are willing to make substantial cuts in the "uncontrollables"—you are

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really talking about cutting about $5 billion out of that remaining 23 or 24 percent.

Now I have been asking people, starting back with Secretary Simon, when he first appeared before this committee, where specifically they would make the cuts, and I have yet to get a direct answer. There is no problem to say that you are going to cut $5 billion. I mean, you might as well make it $20 or $50 billion while you are at it; but when it comes down to where to do the cutting, that is another matter. I was wondering if you might have some specific suggestions.

Mr. McINTYRE. Some of the suggestions I have are things you have heard and haven't done anything about, such as hospital cost containment. We need to move that bill.

Mr. DERRICK. You are the ones that had those votes worked out, not I. Don't start throwing that at the Budget Committee.

Mr. McINTYRE. I am speaking of the generic "you" now. We made several recommendations about savings and we need to move on those. I think they are important.

As far as coming up here and giving the Congress a list in the middle of the Appropriations Committee's deliberations, I think it would be more prudent for us to work carefully with the respective committees and try to cooperatively come up with programs that we can agree on that we can reduce. Otherwise, we divert attention from our common objective to set a total spending figure, which is the responsibility of this committee, and we begin to focus more on the differences between the administration policy and congressional policy.

I think the first step is to set the total. The second step is to work out the differences between those totals. Once we get that total, then we would propose to continue to work with the Budget Committee and the Appropriations Committees and other relevant committees, and the leadership in the Congress, to make those specific program area reductions. And one final point: I did not, in my testimony, eliminate the possibility of additional shortfalls.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Ohio is recognized.

Mr. REGULA. Thank you, Mr. Chairman.

To follow up a little bit on Mr. Derrick's questioning, you responded to a question by Mr. Fisher with words to the effect that you want to build in greater efficiency. What is your impression in your tenure as Director of OMB, is there a great deal of efficiency in the management of Government?

Mr. McINTYRE. Let me turn that around. I think there are a lot of inefficiencies in the management of Government.

Mr. REGULA. What do you propose to do about them?

Mr. McINTYRE. We have several things that we are trying to do about it. One of the recommendations is to tighten down on the Federal budget so that managers in the Government will have to become more efficient, more effective, with limited resources. Such tightening requires managers to be more efficient in carrying out their programs.

There are a number of other things that we have tried to do that may or may not be within the consideration of the Budget Committee. We are concerned about the paperwork and the amount of

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regulations that the Federal Government imposes. In our management side at OMB—and, by the way, I might add here that I think this is often overlooked, that there is a management side of OMB—and we are trying to do something about management in the Federal Government.

Mr. REGULA. May I interrupt there and ask if you have a staff person in most of the agencies who is evaluating the management techniques of those agencies?

Mr. MCINTYRE. We don't have a large enough staff to assign somebody to every agency; but in our budget hearings, one of the responsibilities of our examiners is to discuss the performance of an agency in carrying out its programs. In specific areas where we have specific studies underway to evaluate the performance of specific agencies. For example we are looking at the way that cash is managed in specific agencies in the Government. I have a very small staff on the management side, the evaluation unit, which works with the evaluation units in the various agencies, to try to evaluate how well the Federal Government is carrying out its responsibilities.

Mr. REGULA. Do you require the agency heads, in submitting their requests to you, to prioritize their submissions in terms of program development, so that you can say, "Well, in light of what we can spend without disrupting the economy this year, this has to fall away." Is there any set of priorities that you receive?

Mr. MCINTYRE. Absolutely. As part of the zero-base budget process, all agencies are required to submit their budget requests in the form of priorities.

Mr. REGULA. As part of that, do they give you an evaluation and their opinion as to how that program is working in terms of cost-effectiveness?

Mr. MCINTYRE. To the extent that there are data available, we try to get that data.

Mr. REGULA. Is that public information, so that the public and Members of Congress and, in particular, the members of this committee, could receive these evaluations made by agency heads?

Mr. MCINTYRE. We have instructed every agency head upon receiving a request from a member of this committee or of Congress, to provide such information.

Mr. REGULA. Does this include their evaluation of priorities within their own agency?

Mr. MCINTYRE. As far as their own priority submissions, yes.

Mr. REGULA. Have you had much success in implementing zero-base budgeting? I recall the last time you testified you couldn't really point to any instances in the original January budget submission as to where this had been applied.

Mr. MCINTYRE. I would differ a little bit with the last statement. We have had some success with zero-base budgeting. We put out a report back in the spring in which we did our own self-evaluation of the zero-base process. I think we were quite candid in that, more so than any Government agency is likely to be.

We admitted shortcomings; we admitted some successes. I think it will be more successful this year because this Federal Government is about the biggest business going, that I know of, and the fact that we have the program actually implemented throughout

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the Federal Government, to me, is a huge success. But, yes, there are some successes and I will be glad to send you a copy of our evaluation of that.

Mr. REGULA. I would like to have that.

[Testimony resumes on p. 248.]

[The information referred to above follows:]

[From the Office of the White House Press Secretary]

THE WHITE HOUSE.—The White House released today a detailed assessment of first-year results of zero-base budgeting (ZBB) in the Federal Government. It found that departments and agencies "got off to a good start" in putting the process to work.

President Carter commended department heads recently for instituting ZBB within the short time available to develop the fiscal year 1979 budget and said he expected the process "to aid even more in the 1980 budget cycle." ZBB provides a systematic process by which managers at various levels can analyze performance and allocate resources effectively and economically among Government programs.

James T. McIntyre, Jr., Director of the Office of Management and Budget, said his agency is revising ZBB guidelines to make the process even more useful in tightening the 1980 budget. OMB prepared the first-year assessment, which noted that: Agency budget priorities were explicitly identified and stated; agencies were better able to restrain the size of their budget requests; and Management participation in the budget process increased at all levels. As a result, agencies generally reported a better understanding of the relationship of their separate program plans and policy initiatives.

The report describes some of the savings attributable to ZBB. No single dollar figure can be pinned down to represent total ZBB economies in the 1979 budget, the report explained, since many resulted from a combination of factors. The report does cite a number of instances in which operations were discontinued or funds and personnel were shifted to achieve maximum use of the dollar.

Savings were realized when requests for more money could not be justified within the ZBB discipline. In addition, many large requests never reached OMB because agencies recognized in ranking priorities that the proposals could not be justified.

Major changes to improve the 1980 process will emphasize the development and study of minimum program levels, eliminate unnecessary paperwork, and broaden the involvement of managers.

ASSESSMENT OF THE FIRST YEAR OF ZERO-BASE BUDGETING

A. INTRODUCTION

The 1979 Budget that President Carter transmitted to the Congress in January 1978 was the first Federal budget prepared using zero-base budgeting (ZBB) principles and procedures.

B. WHAT ZBB IS

ZBB provides a single systematic process for allocating resources. There are six basic steps in the process: (1) the identification of decision units; (2) the definition of objectives; (3) the analysis of alternative methods of accomplishing objectives; (4) the analysis of different levels of peformance; (5) the preparation of decision packages; and (6) the ranking of all alternative program levels in order of priority.

A more detailed explanation of how the ZBB process works is included in section E.

C. RESULTS IN THE FIRST YEAR

Federal agencies got off to a good start in installing zero-base budgeting. It was natural that agencies would encounter problems in converting to ZBB in 1 year. The development of the procedure was marked by confusion that occurred before some agencies could complete the design of their ZBB systems and provide needed training for their personnel. Overall, however, the administration is pleased with the first-year results and anticipates an easier effort and increased benefits next year.

1. *First-year benefits.*—A number of benefits from ZBB resulted from the examination of alternative methods of accomplishing objectives. Some of the alternatives developed in the budget cycle were incorporated in the agency request, and will result in increased efficiency and effectiveness rather than direct dollar savings. Other alternatives are continuing to be examined outside the budget cycle.

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Examples of these benefits include: In the National Aeronautics and Space Administration (NASA), the decision was made to discontinue the individual testing of space shuttle engine components prior to the testing of complete systems.

In the Environmental Protection Agency (EPA), areas were identified where more reliance could be placed on State programs (e.g., certification and training for the Pesticides Program), thereby allowing Federal staff to be redirected to higher priority needs.

Within the National Transportation Safety Board, changes were made in the railroad accident investigation program to decrease the emphasis on trespasser accidents and to focus more attention on accidents with greater safety promotion potential.

Within the Interstate Commerce Commission, proposals were made to transfer staff into the field to respond better to complaints made by shippers.

Direct benefits were also derived from the examination and ranking of different levels of effort. Most agencies found that such examination was helpful in identifying potential program trade-offs.

Within the Department of Justice, recommendations were made to reprogram resources to higher priority areas, such as the Immigration and Naturalization Service and the Legal Divisions.

Within EPA, more than 8 percent of the personnel in air pollution abatement programs were recommended to be shifted to health-related activities identified in the Clean Air Act Amendments.

Also within EPA, more than 12 percent of the personnel in the pesticides programs were recommended to be shifted into such areas as enforcement and abatement and control.

Within the Department of Transportation (DOT), a complete phase-out of the Coast Guard's boating safety grant program was recommended, because it was determined—as a result of a zero-base review—that the program had achieved its objective of expanding State boating safety programs.

Also within DOT, the National Highway Traffic Safety Administration determined that funds used for Incentive Safety Grants could be used more effectively for its basic safety grant program.

Within the United States Information Agency, now being consolidated in the International Communication Agency, the process facilitated trade-offs within and between elements of the major overseas programs. In addition, more than 4 percent of the resources devoted to the headquarters media support functions were transferred to overseas programs and to the Voice of America.

Within the Department of Labor, 25 low-priority positions were eliminated from overhead areas within the Occupational Safety and Health Administration.

Also within the Department of Labor, seven positions were eliminated from the Bureau of International Labor Affairs.

For the Corps of Engineers, the quality of the budget justifications for authorized studies was improved by better identifying low-priority ongoing studies.

The ranking of priorities represented a significant improvement over the past budgetary process. In addition to providing a clear statement of priorities, it had several associated benefits:

Top agency policy officials became more heavily involved in the budget process and, consequently, made decisions based on more understanding than in previous years.

It proved to be an excellent tool for new policy officials to learn more about their agency's programs.

It resulted in better communication among top, middle, and lower levels of management.

OMB staff found the rankings beneficial in arriving at their recommendations. The ranking process stimulated trade-offs within and between programs. It often resulted in extensive reallocation of funds from lower to higher priority areas because ZBB made such potential trade-offs more visible.

One of the administration's major goals in establishing ZBB was to increase managerial involvement in the budget process. Of the 19 cabinet departments and large independent agencies, 14 reported substantially greater management involvement in the budget process than in previous years. The other five agencies, the Energy Research and Development Administration (now in the Department of Energy), Department of Justice, Department of Transportation, Civil Service Commission, and National Science Foundation, have traditionally emphasized heavy managerial involvement in their budget processes. More than 9,500 agency managers prepared approximately 25,000 internal decision packages for the fiscal year 1979 Budget, and thousands more managers reviewed and ranked these budget

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proposals. After consolidations and the elimination of lower ranked packages, the agencies submitted approximately 10,000 packages to OMB in September 1977.

Largely because of this greater managerial involvement, many of the agencies reported greater clarity of program objectives and reported greater managerial understanding of the relationship of their budget requests to program plans, including policy initiatives. This greater understanding should make the achievement of program objectives more likely. Some examples of the benefits of ZBB follow:

In the Department of State, managers at various levels were involved more intensely in the budgeting process, resulting in a keener appreciation of the allocation of resources.

In the Department of Justice, the ranking procedure caused the executive staff to address many issues that would not have been addressed under traditional budgeting approaches.

In the Department of Agriculture, the process aided decisionmaking on possible program trade-offs. Key program managers had more extensive involvement in developing and evaluating the budget request than before.

In the Department of Housing and Urban Development, there was a significant increase in the involvement of managers in the budget process, resulting in a dramatic improvement in the quality of the analysis in the budget submission.

Although it would be desirable to point to a single figure that represents the total ZBB savings, it is not possible to do so because:

Many budget decisions that resulted in savings cannot be attributed to one factor (i.e., ZBB), but generally are due to a combination of factors (for example, new agency management, changes in policy direction, and the findings of new or ongoing studies—as well as ZBB).

Dollar savings were realized when requests for added resources could not be justified within the discipline imposed by the ZBB process. Such savings are generally not identifiable because they occur at levels within the agency which cannot be isolated in the higher level agency ZBB reviews.

Program efficiencies may be due to productivity gains that may not be necessarily ZBB-related.

In some instances, the examination of minimum program and funding levels, as required by ZBB, played a part in holding down agency requests for added funding. Many large dollar requests never reached OMB because the decision package write-up and the ranking processes made it apparent to the agency that the request could not be justified. The Department of Transportation, the Department of State, and International Security Assistance noted that the ZBB process—especially ranking—enabled them to hold down their requests more than in previous years. Moreover, the ZBB ranking assured that agency requests in excess of their budget guidance amounts were displayed for the first time in priority sequence, thereby providing an explicit statement of the agency's priorities for consideration by OMB and the president in evaluating the budget request.

As the President said before taking office, the impact of zero-base budgeting in the State of Georgia was quite subtle, but nevertheless real. That has been the experience this past year in the Federal Government. ZBB helped improve budget analysis throughout the Government by making it possible for reviewers to examine budgets more systematically and with greater understanding. However, neither ZBB nor any other analytical budget process can be substituted for the political trade-offs that are, and ought to be, part of the decisionmaking process.

2. *First-year problems.*—The volume of agency budget justifications increased markedly. With the exception of NASA, all of the 19 large agencies experienced increases in paperwork over last year. Agency and OMB staff noted a significant increase in workload as a result. This occurred in spite of attempts by most agencies to guard against excessive paperwork that might tie up the review and ranking process. In almost all cases, however, the agencies were able to keep the extra paperwork to a manageable level.

In some instances, expanded managerial involvement caused agencies to prepare more paper than could be examined given the time constraints of the budget cycle. Most agencies are now focusing on adjustments needed to assure that they can fully examine all viable budget alernatives that are prepared for the 1980 budget cycle. The paperwork required to support the improved budget analyses under ZBB will be greater than before ZBB. Nevertheless, the volume of paperwork for most agencies will either stabilize or be reduced from last year's levels.

OMB staff noted some gaps in information that resulted from the transition to ZBB and from some unavoidable first-year deficiencies in the design of agency ZBB systems. Recognizing this possiblity, and anticipating requests from congressional appropriations, budget, and substantive committees, many agencies also prepared

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traditional budget justifications. With a year of experience, the information gaps should be minimal next year.

Although most agencies were satisfied with the decision unit structure, some found that their structures did not readily meet their decisionmaking needs. In some instances, the decision units covered too broad an area to permit effective review. In other instances, the decision units were developed at too low a level, resulting in too much paperwork. Modifications are being made to rectify this problem for the 1980 cycle.

A number of agencies had trouble defining program objectives, making it difficult in some cases for the agencies and for OMB to arrive at budget recommendations. There is a clear need for improvement in this area.

Most agencies experienced difficulty in the identification of minimum levels. In some agencies, the minimum levels were so close to the current level that an effective review of a possible lower program level was precluded. At times, the minimum levels focused on what would not be accomplished rather than on what could still be accomplished. In other instances, the minimum levels were arbitrarily developed below realistic levels.

In developing detailed instructions, some agencies required that the minimum levels be no more than a certain percentage (generally 75 percent to 80 percent) of the current year funding level. The percentage definition did have some advantages. It saved time for some managers. In addition, the percentage approach helped ensure that managers would at least examine the effects of a significant reduction from their current program level.

However, use of percentages had drawbacks. It often discouraged managers from doing the basic analysis of existing programs that is vital to ZBB. It may also have resulted in minimum levels that were below the level of feasibility.

Most agencies, especially the larger ones, also experienced difficulty in ranking. The major causes of problems in ranking were as follows:

For most agency officials, this was the first time they were required to provide explicit program priorities.

In the more heterogeneous departments, it was especially difficult to compare the marginal contributions of varied and diverse programs.

Many Federal programs are relatively uncontrollable in the short run due to mandatory statutory provisions. Their inclusion in the ranking appeared to some to raise conceptual inconsistencies.

Many agencies expressed concern over the relatively large amount of time and top-level effort that was required to rank large numbers of packages. Nevertheless, most agencies were satisfied that the resulting statement of priorities was valid, and most analysts found that the ranking process provided a better basis for their recommendations.

D. APPLICABILITY OF THE PROCESS

As expected, most agencies found ZBB techniques regarding program levels and ranking to be more useful for discretionary programs with measurable outputs than for relatively uncontrollable programs.

As might be expected, more changes are normally proposed for controllable programs than for those that are relatively uncontrollable. By definition, managers have some discretion to modify controllable programs and little or none to modify relatively uncontrollable programs.

However, ZBB can be beneficial for uncontrollable programs, especially when considering major program changes. The effects of legislative proposals to change uncontrollable programs can be analyzed and ranked against other desired spending programs just as readily as for relatively controllable programs.

ZBB also served to highlight the weaknesses in existing justifications for many programs. One of the strengths of ZBB is that it provides a tool with which management can study the impact of change in existing programs and funding. Programs with measurable outputs are thereby better suited to the ZBB discipline, since the relationships between the funding, activity, and output levels can be ascertained. It is therefore important to develop appropriate measures of accomplishment whenever possible.

E. HOW IT WORKS

The ZBB process, as noted earlier, involves six basic steps. Each plays a significant part in an agency's examination of what it needs to accomplish its mission, both economically and effectively.

1. *Identification of decision units.*—Decision units are the building blocks of the budget request and form the basis upon which budget requests are prepared, ana-

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lyzed, and reviewed. A decision unit is the program or organizational entity for which budgets are prepared and for which a manager makes significant decisions on the amount of spending and the scope or quality of work to be performed. It may be any distinct part of an agency, from a health funding unit to a personnel office. Since significant decisions are usually made at many levels within agencies, ZBB requires greater managerial involvement than do most other budget systems.

2. *Definition of objectives.*—The first step taken by the decision unit manager is to define the long- and short-term objectives of the unit. Objectives provide a benchmark against which the projected accomplishments of existing and proposed budget alternatives are measured.

3. *Analysis of alternative methods of accomplishing objectives.*—Subsequent to the definition of objectives, an analysis is conducted of the alternative methods that could be used to accomplish those objectives. This analysis forces a rethinking of the current way of doing business by encouraging managers to study alternative methods of operation that differ from existing practices. This analysis often requires a reexamination of the program, including the possible need to revise legislation, organizational structure, and existing managerial practices. It also requires managers to search for innovative ways to improve effectiveness or to achieve program objectives at lower costs.

4. *Analysis of different levels of performance.*—The determination of the best method to accomplish program objectives precedes the analysis of different levels of performance for the decision unit. This analysis provides management with a range of choices on program levels, so that the resulting budget request best reflects the priorities of the agency. Levels of performance are defined as follows:

(a) *Minimum level.*—The program, activity, or funding level below which it is not feasible to continue operations because no constructive contribution can be made toward fulfilling its objective.

(b) *Current level.*—The level that would be reflected in the budget if existing fiscal year activities were carried on at current service or output levels without major policy changes

(c) *Intermediate level.*—A level between the minimum and current levels.

(d) *Enhancement over the current level.*—A level of performance above the current level that promises sufficient benefits to warrant the review and approval of higher authorities.

The minimum level challenges the general assumption that current performance levels need not be questioned for purposes of budget review. As a result, the minimum level is usually the most difficult to define in terms that satisfy agency managers. However, the identification of a minimum level is fundamental to the ZBB discipline, forcing managers, if done properly, to consider the budget from zero. It provides the basis for analyzing marginal increases in performance that are reflected in the intermediate, current, and enhancement levels.

5. *Preparation of decision packages.*—Each level of performance that is developed for a decision unit is described in a decision package. This package is the action document that is used to justify each level of performance for a decision unit. The decision package includes such information as:

Activities to be carried out at the given level of performance.

A description of the funds and other resources required to perform the given level of activity.

A description of the anticipated results.

Other information that provides higher levels of management with the information needed to understand the request and to evaluate its importance in relationship to other requests (e.g., required legislation, the effects of new funding).

If the total number of decision packages within the agency is too numerous for higher level review, agencies may recast the content of the lower level packages into a smaller number of consolidated decision packages. This process allows top management to focus on broader program priorities.

6. *Ranking.*—After decision packages are developed for each unit, they are evaluated and ranked in order of importance by each higher level of management. This provides management with a method of determining the specific content of their budget request at varying agencywide funding levels. The ranking also permits management to determine which programs fall within or outside of a specific budget total. In this way, it is easier to determine the program effects of various budget totals at any review level.

Based on the final ranking, agency budget staff prepare detailed budget schedules and other information summarizing and explaining the agency's budget request. This includes special analyses that are required to convey more fully the required justifications to decisionmakers within and outside of the agency.

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F. HOW ZBB CAME TO BE USED IN THE FEDERAL BUDGET PROCESS

When Jimmy Carter was elected Governor of Georgia in 1970, one of his first jobs was to make budget recommendations for the State's programs for fiscal year 1972. The budget requests for 1972 submitted by the State agencies totaled more than 50 percent above the available resources. In addition, the agencies had not arranged their requests in any particular order of priority. He recognized that the State needed a better process to ensure that budget resources were allocated effectively among competing programs.

The Governor became convinced that ZBB would be an improvement over traditional budgeting systems, and he moved quickly to apply ZBB in the 1973 budget cycle. ZBB is now being used in more than 100 State and local governments and private organizations.

After winning the election, President Carter said major benefits for the taxpayer should result from the use of ZBB in the Federal Government. He cautioned, however:

"I don't want to mislead you and leave the impression that implementing zero-base budgeting will create instant miracles in the Federal Government. In Georgia, its impact during my incumbency was quite subtle, but nevertheless real, in making basic changes in our Government's operation. No doubt it will continue to generate improvements in the years ahead."

OMB guidelines for preparation of the 1979 budget provided a Government-wide framework for ZBB. However, because of the wide diversity in their programs, legislation, organization, and management, individual agencies were given considerable flexibility to develop procedures to meet their specific needs.

G. FUTURE IMPROVEMENTS AND CHANGES

Next year's process for the 1980 budget cycle will build on this year's experience. The President has recently sent a memorandum to the heads of all agencies asking them to ensure deeper and broader managerial involvement in ZBB than was generally possible for the 1979 Budget. Because agencies are now more experienced with ZBB, the President has also asked that duplicate (traditional and ZBB) submissions to OMB be avoided. This should minimize nonessential paperwork and improve decisionmaking in the executive branch.

In addition, modifications have been made to the OMB Government-wide guidelines and to individual agency systems to help improve the 1980 process. The major modifications follow:

Agencies will be required to place greater emphasis on the preparation and analysis of minimum levels. In those instances where a percentage of the current level is used to develop minimum levels, agencies will be urged to treat this as only a general guideline rather than as an absolute requirement to be met in every instance.

Decision packages will focus on the marginal services or benefits associated with packages above the minimum levels. This will help reduce paperwork and ease the preparation and review of the materials.

Adjustments are planned to agency decision unit structures that caused problems in the 1979 budget cycle.

Agencies will be urged to complete the linkage of existing planning and evaluation systems with the ZBB decisionmaking process.

OMB and agency representatives, in most cases, have agreed upon the major adjustments needed in agency ZBB systems. These adjustments, coupled with the experience gained in the first year, should result in a smoother process and improved results in the 1980 cycle.

Mr. REGULA. Two quick questions: As Director of OMB, what is your reaction to current Federal Reserve policies?

Mr. MCINTYRE. That is a broad question, Mr. Regula. In my prepared statement I suggested that through a tighter fiscal policy we could perhaps get a more accommodating monetary policy——

Mr. REGULA. True.

Mr. MCINTYRE [continuing]. And I think that that really is how I have to look at the policy of the Fed from my perspective as one of the chief formulators of the executive branch fiscal policy. I think that we need to look at monetary policy very carefully, particularly as we enter into this phase of the economy. I have recommended a

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tighter fiscal policy in hopes that we can get a more accommodating monetary policy as we move forward in this economy.

The CHAIRMAN. The time of the gentleman has expired. The gentleman from Illinois, Mr. Simon.

Mr. SIMON. If I may followthrough on your last response to my colleague from Ohio, suggesting through a tighter fiscal policy a more accommodating monetary policy. I had a conversation with a member of the Board of Governors of the Federal Reserve Board, in which he suggested the very real possibility or probability that if the Vanik-Pickle proposal were accepted, that the interest rates could be reduced.

What if you had a choice on taxation between what has emerged from the Ways and Means Committee and the Vanik-Pickle proposal, simply to extend 1977 taxes with no additional tax reduction. What would your choice be—faced with those two alternatives?

Mr. MCINTYRE. What was the first alternative?

Mr. SIMON. The first alternative is the tax program as it has emerged from Ways and Means, the tax cut there.

Mr. MCINTYRE. I would have to say that the administration's own tax recommendations are the ones that I support, that I think are the most important——

Mr. SIMON. I understand that.

Mr. MCINTYRE [continuing]. And my preference is for the administration's proposals, Mr. Simon.

Mr. SIMON. I undersand that, but sometimes you don't get those kinds of alternatives.

Mr. MCINTYRE. I would rather reserve judgment and try to work to perfect the administation's policy as opposed to picking something that does not represent the administration's policy at this time.

Mr. SIMON. I thank you.

One comment: Talking about productivity, the Comptroller General testified before a task force—and I sent a copy of his testimony to your office—that productivity in Government employment is something that is talked about but the followthrough has not been very effective, and his strong recommendation was that OMB is the office that really ought to have the followthrough and that there ought to be substantially more followthrough on productivity than there has been. Do you have any comments on that?

Mr. MCINTYRE. Yes, Mr. Simon. I am very concerned about the decline in productivity in the Government. I am also concerned about the decline in productivity in the private sector. As far as where I can have some effect, I do think OMB has a role to play in helping improve productivity in the Federal Government.

I have instructed my management people to give this attention as we followthrough on the civil service reform that the President has recommended, and that is now before both Houses of Congress. As we evaluate and look at budget requests we will also be giving particular attention to productivity in the various Federal agencies. I think it is an area OMB can have an impact in, and one I have a personal interest in.

Mr. Cutter would like to add something to that.

Mr. CUTTER. Congressman Simon, earlier this year, when we began to feel that the nature of the debate that occurs sporadically

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about whether the number of Federal employees is too small or too great, we felt that the data or the information on which such arguments were waged was far too general and far too anecdotal.

As a general rule, both in the administration and on the Hill, you can find very strong general views that there are too many Federal employees, and very strong and specific views that in any given program there are too few; that has just been common.

Mr. SIMON. If I may interrupt, I am not suggesting that there are too many——

Mr. CUTTER. Oh, no; I am aware of that.

Mr. SIMON. If the two of you have not read Mr. Staats' testimony, I think it would be worth your reading, because he indicates that we are paying lip service to productivity, we are not really doing much.

Mr. CUTTER. The only point I was going to make was that Mr. McIntyre asked me to set up within OMB—within the examining units, because that tends to be where the data are—a group to look at personnel requirements, so that we can make some specific recommendations to the President, both in this next budget year and over the long term. We are looking at all of the data that currently exist as to Federal Government productivity and how it differs by nature of the work force and how it differs by agency across the Government.

To really get a refined understanding of those data is an extremely difficult problem. To look at it with some vigor and not make just general points is extremely difficult.

Mr. SIMON. We are talking about long budget items. Does your office keep track of them, and are we monitoring what is happening in the off-budget area also?

Mr. MCINTYRE. Yes, we do, and we have a study underway in OMB to address this particular problem in conjunction with a review of credit policy, looking toward making some recommendations to the Congress next year.

Mr. SIMON. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from California, Mr. Leggett.

Mr. LEGGETT. Thank you, Mr. Chairman, and welcome to the committee again, Mr. Director.

I think that we appear to be generally targeting in the same direction. I don't know that that is too dramatic, but we do.

You point up that we have more inflation than we thought we were going to get, and less growth than we thought we were going to get, but more employment than we thought we were going to get; and I presume that your forecasts are very much in line with the experts on this committee, and all of our econometric model studies and things like that just don't seem to be able to give us the right information. How do you account for this? Have you made any critique of it?

Mr. MCINTYRE. My staff of economists have been working very closely with the Council of Economic Advisers, particularly with Chairman Schultze, to try to identify some of the reasons for the dramatic drops in unemployment and what has happened to us on inflation.

I would say that while productivity does play a role in the large number of new jobs I am not personally certain that that is the

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only reason we have seen this dramatic increase in the number of new jobs and the tremendous drop in unemployment; but it is certainly a factor.

Mr. LEGGETT. I get the idea that when we get into the business of fine tuning, many times we are dealing with things that are almost beside the point, and all we are really capable of doing is dealing in gross concepts, and that seems to be about as good as we can do.

I know your estimate of receipts for the economy was very consistent. Your January, March, and your current projections were exactly on target, in spite of inflation and in spite of more people going to work; so I suspect that you probably are on target, but for maybe reasons that you didn't anticipate. Anyway, the numbers came out, very coincidentally, the same.

As far as the projection for 1979, as I see it, you are indicating that we ought to cut something like $5 billion to get down into the low 490's as far as our spending program goes, and as I understand it, that is the chairman's mark, to get down into that area; and I guess we have pretty well done that to date by existing cuts in appropriation bills, whether it be by policy change or by percentage cuts or whatever, and therefore the $5 billion that you suggest cutting to get down to $491 and $492 billion—let me ask you—would that be the same $5 billion cut that has already taken place to get down to the chairman's $490 billion mark?

Mr. MCINTYRE. I haven't seen the details of the chairman's $490 billion mark, but, as I said earlier, I doubt very seriously they would be the same. There are at least two areas that I am concerned about: One, of course, is the way the budget resolution handles the President's energy program. We would count another $1.4 billion in our budget authority and outlay figures. In fact, we do include $1.4 billion in our figures for the President's energy program. This is not included in the chairman's recommendation. As I pointed out in my testimony, this simply illustrates the fact that certainly there are going to be some areas of policy difference.

The CHAIRMAN. Will the gentleman yield?

Mr. LEGGETT. Surely.

The CHAIRMAN. Your outlay figures do not include a cut of approximately $3 billion out by the House Appropriations Committee, do they?

Mr. MCINTYRE. No, but these are cuts from the First Resolution, which was above the President's budget in some cases.

The CHAIRMAN. We do in our mark, so that would account for some of the difference. I think our estimate of outlays under the urban package, although not high the first year, are probably a little different from yours.

Mr. MCINTYRE. That is correct.

The CHAIRMAN. That wouldn't account for all of it.

I think we have some later reestimates that you did not take into account——

Mr. MCINTYRE. I think that is true.

The CHAIRMAN [continuing]. Which probably account for the bulk of the remainder. Thank you.

Mr. LEGGETT. The question comes up, how do we effect cuts in fiscal year 1979 this late in the program in developing the 1979 budget? We have finished in the House about 10 of the appropri-

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ation bills. We have our target resolution, Apparently the infrastructure of your numbers is not like the infrastructure of our numbers, getting down to the $491 billion. How do we get the extra money, either in or out of the program, at this point, considering the fact that we are almost done with the appropriation process?

Mr. McIntyre. We are a long way along in the appropriation process, but I am sure that we are not that close to being through with it. There is still consideration, as you pointed out, of a couple of bills in the House, and there are a number of bills in the Senate.

The Second Resolution has to be adopted, so we still have a way to go yet, although we are far along in the appropriation process. That is why I have recommended that we work together, rather than coming up here and giving you a list. I know that there are going to be policy differences between the Executive and the Congress. Let's see if we can't work these things out reasonably. If we can't then only as a last resort, I would recommend the across-the-board cuts that Mr. Mitchell raised some questions about. I think this is the most reasonable approach to dealing with this very complex issue.

Mr. Leggett. Let me ask you just one more question here. I notice in your reestimates, practically all of your reestimates that you have here for fiscal year 1979, policy changes, obviously, of policy changes you are going to have some new numbers. If you don't pass an energy bill, you get some new numbers. If you have more people at work, you get new numbers. If you don't pass the coastal zone bill, the offshore oil doesn't come in, and you estimate the interest would be going down the first part of the year, and the latter part of the year we estimate it is going up—so, it kind of balances out.

The same thing for international programs—that kind of balances out, but the item that seems to stick out, really, as has been pointed out by Mr. Mitchell, is the defense item, and where we are down in the January estimate $1.5 billion, and we are down now in the current estimate by another $1.8 billion, that gives us a $3.3 billion reduction in outlays, and as you recall, last year, in fact, $1.5 billion lapsed in June, and we estimate that $1.6 billion will lapse come the end of September.

So the question is, Why are defense items seemingly so critical? We seem to scrap—with or without OMB approval—so many items on the floor, over whether or not we are going to have $1 billion or not in the defense accounts, and again it is the roughest estimate that we have in the total program, but we fight hardest on that one item to get every last, seemingly, nickel and dime in the defense budget.

Mr. McIntyre. I would make two points in answer to your question: First of all, we give very high priority to the defense and national security of our country.

Mr. Leggett. I am well aware of that.

Mr. McIntyre. I think that one way you measure that commitment is through the budget and the financing of programs for national security and the defense of our Nation.

Mr. Leggett. Is this part of the general syndrome then of erring on the high side consistently?

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The CHAIRMAN. I am going to have to call time on the gentleman. The gentleman has gone well over his time. I am perfectly willing to let the witness complete an answer, but not to continue a discussion.

Mr. MCINTYRE. Mr. Chairman, I would be glad to complete it in writing, if you so desire, or I would just make a second point.

The CHAIRMAN. You can respond to the gentleman's question, but we can't have a running discourse.

Mr. MCINTYRE. My second point is that it is true that the defense outlays have constituted a substantial portion of the shortfall. I might mention that most of the shortfall has occurred in the construction and procurement programs. There are a number of reasons for this. The changes in spending patterns and rates over the years have affected our ability to spend the appropriations for defense. Bad weather early this winter held up some of the construction programs. There are a number of factors. Not all of it can be explained, but some of it can.

What we have attempted to do, as I pointed out, is to try to get as good a handle on this problem as we possibly can in OMB and to make sure that the appropriations are reasonable and the outlay estimates are also reasonable.

The CHAIRMAN. The gentleman from California, Mr. Rousselot, is recognized for 5 minutes.

Mr. ROUSSELOT. Thank you, Mr. Chairman. Mr. McIntyre, we appreciate your reanalysis of the budget for the Second Concurrent Resolution.

On two occasions, once before this committee and once before Banking, Finance and Urban Affairs, when we were discussing with Chairman Miller, who obviously is heavily involved in the economy in many ways, especially trying to help when necessary to pick up on the deficit problem when that exists, when you can't sell it in the marketplace. His statement was that he felt that we could with some effort trim expenditures for 1979 by about $10 billion. He said that was his judgment. He didn't expect it to be a perfect judgment. Would you comment on that?

You had admitted that we could, obviously, in your current public statements, probably trim from our original budget resolution, and, really, we are just putting a restraint on increases, we are not really cutting our present levels of expenditure; we are just accommodating more modest increases. Would you comment on that statement?

The CHAIRMAN. Would the gentleman yield?

Mr. ROUSSELOT. Of course.

The CHAIRMAN. I am interested in the response to this question, but did you indicate what amount is being cut by $10 billion?

Mr. ROUSSELOT. Yes; $498 billion.

The CHAIRMAN. The $498 billion which was in the First Budget Resolution?

Mr. ROUSSELOT. Yes. I am sure he understands that.

The CHAIRMAN. I wanted to be sure I understood.

Mr. ROUSSELOT. I just thought Chairman Miller was a man of reason, and I just wondered if there had been any coordination.

Mr. MCINTYRE. Mr. Rousselot, I meet with Chairman Miller periodically to discuss some areas of mutual interest and, needless to

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say, the deficit is an area of mutual interest. We have talked about ways of dealing with the Federal budget and so I think I am fairly familiar with some of the chairman's concerns. I must say that I share his concern about the deficit and what it means in fiscal policy and what it means in the private sector in terms of inflation, crowding out, and so forth.

I think that we have taken steps to recognize that the economy is different today than it was in January when we sent this budget to you. In fact, our own recommendations would get the deficit down to about $43 billion.

Mr. ROUSSELOT. You are sharing the thought that deficit financing does affect the private sector in its ability to produce jobs is appreciated.

Mr. MCINTYRE. First of all, I would submit to you that the administration has taken substantial steps to try to get the deficit down. We have reduced the tax cut by $5 billion annually and recommended a deferment of the effective date, which increases 1979 receipts by almost $11 billion.

We have recommended through reestimates a $496.6 billion outlay figure and suggested that an additional $5 billion of reduction be made in outlays in 1979. I think we are well on the way toward trying to get this deficit down.

Mr. ROUSSELOT. I am asking, do you think it is possible to get $488 billion as an expenditure level if we really work at it here?

The CHAIRMAN. Will the gentleman yield?

Mr. ROUSSELOT. Let me have him answer the question and then I would be glad to have you join in.

Mr. MCINTYRE. I have said that I think from a fiscal policy point of view something in the neighborhood of $491 to $492 billion is desirable.

Mr. ROUSSELOT. Do you think we could possibly get it down to Chairman Miller's goal—he said it was a goal—to $488 billion, the expenditure level?

Mr. MCINTYRE. If you could do it, fine. I think it would be extraordinarily difficult to do so. I would also say that there does come a point at which we would have some real concerns about the effect that a significantly lower figure than what we have recommended could have upon our overall economic well-being.

Mr. ROUSSELOT. I appreciate that.

Mr. MCINTYRE. We feel that the point of around $490 billion is a good place to be tight.

Mr. ROUSSELOT. Thank you. Now I yield to my chairman.

The CHAIRMAN. I just want to indicate, as you well know, that while the first budget resolution had outlays of $498.8 billion, the one I am recommending to you has only $490.3 billion.

Mr. ROUSSELOT. I appreciate your frugality.

The CHAIRMAN. Well, that is $8.5 billion toward the $10 billion you are talking about. If we could get a few additional reforms implemented we might even be able to pick up the other $1.5 billion more.

Mr. ROUSSELOT. We may get some more cuts in appropriations.

The CHAIRMAN. Fine. We may get some in appropriations. We may get some in some other programs. It depends on where you want to make the cuts, however.

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Anyway, the gentleman's time long has expired.

Mr. ROUSSELOT. Not really. You took time out for the tape.

The CHAIRMAN. Even with that, the sands have run out.

Mr. ROUSSELOT. I yield to my chairman.

The CHAIRMAN. I now recognize the gentleman from California, Mr. Mineta.

Mr. MINETA. Thank you very much, Mr. Chairman. Mr. Director, I apologize for being late. I was testifying before the Rules Committee on a piece of legislation which, I think, is important toward trying to get a handle on this budget, and that is with reference to sunset legislation.

I would like to start, however, with the conclusion that you come to, and in that connection you talk about the Federal Government's seriousness about its anti-inflationary program and the need to restrain spending. You suggest a $5 billion cut may be an appropriate objective in that regard. Quite frankly, I am disturbed not so much as it is a $5 billion cut but most economists, including administration economists, tell us we are not in a demand-pull kind of inflation but rather a momentum kind of inflation, and that in their opinion a $5 billion reduction amounts to a very small fiscal policy action that would have no impact on inflation. While a $5 billion cut might be a desirable goal, why do you think it is an important element in the fight against inflation?

Mr. MCINTYRE. Mr. Mineta, I think that perhaps the statement that you made might have been true up to a point of about 6 percent. But once I think we broke the 6-percent barrier, then it became a different issue with us. I would also make this point, that we are talking about a budget for fiscal year 1979. All of our economists—I am not certain who you have been talking with—are very concerned about the pressures of increased inflation and feel that it is time to do something now.

We cannot afford to wait 3 or 4 or 5 months or until next January to grapple with this problem.

Mr. MINETA. There is no question there is a great deal of concern about inflation. That is primary, and I think the attention has to be focused there. It seems to me that the thing that concerns me is that that kind of statement seems to perpetuate the notion that Government spending alone is the sole cause of inflation. I just think that does a disservice in terms of perpetuating a myth.

Mr. MCINTYRE. Let me state that I have never said Government spending is the sole source of inflation. I think it certainly has a significant effect in an economy such as we find ourselves right now, particularly as we get closer to full potential in the economy. I believe Chairman Schultz' figures indicate we are at about 84 percent.

I think there are other pressures that have an impact on inflation, and we have tried to tackle those. I think we must deal with the ever-increasing effects of increased wages and prices. We have tried to deal with that through a voluntary program, and I think that is the proper way to pursue this effort.

We also, I think, have to show that we in the Federal Government are serious about inflation. There are too many people around this country and in this Government who have long held the view there was only one inflation fighter in town, and that was

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the fare, and I am here to tell you there is another one, that is, Jimmy Carter. He has put forth a comprehensive program. It is our opinion that the Federal deficit and getting a handle on tight fiscal policy is important in this effort to battle inflation, but I do not think we have said that the deficit is the sole source or the principal cause of inflation.

Mr. MINETA. Your comment about the management side of OMB and the budget side having to get together is something that is important. I know I had a brief conversation with Mr. Carter about this, a 109 circular, and applying it against the public to the General Services Administration. I think it has in effect a more closely felt impact on Federal procurement practices, and I would hope OMB would have a chance to take a look at that.

In your statement you also have in here there is an increase due to the increase in budget authority for the urban initiatives. What is included in there, and how much of an increase in budget outlay is there? Have you included accelerated public works?

Mr. MCINTYRE. Total budget authority in 1979 for the urban initiative is $5.9 billion. The 1979 outlays figure is much smaller, about $1 billion.

There is money recommended for the so-called soft public works program.

Mr. MINETA. That is the intensified public works?

Mr. MCINTYRE. Yes.

Mr. MINETA. What about the local public works?

Mr. MCINTYRE. No.

Mr. MINETA. What about countercyclical?

Mr. MCINTYRE. Countercyclical revenue sharing?

Mr. MINETA. Supplementary fiscal assistance.

Mr. MCINTYRE. Yes, and we feel strongly about that program. There is also a countercyclical jobs recommendation for CETA.

The CHAIRMAN. The time of the gentleman has expired. The gentlewoman from Maryland is recognized.

Mrs. HOLT. Thank you, Mr. Chairman. I will be brief. I want to ask one quick question.

Mr. McIntyre, it seems to me that we are talking about inflation and deficit spending being the critical thing that we are really trying to get a handle on. Yet I get the feeling we are just playing games with it, that we really are not making any efforts at all. If we talk about the $5 billion cut, our amendment that we offered to the first concurrent budget resolution was 488, now we can drop that down. I believe we could go to 480 and simply slow the rate of growth.

If you look back, if you go from 1977 to 1979 and look at some of the growth rate in some of these functions—international affairs, 47.9—your estimate would be 54; energy, 147; housing credit, 299.

Those are tremendous increases. Why couldn't we just slow the rate of growth a little bit at this time in our economic recovery?

Then, on the other hand, we are talking about something like $23 billion increase in taxes with a tax cut of $15 billion which is still going to leave an $8 billion tax increase. I cannot see where we are really talking about any tax cuts at all.

It just seems to me we could go much further than this. I would like to hear your comments on that.

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Mr. McINTYRE. Mrs. Holt, that is a very broad area to address. First of all, as I said in answer to Mr. Rousselot's question, I think there is a point at which fiscal policy demands that we have a certain budget level.

Mrs. HOLT. Of increased spending?

Mr. McINTYRE. A total budget level of total expenditures by the Federal Government. We specifically recommended $491 to $492 billion in outlays as the appropriate level for the Federal budget.

Mrs. HOLT. But we are increasing new initiatives, we are getting ourselves into more and more trouble. We hear over here constantly that part of our budget is uncontrollable, we cannot do anything about it, and we are just creating more of that if we go into new initiatives at this point. I think everybody is recognizing that reduction of the deficit, reduction of spending is the way we should be going today. I have not heard anybody deny that, and yet we are just paying lip service to it.

Mr. McINTYRE. I think that we would all agree there are certain national priorities that we need to address. We have tried to do that in the energy area. That is one reason there has been a significant increase in the Department of Energy budget.

Mrs. HOLT. But we have not done anything. We are just increasing their budget.

Mr. McINTYRE. We have created a department, we have given it a mission, and they are in the process of carrying out some of the responsibilities that this Congress gave them in the statute that created the new agency and established its overall missions. I think they are doing some things. They may not be doing everything as well as we would like, but we are making some progress in dealing with a very serious national priority.

One of the increases in the Federal budget is an increase in the defense budget. Again I would submit to you there are very sound policy reasons for recommending those increases.

Some of our differences have been over the priorities of those increases, not so much over whether or not a given total was desirable, but how it should be spent.

We had to fund the farm legislation that Congress passed last year so that caused a substantial increase in the Agriculture Department's budget. I could go on and explain every one of those increases.

Mrs. HOLT. I am just saying we should not restrain the rate of growth——

Mr. McINTYRE. No. I specifically called for a growth pause in the 1980 budget.

Mrs. HOLT. How about 1979?

Mr. McINTYRE. We have recommended a further reduction in the 1979 budget of some $5 billion below the midsession estimates.

Mrs. HOLT. But that is just the point I am making. Mr. Mineta said he didn't think that was really slowing the rate of growth. I think it is minimal. It is not going to have the effect that we want it to have.

Mr. McINTYRE. This represents a $17 billion decrease in the deficit from the January proposals.

Mrs. HOLT. Thank you, Mr. Chairman.

The CHAIRMAN. The gentleman from Ohio.

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Mr. LATTA. One quick question, Mr. McIntyre. A year or so ago we heard a lot about zero-base budget. What has happened to that concept?

Mr. MCINTYRE. It is still around, it is still kicking. We are going to use it again this year. I have a report in which we did about as fair and frank an evaluation as any governmental agency would do about its own initiatives. I would be glad to see that you get a copy of it. It points out that there were shortcomings last year, and we are moving to overcome those shortcomings and I think the report on this year's performance will be a much improved report with many more suggestions.

Mr. LATTA. I would like to have a copy of it.

[The report referred to may be found on p. 243.]

Mr. LATTA. Thank you.

The CHAIRMAN. Mr. Director, I want to thank you very much for your testimony and for your responses to the questions from the members of the committee. We thank you again for your cooperation.

Mr. MCINTYRE. Thank you, Mr. Chairman.

The CHAIRMAN. Our final witnesses this afternoon are Shearon Harris, chairman; Richard Lesher, president; and Jack Carlson, vice president and chief economist of the Chamber of Commerce of the United States.

As you know, the committee will begin marking up the Second Concurrent Resolution on the budget this Wednesday. My recommendations to the committee would result in a deficit of $43.6 billion—a $17 billion reduction from the $60.6 billion deficit proposed last January by the President.

Gentlemen, we are interested in whether you think expenditures should be further reduced and whether the percentage cut across-the-board method of achieving reductions is an efficient way to do it.

The Ways and Means Committee, as you also know, completed action on a tax bill last Thursday. Under the rules that are likely to be adopted for the tax bill, several substitutes will be in order. We would like to have your opinions of the Kemp-Roth and Fisher proposals, as well as the bill as reported. You may proceed as you wish.

One point I would like to make. We tried very hard to obtain copies of your testimony in advance of your appearance because it is always more helpful to us and the staff when we get testimony in advance. It would help in future hearings if we could have the statements in advance. That way we can review it and ask more intelligent questions. You may proceed.

STATEMENT OF SHEARON HARRIS, CHAIRMAN; RICHARD LESHER, PRESIDENT; AND JACK CARLSON, VICE PRESIDENT AND CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. HARRIS. Thank you, Mr. Chairman, members of the committee. I am Shearon Harris, chairman of the Chamber of Commerce of the United States. That is a part-time position. My full-time occupation is chairman of the board and chief executive officer of Carolina Power and Light Co.

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I first would like to apologize for any problems we created in not being able to provide our testimony. The final copy was placed in my hand as I left the office to come to this hearing. We have not had it ourselves, and we would have provided it had we been able to provide it earlier, and in the future I hope we will not cause you any such inconvenience.

I would like for the testimony to appear in the record of this hearing on the Second Concurrent Resolution as if I had read it all.

The CHAIRMAN. Without objection, we will include your statement in the record.

Mr. HARRIS. I would like to concisely make the points that we think are most salient in this rather carefully thought out document. The care in thinking it out is the problem in not getting it here earlier. You have spent a great deal of time in this hearing on the Second Concurrent Budget Resolution. I regret I have not been here so I could say I agree with this and disagree with that and focus on what has already been put before you and to some extent by necessity it may be a little redundant to make some of our points.

Let me say that the national chamber attempting to act for its business community constituency is deeply concerned about inflation. We have resolved to attempt to lead a business community action program to reduce inflation, to create, if we can, a political climate in which every elected public official would find it popular and patriotic to go to the roots of the causes of inflation.

Double digit inflation, 10.4 percent. The CPI rate for the year 1978 so far produces the equivalent of an annual loss of $3,000 per average family. The 7.4-percent rate for the 12 months just ended is unacceptable, but the administration forecasts that we should expect a 7-percent rate for the foreseeable future. This undermines all savings, all pensions. For example, $100, as you are familiar with the arithmetic, put in a retirement program and held in it for 20 years loses in its buying power down to about $28. As we continue what I regard as irresponsible fiscal and monetary administration, we stand on the brink of a corrective recession unless through an orderly process in our society we can wind down over a period maybe as long as we have taken to wind up to this level.

Our National Chamber survey conducted for us by the Gallup organization says that this aura of fear of inflation is reducing the willingness to make investment. The University of Michigan and the Gallup surveys have indicated that consumers are really fearful in the marketplace even though as of today they seem to be buying fairly strongly.

We think it is rather universally agreed, Mr. Chairman, that President Carter has correctly identified inflation as the Nation's No. 1 problem. We think also related to inflation as the No. 1 problem, the counterproductivity of our national tax policy probably should be considered as part of the No. 1 problem. Every 1-percent increase in prices unintentionally increases the level of tax as was fixed by the Congress, resulting in a 1¼-percent increase in Federal taxes. We have seen 12-percent growth in taxation in 1978, and the administration's pending proposal before you represents another 12-percent increase in taxation for 1979.

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Federal taxes now stand at the equivalent of $6,700 per family, with the pending proposals before the Congress to increase it by $800 per family for fiscal year 1979. Twenty-four percent of personal income before taxes is what the Federal establishment is now taking, and it is the highest tax rate in 30 years and it endangers the very basic freedoms upon which this democracy has been founded. It discourages investment, it limits productive capacity, it creates bottlenecks. It slows down productivity and our productive capacity is not keeping up with the huge increase in employment.

So I would say that unintentionally the situation in which we exist today represents inflation as the cruelest tax of all, and unfortunately it hits those the hardest who are the least able to bear it.

You have had some discussion about whether deficit spending is the cause of inflation or whether it is one of the principal causes of inflation. Mr. Chairman and members of the committee, the National Chamber would submit to you that it is one of the principal causes, and it is also coupled with other Government policy such as increases in minimum wage, social security taxes, farm price supports, compliance with the myriad regulations, with property taxes, all of which are driving inflation.

There is discussion in recent times about what is the real significance of Proposition 13 in California. On a Chamber mission I spent the last few days of May and the first few days the week before the June 6 primary in California visiting in southern California. I would not have believed what I observed had I not been there to see it. I do not think that Mr. Jarvis and Mr. Gann created a tax revolution in California. I think the vote on June 6 was the culmination of the real sentiment of hundreds of thousands of voters that we have too much government and it is costing us too much to have it. There are now 30 States that are also considering some form of spending and taxing limitations.

So we submit that a responsible leadership in the Federal Government today should provide a more orderly way of reordering the Federal budget. I want to associate myself with your remarks, Mr. Chairman, and commend you for the leadership that I consider you are providing, and particularly, I should like to adopt, as if I had said it myself—and I wish that I had—your language in saying that "restrained spending will signal to the Nation that the Congress is dead serious about fighting inflation."

I would agree with you that is the key issue involved in the deliberations over the Second Concurrent Resolution.

I think this committee has a magnificent opportunity to render great leadership in the manner in which you deal with this Second Concurrent Resolution.

The Chamber, in its prepared testimony, has put before you suggested solutions that involve slowing down Government spending, taxing and the growth in the deficit and eventually over time to bring the budget into balance. We strongly recommend that in the Second Concurrent Resolution you provide or contemplate both sizable tax relief and spending limitations for fiscal year 1979. We recommend $25 to $30 billion of tax relief on an annual basis, which is about twice as much as the Ways and Means Committee today recommends. We recommend targeting one-third of that tax

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relief to encourage job-creating, capacity-expaning, and inflation-dampening investment.

We recommend $32 billion or a 7 percent limit to the growth in budget outlays.

Let me come back to your remarks, Mr. Chairman, with respect to restrained spending "signaling to the Nation that the Congress is dead serious about fighting inflation." Given a 7-percent inflation rate, can the Congress be dead serious if it recommends a growth in spending greater than the inflation rate of about 7 percent? We believe that such a limit, coupled with an appropriate degree of tax relief, which would limit the deficit spending to something around $40 billion, a little under your $43.6 billion, would be a really dead serious indication.

Mr. Chairman, on pages 10 and 12 of the prepared testimony we submit to you suggestions about 5-year planning, which we also submit is in accordance with the requirement of the law. I shall not deal further with that except that obviously if we are going to deal with inflation we must create an understanding in the public throughout the whole economy that we are on a sustained program over a period of time. We cannot take a little dip this year and expect it to do the job forever.

So we must signal a sustained commitment to continuing to cut the deficit and to let the private sector of the economy operate with greater freedom and therefore with greater success and with greater contribution to the good of the country.

With that, my associates and I would be happy to try to entertain your questions. If you get too technical with numbers, I am going to rely upon my associates to assist me.

[Testimony resumes on p. 285.]

[The prepared statement of Mr. Harris follows:]

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STATEMENT
on
SECOND CONCURRENT BUDGET RESOLUTION
before the
HOUSE COMMITTEE ON THE BUDGET
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
Chairman Shearon Harris, President Richard Lesher
Vice President Jack Carlson
July 31, 1978

I am Shearon Harris, Chairman of the Board of the Chamber of Commerce of the United States. I am accompanied by Richard Lesher, President and Jack Carlson, Vice President and Chief Economist of the National Chamber. On behalf of the National Chamber's 75,000 members, we greatly appreciate the opportunity to present our views on the Second Concurrent Budget Resolution.

RECOMMENDATIONS

The National Chamber strongly recommends that the Second Concurrent Budget Resolution provide both sizeable tax relief and spending limitations during fiscal year 1979. We recommend:

- $25 to $30 billion of tax relief on an annual basis, about twice as much as proposed by the Ways and Means Committee;
- targeting one-third of the tax relief to encourage job-creating capacity-expanding, and inflation-dampening investment;
- $32 billion or 7% limit to the growth of Budget Outlays, enough to provide for current services and prior commitments;
- limit the growth of Budget Authority which is excessively building up spending for fiscal years 1980 and 1981;
- limit the federal deficit to $35 to $40 billion, required to help bring down inflation and allow interest rates to subside.

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- limit growth of the federal debt to $40 billion, so as to reduce the mortgage on the lives of all Americans.

In regard to the specific components of the Budget Resolution, the National Chamber recommends fiscal year 1979 limits as follows:

- Federal Receipts of $441 billion
- Budget Outlays of $480 billion
- Federal Deficit of $39 billion
- Budget Authority of $550 billion or less
- Federal Debt Limit of $830 billion (see Table 1).

The Chamber's recommendations contrast with the First Concurrent Resolution targets, the Chairman's Recommendations for the Second Resolution and the Administration's latest estimates (see Table 1).

TABLE 1

CHAMBER'S RECOMMENDATIONS, CONGRESS' FIRST RESOLUTION, AND HOUSE BUDGET COMMITTEE CHAIRMAN'S RECOMMENDATIONS FOR SECOND CONCURRENT BUDGET RESOLUTION
(Billions of Dollars)

	FY 1978	Chamber FY 1979	Congress' First Resolution FY 1979 a/	Chairman's Recommendations Second Resolution FY 1979 a/	Administration's Mid-Year Review FY 1979 b/
Federal Receipts	$401	$441	$448	$447	$448
Federal Outlays	448 c/	480	499	490	497
Federal Deficit	-47	-39	-51	-44	-49
Federal Budget Authority	507	550	569	561	571
Debt Outstanding (end of year)	768	834	849	841 d/	848

a/ "Chairman's Recommendations for the Second Concurrent Budget Resolution on the Fiscal Year 1979 Budget," Committee on the Budget, U.S. House of Representatives, July 28, 1978.
b/ "Mid-Session Review of the 1979 Fiscal Budget," Office of Management and Budget, July 6, 1978.
c/ Chamber estimate of additional shortfall in FY1978 spending. The OMB estimates $452 and the CBO estimates $451, but both these sources have over-estimated outlays and underestimated the shortfalls during both 1977 and 1978.
d/ Estimated from other fiscal data.

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In comparison with the Congress' First Concurrent Budget Resolution, the Chamber's recommendations would:

- reduce federal taxes by an additional $7 billion, which means about $117 more in tax relief for the average American family;
- trim $19 billion of federal outlays from an 11% to 7% growth, and at least that amount of Budget Authority;
- lower the federal deficit by $12 billion;
- trim $19 billion of Federal Debt Outstanding, equivalent to $317 lower mortgage on each family (see Table 2).

TABLE 2

COMPARISON OF CHAMBER'S RECOMMENDATIONS
AND THE CONGRESSIONAL FIRST CONCURRENT BUDGET RESOLUTION
FOR THE FISCAL YEAR 1979 BUDGET
(Billions of Dollars)

	Increase in Billions of Dollars			Percent Growth			Increase Per Family		
	Chamber	Congress First Resolution a/	Chamber Improvement	Chamber	Congress First Resolution	Chamber Improvement	Chamber	Congress First Resolution	Chamber Improvement
Receipts	$40	$47	$7	10%	12%	2%	$667	$784	$117
Outlays	$32	$51	$19	7%	11%	4%	$533	$850	$317
Deficit	$39	$51	$12	-17%	9%	-26%	$650	$850	$200
Authority	$43	$62	$19	8%	12%	4%	$716	$1033	$317
Debt Outstanding	$62	$81	$19	8%	11%	3%	$1033	$1350	$317

a/ "Chairman's Recommendations for the Second Concurrent Resolution on the Fiscal Year 1979 Budget," Committee on the Budget, U.S. House of Representatives, July 28, 1978.

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However, the Budget Committee Chairman's Recommendations provide for some improvement. Nonetheless, in comparison with the Chairman's proposal, the Chamber's recommendations would:

- reduce federal taxes by an additional $7 billion, which means about $116 more in tax relief for the average American family;
- trim additional $10 billion of federal outlays, from a 9% to 7% growth, and at least that amount of Budget Authority;
- lower the federal deficit by $5 billion;
- trim $11 billion of Federal Debt Outstanding, equivalent to $184 lower mortgage on each family (see Table 3).

TABLE 3

COMPARISON OF CHAMBER'S RECOMMENDATIONS
AND THE HOUSE BUDGET COMMITTEE CHAIRMAN'S RECOMMENDATIONS FOR THE
SECOND CONCURRENT RESOLUTION FOR THE FISCAL YEAR 1979 BUDGET

	Increase in Billions of Dollars			Percent Growth			Increase per Family		
	Chamber	Budget Chairman-Second Resolution a/	Chamber Improvement	Chamber	Budget Chairman Second Resolution	Chamber Improvement	Chamber	Budget Chairman Second Resolution	Chamber Improvement
Receipts	$40	$47	$7	10%	12%	2%	$667	$783	$116
Outlays	$32	$42	$10	7%	9%	2%	$533	$700	$167
Deficit	$39	$44	$5	-17%	-6%	-11%	$650	$733	$83
Budget Authority	$43	$54	$11	8%	11%	3%	$716	$900	$184
Debt Outstanding	$62	$73	$11	8%	10%	2%	$1033	$1216	$184

a/ "Chairman's Recommendations for the Second Concurrent Resolution on the Fiscal Year 1979 Budget," Committee on the Budget, U.S. House of Representatives, July 28, 1978.

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Unfortunately, the Administration's current estimates are less attractive, as updated in the Mid-Year Review in July. In comparison with the Administration's estimates, the Chamber's recommendations would:

- reduce federal taxes by an additional $8 billion, or by 2%, which means about $133 more tax relief for the average American family;
- trim federal spending by $17 billion, from 10% to 7% growth, and at least that amount of Budget Authority;
- lower the federal deficit by $10 billion;
- trim $18 billion of Federal Debt Outstanding, equivalent to $300 lower mortgage on each family (see Table 4).

TABLE 4

COMPARISON OF CHAMBER'S RECOMMENDATIONS
AND THE ADMINISTRATION'S MID-YEAR REVIEW
OF THE FISCAL YEAR 1979 BUDGET

	Increase in Billions of Dollars			Percent			Increase per Family		
	Chamber	Administration a/	Chamber Improvement	Chamber	Administration	Chamber Improvement	Chamber	Administration	Chamber Improvement
Receipts	$40	$48	$8	10%	12%	2%	$667	$800	$133
Outlays	$32	$49	$17	7%	10%	4%	$533	$816	$283
Deficit	$39	$49	$10	-17%	4%	21%	$650	$816	$166
Budget Authority	$43	$64	$21	8%	13%	5%	$716	$1067	$351
Debt Outstanding	$62	$80	$18	6%	10%	2%	$1033	$1333	$300

a/ "Mid-Session Review of the 1979 Fiscal Year Budget," Office of Management and Budget, July 6, 1978; and OMB Director's House Budget Committee Testimony, July 26, 1978.

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JUSTIFICATION

After receiving the President's proposed fiscal year 1979 budget and observing the behavior of the Congress, George G. Mahon, Chairman of the House Appropriations Committee testified (February 1, 1978) that the President's budget policies

> "...are not without risks. The biggest risk, in my judgment, is inflation.
>
> For years now the Federal Government has been generating large budget deficits and increases in the national debt. During the severe recession of 1974-75, there was probably some justification for this but that recession is clearly behind us.
>
> The same economic philosophy that calls for government spending stimulus in economically depressed times calls for surpluses or at least less deficit spending in improved times. But instead of following this philosophy, the President and the Congress are applying only the spending side of the philosophy, not the restraint side.
>
> It seems to me there are inflationary pressures here along with increased interest rates and a tightening of funds for private borrowers as the economy continues to improve and the idle productive capacity of our economy begins to be utilized." (Underlining provided.)

In the same Hearing he added:

> "I also applaud the concept of promoting economic growth by means of proposed tax legislation, not stimulus through massive new shotgun spending programs. I have not been impressed with the results of hastily conceived spending programs as a cure for the Nation's economic woes."

He supported placing "...principal reliance for economic growth on the private sector."

The National Chamber agrees with Chairman Mahon's observation and laments the fact that neither the Administration nor the Congress followed his advice. Since February when Chairman Mahon issued these words, both the President and the Congress have proposed higher spending, less tax relief and thus higher taxes, and therefore less reliance on the private sector (see Chart 1).

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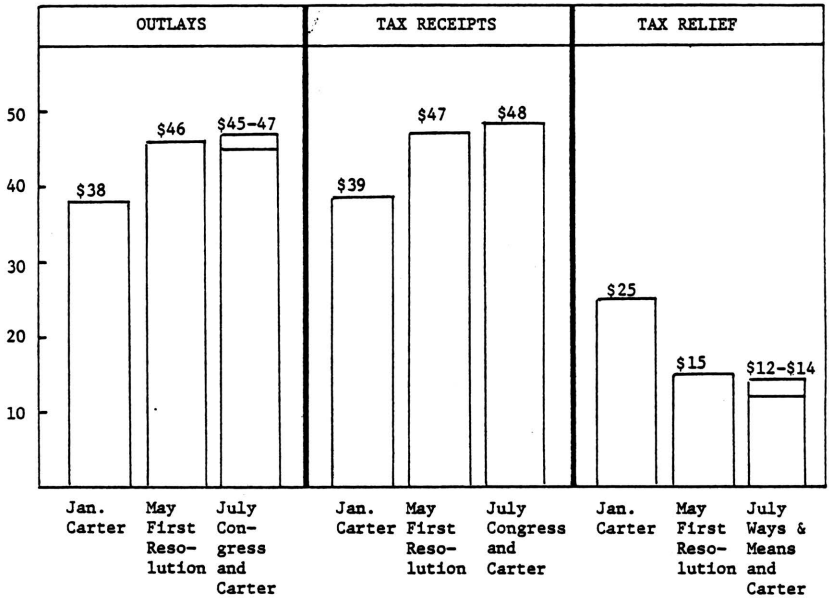
CHART 1

CHANGES FROM JANUARY TO JULY IN SPENDING, TAXES AND TAX RELIEF
PROPOSED FOR FISCAL YEAR 1979
(Billions of Dollars)



This is equivalent to shrinking tax relief for the average family from $417 to $233 or increasing the tax burden from $616 to $800 (see Table 5).

TABLE 5

CHANGES FROM JANUARY TO JULY IN TAX RELIEF AND RECEIPTS
PROPOSED BY THE ADMINISTRATION AND THE CONGRESS
(Dollars per Family)

	January	May	July	Loss for Taxpayers from Jan. to July
Tax Relief	$417	$250	$233	$184
Additional Receipts	$616	$784	$800	$184

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The increase in tax burden would occur in every state (see Table 6).

TABLE 6

CHANGES FROM JANUARY TO JULY IN ADMINISTRATION'S AND CONGRESS' PROPOSED TAXES FOR AN AVERAGE FAMILY FOR FISCAL YEAR 1979

States	Increase in Tax Burden	States	Increase in Tax Burden
UNITED STATES	$184	Missouri	$172
Alabama	172	Montana	169
Alaska	297	Nebraska	192
Arizona	176	Nevada	196
Arkansas	170	New Hampshire	177
California	217	New Jersey	235
Colorado	212	New Mexico	147
Connecticut	237	New York	217
Delaware	235	North Carolina	165
Dist. of Columbia	247	North Dakota	212
Florida	177	Ohio	172
Georgia	176	Oklahoma	162
Hawaii	236	Oregon	176
Idaho	172	Pennsylvania	182
Illinois	237	Rhode Island	184
Indiana	177	South Carolina	157
Iowa	182	South Dakota	162
Kansas	186	Tennessee	157
Kentucky	162	Texas	179
Louisiana	167	Utah	234
Maine	161	Vermont	166
Maryland	232	Virginia	189
Massachusetts	172	Washington	191
Michigan	187	West Virginia	157
Minnesota	187	Wisconsin	183
Mississippi	137	Wyoming	184

The Chamber's tax relief proposals for fiscal year 1979 are smaller than past tax relief during the last 25 years (see Chart 2).

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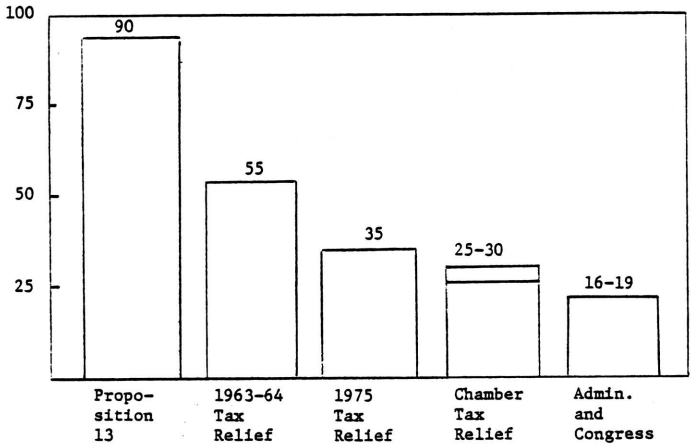
CHART 2

CHAMBER TAX RELIEF COMPARED WITH OTHER TAX RELIEF
(Tax relief in other years or for a state were sized
for the U.S. economy in fiscal year 1979 in annualized billions of dollars)



The Chamber proposal to limit spending to the level of the current services budget which provides for past and present commitments, may be considered unnecessarily generous. Clearly, application of productivity improvements that are taken for granted in the private sector would mean the Federal government could free 2% to 3% or $8 to $12 billion of resources for new initiatives. The National Commission on Federal Paperwork has identified areas where government waste can be greatly reduced. The General Services Administration has uncovered rampant overpayment for government services. HEW Secretary Califano and his Inspector General have identified waste and fraud exceeding 5% of many programs. These revelations clearly indicate that reduction in waste and increased productivity need not be limited to the

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"controllable" programs but can be applied across all programs. Therefore, the National Chamber recommends that any necessary trimming in the growth of Budget Outlays and Authority should occur across most programs. Such an approach nearly passed the House of Representatives during the debate over the First Concurrent Budget Resolution (Fisher Amendment). Of course, the Chamber's recommendations should not preclude trimming some programs deeper than others or refraining from initiating new programs. For example, the proposal to create a new program to give money to state and local governments (Supplementary Fiscal Assistance Act H.R. 12293) as a counter to Proposition 13 and other state and local efforts to limit government taxing and spending appears to undermine representative government.

THE NEXT FIVE YEARS
(1979-1983)

Appropriately, the Budget and Impoundment Control Act of 1974 requires a five year planning budget for setting taxes and spending. That law requires that the report by the Committee on the First Budget Resolution "shall include .... projections .... for the period of five fiscal years .... of the estimated levels of total budget outlays, ... total new budget authority, the estimated revenues to be received, and the estimated surplus or deficit .... and the estimated levels of tax expenditures .... by major functional categories ...." (Underlining provided.)

We urge that the House Budget Committee now follow this requirement and the spirit of the law and provide such a projection and use it for setting a policy course for fiscal year 1979 in the context of the next five years. In particular, we recommend the Committee propose 1979 actions and present projections through 1983 which would make possible lower spending and thereby tax relief starting in fiscal year 1979 and extending through 1983.

When considering FY 1979 in the perspective of the next 5 years the

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National Chamber recommends the Administration and the Members of Congress commit themselves to policies that will reduce inflation by at least one-half percent each year until price stability is achieved. In the context of the Budget Resolution process, the National Chamber recommends the following objectives:

- slow down the record growth of taxes to much less than the growth of each person's income;
- slow down the record growth of spending to about the rate of inflation;
- reduce the size of the federal deficit and achieve a balanced budget by 1982 and maintain a balanced budget at high levels of employment;
- encourage job-creating, productivity-increasing, capacity-expanding and inflation-dampening investment; and
- increase individual choice and personal freedom by reducing federal taxes and spending from 22% to 18½% of Gross National Product.

These objectives can be achieved only by slowing down the growth of federal taxing and spending such as indicated by the following pattern (see Table 7).

TABLE 7

CHAMBER RECOMMENDATIONS FOR FISCAL POLICY

	FORECAST					
	FY78	FY79	FY80	FY81	FY82	FY83
Tax Receipts	$401	$441	$484	$530	$580	$617
Percentage of GNP	20%	19.5%	19.3%	19.0%	18.8%	18.5%
Outlays	$448	$480	$511	$544	$580	$617
Percentage of GNP	22%	21.2%	20.3%	19.5%	18.8%	18.5%
Deficit	-48	-39	-27	-14	0	0
Budget Authority	507	550	580	610	640	670
Percentage of GNP	24.8	24.3	23.1	21.9	20.9	19.9

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The Administration's "Outlook" (and presumably Congressional estimates) are far less desirable in comparison with the National Chamber's recommendations. The Chamber's fiscal policies would save $142 billion of taxes during the next five years (see Table 8).

TABLE 8

TAX INCREASES
(Billion dollar changes in level)

	FORECAST					
	1979	1980	1981	1982	1983	1979-1983
Chamber Recommendation a/	$40	$43	$46	$50	$37	$216
Administration Outlook a/	47	59	73	84	95	358

a/ Same percentage increase as FY 1981 estimate.

For the average American family, federal taxes would grow more slowly with the Chamber's recommendations (see Table 9).

TABLE 9

TAX INCREASES FOR THE AVERAGE FAMILY

	FORECAST				
	1979	1980	1981	1982	1983
Chamber	$550	$613	$650	$690	$730
Administration	783	983	1217	1400	1600

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Consequently, the Chamber recommendations would save $2,650 taxes within the next five years (see Table 10).

TABLE 10

CHAMBER TAX SAVINGS FOR THE AVERAGE FAMILY
IN COMPARISON WITH THE ADMINISTRATION AND THE CONGRESS

	1979	1980	1981	1982	1983	5-Year Total
Administration	$233	$370	$567	$660	$820	$2,650

The Chamber's recommendations would greatly reduce the National Debt by $190 billion by fiscal year 1983, equivalent to reducing the mortgage on the life of the average American family of $3,167 (see Table 11).

TABLE 11

LOWER NATIONAL DEBT IF
CHAMBER RECOMMENDATIONS ACCEPTED
(End of FY 1983)

	Nation	Per Family
Administration	$190 B.	$3,167

If the Chamber's recommendations are followed, by 1981 tax relief could be nearly comparable to Proposition 13 and larger than recent tax relief. The economy will be healthier and generate higher incomes and consequently create greater tax liabilities. Consequently, additional tax receipts from a faster growing economy would offset about 40% of the initial tax relief (see Chart 3).

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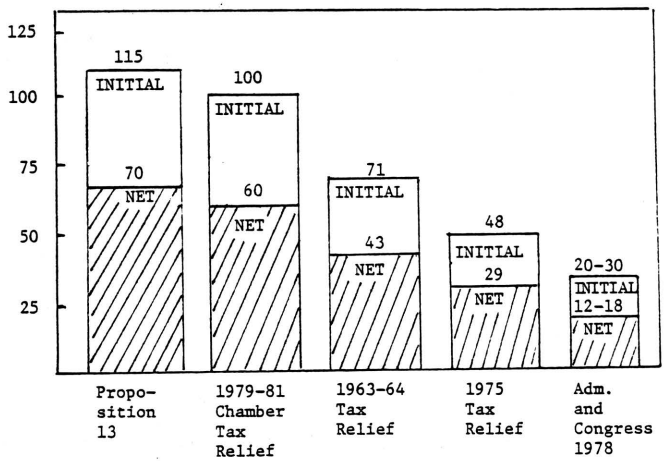
CHART 3

CHAMBER'S TAX RELIEF COMPARED WITH OTHER TAX RELIEF BY FY 1981 (INITIAL AND NET)



NEED TO STIMULATE INVESTMENT

Not only is the size of the tax relief important for fighting inflation, increasing wages and providing jobs, but also the composition of tax relief. The federal tax structure greatly discourages investment in modern tools for the growing work force. For example, the allowance provided under tax laws for replacing worn out equipment and structures was $17 billion short of replacement costs during 1977. Consequently, taxes were artificially increased and the Federal government siphoned funds away from investment.

Investment, after adjusting for inflation, has grown only 1.1% since 1973 while new workers needing modern tools have grown by 2½%. In spite of slightly lower working hours, capital per labor hour is growing more slowly and is a major cause for slower productivity growth and a decline in real average

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weekly earnings of non-farm workers (see Table 12).

TABLE 12

SLOWING ANNUAL GROWTH RATES IN INVESTMENT AND THE RESULTING SLOW-DOWN IN PRODUCTIVITY AND REAL WAGES GROWTH 1/

	Investment Growth After Adjusting for Inflation	Capital per Labor Hour	Productivity Growth	Real 2/ Wages
1948-1966	3.4%	3.1%	3.3%	2.7%
1966-1973	3.0%	2.8%	2.1%	1.0%
1973-1978 Second Quarter	1.1%	1.5%	0.8%	-1.0%

1/ Economic Report of the President, January 1978, and Bureau of Labor Statistics.
2/ Real Average weekly earnings in Nonagricultural Industries.

Government tax and spending policies have increasingly ignored the plight of workers having to work with obsolete and worn out tools. A greater proportion of tax relief provided in the past was earmarked for encouraging investment in better plant and equipment for workers than now proposed for 1979 (see Table 13).

TABLE 13

PROPORTION OF TAX RELIEF FOR INVESTMENT

1963-64	1975	Admin. Proposal for 1979
1/3	1/4	1/5

In dollar amounts, tax relief for stimulating investment would be shrunk severely (see Chart 4).

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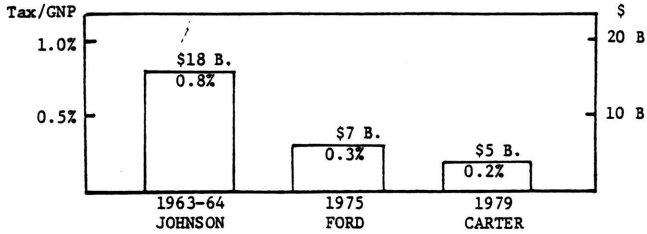
CHART 4

PAST TAX RELIEF FOR BUSINESS INVESTMENT
SIZED FOR THE FY 1979 GNP



Even seemingly useful legislation enacted for other reasons during 1977 will reduce investment by $2,900 for each new worker during 1979 (see Table 14).

TABLE 14

LEGISLATION ENACTED BY THE CONGRESS AND SIGNED INTO LAW BY THE PRESIDENT DURING 1977	Impact on Investment For Each New Worker			
	1978	1979	1980	1985
Increase in Minimum Wage	-150	-2,350	-2,600	-2,400
Increase in Social Security Taxes	0	-200	-600	-2,750
Increase in Farm Price Supports	-150	-250	-200	-250
Increase in Federal Pay	-50	-100	-100	-100
Total	-350	-2,900	-3,500	-5,500

This trend towards discouraging investment in modern tools for American workers must be reversed. The National Chamber recommends one-third of tax relief be earmarked for encouraging investment. Stimulus of investment can be achieved by:

- providing a permanent 12% investment tax credit on an expenditure basis, uniformly applied to all business, without limitation based on tax liability, and extending to structures;
- reducing the tax on capital gains;
- adopting a complete capital cost recovery system;
- reducing corporate normal and surtax rates; and
- eliminating the double taxation of corporate income.

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The Chamber-Gallup Business Confidence Survey indicates that nearly one-half of American business would increase their investment in equipment and structures if tax relief were provided to stimulate investment. Moreover, the investment would occur in all regions of the country, including central cities in which are distressed economic areas.

Based upon forecast economic conditions and past experience each initial $1 billion of tax relief could cause as high as $6 billion to be spent for plant and equipment, cause production capacity to expand by as much as 0.3% which would reduce bottleneck inflation, create 240,000 new jobs, and increase average family income by as much as $80 (see Table 15).

TABLE 15

IMPACT OF $1 BILLION OF TAX RELIEF WITHIN 4 YEARS

	Investment Tax Credit	Capital Gains	Depreciation Allowance	Corporate Rate
Investment (Billions)	$4-$6	$2-$4	$2-$3	$1-$2
Capacity Expansion	0.3%	0.2%	0.2%	0.1%
Jobs (000)	180-240	100-180	110-170	60-90
Family Income	$60-$80	$35-$60	$35-$50	20-30

Tax relief to stimulate investment results in two-thirds of the final benefits accruing to low or middle income families. About two-thirds of the investment-led growth in the economy occurs in wages and salaries which are paid primarily to workers from low and middle income families.

Investment created jobs could be a far less costly way to create jobs than public sector jobs or public works (see Table 16).

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TABLE 16

INCREASED EMPLOYMENT FROM INVESTMENT-
STIMULATING TAX RELIEF COMPARED TO OTHER STIMULUS
FOR CREATING NEW JOBS (FY 1979)

	Tax Relief or Spending Cost per Job
Higher Investment Tax Credit, Capital Gains Tax Reduction or Improved Depreciation Allowance	$5,000 to $10,000
Public Sector Jobs Spending	$10,000 to $13,000
Labor Intensive Public Works Spending	$25,000 to $35,000
Proposed Local Public Works Spending	$25,000 to $50,000

ECONOMIC CONSEQUENCES

The government's fiscal policies could produce:

- persistent inflation at or above 7%
- unemployment at or above 6%
- low rates of investment
- greater loss of individual freedom because of taxes and spending growing faster than income.

Therefore, the economy could be plagued by high inflationary government spending, high taxing and less individual choice by 1983 (see Table 17).

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TABLE 17

LONG RANGE ECONOMIC OUTLOOK
WITHOUT CHAMBER'S RECOMMENDATIONS
(Billions of Dollars)

	FY 1979	FY 1983
Gross National Product	$2,254	$3,291
Percent Change	10.4%	9.4%
GNP in 1978 Dollars	$2,108	$2,393
Percent Change	3.0%	3.3%
Business Fixed Investment	$223	$268
Percent Change	5.7%	4.8%
Consumer Price Rate	7.2%	7.0%
Total Employment (Changes in Level)	1.0	8.9
Unemployment Rate	6.2	6.2
Capacity Utilization	83	83
Federal Outlays as percentage of before tax income (Personal Income)	27	26
Federal Tax Receipts as percentage of before tax income (Personal Income)	25	24
Federal Deficit	-49	-65

Source: U.S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modelling by Dr. Jack Carlson and George Tresnak using econometric models of Data Resources, Inc. and Chase Econometric Associates.

The Chamber's recommendations could change the outlook significantly by slowing down federal spending and taxing, achieving a balanced budget; and the capacity-expanding and productivity-increasing investment would bring down the rate of inflation (see Table 18).

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TABLE 18

LONG RANGE ECONOMIC OUTLOOK WITH THE
CHAMBER'S RECOMMENDATIONS FOR TAX RELIEF AND
SPENDING LIMITATIONS 1/
(Billions of Dollars)

	FY 79	FY 80	FY 81	FY 82	FY 83
Gross National Product ($ Billions)	2,260	2,513	2,785	3,066	3,366
Percent Change	10.7	11.2	10.8	10.1	9.8
GNP in 1978 Dollars ($ Billions)	2,112	2,199	2,287	2,378	2,473
Percent Change	3.5	4.1	4.0	4.0	4.0
GNP Deflator (%)	7.0	6.8	6.6	6.2	5.9
Consumer Price Index	6.9	6,6	6.4	6.2	5.9
Additional Employment (Millions)	1.2	2.5	2.4	2.4	2.4
Unemployment Rate (%)	6.3	6.0	5.7	5.5	5.4
Productivity (%)	2.1	3.3	2.9	2.7	2.5
Investment	224	244	269	300	336
Percent Change	6.1	8.7	10.3	11.7	11.7
Capacity Utilization (%)	85	86	86	86	86
Federal Tax Receipts (Billions)	441	484	530	580	617
Percent Change	10.0	9.8	9.5	9.4	6.5
Federal Outlays ($ Billions)	480	511	544	580	617
Percent Change	7.0	6.5	6.5	6.5	6.5
Federal Budget Balance ($ Billions)	-39	-27	-14	0	0
Receipts as % of GNP	19.5	19.3	19.0	18.8	18.5
Outlays as % of GNP	21.2	20.3	19.5	18.8	18.5
Receipts as % of Personal Income	24.2	24.0	23.6	23.3	23.0
Outlays as % of Personal Income	26.3	25.2	24.2	23.3	23.0

1/ Fiscal Policy Assumptions:

- Personal tax relief of $13 billion in FY1979 (equivalent to $18 billion in calendar year 1979), $32 billion in FY1980, $54 billion in FY1981, $78 billion in FY1982, and $104 billion in FY1983.
- Investment tax relief of $7 billion in FY1979, $17 billion in FY1980, $28 billion in FY1981, $41 billion in FY1982, and $55 billion in FY1983.
- Federal spending limitation of $32 billion increase (current services budget) in FY1979 and 6.5% increase each year thereafter.

Source: U.S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modelling by Dr. Jack Carlson and George Tresnak using econometric models of Data Resources, Inc. and Chase Econometrics Associates.

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Specifically, the Chamber's recommendations would produce the following improvements for the average American family by 1983:

- save $2,650 in federal taxes in 1983 alone and would have saved $5,483 between 1979 and 1983;
- retain individual choice and freedom by reducing government spending and taxes from 24%-26% before tax income (Personal Income) to 23%;
- reduce consumer prices by 3%, equivalent to $1,360 of purchasing power;
- create 2 million additional jobs (see Table 19).

TABLE 19

ECONOMIC IMPACT OF CHAMBER TAX RELIEF
AND SPENDING LIMITATION RECOMMENDATIONS
(Change in Levels)

	FY79	FY80	FY81	FY82	FY83
Gross National Product (%)	0.2	1.3	2.0	2.6	3.3
Consumption	0.3	1.3	1.9	2.6	3.5
Business Fixed Investment	0.5	3.7	8.0	13.7	15.9
Net Exports	11.0	18.5	22.3	25.1	27.8
Employment (Million Jobs)	0.2	0.5	1.0	1.5	2.0
Unemployment Rate (% Level)	-0.1	-0.3	-0.5	-0.7	-0.8
After-Tax Family Income (P.I.)	146	461	741	937	1106
GNP Deflator	-0.3	-0.5	-0.8	-1.5	-2.5
Consumer Prices	-0.3	-0.7	-1.2	-1.9	-3.0
Capacity Utilization (% Level)	1	1	3	3	3
AAA Corporate Bonds (Level Change)	-0.1	-0.2	-0.4	-0.7	-1.2

1/ Fiscal Policy Assumptions

- o Personal tax relief of $13 billion in FY1979 (equivalent to $18 billion in calendar year 1979), $32 billion in FY1980, $54 billion in FY1981, $78 billion in FY1982, and $104 billion in FY1983.
- o Investment tax relief of $7 billion in FY1979, $17 billion in FY1980, $28 billion in FY1981, $41 billion in FY1982, and $55 billion in FY1983.
- o Federal Spending limitation of $32 billion increase (current services budget) in FY1979 and 6.5% increase each year thereafter.

Source: U.S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modelling by Dr. Jack Carlson and George Tresnak using econometric models of Data Resources, Inc. and Chase Econometrics Associates.

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The Chamber's recommendations would benefit families in each state. For example, the average family in Connecticut would save $2,840 in federal taxes in 1983 and would have saved $5,875 in taxes from 1979 through 1983, experience 3.6% less consumer price inflation and 1.3 percentage points lower long term interest rates; $602 million additional investment; 3.9% less government control over the lives of Connecticut families (see Table 20).

SUMMARY

The National Chamber calls upon the Congress to repent of its spending and taxing ways and slow down the growth of both taxes and spending and aim for a feasible balanced budget by 1982 by actions for 1979 and a charted path for 1980 through 1983. The necessary tax relief should include one-third for stimulating investment. The results of such an approach would be a much healthier economy and less oppressive government.

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TABLE 20

Economic Gains by 1983 Caused by Chamber Tax Relief Recommendations in Comparison With The Administration's Outlook

(1983 Change in Levels)

	Tax Savings Per Family ($78/Family)		Lower Consumer Prices (%)	Lower Long Term Interest Rates (%)	Greater Investment (Millions of 78 Dollars)	Additional Jobs	Less Government As a % of Personal Income (%)
	1983	1979-1983					
UNITED STATES	2,650	5,483	-3.1	-1.1	40,118	2,115,000	-3.3
Alabama	1,624	3,360	-2.4	-0.8	963	32,443	-2.5
Alaska	3,169	6,557	-5.1	-1.8	60	3,667	-5.5
Arizona	2,687	5,560	-2.9	-1.0	321	23,835	-3.1
Arkansas	1,644	3,402	-2.4	-0.8	361	20,087	-2.5
California	3,495	7,231	-3.5	-1.2	2,808	221,080	-3.7
Colorado	2,339	5,253	-3.2	-1.1	401	29,858	-3.4
Connecticut	2,840	5,875	-3.6	-1.3	602	30,179	-3.9
Delaware	2,868	5,935	-3.6	-1.3	160	6,064	-3.8
Dist. of Columbia	2,774	5,739	-4.0	-1.4	24	15,871	-4.3
Florida	2,044	4,229	-2.9	-1.0	883	88,332	-3.1
Georgia	2,040	4,221	-2.7	-1.0	963	52,029	-2.9
Hawaii	3,450	7,137	-3.9	-1.4	56	8,632	-4.2
Idaho	2,135	4,417	-2.7	-1.0	120	8,092	-2.9
Illinois	2,943	6,088	-3.6	-1.3	2,487	105,238	-3.8
Indiana	2,378	4,920	-2.9	-1.0	1,565	52,501	-3.1
Iowa	2,609	5,398	-3.1	-1.1	562	29,664	-3.3
Kansas	2,415	4,997	-3.2	-1.1	321	23,251	-3.4
Kentucky	1,925	3,982	-2.5	-0.9	602	31,214	-2.6
Louisiana	2,258	4,673	-2.7	-1.0	1,123	33,816	-2.9
Maine	2,324	4,809	-2.4	-0.9	201	9,662	-2.6
Maryland	2,807	5,807	-3.5	-1.2	481	40,106	-3.7
Massachusetts	3,272	6,771	-2.7	-1.0	802	53,917	-2.9
Michigan	2,798	5,790	-3.2	-1.1	2,848	83,887	-3.4
Minnesota	2,992	6,191	-3.2	-1.1	522	40,757	-3.4
Mississippi	1,801	3,726	-2.2	-0.8	361	21,660	-2.4
Missouri	2,110	4,366	-2.9	-1.0	642	47,135	-3.1
Montana	2,485	5,142	-2.8	-1.0	120	7,216	-3.0
Nebraska	2,337	4,835	-3.2	-1.2	160	16,748	-3.5
Nevada	2,786	5,764	-3.4	-1.2	32	7,369	-3.6
New Hampshire	2,061	4,264	-2.8	-1.0	120	8,255	-3.0
New Jersey	2,925	6,054	-3.6	-1.3	1,404	68,277	-3.8
New Mexico	2,188	4,528	-2.4	-0.8	120	10,859	-2.5
New York	4,084	8,450	-3.5	-1.2	2,307	161,043	-3.7
North Carolina	1,953	4,042	-2.5	-0.9	1,444	58,519	-2.7
North Dakota	2,456	5,082	-3.2	-1.1	40	6,249	-3.4
Ohio	2,168	4,485	-2.9	-1.0	2,768	105,534	-3.1
Oklahoma	1,916	3,965	-2.6	-0.9	361	26,428	-2.8
Oregon	2,559	5,295	-2.9	-1.0	481	24,791	-3.1
Pennsylvania	2,403	4,971	-3.0	-1.1	2,247	109,798	-3.2
Rhode Island	2,625	5,432	-3.1	-1.1	160	8,721	-3.3
South Carolina	1,772	3,667	-2.5	-0.9	883	28,909	-2.7
South Dakota	2,160	4,468	-2.7	-1.0	28	6,936	-2.9
Tennessee	1,764	3,650	-2.5	-0.9	963	46,659	-2.7
Texas	2,028	4,195	-3.0	-1.1	3,209	130,843	-3.2
Utah	2,065	4,272	-3.9	-1.4	120	12,845	-4.1
Vermont	2,708	5,602	-2.6	-0.9	80	4,254	-2.7
Virginia	2,164	4,477	-3.2	-1.1	842	53,532	-3.4
Washington	2,662	5,509	-3.2	-1.1	682	32,264	-3.4
West Virginia	2,024	4,187	-2.4	-0.9	361	15,051	-2.6
Wisconsin	2,947	6,097	-3.1	-1.1	923	46,474	-3.3
Wyoming	2,831	5,858	-3.1	-1.1	20	4,450	-3.3

Source: U. S. Chamber of Commerce, Forecast and Survey Center. Assumptions and modelling by Dr. Jack Carlson and George Tresnak using econometric models of Data Resources, Inc. and Chase Econometrics.Associates.

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The CHAIRMAN. Thank you very much, Mr. Harris. You say that the Chamber is deeply concerned about inflation, and I know you are. Then you recommend a tax cut of $25 to $30 billion. You also recommend an additional $10 billion reduction in spending, and I believe your $10 billion is below——

Mr. HARRIS. Our $10 billion would take you to the $480 billion you have been discussing.

The CHAIRMAN. You would be at the $480 billion rather than $490 billion?

Mr. HARRIS. Yes, sir.

The CHAIRMAN. As you know, we are trying to get spending down in this committee and in the Congress. However, in the event that there were not to be an additional $10 billion spending reduction in fiscal year 1979, would you still, given your concern for inflation, recommend a $25 to $30 billion tax cut?

Mr. HARRIS. Mr. Chairman, I would stick, with the linkage.

The CHAIRMAN. You would. You would say it should be accompanied by an additional $10 billion cut?

Mr. CARLSON. We think it is important to keep the deficit going down and below $40 billion. So to the extent you increase spending, tax relief has to suffer.

The CHAIRMAN. Then you would not agree with a substantial tax cut in the area of $25 to $30 billion without additional spending reductions?

Mr. HARRIS. That is a correct statement of our position, sir.

Mr. CARLSON. But we are strongly advocating that the taxpayer ought not to be traded off.

The CHAIRMAN. I understand. I do not want to trap you. I think you understand what I am getting at. You know that there are proposals to have a substantial tax cut somewhere in the neighborhood of $28 billion the first year, with larger reductions the second and third year as well. They are not tied to a $10 billion reduction in expenditures as they have been in the past. I believe you had such a proposal last year or earlier this year.

But I understand the present tax proposal known as the Kemp-Roth proposal would not be tied to an additional $10 billion reduction. I just wanted to get your opinion.

Mr. HARRIS. In our testimony we have tied the tax reduction to a spending limitation.

The CHAIRMAN. Yes, and I think we should. I have been trying, as you know, to get the message across that we must get the deficit down as much as we possibly can and as quickly as we can. Obviously none of us believes we can eliminate it all in 1 year or even in 2, but we should strive to get rid of this deficit within 3 years.

I feel that the elimination of the deficit is one of the most important steps that Congress or the Government can take to indicate to the private sector our seriousness in combating inflation.

There is a serious question as to whether we should have any tax cut this year, as you know. The idea is to hold the line on spending and at the same time see if we can get it down below but certainly hold it at $490 billion, which is a reduction from where we started out. Then if we were to have no tax cuts we could get an additional $15 billion or more—perhaps somewhat less—off the deficit.

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Would you comment on the proposal of some Members of Congress not to have any tax cut at all?

Mr. HARRIS. Mr. Chairman, I would offer a comment which is really not representative of a specific policy resolution by the Chamber board but represents more a personal view of my own as to how to deal with the whole inflation problem. I think I come up this way. Obviously we have to reduce spending in order to reduce taxes, and as we take off taxes, we ought to at the same time relate some of the spending reduction to reducing deficit and some of it to stimulating the economy.

I think this is a sort of seed corn proposition where if you took off an additional $15 billion of taxes and held spending tight and reduced the deficit by $10 billion, the additional $15 billion goes back to the taxpayer. So the next time he files his 1040 tax return he is out there helping every Member of Congress to stand fast on the spending.

If you are going to get that voter to support you in standing fast on the spending limitation, you have to give him a little back on his tax return while he is pressing you to stop the spending. That is a personal reaction as to the best strategy to deal with the problem.

The CHAIRMAN. Would you like to respond, Mr. Carlson?

Mr. CARLSON. Yes. I think it is important also to note that the tax structure, given the inflation we have, is greatly discouraging investment, and tax relief in the investment area is mighty important to increase the capacity of the economy so you won't have these bottlenecks we are starting to see.

The CHAIRMAN. So you think that you would not agree with the Pickle-Vanik proposal that there should be no additional tax cut?

Mr. CARLSON. No, sir. We would think the Ways and Means Committee proposal right now is a good starting point to add to and especially to keep one-third to encourage investment.

The CHAIRMAN. You stated that deficit spending is one of the major causes of inflation, although you also mentioned overregulation, property taxes and farm prices because of Government subsidies as contributors. Could you tell me what you think some of the other major causes of inflation are that are less closely related to Government?

Mr. HARRIS. First let me say that I think my colleagues and I agree that probably about 60 percent of the driving forces of inflation are related to Government policies and Government action, deficit spending being one of those, regulation being another.

I would say that the discouragement or the disincentive to save that flows from our tax policy is an important third part of the 60 percent attributable to Government policy and Government action.

Another 20 percent is probably related to our imbalance in payments in our foreign trade. A great deal of that is attributable to our imported energy for which at the moment we do not have an instant solution. The remaining 20 percent I would submit is mostly related to wage adjustments that do not have an equal relationship to increase in productivity.

I would be quick to point out to you that I think that last 20 percent is not as much a driving force as it is a following force. If

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you would deal with the other 80 percent, you would moderate the demand for wages and it would not follow quite as fast.

The CHAIRMAN. Thank you. That is a good answer. The gentleman from Ohio, Mr. Latta.

Mr. LATTA. Thank you. Gentlemen, it is very nice to have you this afternoon. Sorry you had to wait so long.

We had a witness before the committee this morning, Dr. Oswald, representing the American Federation of Labor. He made a couple of suggestions, and I would like to have your comments on them. He said, "We are calling for enactment of a fair and responsible $11 billion individual income tax cut to be accomplished simply by increasing the present $35 per person general tax credit to $150." Would you care to comment on that suggestion?

Mr. CARLSON. Yes, sir. We think it is very important at this point to encourage investment because the 10 million increase in employment that we have seen since 1975 has not been accompanied with an appropriate increase in investment. So consequently on the average they are working with inferior tools, plant and equipment, and we need to have a marked increase to make those workers much more productive so the real wages can go up.

Also, we would differ with the cuts being just for the low end of the income spectrum. We think inflation affects all Americans and a tax cut should be across the board as opposed to just one group in the country.

Mr. LATTA. Did we not go down that road a few years ago—the $50 rebate they were going to give to everybody?

Mr. CARLSON. Yes, sir, last year, and the President withdrew that. I think he is wise in withdrawing the $50 rebate because of the yo-yo effect of that kind of proposal.

Mr. LATTA. He also made this rather startling recommendation: Establishment of reserve stockpiles—talking about agricultural stockpiles—and effective export controls on agricultural commodities. Since we have to depend on those exports of agricultural commodities to get us at least $26 billion worth of exports, I wonder how export control would affect those exports and where our balance of payments might be if we went that route.

Mr. CARLSON. That would be devastating on exports and balance of payments to have export controls that were effective in any way. It would lead to a further devaluation of the dollar, and if that were to occur instead of having 1 percent of the inflation rate being caused by the increase in imports, it would be much higher. Clearly that is the wrong way to go. Having some reserves for drought years is rather important but not for speculating in the marketplace.

Mr. LESHER. In the long term, that would be devasting to the economy because it would dry up the supply of agricultural products for markets abroad in the longer term. And looking to the longer term, we will need to rely increasingly on farm exports for payment for those natural resources that we buy abroad. So that would be a serious mistake to follow that policy.

Mr. LATTA. While we are talking about agricultural matters, let me ask you a related question which concerns me very much. We have had going on for the last couple of years negotiations for an international wheat agreement whereby the United States would

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be limited in its exports, and so on. Would you care to comment on that?

Mr. CARLSON. Sir, we would generally be opposed to any cartel monopoly-type arrangement where in fact a few countries or companies were to control products through some sort of an agreement to fix the price.

Mr. LATTA. These limitations would be on the exporting countries of the world. We had the Secretary of Agriculture before this committee several months ago, and he was very much for it and said the negotiations are going on now.

Mr. CARLSON. I think one has to find out what kind of arrangement he is talking about. If you are talking about having reserves on hand to take care of drought conditions around the world, that is one thing, another if you are trying to influence the terms of trade, the prices the exporting countries receive over an extended period of time, that is another. That would be rather protectionist oriented and I would prefer not to see us move in that direction.

Mr. LATTA. I would like to suggest to the Chamber that they look into this matter quite thoroughly because, as I say, it is ongoing and they are trying to bring about such an agreement. We had the Secretary of Agriculture say he was all for those agreements.

Mr. HARRIS. We appreciate your suggestion and we will look into it.

The CHAIRMAN. Mrs. Holt.

Mrs. HOLT. I have no questions. Thank you, gentlemen.

The CHAIRMAN. Mr. Rousselot.

Mr. ROUSSELOT. I appreciate your testimony especially since several of your recommendations concur with several of us on this committee, and also those of us that serve on some of the other committees.

Since you have recommended a $25 billion to $30 billion tax relief, and you both said across the board, is the makeup of those tax relief proposals across the board in the personal income tax field and corporate also?

Mr. CARLSON. On the investment side, as opposed to encouraging consumption, we would encourage capital gains tax relief, investment tax credit extended to structures, the corporate rate reduction, both the surtax and a normal tax, and we encourage in time more adequate depreciation so that it fully recovers.

Mr. ROUSSELOT. How much of a reduction have you called for?

Mr. CARLSON. We think the Ways and Means Committee's markup is a starting point. We would want the reduction in corporate rates to go up to 3 or 4 percent, depending on the size of the total tax cut.

Mr. ROUSSELOT. You mean down the road?

Mr. CARLSON. Yes, if in fact we have the $25 billion to $30 billion tax cut, and you are talking about one-third for investment purposes, then it would be appropriate in a mix of encouraging investment to have a larger reduction in the corporate rate.

Mr. ROUSSELOT. When you make these suggestions of tax reductions, do you project the same way that former Chairman of the Council on Economic Advisers Heller does, that there is no feedback effect down the road, or is it just a flat reduction in revenues to the Federal Government, period? Is there any feedback effect?

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Mr. CARLSON. Yes. I think Dr. Heller would also estimate some feedback, maybe not as much.

Mr. ROUSSELOT. Not very much?

Mr. CARLSON. Our estimates of feedback would be comparable to what Nancy Teeters has talked about elsewhere. There is some feedback; revenues do go up because of a faster growing economy, so tax receipts go up and give some offset to the initial cuts.

Mr. ROUSSELOT. How much of a feedback?

Mr. CARLSON. I clearly think 40 percent, so a net tax cut would be about 60 percent of what you start with.

Mr. ROUSSELOT. At what period of time does this 40-percent feedback affect?

Mr. CARLSON. It takes a period of time, certainly a couple of years. It depends on the startup time on investment, and one thing about investments, they also increase capacity and increase productivity, so you have more efficiency in the economy by encouraging investment and consequently less inflation by going as we are proposing; that is, one-third of a tax cut for investment purposes. So we end up with 3 percentage points a year lower inflation over our planning horizon than the program we think you are going to follow.

Mr. ROUSSELOT. Three percent less inflation?

Mr. CARLSON. Yes.

Mr. HARRIS. You would not want to overlook in evaluating the feedback rate the fact that we really literally have a sort of pent-up accumulation of potential capital investment. It has been lacking for some time. If we would adopt a policy and satisfy the economy, particularly investment managers, that we are on the sustained continued program that I mentioned to the chairman, I think you would release some of that pent-up investment right now so that when you say——

Mr. ROUSSELOT. So the effect would be immediate, you are saying?

Mr. HARRIS. Some of it would come immediately, yes.

Mr. CARLSON. One does not need to speculate on the reaction of the economy to a tax relief to show it is wise to go that direction.

Mr. ROUSSELOT. Are you familiar with Mr. Heller's editorial in the Wall Street Journal a few weeks ago where he just said it would be a total loss if the Kemp-Roth bill was put in, $115 billion over a loss of revenue over a period of 3 to 4 years?

Mr. CARLSON. No. In fact, we have estimates over a 4-year period of over $100 billion and we have the estimates of what the tax effect will be, in terms of feedback, in our testimony. Clearly it does encourage the economy. It depends on whether you are running the economy at overcapacity and really adding to inflation, which were his words.

Mr. ROUSSELOT. Right. That was his prime worry, that it would add more to inflation.

Mr. CARLSON. Yes. If you have spending limitations in the direction our Chamber chairman has talked about, then you make room for the tax cuts so you do not have that feeding of inflation; in fact, you abate inflation because you are adding to capacity.

Mr. ROUSSELOT. So your statement is, then, that with the $25 billion to $30 billion tax cut as you have suggested, accompanied by

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the reduction in increase in expenditure level by the Federal Government—your 7-percent increase—you do not have all of that revenue loss projection that Dr. Heller suggests?

Mr. CARLSON. No. There is additional growth to the economy that cuts the net tax.

Mr. ROUSSELOT. Are there other economists that agree with that?

Mr. CARLSON. I think most agree there is some feedback.

Mr. ROUSSELOT. I know there is disagreement as to how much.

Mr. CARLSON. The real debate right now is whether you would recover all of it or some of it.

Mr. ROUSSELOT. Right. We understand that.

Mr. CARLSON. You do not need to be speculative of whether you recover all of it to make your argument that tax cuts are wise.

Mr. ROUSSELOT. Dr. Heller made a flat-out statement it is a $150 billion loss flat out. To cope with that argument, which I am sure we are going to hear on the floor, we would like to have your backup material. I know part of it is in your testimony. We evidently need more than one economist to back that up if we are going to present some of those arguments on the floor. I happen to agree with much of what you said in your statement here.

Mr. CARLSON. I would like you to refer to page 14 where we have tried to show the initial tax relief and what the net tax relief might be of Proposition 13 applied to the Federal Government or our tax relief we propose or the 1963–64 tax relief sized for the larger economy today or the 1975 tax cut to get some sort of order of magnitude.

Mr. ROUSSELOT. Are there other economists besides yourself who agree with this thesis?

Mr. CARLSON. I think Arthur Okun, who made the estimates and who was also chairman of the Economic Advisers Council, made the estimates of the Walter Heller tax program of 1963–64 to find if there is a feedback effect.

Mr. ROUSSELOT. Obviously you know by the article if you read it, Dr. Heller said there is a loss of $150 billion in revenue, period. I know that argument is going to be used on the floor.

Mr. CARLSON. Taken out of context, that statement is wrong.

Mr. ROUSSELOT. Thank you.

The CHAIRMAN. Mr. Regula.

Mr. REGULA. Thank you, Mr. Chairman. Just a couple of questions.

You mention the investment tax credit as being an important feature; in fact, you suggest a 12-percent rate. How about expanding this to include not only structures but modernization so that the cities, particularly those with older industries which have a problem of retraining, would benefit from that type of inducement for modernization? How would you react to that?

Mr. CARLSON. Yes, sir, we support that.

Mr. REGULA. As to using the investment tax credit for that purpose, have you so testified in the Ways and Means Committee?

Mr. CARLSON. Yes, we have, even though the testimony was not specifically aimed at that particular tax provision. We have in principle supported a movement in that direction.

Mr. LESHER. We think it is time to experiment with using tax incentives to get jobs back in the cities, because tax penalties have

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been driving jobs out of the cities, so we would like to see a little bit of reversal of the knee-jerk reaction that we have been following for 4 years.

Mr. REGULA. Have you developed some other proposals beyond just the investment tax credit for modernization? I like this idea of other kind of tax incentives to get jobs into the central city, and this might be far more effective than some of the social programs we have been talking about.

Mr. LESHER. Our tax policy also favors a tax subsidy for jobs that are created in the inner city.

Mr. REGULA. Very good.

Mr. CARLSON. For people who are structurally unemployed.

Mr. REGULA. I congratulate you on that. One other question. How would you react in terms of capital formation to some type of substantially accelerated depreciation as a means of quick capital recovery to get that money back to reinvest and also to avoid the erosion of inflation on the purchasing power of that capital?

Mr. CARLSON. We think it is wise that the tax structure should be such that a person, as the structure wears out, can recover his costs to replace it. Last year Americans were $17 billion short of having adequate funds to replace. So adequate costs recovery, either accelerated depreciation or straight line with reduced life, is a wise direction to go.

Mr. REGULA. The other thing. How much of a deficit do you think we could take, or how much should it be reduced in order to send out a message which would restore confidence in the business community? What is the magic figure for fiscal year 1979 in your judgment?

Mr. CARLSON. I think a deficit between $35 to $40 billion is called for. Even that deficit is not back to the old rule of thumb of a balanced full-employment budget, which according to the Congressional Budget Office is going to run around $20 billion in deficit with the administration plans up to date.

Clearly, moving that down toward the full employment balance or a deficit next year of $35 to $40 billion and then going down to $20 billion the following year and a balanced budget by 1982, but without necessarily having taxes in double-digit growth to bring it into balance, not increasing the size of Government but having the relative size of Government shrink somewhat, is our preferred path.

Mr. REGULA. Thank you, Mr. Chairman.

The CHAIRMAN. Gentlemen, you may not have had much time to study it but I am sure you are familiar with the tax package voted out the other night. I would be interested in your comments. I heard one of you say it is a good tax bill to start with. Would you comment further on it for us.

Mr. CARLSON. Yes, sir. We do think that it is a good starting point, the Jones compromise modified at the $16 billion annual level. We would prefer it to be a larger size and we would prefer to have a larger proportion of whatever size to encourage investment. In fact, we would support a full Steiger amendment as opposed to a modified or half Steiger amendment to that bill. We would support the investment tax credit being extended to all structures, not just

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to the highly limited number, and we would like to see more effort go on in terms of more adequate depreciation allowance.

If you had a larger package, then you could have more than a 2-percentage point reduction in the corporate rate. We do support larger tax relief on the low end of the corporate rate for small business. We prefer a two-step process as opposed to the process that was applied in that bill, but we would have the steps here so there would be greater tax relief for smaller businesses.

Those are the changes we would recommend that the Congress consider in marking up that bill.

Mr. LESHER. This country is falling far behind in the rate of productivity of the other Western nations and lagging in the rate of capital formation. If you are concerned with inflation, you have to be concerned with those two issues. You have to be concerned with productivity broadly. Most of the things we are doing tend to impinge upon productivity, so you have to look to tax policy to look for incentives for capital formation, which in turn will lead to increases in the rate of growth of productivity.

The CHAIRMAN. You would agree that this tax cut proposal of Ways and Means seems to be different from earlier ones in that it seems to be directed more toward capital formation incentives and stimulus in the private sector. I think that is a healthy start.

Mr. LESHER. Yes; we applaud that very much. That is a remarkable turn from the rumors that came out of Capitol Hill and the administration all last year that we were going to see an increase in the tax on capital gains. In our opinion this was one of the most devastating things that was taking place last year. Nothing can be more devastating to investor confidence than to suggest that capital gains taxes are beginning to go up and that the rules of the game will be changed periodically.

I believe, as our chairman pointed out in the opening statement, that the problems we are talking about here today, inflation, taxation, and productivity, are long-term problems. It is going to take a long-term program to solve them, so we will be back again next year hoping some of these new directions pick up momentum and we see a decided emphasis on the investment portion of tax reduction.

Mr. HARRIS. Mr. Chairman, I would invite your attention to our table 16 on page 18, where we try to compare the cost of creating jobs. This trend of giving the tax reduction to the private sector to encourage investment is a more efficient way of getting the same thing done that we have been trying to do through Government spending.

Mr. CARLSON. I would also like to add, Mr. Chairman, that it is not correct to say that tax relief to encourage investment is only for millionaires, because the jobs that are created, whether it is capital gains tax relief or the others, are disproportionately filled by workers from middle and lower income households. Consequently, encouraging investment actually disproportionately drives money toward middle and lower income people, not the other way around. So the President's statement is highly misleading in this area in terms of programs that are aimed toward tax relief for investment.

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The CHAIRMAN. Thank you very much. Are there any further questions? If not, this concludes the hearing. Again we thank you very much for your patience, but especially for your testimony and responses.

Mr. HARRIS. We appreciate the opportunity to appear, Mr. Chairman.

The CHAIRMAN. The committee stands adjourned.

RESPONSE TO QUESTIONS FROM CONGRESSMAN PAUL SIMON BY HON. BARRY P. BOSWORTH

Question. In the whole tax reduction area, I am interested in what the impact on inflation is of a $20 billion tax reduction versus $15 billion, versus the Vanick-Pickle proposal for no additional tax reduction. Or, also in theory just the theoretical question whether it is wiser to have a general tax reduction that stimulates the economy generally or to put a specific amount into a government program where you aim it at structural unemployment?

Answer. The difference between the inflationary impacts of $15 and $20 billion *general* tax cuts is negligible. This is not to say, however, that the manner in which the tax reduction is allocated is unimportant. Which income classes get the tax break and for what purposes does have a differential effect.

We are presently in an inflationary situation that has a great deal of built-in momentum. At the same time, increases in payroll taxes and fiscal drag (due to the movement into higher tax brackets as inflationary artificially increases nominal income) threatens to reverse the impressive gains we have made in employment. Thus, there is a need for a tax cut of $15 to $20 billion to maintain moderate economic expansion. The difference between a cut of this magnitude and no cut at all is estimated to be only a tenth of a percentage point.

On the other hand, this clearly is not the time to increase the budget deficit. While an abrupt balancing of the budget would be much too severe a response to the inflation, a gradual reduction in the deficit, accompanied by other anti-inflationary measures, can be successful in reducing both the rate of inflation and the unemployment rate as we approach the potential of the economy in coming years.

The issue of the theoretical value of a general tax reduction versus employment programs has not yet been resolved in the profession. Undoubtedly, as we approach capacity constraints in the economy, some structural measures are necessary. The Administration has tried a very balanced approach. Since many of these programs are new, we have recommended gradual increases in their outlays. This will permit time for proper testing and evaluation. At the same time, a tax reduction bill was proposed because of the above-mentioned fiscal drag and payroll taxes and because of the need for new investment in the economy.

Question. In view of your comments on the agricultural situation, I am interested in the set-aside and what impact that has, and if this is wise, taking a look at the inflation thing?

Answer. Acreage set-asides are a direct means of reducing supplies and thus maintaining market prices. Their inflationary impact depends upon whether or not prices are raised above the minimum support level. If not, the set-aside reduces the costs of purchasing grains for the reserve. The wisdom of this action, in turn, depends upon the adequacy of the reserve to meet future contingencies. In my view, existing wheat reserves are adequate and a set-aside is an appropriate way of reducing budget costs. However, the same is not true for feed grains where the available reserve is at critically low levels.

Question. In connection with agriculture, whether we should not be more reliant on target prices and in the process lower the price of food?

Answer. In the short run, an emphasis on *target prices* as a means of maintaining farm income is less inflationary than the manipulation of *support prices.* The first triggers budgetary payments whereas the latter specifies a minimum level of market prices. In general, the cost to consumers is the same since they pay either in the form of higher prices or higher taxes. But, the direct-payments route avoids the passthrough of costs into other prices and wages. However, over longer periods of time, the large budget outlays associated with target prices generate pressures to shift the highly visible payments out of the budget and into less viable higher private market prices. Thus, high target prices do, over time, lead to high support prices.

Question. I have suggested the possibility of the Congressional Budget Office having an inflation impact statement with every bill that emerges from a committee of the House. I would be interested in your reaction to that.

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Answer. I would strongly encourage and support efforts to provide an inflation impact analysis for major legislation. However, I would hope that its format would be structured to be more useful for decisionmaking than that of the environmental impact statement.

Question. You mentioned regulations. I just had some correspondence which amazed me that shows that the environmental impact statement has increased the length of the time it takes to okay bridge construction from 1 year to about 5 years. I would be interested in and I have made notes for Allen Cissel of my staff to find out whether any bridge anywhere was ever turned down for environmental impact reasons.

Answer. We are also concerned with the delays imposed by the regulatory process and the inflationary costs associated with such delays. There is a need to expedite the procedures for issuing construction permits. Therefore, we were encouraged by reports of a new program, announced by the Environmental Protection Agency only last week, which promises to reduce the often lengthy delays faced by industries required to obtain pollution control permits. Hopefully, this is an indication of the kind of improvement in this type of procedure which can be extended to other types of regulation. At the same time we feel that despite the costs involved, some investigation is necessary to insure that potentially adverse results, which can be extremely costly, are avoided.

Question. I think I am correct in saying Italy and the United States are the only nations that do not have either standby wage and price controls or some type of wage and price controls. Does it in theory make sense to have some standby wage and price controls and, if not, Dick Bolling this morning before this committee talked about some advanced notice on price increases.

Answer. The history of wage and price controls has not been encouraging. Controls simply have not worked well in this country or in any other country, with the exception of their use as in national emergencies such as war. Consequently, they are, at best, a short-term measure which seem inappropriate as a response to the continuing inflation problem that this nation faces today. Since we view this policy response as inappropriate, the request for the authority is unnecessary. In fact, the authority itself, could actually cause anticipatory wage and price increases.

As for the suggestion of prenotification on price increases, the Council has worked with some industries on this matter. More cooperation from certain industries is necessary, but we anticipate that this will be forthcoming.

Question. Finally, do you have any impression of the impact or the desirability of having off-budget agencies with their expenditures without Congressional control, and the off-budget guaranteed loans?

Answer. The Office of Management and Budget is presently studying ways to achieve better control over credit programs. The administration will shortly propose to the Congress, after working with the appropriate congressional committees, a set of control procedures.

[Whereupon, at 5:10 p.m., the committee adjourned.]

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