

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETIETH CONGRESS
FIRST SESSION
—
INVITED COMMENTS
—
PART 5
—

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JANUARY 1967 ECONOMIC REPORT OF THE PRESIDENT

The letter appearing below was sent to the following organizations: American Bankers Association, American Farm Bureau Federation, Committee for Economic Development, Communication Workers of America, Conference on Economic Progress, Consumers Union of U.S., Inc., Cooperative League of the U.S.A., Federal Statistics Users' Conference, Independent Bankers Association, Life Insurance Association of America, Machinery & Allied Products Institute, National Association of Mutual Savings Banks, National Federation of Independent Business, National Federation of Independent Unions, National Grange, National League of Insured Savings Associations, Railway Labor Executives Association, United Mine Workers of America, United States Savings and Loan League. These organizations were invited to submit their views or comments on the text and recommendations contained in the 1967 Economic Report of the President. Eleven organizations submitted statements and their views were considered by the Joint Economic Committee in the preparation of its report on the President's Economic Report.

FEBRUARY 10, 1967.

DEAR MR. ———: Since our schedule of hearings on the 1967 Economic Report of the President is very full and time is short, the Joint Economic Committee once again is calling upon a number of leaders of banking, business, labor, agriculture and consumer organizations for written statements containing economic facts and counsel for consideration in the preparation of its report.

The 1967 Economic Report of the President, including the Annual Report of the Council of Economic Advisers, is enclosed. We would appreciate having your comments on the materials and recommendations in this report.

In order that we may have ample time for consideration of these comments, written statements should be received by March 1, 1967. We will need 30 copies sent to G-133, New Senate Office Building, Washington, D.C. 20510, for distribution to Committee members and the staff.

Such comments as you care to give us will be made available to the public in a printed volume of the invited statements.

Sincerely yours,

WILLIAM PROXMIRE, *Chairman.*

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AMERICAN BANKERS ASSOCIATION

COMMENTS ON THE PRESIDENT'S 1967 ECONOMIC REPORT

SUMMARY

Briefly stated, the views of the Association on the major issues covered in the Report are as follows:

We agree with the Administration that private demand for goods and services is likely to be weaker during the first half of 1967 than throughout most of 1966. Accordingly, a shift to marked fiscal restraint in the very near future would be inappropriate.

We also agree that aggregate demand may rise rapidly in the second half of 1967 and on into 1968; a strong shift toward fiscal restraint may well be appropriate during that period. To the extent possible, however, this shift should consist of reductions in planned nondefense spending rather than increases in Federal tax rates.

We agree with the Council of Economic Advisers that monetary restraint in 1966 was highly effective in limiting aggregate demand but that its impact was uneven. We do not agree that the slump in homebuilding calls for significant structural changes in the financial system, such as Federal chartering of mutual savings banks.

Although a consistently low level of unemployment is a desirable social objective, we believe that, given today's level of skills and organization in labor markets, the Council is incorrect in assuming that unemployment levels of 4 percent or below are compatible with reasonable price stability. We are convinced this highly desirable goal is attainable only if efforts to reduce structural unemployment are intensified, and we applaud the Council's discussion of this problem.

The apparent progress toward evolutionary improvement in the international monetary system is gratifying. But we also believe that efforts to achieve equilibrium in our international accounts are inadequate and, to the extent market processes have been warped or thwarted, in the long run inappropriate.

We do not agree that Administration economic policies in 1966 were successful in promoting the Nation's major economic goals. Inappropriate policies in 1965 and 1966 created significant problems for 1967, problems that greatly complicate the task of achieving noninflationary, sustainable growth in the period ahead.

THE SETTING FOR ECONOMIC POLICY IN 1967: THE ECONOMY IN 1966

The administration may continue to argue that the question of appropriate policy mix and degree of fiscal restraint in 1966 is an open one; the record of economic performance is not. The general price stability of the preceding 8 years was disrupted. Credit conditions tightened precipitately and interest rates rose to their highest levels since the 1920's. Unit labor costs, after 6 years of stability, rose sharply. The U.S. trade surplus deteriorated seriously.

The major positive achievements in 1966 were a drop in unemployment to an average of less than 4 percent for the first time since 1953 and a real increase in gross national product of almost 5½ percent. These real gains are impressive, but we question whether they were worth the current and possible future costs.

One current cost in 1966 is the inequity of inflation, with its especially severe impact on those with fixed or lagging incomes. Another current cost resulted from the effect of tight money on State and local governments, which found their borrowing activities seriously curtailed, and on those industries which rely heavily on credit to finance their operations and/or sale. Homebuilding is an important, although not the sole, example of this latter group. Still another current cost is the \$3 billion increase in Federal spending in fiscal 1967 which, according to Government officials, was a result of stringent monetary conditions in 1966.

It is clear in retrospect that the period beginning in mid-1965, when the war in Vietnam began to escalate sharply, and extending well into 1966 involved a variation of "forced saving" in the classical inflationary sense. Federal tax revenues were not large enough to command the transfer of real resources necessary for the war effort. Deficit financing had to be used and, with near-full employment, price inflation was the result. This inflation, coupled with the impact of tight money on groups vulnerable to tightening credit conditions, "forced" the real saving necessary to release resources sought by the Federal Government.

These can be viewed as the current costs of inappropriate policies in 1966. The future costs, although less easy to identify, may be even more significant for the performance of the economy. They stem directly from the imbalances generated by the demand-pull inflation of an overheated economy.

OUTLOOK FOR 1967

These imbalances have led to more than the usual disagreement among economists concerning the outlook for 1967. Although a "standard forecast" of "weak first half, strong second half" appears to be developing, there is still a significant minority of observers who expect, if not recession, at least a distinct pause in the pace of economic growth this year. This view, bolstered by the clear diminution in the strength of private demand in recent months, calls for caution in carrying out economic policies in the months ahead.

The American Bankers Association believes 1967 will be a year of rising economic activity, but with perhaps much greater strength of private demand in the final 6 months than in the first half. Still, the arguments of those who foresee the end of the long economic advance should not be ignored. In part, their position reflects concern with the most significant short-run imbalance of 1966; namely, the high rate of inventory accumulation, which reached its peak in the final quarter. If the inventory situation were the only factor, the continued strong uptrend in Government spending (barring an end to the Vietnam conflict) could be expected to soften and shorten any adjustment. This view supports the standard forecast.

But there are in addition deep-seated imbalances which, if not corrected, will continue to threaten the longrun sustainability of the economic advance. The most important of these imbalances is reflected in the tendency for total labor compensation to rise much faster than output per man-hour. Stability in unit labor costs of production—the mathematical result of equal percentage increases in total labor compensation and output per man-hour—has been a major factor account-

ing for the strength and durability of the 6-year-old economic advance. This experience stands in sharp contrast to earlier postwar expansions; in those instances, sharply rising unit labor costs are generally viewed as having been important factors in stopping expansions.

The reasons for this are not difficult to identify. Rising unit labor costs, if absorbed by industry, reduce profit margins and diminish the attractiveness of new investment in plant and equipment; this curtails aggregate demand in the short run and economic growth in the long run. Rising unit labor costs can be fully passed on to customers only if Federal economic policies (fiscal and monetary) facilitate an increase in aggregate demand for the products of industry as a whole.

But this latter approach means more inflation, which not only results in the inequities noted earlier but tends to reinforce the wage-cost-price spiral and intensify the problem of stabilizing such costs. This is because the demand-pull pressures of an overheated economy are the basic cause of excessive wage settlements. Demand-pull pressures break out in inflation when labor becomes relatively scarce; additional overheating, therefore, simply adds to pressures in labor markets as business firms bid for additional workers in order to increase output and meet rising demand for their products. In addition, the accompanying rise in consumer prices encourages unions to strive for wage increases which, in addition to covering national productivity gains, offset at least in part the shrinking purchasing power of their workers' take-home dollars. Indeed, with rising consumer prices, the national productivity trend is likely to become a floor to which cost-of-living increases are added for obtaining, in labor's view, equitable wage settlements.

THE WAGE-PRICE GUIDEPOSTS

Before turning to comments on economic policies for 1967, it should be noted that the wage guideposts have proved ineffective, if not perverse, as an approach to "incomes policy" in an overheated economy. They have been largely ineffective because market pressures in a fully employed economy are simply too strong to be overcome by exhortation. A perverse impact may have occurred if, as seems likely, reliance on the guideposts helped to delay the administration's shift toward economic restraint in 1965 and 1966. What may be more important in the long run is that, to be effective, wage as well as price guideposts must be implemented through some sort of de facto control such as the use (or threat of use) of Executive power. Surely this type of approach works against the strength and viability of a market economy. From a longrun standpoint, it would be far preferable to concentrate on creating an adequate and workable degree of competition in both labor and product markets.

Also important from a longrun standpoint are the efforts to reduce structural unemployment and improve the performance of labor markets in general. The Council's discussion of this problem (pages 100-113) is highly constructive. But until these longer run measures can take effect, the administration should continue to view 4-percent unemployment not only as an interim target but also as probably the lowest level to which unemployment can now be pushed without stimulating strong inflationary pressures. Experience in recent years indicates that average levels of unemployment of $4\frac{1}{4}$ to $4\frac{1}{2}$ percent may be closer to the equilibrium level. To advocate recognition of

this probability, and to recommend that policy be adjusted to it, is not to suggest that 4- to 4½-percent unemployment is socially desirable or acceptable as a permanent target. It is rather a recognition of the fact that the economic overheating necessary to hold unemployment below this level may well, in the long run, lead to even higher unemployment and a slower rate of economic growth as a result of the imbalances that result from demand-pull inflation.

One important aspect of structural unemployment is missing from the report: the effect of Federal minimum wage legislation. On February 1, 1967, the minimum wage was boosted to \$1.40 per hour and is scheduled to increase to \$1.60 per hour in 1968. This may explain much of the high unemployment rates among teenagers. In addition, these wage rates are higher than the rate paid persons in some job retraining programs, discouraging participation in our primary means of reducing structural unemployment.

STABILIZATION POLICY FOR 1967

With these comments as background, what should be the major content and thrust of Federal stabilization policies in 1967? "Caution" and "flexibility" should be the watchwords—caution in applying either expansive or restrictive measures; flexibility in order to move quickly in whichever direction events dictate.

Flexibility is especially necessary in order to guard against re-emergence of the overheating that is the basic cause of our current difficulties. If, as seems likely, the current weakness in private demand is replaced by marked strengthening later in the year, the case for additional fiscal restraint will be strong; otherwise, monetary conditions are again likely to tighten more than is desirable. But even under these conditions the American Bankers Association would be reluctant to endorse a surcharge on personal and corporate income taxes. Fiscal restraint can be achieved through either an increase in taxes or a decrease in spending. We strongly favor the latter approach because of our great concern over the mushrooming of Federal spending and influence in recent years. Of considerable practical significance is the fact that taxes, once raised "temporarily," are sometimes very difficult to reduce later.

The avoidance of additional overheating in the months ahead will not in itself restore balance to the economic advance. As noted earlier, wage settlements in 1967, as a legacy of 1966, are likely to continue to exceed productivity gains by a significant margin. The avoidance of further demand-pull inflation through fiscal restraint will set the stage for reestablishing such balance later, perhaps in 1968. In the meantime, we will simply have to bear the costs of our earlier mistakes. These costs will not have proved so great, on balance, if in the future they lead to firmer and timelier adjustments of Federal stabilization policies to changes in economic conditions.

MONETARY POLICY AND THE MORTGAGE MARKET

An additional important reason for avoiding further demand-pull inflation through appropriate fiscal actions in 1967 is the need to avoid the extreme reliance on monetary policy that occurred in 1966. Easier monetary conditions—and considerable easing has occurred—would

militate against the inequities that tight money gave rise to last year. Easier money, in particular, should result in a somewhat larger flow of funds into home mortgages.

To recognize this fact is not to admit that tight money alone was responsible for housing's difficulties in 1966. The evidence is persuasive that overbuilding had reached serious proportions in several parts of the country. In these instances, the tightening of money can be viewed as speeding needed and overdue adjustment. In addition, the strong and steady postwar rise in construction costs should not be overlooked as a significant factor affecting the course of demand for housing. Nevertheless, extreme swings in mortgage availability and housing starts are undesirable, and it is therefore appropriate that the Council discussed means of remedying this situation.

In this respect, the Council's suggestion that better access to the open capital market for the mortgage market is worthy of exploration. If by this suggestion the Council means that the marketability of mortgages should be improved, with the goal of creating a viable and active secondary market, then we recommend to the Administration the general outline of a proposal developed by the American Bankers Association several years ago. This proposal, drafted as a Mortgage Market Facilities Act, would authorize Federal chartering of private organizations to insure conventional mortgages; Federal chartering of private mortgage marketing organizations to provide a secondary market for conventional and other mortgages; and issuance of debentures by the mortgage market organizations upon the security of insured or guaranteed mortgages in their portfolio. This proposal doubtless needs study and revision, but some adaptation of it could well provide a practicable means of improving the marketability of mortgages.

Few would argue with the Council's contention that better liquidity and management practices on the part of many savings and loan associations would do much to help stabilize the flow of funds into mortgages and homebuilding. Noteworthy is the suggestion that the associations emulate commercial banks by accumulating secondary reserves in easy money periods that could be used to sustain leading activities in tight money periods.

After making these reasonable suggestions, however, the Council goes on to recommend a far-reaching change in the Nation's financial system; namely, Federal chartering of mutual savings banks. The Council states:

Such institutions would have the power to invest in corporate securities and consumer loans as well as mortgages. While broadened investment privileges of federally chartered mutual savings banks might initially divert some funds from the mortgage market, such chartered banks should improve the efficiency of thrift institutions, strengthen them in competition with banks, and thereby ultimately benefit the mortgage market [Report, pp. 66-67].

A complete and definitive answer to this argument cannot be provided in the absence of the assumptions on which the Council's reasoning is based. On the surface, at least, it seems contradictory to argue that legislation permitting mortgage lenders to lend more in non-mortgage forms would strengthen the mortgage market. Proponents of the chartering measure anticipate a substantial number of conversions from savings and loan associations to the new banking system. It is clear that a major reason for such a movement would be

the desire of the associations to escape the present legal requirement that the bulk of their funds be kept in real estate loans, while still retaining highly preferential Federal tax treatment. The Council's conclusion that there will be a diminished flow of funds into real estate loans only in the short run may have substantially underestimated both the amounts which would be lost to the residential loan market as well as the time over which such losses would extend.

In any event, the Council should spell out the reasoning underlying its proposal in greater detail. Thus far it is appropriate to question how a measure which would encourage lending by thrift institutions in areas other than home loans would in fact stimulate the flow of funds into home loans.

This is not the only questionable aspect of the proposal. Implicit in the Council's argument is the view that commercial bank competition with other thrift institutions was a major adverse force leading to the sharp reduction in mortgage lending in 1966. The record proves otherwise. The major competitor was the securities market, which attracted large amounts of individual savings in 1966. According to the Council's figures, individuals' savings in the form of Government, corporate, and other securities rose by \$14.9 billion in 1966, three times the 1965 increase and more than twice the expansion in 1964. On the other hand, growth in commercial bank time deposits—consisting of money market certificates (not individuals' savings) as well as savings certificates—was on a percentage basis less than half the 1965 increase and substantially below the 1964 increment.

Clearly, therefore, in 1966 the securities markets, through the process known as "disintermediation," provided the strongest competition for thrift institutions in 1966—for commercial banks as well as savings and loan associations and mutual savings banks. Federal chartering of mutual savings banks will do nothing to prevent this sort of competition if interest rates again rise to the extremely high levels of 1966.

The fundamental reason the flow of mortgage funds decreased so sharply in 1966 was not the securities market; it was not the actions of commercial banks; nor was it the failure of mortgage-lending institutions to react properly to emerging conditions. The fundamental reason was the inadequate fiscal policy of the Federal Government which, by default, left to monetary policy the greatest part of the task of restraining inflation. Inevitably, this led to extremely tight credit conditions and high-interest rates.

Rather than calling for far-reaching structural changes in the financial system, those who want to protect the homebuilding industry from such sharp drops in credit availability in the future should instead insist upon the application of a balanced mix of fiscal and monetary policies.

DEBT MANAGEMENT AND THE INTEREST RATE CEILING

Debt management is viewed by some as an important aspect of Federal economic policy; at the least, the economic and financial implications of handling a public debt of \$330 billion are worthy of attention and discussion. Consequently, it is extremely disappointing that neither the President nor his Council of Economic Advisers has discussed the matter in the 1967 report.

This omission is especially disturbing in view of the continued restrictive impact of the 4¼-percent ceiling applicable to new Treasury issues with a maturity in excess of 5 years. The average maturity of the public marketable debt, now at 4½ years, is the shortest since 1960. The 4¼-percent ceiling obstructs an orderly approach to debt lengthening and should be removed. We urge administration officials to initiate discussions with congressional leaders in order to resolve this problem.

BUDGETARY CONCEPTS AND PRESENTATION

We applaud the decision of the President, as announced in his Budget Message, to seek the advice of a bipartisan group of informed individuals with respect to budgetary presentation and concepts. Each of the current budget approaches—administrative, consolidated cash, and national income accounts—has its strengths and weaknesses, but none of the three is sufficient in itself to meet the needs of Congress and the public.

In view of the President's decision to seek such advice, we deem it unfortunate that the administration has, starting this year, adopted the national income accounts budget as the basic instrument for presentation of the Federal program. As the President noted, the NIA budget is not well suited for an analysis of individual Federal programs. It does not include Federal lending activities, which at times can be of special economic significance. Moreover, the NIA budget (as well as other approaches) can be misleading with respect to the initial impact of Federal spending programs.

Admittedly, both the administrative and cash consolidated budgets have serious shortcomings. But in view of the impending study, a strong case could be made for no change in the basic budget concept at this time. If the administration deemed such a change mandatory, the cash consolidated budget, which includes Federal lending activities, would appear to be superior to the NIA budget.

As for the study group from which the President will seek advice, development of some measure of Federal Government activities is likely to be its first order of business. To illustrate the problem, expenditures for fiscal 1968 are estimated at \$135 billion in the administrative budget; \$172 billion in the cash consolidated budget; and \$169 billion in the NIA budget. But each of these budgets conceals a wide range of Government activities. For example, it is estimated that in fiscal 1968 expenditures of the Postal Department will run \$6.7 billion and receipts \$5.3 billion, leaving a deficit of \$1.4 billion. However, only the deficit is entered on the expenditure side of each of the three budgets, thus understating the dollar total of Government activities by more than \$5 billion. Some indication of such "netting" is indicated from the official statement of "Gross Expenditures of Government-Administered Funds" which estimates fiscal 1968 spending at \$210 billion. Clearly it will be no easy task for the study group to determine the best measure of total Federal activity.

Even if one had an acceptable measure of past expenditures, receipts, and the resulting deficits or surpluses, he could not make inferences regarding the fiscal impact of Government activities; i.e., whether fiscal policy was restrictive or expansionary. Under the exist-

ing U.S. tax structure, revenues increase and fall about 10 percent faster than GNP. Hence a recorded surplus may reflect, not a restrictive policy, but an expansionary policy under which tax revenues rose faster than Government spending. To measure the fiscal impact of Federal activities, additional analytical tools must be developed.

Another important contribution the study group could make would be to provide a framework for analyzing fiscal impact of all budget projections, both spending and taxation, on a semiannual basis. This would not only make short-run or cyclical analysis more meaningful but would also make it far easier to convert fiscal year estimates to calendar year estimates. Semiannual estimates become very important when expenditures and corresponding tax increases take effect in different halves of the year. This occurred in the social security program in fiscal 1966 and is proposed for fiscal 1968. The same is true of the excise tax cuts in fiscal 1966: some took effect at the beginning of fiscal year 1966 and others took effect at the beginning of the calendar year (midway through the fiscal year).

The American Bankers Association offers its assistance in these approaching studies. They are both timely and necessary.

SELECTED USES OF ECONOMIC GROWTH

This chapter of the 1967 report treats a wide range of social welfare problems on which the Council takes no position but attempts to raise some issues that will require difficult choices. The issues include poverty, income maintenance for the poor, public assistance, the proposal for a negative income tax, education, urban problems, and a discussion of the overall relationship between Federal, State, and local government finance. The common denominator underlying analysis of each of these problems is that they raise two emotion-laden issues: the size of the public versus the private sector, and the relative roles of Federal, State, and local governments.

It is a mistake to assume that planning with respect to uses of future economic growth must await the end of the Vietnam conflict, although admittedly the necessity for successful prosecution of the war calls for caution. But the fact is that, barring a greater Vietnam escalation than now seems likely, Federal defense spending can be expected to level off at or close to the level projected for the coming fiscal year. Federal revenues, however, should continue to increase with an expanding gross national product. The extent of this growth depends on our success in achieving a high and sustained rate of economic growth. If reasonably successful, we might expect gross national product to expand by 3 to 5 percent in the years ahead (over the next 3 or 4 years, about \$25 to \$35 billion on the basis of 1966 dollars) with an accompanying expansion in Federal revenues of up to \$10 billion a year.

Clearly, therefore, it is not too early to begin public discussion and debate as to policies for using these additional revenues and thereby preventing excessive fiscal drag. The obvious choice in an overheated economy, such as occurred last year, would be to use at least a portion of the growing revenues to retire Federal debt; that is, to create and maintain as long as necessary a Federal surplus.

From a longer range standpoint, however, other alternatives are available. Experience in the first half of the 1960's indicated that

broad-based properly structured reductions in Federal tax rates can help sustain economic activity and utilize the fruits of growth to help bolster living standards. Another choice—one that has been receiving increasing attention—is to return a portion of Federal tax receipts to State and local governments. Still a fourth option, of course, is to increase Federal spending.

The American Bankers Association has studied and commented on aspects of these alternatives in the past and will continue to do so in the future. The important point to recognize at this time is that, although there is currently a deficit in the Federal budget, long-range prospects for rapidly increasing revenues call for careful, extensive research and discussion of these vital matters.

THE INTERNATIONAL ECONOMY

The apparent progress toward establishing a technique and mechanism for orderly accretions to international reserve assets is most gratifying. Hopefully, progress will continue so that, when the need for additional reserves becomes clear, the new mechanism will be ready to be put into operation. The American Bankers Association, without commitment to any given approach, urges continued discussion and negotiation toward this end.

Still, we cannot view the international economy with complacency so long as the U.S. balance of payments remains in substantial disequilibrium. The adverse effects of the 1965-66 overheating of the economy were not confined to the domestic economy; the overheating contributed directly to the surge in imports that was the main factor in cutting sharply into our trade surplus. The impact of this deterioration has been obscured by the large inflow of volatile funds, reflecting the extremely tight money situation here.

While the Vietnam conflict has contributed to an additional foreign exchange drain of substantial magnitude, this contingency provides no latitude for dealing with the fundamental problem. Rather, it adds to the urgency.

The additional avenues for closing the payments gap have been discussed many times, both by this association and by other observers, and need not be repeated in detail here. Surely the reestablishment of balanced, noninflationary economic growth is a prime requisite. Otherwise it will be difficult to recover the ground lost by shrinkage of the trade surplus. We cannot share the optimism of the Council concerning the trade surplus in 1967. Some improvement may well occur, but the prospects for continued wage and price increases, coupled with a less expansionary environment in important economies abroad, dampen these prospects.

As time goes by—and recalling that since 1949 the U.S. account has been in deficit every year but one, with truly sizable deficits during each of the past 10 years—it becomes increasingly clear that fundamental realignments in free world defense and aid spending will be necessary before true equilibrium is reached. Informed observers in the financial community and elsewhere increasingly are questioning the heavy budget and foreign exchange outlays for the maintenance of large U.S. garrisons in Western Europe. They also believe that our prosperous free world friends are able to share a larger portion of the overall defense and aid burden.

It is not sufficient to answer these statements simply by stating that the defense and aid programs, as now constituted, are overpowering aims of U.S. foreign policy. Experience in recent years should have taught us that a nation with a weak currency can be severely handicapped at the international bargaining table. In fact, foreign policies relating to defense, aid, and financial matters are inseparately related.

Our concern about the lack of progress in correcting the fundamental imbalance in our international accounts is greatly heightened by the heavy reliance on nonmarket devices such as the interest equalization tax and foreign lending and investing guidelines. However necessary these devices may be in the short run—and it should be remembered that the interest equalization tax, which shows signs of becoming a permanent appendage to our system, was first recommended three and one-half years ago—their long-run retention clearly is against the interests of this Nation and its citizens. Equilibrium achieved with these measures still in effect will not be equilibrium in the true sense of the word.

CONCLUSION

In the preceding pages we have attempted to provide constructive criticism of the President's economic messages for 1967. The rupture of stable economic growth in 1966 was disappointing, but it can be hoped that the policy inadequacies of 1965 and 1966 will be recognized by the Congress and the administration and that, as a result, future policies will be better conceived and executed. As important as this consideration is, however, it should not be allowed to obscure certain fundamental trends that, if continued, can do considerable harm to our market economy.

The Employment Act of 1946 requires that all measures taken to promote economic growth and stability be carried out "in a manner calculated to foster and promote free competitive enterprise." The record of recent years indicates that, in the interests of achieving important short-run goals, this mandate is being violated. We refer to heavy emphasis on guideposts, guidelines, and the interest equalization tax.

The wage-price guideposts were first enunciated in 1962, but only as "a contribution to public discussion." In subsequent years they evolved into a type of "voluntary" incomes policy and, in the current Report, the Council refers to a "national price policy for 1967" (p. 132). Reference is made to the many conversations between administration officials and companies contemplating price increases, and the Council states its intention to continue such discussions in the future. Administration intervention in labor-management negotiations is a matter of record and no little public attention. In effect, administration of the guidepost technique has moved at least part way toward de facto price and wage controls.

The interest equalization tax was first proposed in the summer of 1963 as one means of curtailing the heavy outflow of portfolio investment. It was enacted a few months later and, in 1965, extended until mid-1967. Now the administration is proposing that the tax be extended for another 2 years and that the President be given discretion to vary the tax within a range of 0 to 2 percent, or up to twice its current effective level.

The guidelines for foreign lending and investing by American financial institutions and business corporations were proposed by President Johnson in early 1965. They have since been tightened and extended in coverage.

This recounting of efforts to deal with pressing short-run problems raises serious questions about the future of our market economy. The fundamental danger of guidelines and guideposts as permanent devices for influencing crucial decisions in our type of economy is that proliferation of such programs can seriously undermine the very strength of the economy itself. The market system's reliance on private initiative, self-interest, the profit motive, and competitive pricing provides the fundamental strength and drive of the system. Guideposts and guidelines, however, represent an attempt to induce market participants to behave in ways other than they would if they were reacting solely to market pressures and in the best interest of those whom they represent. Reference here is not to short-run self-interest, but to long-run, enlightened self-interest.

This is not to argue that competition is pure and perfect in either product or labor markets; such obviously is not the case. It is to argue that, rather than responding to pressing short-term problems by adopting methods which work against market processes, the proper approach is, whenever possible, to work by and through the market mechanism. To the extent the mechanism itself is faulty, then attention should be directed to the fundamental factors accounting for that weakness.

Stated differently, it is far preferable to attempt to correct fundamental market deficiencies than to try to transform or redirect actions growing out of market processes. As noted earlier, the latter course runs the serious risk of undermining the very strength which accounts for the superiority of our type of economic organization—a superiority which throughout modern industrial history has been demonstrated beyond doubt.

COMMITTEE FOR ECONOMIC DEVELOPMENT

(By EMILIO G. COLLADO, CHAIRMAN, RESEARCH AND POLICY
COMMITTEE)

We appreciate this opportunity to present the views of the Committee for Economic Development on the Economic Report of the President and the annual report of the Council of Economic Advisers. We regard this annual review as important, and we have, I believe, an uninterrupted record of annual statements to the Joint Economic Committee since the review was established.

The 1967 Economic Report of the President and the annual report of the Council of Economic Advisers which accompanies it constitute a very helpful description and analysis of the economic problems before the country today. These reports present in condensed, readable form an enormous amount of factual information and a wealth of instructive argument relating to economic policy. They are valuable contributions to professional and public understanding of economic issues.

The report of the Council discusses several disturbing aspects of the present state of the economy as well as its performance in the past year. I find myself in agreement with many of the views expressed. The Council is rightly concerned with the future course of price stability and with the maintenance of high employment. Indeed, I interpret this year's report as dealing in major part with the need to construct once again the conditions which were so important to the prolonged period of price stability which marked the early parts of the present expansion. To be specific, we agree entirely with the following assessment made in the report (p. 72).

The public sensed what every economist knows—that a reasonably stable price level is essential if balanced prosperity and full employment are to be continued at home and if the strength of the dollar is to be maintained abroad. Experience proves that rising prices can generate distortions that can eventually topple an economy from boom to recession. Experience also shows that rapidly rising prices can quickly erode a country's competitive position in international markets. The critical economic problem to be solved in the year ahead is that of maintaining income growth and full utilization of resources without becoming trapped in an inflationary price-wage spiral.

I share with the Council a concern for the possible resumption of the cost push inflation of the 1955-57 period, especially in the light of the reduced rate of gain in productivity compared with that of recent years and the increased pace of wage and other cost increases. These disturbing developments add emphasis to our own and the Council's views on general monetary and fiscal measures of restraint.

STABILIZATION POLICIES—1966 AND 1967

The Council's report interprets the stabilization policies pursued in 1966 as appropriate and adequate to the problems which arose. In

the eyes of the Council, the fact that the Federal budget on "National income and product account" moved into surplus in the 1st quarter of 1966 signaled sufficient fiscal restraint. The Council also remarks that the monetary authorities pursued a complementary policy in the last half of 1966. While there is concern with the distributional effects of the monetary restraint and some disappointment with the rate of price increase, the Report suggests that the stabilization policies were generally appropriate to the tasks of the year. We take a different view.

A shift of the Federal Budget, in the national income accounts, from surplus to deficit between the first and second half of 1965, accompanied by rapid monetary expansion, contributed to converting vigorous economic growth into an inflationary boom. Perhaps it is too much to expect that policy, especially fiscal policy, could be so flexible or so foresighted as to prevent such a development. However, when fiscal decisions were being made at the beginning of 1966 it was time to recognize what was happening and to take balanced restraining measures. In fact, partly because of incorrect estimation of the probable military expenditures, the measures taken were inadequate in total and left too much of the problem of restraining inflation to monetary policy. The budget did move into surplus at the beginning of 1966, but this was largely the result of the sharp rise in prices and thus taxable incomes. Fiscal policy, while it became more restrictive than it had been, was not sufficiently restrictive to keep the demands of the public and private sectors within the bounds of our capacity to produce at stable prices. As demands outstripped capacity, prices and wages rose rapidly. The monetary authorities found themselves with the major burden of responsibility for stabilization. The amount of monetary restriction necessary to keep the rise in prices and costs to the rates actually realized pushed interest rates up very rapidly to levels not experienced in 40 years.

The credit stringencies induced by the anti-inflationary monetary policy resulted in a very sharp drop in residential construction. The balance in capacity utilization which the Council commented upon in its 1966 report deteriorated. At the end of 1966 the gap between actual and preferred operating rates was only one percentage point different from that in the previous year. There was, however, much wider variation in this gap among industries at the end of 1966 than was true of 1965. Many industries found themselves operating considerably above preferred levels while others were operating substantially below their preferred levels. Finally, the last quarter of 1966 saw one of the sharpest rises in inventory accumulation in the postwar period.

The high interest rates of 1966 attracted extraordinarily large amounts of private savings to open market instruments including some of the assets accumulated in savings institutions. Mortgage lending institutions found themselves with very small net inflows and mortgage extensions fell sharply. Commercial banks found themselves under substantial pressures throughout the summer and the Federal Reserve instituted selective controls over discounting in early September further to restrain bank loans to business. These belated actions together with the elimination of the investment tax credit on machinery and equipment and certain of the accelerated depreciation pro-

visions and along with the cessation of sale of participation certificates, so changed expectations in the financial markets that there was a marked reduction in interest rates and in the strength of final demand (gross national product minus inventory accumulation) as 1966 ended.

It is our view that while the fiscal policy moves taken were in the appropriate direction, they came too late, were insufficient in amount and misdirected in form. There was a concern for what was thought to be "excessive" amounts of investment. There was also increasing concern that there would be growing upward pressures on wage rates and a slower growth in productivity as the economy reached full employment. Under these circumstances the most sensible policies to pursue would have been to restrain total demand by a tighter fiscal policy while at the same time permitting the mix of demand to contain more investment, especially in equipment. If this had been done, total demand could have been kept within the economy's potential to produce, and increases in productivity stimulated by the addition of fast payoff additions to productive capacity.

The actual policies pursued were quite the opposite of these. They were to reduce investment and limit the extension of business loans by commercial banks. While these policies acted to lessen total demands, they did it in a way which discouraged the generation of new capacity in general and therefore unduly discouraged capacity which would increase productivity.

We have dwelt at length with an examination of policies pursued in 1966 because we feel that some of the policies which are suggested for 1967 expose us once again to many of the same risks we faced at the outset of 1966. The President's budget plans, assuming the proposed tax increase is enacted and that total demand is at the level of \$787 billion of gross national product projected by the Council, imply an economy at full employment with a deficit on "National income and product account." Once again, we are pursuing policies meant to exact the last ounce of output from the economy though such a policy implies the chance that total demand will be too strong and hence inflationary.

Once we explicitly recognize that the Council's economic projections for 1967, like all economic projections, are uncertain projections, the appropriateness of their fiscal policy suggestions is open to further question. For the total private demand in prospect, different levels of Federal spending and taxing subject the economy to a chance that total demands will either exceed or fall short of our capacity to produce at stable prices. The more stimulating the fiscal policy pursued at any total or private demand, the larger is the chance that aggregate demand will outrun capacity and the smaller is the chance that it will fall short.

The choice of the most appropriate role for Federal spending and taxing requires an estimate of the probable costs associated with excessive total demand and with insufficient total demand. In 1967, the costs of excessive total demand are clear and substantial. Pressures for wage increases are already strong and will only be increased by further rises in prices. Monetary policy was strained to the extreme in late 1966 and it would be unwise to take actions which might require a very restrictive monetary policy in late 1967. The balance-

of-payments position of the United States would also be adversely affected by a renewal of inflationary pressures; exports will tend to fall and imports will tend again to grow sharply. Moreover, the Council's report contains many references to the fact that cost increases—that is, wage increases, price increases, or interest rate increases—once introduced become institutionalized as a permanent part of the economic structure. For all these reasons excessive demands leading to price inflation in 1967 would be most detrimental to both our short-run and long-run objectives.

To be sure, there are also costs associated with a level of Federal spending and taxing, which results in insufficient total demand. An obvious and most important cost is that of unemployment of men and machines. However, if it appeared as the year progresses that total demand is weak, several options would be open to the stabilization authorities. Monetary policy could be eased to accelerate the expansion, the investment tax credit could be reinstated, and certain of the Government's socially desirable programs now being curtailed, could be expanded. If a major drop in demand occurred as a result of a settlement in Vietnam, a general tax reduction could be considered.

Thus, finding the right fiscal policy is a question of balancing the risks. The costs of too expensive a fiscal policy are clearly substantial. At the moment, the costs of potential under-utilization are less, in large part, because of our ability quickly and effectively to initiate expansionary influences. This strongly suggests that the appropriate fiscal policy for 1967 is one which exposes us to only a very small chance that total demands will exceed our capacity to produce at stable prices.

A. STABILIZING BUDGET FOR 1967

For many years the CED had advocated a budget policy designed to deal effectively with the problem of balancing the demands in the years ahead with our capacity to produce at stable prices as well as the problem of developing the incentive and capacity for rapid growth. The main characteristics of this budget policy which is concerned not only with economic stability but also economic growth and efficiency are the following:

Policy should aim for a budget surplus to be used for debt retirement under conditions of high employment. This is important because the surplus would add to the funds available for private investment, thereby easing the pressures on monetary policy and promoting steady economic growth.

The impact of the budget should vary with the condition of the economy as a whole, being more expansive when the economy is depressed and more restrictive when the economy is booming or inflationary.

The overall impact that the budget exerts upon the economy should not, when combined with appropriate monetary and other policies, be so restrictive as to make attainment of high employment unlikely, or be so expansive as to lead to persistent inflation.

Such a stabilizing budget policy is achieved when the Government sets its expenditure programs and tax rates so they would yield a constant, moderate surplus under conditions of high employment and price stability. Such a policy is independent of conditions at any particular time and it does not depend on correctly forecasting the

future trend of the economy. But it does require attention to the surplus that would result at high employment. The present budget policy of the Government indicates that the budget will be in deficit at high employment, a policy that falls short of the stabilizing budget rule which we believe to have withstood the test of time. At high employment—and we now have high employment—there should be a moderate surplus in the Federal budget.

The built-in flexibility provided in the CED's stabilizing budget rule may not always suffice to avoid inflation or recession, however. If further action is needed to deal with these conditions beyond the swings that the automatic stabilizers generate, deliberate variation of the balance in the Federal budget supplies the chief tool that is available.

We have argued in earlier CED policy statements for agreement in advance, between the President and both Houses of Congress, on a method for quickly enacting temporary changes in tax rates as a way of stopping a recession and promoting recovery, or holding back excess demand and averting inflation. This would require that means be devised for putting the tax change quickly into effect and for assuring its termination at some point.

Time will be wasted in searching for an agreement between the Executive and Legislative branches of government on continuing authority to practice a discretionary fiscal policy. For this reason, in a statement issued last December "A Stabilizing Federal Budget for 1967," we expressed our preference for a temporary across-the-board tax increase for the calendar year 1967 to the extent that it is needed to provide a surplus in the Federal budget. We repeat that recommendation now.

EXPENDITURE REDUCTIONS

With the economy operating at or near the peak of its capacity as we enter 1967, it is especially important that the Federal Government examine its spending plans with extreme care. The total of Federal expenditures must be such that these demands together with the total of demands from the private sector as a whole do not exceed the economy's potential to produce at stable prices. As we said in our program statement in December,

This committee believes that holding down the rate of Government expenditure growth would be preferable to raising taxes as a way of achieving the necessary surplus; temporary tax increases tend to remain in effect and the revenues they generate tend to be absorbed in permanent spending programs. But it would not be realistic to expect the required expenditure reduction in the next 6 to 8 months, when it is most needed.

The Federal Government must also assure itself that the uses to which it places resources are at least as productive as the uses to which they would be put if they were available to the private sector. It is in this connection that the issues raised in chapter 4 of the Council's report on the "Selected Use of Economic Growth" and by the CED in its policy statement "Budgeting for National Objectives," are so very important. In this latter report, the CED supported President Johnson's "planning-programing-budgeting" proposals of August, 1965 and suggested new Congressional procedures for better ways to define and program the budget in order to meet our national objectives.

As maintained earlier in this statement to the joint economic com-

mittee and in the Council's report, inflation has been and continues to be a major problem for the U.S. economy. The Consumer Price Index is frequently used in labor contracts embodying a "cost-of-living" escalator. Moreover, this index reflects the movements in the prices of many of the products bought by the vast majority of wage-earners, and thus has substantial impact on wage bargains beyond those in which it enters directly. Since about one-fifth of the total index is comprised of farm products, any artificial increases in agricultural prices can put pressure on wages and costs.

Five years ago the CED issued a statement entitled "An Adaptive Program for Agriculture" which outlined the directions in which the farm support programs ought to move. The objectives of that statement and to a considerable extent the directions of subsequent government policy, were: (1) to cushion the income decline resulting from a proposed movement toward lower levels of price supports, and (2) to encourage voluntary acreage reductions in specified crops so that the then existing excess stocks could be moved into the market.

As we enter 1967 we find conditions in agriculture radically altered, partially as a result of the success of those programs. Farm income is the highest in years and the income per farm is at an all-time high. Dairy surpluses are gone, and the Department of Agriculture has requested an expansion of the production of wheat and feed grains, the prices of which are well above the support levels.

Despite this sharp change in agricultural conditions the proposed budget for price and income supports includes much of the same income supplements that were designed to reduce output and deal with low farm prices. Payments designed to induce acreage reduction and bolster income when wheat prices were low and large surpluses existed are being continued when output expansion is requested and market prices are almost 30 percent above the support level.

We estimate that \$1 billion could be cut from the provisions in the budget for expenditures on wheat certificates, feed grains and cotton diversion payments, and price supports for feed grains and vegetable oils.

THE BALANCE OF PAYMENTS

In its chapter on "Growth and Balance in the World Economy" the economic report expresses many points which are similar to those expressed in the recent CED policy statement, "The Dollar and the World Monetary System." There are two important differences in emphasis between these documents which deserve comment. Our stress on the critical importance to our balance-of-payments position of the pursuit of a stabilizing budget policy appears to be different from that of the Council.

In addition we feel that, since there is no precise way to determine the optimal allocation of capital between domestic and foreign investment, free capital markets will insure a better allocation than any controlled system. Thus we believe that the increased controls now being imposed on capital movements are undesirable. The capital account is merely one part of a set of interrelated accounts. To seek to use inhibitions on capital exports as the device to secure balance-of-payments equilibrium is likely to be a shortsighted policy.

COMMUNICATIONS WORKERS OF AMERICA

The Communications Workers of America commend President Johnson and the Council of Economic Advisers on the candor and the fresh approach which characterize much of the Economic Report of the President for 1967. We submit that this caliber of economic dialogue can make a significant contribution to the understanding by the American people, not only of the nature of the budgetary and fiscal problems which the President must tackle this year, but of the finely balanced performance which our economy must achieve—both in the private and public sectors—if we are to maintain a viable level of growth in 1967 while fulfilling our commitments at home and abroad.

We salute, in the President's budget message and in his Economic Report, the highlighting of the national income accounts basis for measuring the import of the Federal Government's operations. Such an approach, long advocated by analysts both in and out of Government, gives a far more realistic—and a more significant—overview of the revenues and expenditures of government at the Federal level than does the administrative budget.

By taking account of all Federal transactions which directly affect private spendable income, including that of State and local governments (the operations of the social security trust fund, for example), by counting such transactions at the time of their impact on the private economy (the withholding of income and social security taxes or the accrual of corporate income taxes), and by excluding loans or exchanges of assets, the national income accounts budget more accurately portrays the total effect of the Federal operation. It also provides a more meaningful measure of the net "plus" or "minus" of the Federal operation; for the calendar year 1966, for example, the NIA budget showed a surplus of \$200 million, while the administrative budget indicated a deficit of \$7.3 billion.

Of prime concern to the labor movement has been the attempt, as we saw it, to impose a rigid, decimal point ceiling on wage negotiations via the—by now—infamous wage-price guidelines. We railed against the guidelines, particularly in their 1966 version, both because of their unrelenting inflexibility, as they were applied to specific collective bargaining situations, and because they seemed only to be applicable to one factor in the economic equation—the wage-cost item—in their implementation.

We find most refreshing the approach taken by the Council of Economic Advisers to a national wage-price policy in their 1967 report—on several counts. We were encouraged by the lack of a hard-and-fast figure for wage settlements in 1967, and by the recognition that negotiations in the coming year will take account both of increased output per man-hour, and of the necessity for closing the gap between dollar earnings and lagging purchasing power—the most significant "drag" on the economy today in the 73d month of this unprecedented boom in the American economy.

We commend the Council's concern with price increases, as evidenced by their involvement in price rises for some 50 product lines during 1966—and their firm statement of a continuing “watchdog” role in this area in 1967. Directly related to price movements is the Council's concept of profit measurement for 1967; we strongly support the approach taken by the Council that evaluation of profit rates must necessarily be modified in the light of a continuing uptrend to the economy over an extended period of time—as opposed to the “boom and bust” approach, which dictated a maximization of profits in good years, to offset the lower levels of profit in bad times.

CWA notes with concern, however, the Council's comments on collective bargaining provisions which are geared to protecting the purchasing power of union members' wages. We reject the notion that an escalator clause is or is likely to create an “engine of inflation,” as implied by the Council. We see such provisions as a necessary underpinning to the maintenance of that purchasing power base which is the only viable assurance of continued growth and prosperity. We deplore the Council's unfortunate sense of timing in raising this issue in an otherwise useful and healthy discussion of wage-price problems in 1967.

Finally, we take special note of the President's announcement, in his Economic Report, of his intention to explore proposals now current for guaranteeing minimum incomes to those being shortchanged or ignored under our present system for allocating this nation's affluence. Such discussion is a natural followthrough to the recommendations of the National Commission on Technology, Automation, and Economic Progress; we assure the President of our vital interest in establishing a “floor committee” for the economic future of this remarkable apparatus of ours.

CWA firmly supports the raising of the level of economic and political discussion which characterizes this year's Economic Report. We pledge our full efforts to the Administration's objective of a continuing narrowing of the gap between our potential and our performance.

CONFERENCE ON ECONOMIC PROGRESS

BY LEON H. KEYSERLING,* PRESIDENT

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CONFERENCE ON ECONOMIC PROGRESS

INTRODUCTION

Once again, I am deeply appreciative of the year-by-year opportunity which the Joint Economic Committee has accorded me to comment upon the Economic Report of the President and the Annual Report of the Council of Economic Advisers.

These two Reports are essentially consistent with each other. And as the comprehensive Council's Report provides the facts and economic analysis upon which the succinct President's Report is based, I shall address most of my comments to the Council's Report. Toward the end of my statement, I shall deal briefly with the President's Report.

In commenting upon the Council's Report, I shall organize my comments under each of the five chapter headings in that Report.

CHAPTER I. EXTENDING THE RECORD OF PROSPERITY

I regard the Council's entire appraisal of current and foreseeable economic conditions as far too optimistic. Further, I find the Council's analysis weak, and its diagnoses off the mark.

Unemployment at 4 percent cannot be justified

The Report opens by hailing a full-time unemployment rate which reached a 13-year low of 3.9 percent in 1966, and described this as "essentially full-employment." The "interim" target of 4 percent which the Council set in early 1961 has thus become an ultimate goal.

I submit that unemployment in the neighborhood of 4 percent (full-time unemployment, as officially counted) is intolerably high, especially because it necessarily means a full-time unemployment rate several times as high among vulnerable groups; and especially when the enormous burdens placed upon the American economy—both international and domestic—require that we marshal fully our productive resources. Under current and foreseeable circumstances, I deem full-time unemployment somewhat below 3 percent to be consistent with maximum employment within the meaning of the Employment Act of 1946. It would be still better to set a goal of 2 percent.

Moreover, a full-time unemployment rate in the neighborhood of 4 percent means a true level of unemployment in excess of 5½ percent. This takes into account the full-time equivalent of part-time unemployment, and the concealed unemployment which results because the scarcity of job opportunity prevents many from looking actively for work, in which case they are not officially regarded as being in the civilian labor force or unemployed. I think that the goal for the true level of unemployment should be about 4 percent, and preferably about 3 percent.

The Council's 4 percent economic-growth goal is far too low

I reject entirely the Council's thesis that 1966 was "in some respect too big a year." From first to fourth quarter 1966, the annual rate of U.S. economic growth in real terms dropped sharply and dangerously to 3.3 percent, after averaging 5.1 percent in real terms during 1962-66, and even that higher rate was not sufficient to bring us even tolerably close to maximum employment and production. Consequently, I reject the Council's support of the restraining policies applied during 1966. Correspondingly, the Council's declaration of determination to prevent "any further slowdown" misses the mark. We need immediate and vigorous measures to reverse the current trend toward economic stagnation, and to accelerate greatly the rate of real economic growth.

Indeed, the Council's claims for a "remarkable uninterrupted expansion" from early 1961 to date are very excessive. After the 1960-61 recession, the upturn 1961-63 started rapidly and then slowed down greatly, and, with only timid measures of stimulation being applied, was mainly of an automatic or cyclical variety. Unemployment remained very high, and inadequate economic growth, if not stagnation, marked the second half of this period. For these reasons, and also because the massive tax reduction—the one really powerful stimulative measure applied 1961-67—was not enacted until 1964, it is excessive to claim proudly a sustained and satisfactory 6-year economic advance from early 1961 forward.

In consequence of this massive tax reduction, the average annual growth rate during 1963-66 was very much higher than the growth rate during 1962-63, but not nearly high enough to restore maximum employment and production. And while such a potent shot in the arm as this tax reduction could not fail to stimulate the economy for a time, the erroneous nature of the diagnosis and remedy (discussed later on) led to another period of stagnation (as evidence by the very growth rate from first to fourth quarter 1966, as cited above). Increasing weaknesses have been appearing in many important sectors of the economy, and the most responsible forecasts for 1967 are not reassuring. Whether another recession is in the offing within a year or so is not yet clear, although the threat is real. Viewing the most recent 6 years as a whole, there has been no satisfactory solution of the recurrent pattern of upturns, stagnation, and recessionary dangers to which I have repeatedly called attention from 1953 forward before this committee and elsewhere.

Under these circumstances, the Council's conclusion that a 4-percent growth rate would be satisfactory and even optimum for 1967 and for the years immediately thereafter does not track at all. With productivity advancing at about 3.5 percent annually and the labor force growing at about 1.5-1.7 percent annually, we need an average annual growth rate of at least 5 percent to hold unemployment stable (we should not be misled by the concealed unemployment and the repressed productivity growth rate which result when there is excessive economic slack). And as of now, considering also the excess unemployment, we need an average annual growth rate of about 6.3 percent to restore maximum employment by early 1969.

Council's twisted treatment of productivity issue

The Council's belated recognition that productivity gains in the private economy during 1961-66 averaged annually 3.5 percent, and even averaged annually 3.8 percent during 1961-64, vindicates fully the position which I have taken throughout the years that this high rate of productivity growth was in process. But the Council appears by now to have become congenitally unable to look at the productivity facts when it seeks to determine policies (such as the guideposts) or to set goals (such as the current 4 percent economic growth goal). For taking into account a labor force growth factor of even 1.5 percent, and without regard to reducing unemployment, the 4 percent economic growth goal must assume a prospective productivity growth rate of only about 2½ percent annually.

How the Council attempts to support a productivity growth rate figure only somewhere in the neighborhood of 2½ percent as a factor in its economic growth rate objective is not made clear because it cannot be made clear. If the 2½ percent productivity factor is derived from data indicating that the productivity growth rate during 1964-66 was very much lower than the 1961-66 annual average, then the Council cannot explain why it has shifted from a "moving average" to a 1- or 2-year figure in estimating productivity gains for purposes of policy. Besides, the very most recent productivity estimates are preliminary and subject to many uncertainties.

I do not agree at all with the Council's view that a higher productivity rate is feasible when the economy is moving from very slack resource use to somewhat slack resource use than when the economy is moving under conditions of somewhat slack resource use or the maximum resource use intended by the Employment Act. Substantial economic slack militates against efficient use of the employed labor force; a more healthy economy, as experience demonstrates, should improve efficiency and productivity. The reason why the economic growth-rate potential is higher when there is large economic slack is because there are more unused resources to draw upon, not because the productivity growth potential is higher when there is large economic slack. I believe that the decline in the productivity growth rate to just under 3 percent during 1965-66, if verified by the final date, vindicates my position, because that decline occurred during a period of slowdown in the rate of economic growth accompanied by a slackening of capacity use in some important sectors.

As I have insisted many times before this committee and elsewhere, the economic growth rate goal should factor in the potential productivity growth rate and the potential growth rate in the civilian labor force as these would be called forth by optimum demand. To relate the economic growth rate objective to the repressed productivity growth rate and to the repressed growth rate in the civilian labor force as affected by inadequate demand is to aggravate the difficulty of moving to overcome it.

The Council's statement as to the gap between actual and potential GNP from 1958 to 1965 is a gross understatement. (1) because it is predicated upon a productivity growth factor which is much too low, and a labor force growth rate factor which is also too low, and (2) because the base year should be 1953 rather than 1958 (because the pattern of inadequate growth started with 1953, not with 1957-58),

and thus the Council grossly underestimates the gap as of 1958. We have never returned to the 1947-53 growth rate trend line. The Council's estimate of no gap in 1966 is grossly erroneous for reasons which I have already stated.

The combination of the estimated fiscal 1968 budget deficit and the proposal for the 6 percent across-the-board tax increase, even allowing for some loosening of monetary policy, will not provide enough net stimulus to the economy in terms of the considerations which are set forth above. My position is indeed reinforced by the fact that the Council views with equanimity and even positive approval its estimated growth rate of about 4 percent, with full-time unemployment estimated at 3.9 percent for 1967 as a whole.

Council's erroneous position on fiscal-monetary "mix"

The Council's recognition that the combination of fiscal and monetary policies have operated to produce many imbalances in relative trends during 1966 is very belated recognition of the disequilibrium which I have long insisted would result from the unwholesome nature of the fiscal monetary measures. Further, the Council's analysis at this point is much too limited, in that it does not deal with the fundamental issue of the relationship between investment in the plant and equipment which add to our productivity capabilities and the demand for ultimate products in the form of consumer outlays and public outlays combined. The Council's recognition that proposed policies will hold the growth in consumer outlays and in disposable personal income in 1967 somewhat below the gains in 1966 is in my view a confession of the wrongful diagnosis of our needs and the consequent inadequacies in actual and proposed national economic policies.

The Council's very tardy (and still insufficient) recognition that monetary policy has operated irrationally, in term of its relative impact upon different parts of the economy, comports with what I have been saying for many years. But the adverse impact upon residential construction is not the only gross defect in the prevalent monetary policy. It prevents adequacy of credit on reasonable terms for many parts of the economy which are moving too slowly and which receive deficient incomes by all fair tests, while it does little to restrain the excesses in other sectors of the economy which are not nearly so dependent upon credit, if dependent upon it at all. Rising interest rates during the past ten years have redistributed far more than 100 billion dollars of income from those who have too little to those who should not receive this form of income supplementation.

The prevalent idea of a new product "mix," in which fiscal policy is tightened and money policy loosened, is in my view the ultimate in confusion. When the economy is too slack, as is now the case, both policies should be liberalized; when the economy is too tight, both policies should be tightened. This is the proper way to have each policy carry part of the load. If there are two horses to pull a wagon, the proper method is not to hitch them up to opposite ends of the wagon and have them pull in opposite directions. The real problem, thus far neglected, is that both fiscal policies and monetary policies should be much more selective in their impact, and should serve to improve equilibrium by restraining some parts of the economy and simulating others. The excessively aggregative approach of the Council neglects this whole problem, and results from the Council's failure

to develop, as I have frequently urged, a long-range balance sheet of product and income flows in the various sectors, so as to reveal what types of corrective action are needed.

My additional data

My chart 1 depicts the inadequate nature of the economic advance from 1953 and from 1961 forward, and portrays the effects of this upon unemployment and upon the production gap. It thus helps to dispel the unrestrained optimism and excessive claims in the Council's report.

My chart 2 estimates the large national economic deficits during 1953-66, in consequence of the inadequate economic performance. I have already set forth why the Council's estimates as to the size of the production gap are far too low.

Bearing directly upon why the Council's estimates of our appropriate growth potential have always been and still are far too low, my chart 3 sets forth the trends in productivity for the entire private economy, 1910-66, indicating the clear tendency toward a long-term acceleration in the rate of productivity gains, except when these gains are artificially repressed by recessionary or stagnation trends.

My chart 4 depicts a diagnosis which the Council has persistently and egregiously neglected. This diagnosis shows clearly that the core reason for economic instability and inadequate growth has been the tendency during the upturn periods for the investment in plant and equipment, which adds to our ability to produce, to outrun ultimate demand in the form of private consumer expenditures plus total public outlays for goods and services. The alarmingly serious nature of this trend from fourth quarter 1965 to fourth quarter 1966 is depicted on this chart.

The Council's forecasts that we now are experiencing a sharp decline in the rate of investment growth is really an implied admission that the excesses which have been aggravated by national economic policies to date may now run into a reaction so severe as to repeat the processes of stagnation and recession depicted on the chart. I have foretold this from the moment when the massive tax reduction was first proposed.

My chart 5 carries this same thesis forward, by showing the comparative growth rates in various aspects of the economy during 1961-66, and from fourth quarter 1965 to fourth quarter 1966. The chart speaks for itself, without need for much additional comment. It is worthwhile to point out, however, that the stabilization of corporate profits from fourth quarter 1965 to fourth quarter 1966 is a stabilization of profits which are still dangerously high relative to other forms of income.

My chart 6 carries this analysis still further by comparing price, profit, investment, and wage trends during the current economic upturn.

My chart 7 depicts how the long-term shrinkage in the Federal budget, relative to the size of the total economy and the priorities of our nationwide needs, has contributed to the deficiency in public outlays, the consequences of which I have set forth above.

My chart 8, more relevant now than earlier in the light of additional experience, shows how the tax cuts of 1962-65 were ill-designed to encourage economic equilibrium, but instead exacerbated both the

excesses in some sectors and the deficiencies in other sectors which I have already pointed out.

My chart 9, also more relevant now than earlier in the light of additional experience, shows how the 1964 personal tax cuts were inequitable and reduced the progressive nature of the Federal tax system, thus being unsound on economic grounds and indefensible on social grounds.

My chart 10 illustrates that the unfortunate trends in Federal tax policy are doubly unfortunate when viewed in the broader perspective of the regressive and inequitable nature of the entire nationwide tax burden, taking into account taxes of all types paid at all levels of government.

My chart 11 reinforces the foregoing analysis by depicting the maldistribution of income in the United States as of 1965. It also shows that, in some respects, the maldistribution was worse in 1965 than in 1947.

My chart 12 shows how the errors in fiscal policy have been compounded by the sins in the prevalent monetary policy. The chart shows that, during 1955-66 (going back to 1952 would further confirm the picture), the average annual growth rate of only 2.1 percent in the nonfederally held money supply was totally inadequate to support optimum economic growth. It also shows the direct impact of the periodic very sharp contractions in the growth rate of the money supply upon the GNP growth rate. Exceptionally noteworthy is the only 1.8-percent growth in the money supply during 1965-66, which in itself indicates that the prevalent monetary policy bears a major responsibility for the very sharp contraction in the U.S. economic growth rate from first to fourth quarters 1966 and on into 1967, as discussed above.

CHAPTER II. PRICES AND WAGES IN 1966

The whole discussion in this chapter of the Council's report, despite the display of statistics, strikes me as surprisingly shallow and lacking in analytical discernment. The Council's discussion does not even raise most of the questions which ought to be raised and also answered.

Deficiencies in Council's entire price analysis

The Council says that the recent advance in prices was due in large measure to the acceleration of the growth in demand which began in mid-1965, and to the particularly rapid increase in the output of capital goods and defense products. But price-trend analysis needs to be set in a very much longer-time perspective to be really meaningful. For example, how does the Council's explanation of the recent price changes square with the very serious price inflation during 1955-58, when the U.S. economy was afflicted by stagnation and recession?

Further, the sharp rise in industrial prices in many administered price sectors might possibly be explained, but cannot be justified, by high or rising demand relative to productive capabilities. Why should administered price be raised, when profits even at existing prices are soaring in consequence of higher demand and excessive profit margins per unit?

The price increases and excessive profits which have occurred recently in some of these administered price areas are in themselves a manifestation of the woeful defects in the Council's price-wage guideposts from the date of their inception. While considerably effective pressures were exerted against some important rates of wage increases, the application of the guideposts on the price side was mostly ineffectual from the beginning. No quantitative price guideposts were attempted with respect to those industrial sectors where the rates of productivity advance inevitably and greatly exceeded wage-rate advances, in consequence of the unrealistic nature of the guideposts themselves.

Moreover, I have offered for many years an entirely different analysis of the inflationary problem. I have insisted that, in the long run, prices tend to increase more rapidly under conditions of inadequate economic growth and excessive idleness of manpower and other productive resources than under conditions of economic growth closer to the optimum with less idle manpower and resources (short of the many hypertensions during the World War II and Korean war eras, to which there have been no recent economic analogies).

The reason for this is that, in the administered price areas, there is a palpable effort to attempt to compensate for inadequate volume of business by price increases unjustified in terms of profit margins per unit. My own analysis from 1953 forward bears this out, and it is strikingly brought out by the reappearance of these price increases during the most recent period, at the very time when the economic growth rate was falling sharply, when weaknesses were appearing in many sectors of the economy, and when optimism as to the economic outlook was waning rapidly. These price increases have reflected the desire to get while the getting is good.

The recent increases in farm price have reflected in part a temporary trend toward a larger share of the national income for farmers, although still a woefully deficient share, and farm income is now deteriorating again. At other levels, the increases in the price of food have been due to some of the administered price increases to which I have referred. They have been also due to the unwise national farm policy, during many years, of pushing farm acreage and the farm population drastically downward, failing to recognize (as I have repeatedly pointed out) that this would confront us with serious shortages when measured against the industrial and consumer demands for farm products in a growing economy and a growing population, plus the demands which would appear if we brought a nutritious and balanced diet to the millions of American families who still do not have it, plus the demands which would arise if we made enough of our food available to the one-third of the world which is confronted with actual or potential starvation.

The most rapid increases in consumer prices in the service areas have been in the medical care and financial categories. The increases in the financial category tie in with the indefensible monetary policy. The increases in the medical care category are closely connected with nationwide shortages of hospitals, doctors, nurses, and medical technicians. These shortages have been aggravated by the unwillingness to increase public outlays enough to meet the great priorities of our domestic needs, a matter to which I have repeatedly called attention.

Deficiencies in Council's treatment of wages and labor costs

The Council's analysis of labor compensation and labor costs is faulty to the Nth degree. It compares changes in productivity or output with money changes rather than real changes in average hourly compensation, that is, without factoring in the rising cost of living. This is not only social injustice; it is also economically unsound.

One of the major justifications for rough compatibility between increases in productivity and in wage rates is that this will enable the purchasing power of individual workers to rise pro tanto with the increase in productivity, and thus help to maintain a balance between production capabilities and effective demand. For this purpose to be achieved, it is manifest that real wage-rate gains rather than money wage-rate gains are relevant.

The other reason for compatibility between productivity gains and wage-rate gains is from the viewpoint of business costs. It is argued that, if money wage rates rise more rapidly than productivity, profit margins and profits will be unduly squeezed. But this argument has little merit, either in logic or in observation, and almost none in recent observation. When money wage rates rise more rapidly than real wage rates in consequence of a cost-of-living adjustment for a rising general price level, experience shows clearly that the rising general price level, for many reasons, operates also to increase money profits, and in fact to increase these sufficiently to expand per-unit profit returns and to lead to excessive profits in the event of adequate volume (and to militate against adequate profits only if sales volume is adversely affected by inadequate expansion of money wages, among other factors).

Thus, to oppose cost-of-living adjustments after prices have risen not only locks the door on workers after somebody else has done the stealing; it also rewards those who have done the stealing. The Council should stop and consider the extent to which its stubborn and wrongful opposition to cost-of-living adjustments has contributed to the gross imbalances within the economy during recent years and even now.

Further, in the Council's analysis of this whole problem, including the problem of per-unit labor costs, relatively too much emphasis is placed upon developments within the last year, and not enough relative emphasis is placed upon longer-term trends (due to prevalent policies) which are far more significant. Viewing the great lag in wage-rate changes behind productivity gains from 1957 or from 1961 forward, it would be entirely healthy and desirable, as part of a necessary catching-up process, for real wage-rate gains to rise somewhat more rapidly than productivity gains for a time.

The discussion of prices and the distribution of real income by the Council takes the rather automatic position that no attempts by management or labor to increase its relevant share can be for long successful. It is highly doubtful whether this is true. As my demonstrations have shown, viewing the period from 1961 forward as a whole, management's share has been greatly increased at the expense of labor and other consumers; this has been bad for the whole economy; and it has been due in substantial measure to the price wage guideposts, the fiscal and monetary policies, and other national economic policies.

In sober fact, the problem of devising national economic policies which would bring income distribution more into accord with require-

ments for optimum economic growth, sustained maximum employment and production, and social justice, is the core problem of rational economic policy. The Council's proud and continuous neglect of this problem, under a claim of "neutralism," thus neglects the core economic problem. In reality, no powerful changes in key national economic policies are "neutral." They all serve to redistribute income profoundly, and the main question is whether they do so in sound or unsound directions.

My additional data

Many of my charts, to which I have already referred, have a direct bearing upon my immediately foregoing comments. In addition, my chart 13 depicts the relative trends in economic growth, industrial production, unemployment, and prices during 1952-1966. This chart brings quantitative support to the theory of price change which I set forth above in general terms. The failure of the Council of Economic Advisers to undertake this kind of long-term analysis, whether or not it would leak to exactly the same results as I have obtained, is a vital gap in the work of the Council which should promptly be corrected.

The Council should also, instead of fanning the fires of excessive preoccupation with the inflationary danger, take more trouble to point out how remarkably stable the price level of the U.S. economy has tended to be in the long run, except under wartime conditions of a nature not now existent and not foreseeable in the context of the development of current economic policies. This is shown on my chart 14.

My chart 15 compares the rates of change in productivity and in wage and salary rates in the total private nonfarm economy during 1947-1966. It depicts, from 1957 or 1961 forward, the serious and even dangerous lag in wage-rate gains behind productivity gains. The chronic imperviousness of the Council to this extremely important problem is both inexplicable and indefensible.

CHAPTER III. MAINTAINING PRICE STABILITY AND REDUCING UNEMPLOYMENT

Stable prices is not the top priority

The very caption of this chapter is unfortunate. It erects into a datum the unsavory proposition that maintaining price stability and reducing unemployment are goals of the same nature and are of equal importance; indeed, it seems to give higher priority to absolute price stability. Reducing unemployment is an ultimate value goal, not only for human and social reasons, but also because the larger output which the reduced unemployment brings means larger capacity to lift living standards and to service national priorities. Price stability, on the other hand, is a means rather than an ultimate goal. It is desirable only insofar as it advances the ultimate goals of growth, priorities, and justice. Further, all our economic history shows that a stable price level is not automatically conducive to these ultimate goals. Except for falling farm prices, the U.S. economy had a remarkably stable price level during 1922-1929. And yet, within the environment of this stable price level, there developed imbalances in incomes and economic activities which brought on the Great Depression.

I have indicated earlier in my statement why empirical observation does not support the conclusion that there is a direct correlation be-

tween the degree of price stability on the one side, and the amount of slack resources on the other side. But even if there were that direct correlation, it is in my view monstrous to argue in effect that millions of breadwinners and their families should bear the curse of unemployment in order that the comfortable, the affluent, and the rich may be insured against the small marginal price advance at most which might be attributed to efforts to bring about a lower level of unemployment. Surely, we have reached the state of economic knowledge and social conscience where we can find fairer ways than this, and more workable ways, of combating inflation.

In any event, the conclusion of the Council on the first page of this chapter that 4-percent unemployment is some magical figure, in that lower employment would ineluctably bring more price inflation, is a declaratory judgment unsupported by evidence. As I have indicated earlier, we faced the so-called paradox of very substantial price inflation during the 1957-58 recession, when full-time unemployment rose to almost 7 percent.

The unwarranted bias of the Council on this subject is illustrated on page 100 of this chapter, when it combines the statement that any involuntary unemployment is too much with the statement that the overwhelming majority of Americans would also say that any rise in prices is too much. This really smacks of the disingenuous, because the Council knows that any rise in price may not be too much, if related to over valid objectives, and the Council also knows that nobody is arguing for eliminating all involuntary unemployment.

Deficiencies in Council's analysis of unemployment problem

The Council argues that the current unemployment is structural, or due to a failure of the unemployed to match actual job requirements, rather than being due to deficiencies in aggregate demand. This is a far step backward from the Council's earlier position.

The new position is entirely unsound. In the first place, World War II experience showed conclusively that recognition by the Nation of the need to utilize the product of practically the entire labor force led quickly to useful employment of those who somewhat earlier were deemed structurally unfit. In the second place, analysis of the differences in personal characteristics and capabilities between the employed and the unemployed, when total unemployment is too high, does more to explain why certain people have been selected for unemployment than to explain the too high level of unemployment. It stands to reason, in an efficient industrial system, that those with relatively lesser qualifications will be denied employment before those with relatively higher qualifications. If the full-time unemployment rate rose from 4 to 8 percent, the additional unemployment would strike those less qualified than those who remained employed. This might help to explain why they were selected for unemployment; it should not be used to justify or rationalize the unemployment.

In the third place, and most important of all, no matter what may be the personal characteristics of the unemployed, and no matter what may be the best ways to get them employed, it is nonetheless true that no unemployed person can become employed (without taking a job away from someone else) without additional money being spent to employ this person. And as total spending equates with GNP, additional employment requires more aggregate demand; that is, a

higher economic growth rate, by definition. I do not understand how the Council has overlooked this obvious fact. Not a word of what I have said argues against appropriate training programs.

Needed changes in the structure of demand

The top problem is not the structure of the unemployed, but rather needed changes in the structure of total demand. The purely aggregative approach of the Council is erroneous, not only in refusing to recognize that aggregate demand must expand faster to restore maximum employment, but also in failing to recognize that every dollar spent does not have the same impact upon stimulating employment. If production-distribution of one type of product increases by x , and productivity in the industry producing that product increases by $x \times 2$, there will be less employment despite the increase in dollar demand. The whole meaning of the new technology and automation is that we need to restructure the composition of demand, so that more of it will flow into those sectors where the unmet needs of the Nation are so huge that to meet them effectively would call for larger increases in output in these sectors than the advance of technology and productivity in these sectors.

The Council has appallingly neglected this whole problem. If it paid attention to this problem, it would soon see, among other things, that the needed restructuring of demand along these lines would involve relatively more emphasis upon the public sector where so many of the unmet needs are so huge. Thus, the very readjustments which would be best from the viewpoint of the great national priorities and from the viewpoint of social justice would also be best from the viewpoint of encouraging maximum employment and optimum economic growth. The technological considerations which lead me to these conclusions are clearly revealed on my chart 16.

For these reasons, while there is nothing wrong per se in the emphasis which the Council places upon manpower training, it is an exaggerated emphasis when unaccompanied by more fundamental recognition of the points which I have made just above.

Deficiencies in Council's analysis of wage-price problems

The Council's discussion of wage-price problems in this chapter is freighted with all the errors which have characterized the Council's previous approaches to these same problems.

The Council is theretically correct in its argument that wage-rate increases in each sector approximating the nationwide average of productivity gains would be more equitably ideal than wage-rate increases in each sector geared to productivity gains in that sector. But the Council has never come to grips with the point that this ideal could be pursued in practical terms only if accompanied by a price-profit policy and a tax policy which prevented the high-productivity industries from reaping an unjust harvest from the guideposts formula. Such a course would also be necessary to help the wage earners lower down, and other consumers, to get the benefit of the theoretically equitable policy.

The Council has admitted all along that the attainment of this policy would require very substantial price reductions in many sectors, but the Council never established any quantitative or meaningful guideposts for such price reductions. Worse still, the Council has

equated wages with prices when, from the viewpoint of economic balance and equity, wage trends should be more closely related to profit trends. What meaningful standard for profits has the Council ever attempted to set up?

The Council's examination of the effects of the guideposts to date shows how utterly one-sided the Council's approach is. It examines closely the effects of the guideposts upon wage determinations, but does not examine closely their effects upon profit trends. What kind of economic analysis is this?

The Council then says, with a spurious showing of evenhanded impartiality, that the consumer price rises have been due to failure to observe the guideposts both by organized labor and by business. Just what examples does the Council cite in support of the proposition that cost push has justified the recent price increases and the profits which they have brought?

Then, the Council says that much of the rise in corporate profits which has occurred would have occurred even if the guideposts had been precisely followed. In view of the clear demonstration of how far profit advances, and the investment stimulated thereby, have gotten out of line with the rest of the economy in recent years, what could be a better example of an admission by the Council that the guideposts in the form written could not deal properly with this problem?

The Council then repeats its stubborn and wrongful objection to allowance of cost-of-living increases in determining wage rates, although it is forced to admit that there will be some of this in 1967. I have already stated fully above the economics of this issue.

Later on in the same chapter, the Council argument really runs thus: If wage earners get the wage-rate increases which are justified by productivity gains, and if these wage-rate increases are also adjusted to cost-of-living increases—and are also kept in line with ability to pay—this will not do wage earners much good, and will do the public much harm, because management will simply resort to still higher prices. This is a highly circular argument which begs the whole question. It is tantamount to saying that wage payments in ratio to profits must remain too low in terms of the good of the whole economy, and that the only choice is whether they remain too low by virtue of inadequate wage-rate increases and stable prices, or remain too low by virtue of wage-rate increases which would be adequate except that they are followed by unwarranted price increases. This type of begging the question does not rise to the dignity of responsible argument; it does not meet the national problem.

If the Council wants to establish voluntary standards for price-wage profit behavior, it must deduce these standards from the kind of long-range economic balance sheet which I have consistently advocated. That is the analytical method used under conditions of full-scale war, and it is an analytical method essential at all times, even though the current situation does not call for direct controls which were needed during full-scale war.

The Council's plea to industry to exercise price moderation is commendable, but it is a cry in the dark and does not compensate for the Council's errors of omission and commission, to which I have called attention many times before.

CHAPTER IV. SELECTED USES OF ECONOMIC GROWTH

A good deal of what the Council says in this long chapter is unobjectionable, but it does not go nearly far enough. The chapter is composed mostly of some generalities about what we can do with our increasing wealth. Instead, the Council should long ago have made a specific and quantified long-range budget of the great priorities of our national needs, and trained all national policies upon their attainment in adequate degree year by year, beginning at once.

Errors in Council's analysis of the poverty problem

The Council is in error in stating that most poor families are headed by persons who cannot or should not be in the labor force, at least on a full-time basis. I have estimated that 60 percent of all U.S. poverty is directly attributable to unemployment, underemployment, part-time unemployment, and those employed full time or part time, but at inadequate wages. The other 40 percent of the U.S. poor are in groups who should not be within the employment stream. My published study for the Conference on Economic Progress, "Progress or Poverty," develops this fully.

Inadequate stress upon social welfare programs

The Council's approach to the dismal inadequacy in welfare and social security programs at all levels is timid and inadequate. It goes no further than to voice approval of current proposals for improvement which are seriously inadequate. I believe the time has come for the Council to espouse—not merely refer to—a universal floor under all incomes, that floor being designed to lift all Americans at least above the poverty-income cellar.

What the Council says about education, health care, and the needs of our cities, fails to rise to appropriate quantification of the magnitudes of the problems, and consequently fails to rise to the required policies.

What the council has to say about the regressive nature of our nationwide tax system is true. Unfortunately, the Council did not take account of these considerations in the tax reductions which it has thus far proposed successfully, nor in those which it is now proposing for enactment in 1967.

Revenue-sharing with the States

The Council offers a rather ambivalent discussion of Walter W. Heller's proposal for Federal revenue-sharing with the States, without standards or strings as to how these federally collected revenues are to be spent by the States. I am against this proposal. We need more, not less, purposefulness in the deployment of expenditures supported by Federal taxation. And I can conceive nothing more inimical to good government than that 50 State governments should spend without standards or strings a substantial part of what one Federal Government collects. I am developing fully my opposition to this revenue-sharing plan in some of my coming publications.

Council's persistent neglect of any satisfactory model for maximum employment, production, and purchasing power

The Council's entire discussion in this chapter falls lamentably short because it ignores what I regard to be the mandate of the Employment

Act of 1946 to set both short-range and long-range goals for maximum employment, production, and purchasing power; because it fails to develop an equilibrium model on the product and income side; because it fails, in the absence of such an equilibrium model, to deduce appropriate national economic policies; and because it neglects specific projections of the great priorities of our national needs and of policies to meet these needs within the equilibrium model, and with justice to all.

Without these efforts, I think that the Council's long chapter IV serves to create the impression that the Council is actually doing what it really is not doing but should be doing. There is no reason why, at this late date, the Council should be so far behind what has been done in this regard, during many years past, by the Rockefeller Reports on the National Economy, President Eisenhower's Commission on National Goals, the National Planning Association studies, and my own studies for the Conference on Economic Progress.

My own projections for U.S. economic performance

Merely as an indication of what can and should be done in this direction, my chart 17 projects goals for U.S. economic and social development through 1970 and 1975, in the perspective of an equilibrium model which I have usually called an American Economic Performance Budget.

These interrelated goals are not excessive in their aggregates. They contemplate an average annual U.S. economic growth rate in the neighborhood of 5 percent after maximum employment production and purchasing power are restored. This 5 percent rate, as I have indicated earlier, is really rather conservative in view of our pressing obligations, both domestic and international, and our current inability to meet these adequately out of the current product. The 5 percent average annual growth rate projection is somewhat lower than the sum of the estimated average annual increase in the civilian labor force and the estimated average annual increase in productivity in the private economy during 1961-66. If the growth rates in productivity and in the civilian labor force in future fall below these estimates, it will be only because national economic policies which fail to provide appropriate incentives to optimum economic growth repress the actual growth rate in productivity and in the civilian labor force far below the real potentials.

Further, it is dangerously nondynamic to assume that there are such rigorous or mechanical limitations as those set forth above, with respect to growth in productivity and in the civilian labor force. Many incentives, the most important of which is a maximum-employment environment itself, can be brought to bear upon accelerating the growth rate in the civilian labor force. Many incentives can and should be used to accelerate productivity growth.

During World War II, we averaged annually an economic growth rate of 9 percent in real terms. While it is true that in 1941 we had a vast reservoir of unemployment to draw upon, this reservoir was much smaller than the numbers drawn into the Armed Forces after 1941, and thus not available for the civilian labor force. While I would not favor now the forced pressures which could, if need be, again lift our average annual economic growth rate to anything approximat-

ing the 9 percent realized during World War II, I think that we should really try to do considerably better than 5 percent. Of course, we must pay in some ways for whatever high goals we set. But we also pay in many ways, and we are paying heavily now, when our goals are too low and our performance suffers accordingly. An average annual growth rate of 6 percent in real terms would in my view be none too high, under the current and foreseeable burdens confronting us.

In any event, even if satisfied with the 5-percent average annual growth rate which my chart 17 utilizes after maximum resource use is attained, the chart is based upon a 6.3 percent growth rate until maximum resource use is attained in early 1969, with 5 percent thereafter. The Council's espousal of the 4 percent average annual growth rate, as I have shown in detail above, cannot be defended on any grounds. Fortunately, an increasing number of outstanding economists are now scoring the Council's position, and indeed censuring it for underestimating the needed growth rate all along.

My chart 18 sets forth entirely consistent, and therefore entirely feasible, goals for the liquidation of poverty in the United States.

And finally, my charts 19 and 20 set forth the composition of a proposed Federal budget, as an integral part of my "American Economic Performance Budget." It is significant that these goals for the Federal budget would result in a Federal budget smaller in ratio to total national production in calendar 1975 than in fiscal 1968 (estimated). This should dispose of any notion that we cannot meet the great priority of our domestic needs without sacrifice of our international obligations, or without distorting the relative responsibilities of private enterprise, the States and localities, and the Federal Government.

If the objectives which I have set forth are vigorously pursued and substantially achieved—which is well within our potentials without excessive strain—we can create an America by 1975 in which poverty will have been virtually liquidated, without impairing income progress for others; in which almost all of the one-fifth of our people who still live in slums will have been rehoused, and our cities substantially renewed; in which our obsolete transportation systems will have been restored; in which adequate educational and health facilities, at costs within their means, will be made available to all; in which the specially acute tragedy of private poverty and public neglect in our rural areas will have been substantially eradicated; and in which our natural resources will have been properly conserved and replenished, with accent upon extraction of the poisons from our airs and waters. My charts 19 and 20 show clearly how attainment of these goals would not impair—if needed—very liberal allowances for expansion of Federal outlays for defense, space, and international aid to underdeveloped countries.

CHAPTER V. GROWTH AND BALANCE IN THE WORLD ECONOMY

The plea by the Council for more attention to the grievous problems of the underdeveloped countries would be more persuasive, if accompanied by assertion of the need for the United States to devote more than an infinitesimal portion of its GNP to the economic assistance of manifold kinds which these underdeveloped countries imperatively and immediately need. This would do even more good than lecturing these underdeveloped countries about changes they should make in

their own policies, which impresses me as being both knowledgeable and self-righteous in view of the dearth of more concrete assistance.

Kennedy Round

The reference by the Council to the Kennedy Round should recall to attention how little has thus far been accomplished by the Trade Act of 1962, for which (as I said at the time) exaggerated claims were made.

Council's misplaced emphasis in re balance of payments

I disagree entirely with the Council's whole approach to the balance-of-payments problems, now and earlier. By definition, all countries of the world cannot simultaneously have a favorable balance of payments. Many countries desperately need, for their very survival, to improve greatly their unfavorable balance-of-payments position. The United States is in no such circumstance. To the contrary, I believe that we should run, for many years ahead, a larger unfavorable balance of payments than we have been running in recent years, with ever-increasing stress upon investment in the underdeveloped countries. Because the Council misinterprets this fundamental goal, its entire analysis and policy recommendations fall short.

Even if I were wrong as to the desirability of the United States increasing its unfavorable balance of payments, this much seems certain: The Council's long overemphasis upon the need to reduce this unfavorable balance, insofar as it has led the Council to sacrifice domestic employment and growth, has been utterly pennywise and pound foolish. And the Council has even selected the wrong means to achieve its own mistaken aims. To illustrate, differential interest rates have not been the main explanation of the flow of investment capital from the United States to developed countries overseas. One of the main explanations, as I foretold, has been the fiscal policies which yielded so much more to U.S. domestic investors than they could use at home that they sought highly profitable investments overseas. In addition, policies different from those recommended by the Council, and more conducive to maximum employment and production and optimum economic growth in the United States, would have induced more investment capital to be used here—and without relative overinvestment—than has actually been the case.

The gold supply of the world has been increasing at less than 1 percent a year, while monetary expansion needs to increase at 4 to 5 percent a year to support appropriate expansion of economic activity. This being the case, we should take gradual but firm steps to disengage from the extent to which we tie our own credit structure and our international economic and financial policies to the stock of gold. We must gradually surmount this costly anachronism.

Beyond all this, if set forth in a proper manner, with due weight to short-range and long-range factors, we are hardly running an unfavorable balance of payments even now.

The urgent need today is for a sufficient improvement in the international mechanism of finance and exchange to service these various considerations, somewhat along lines that the Federal Reserve System was initially brought about improvements on the domestic scene when first enacted. I am glad to note some improvement in

the general thinking on this subject. But I believe that we have dragged our feet too long, and are not yet moving forward with the requisite degree of decisiveness and vigor. We cannot make this gain, so long as we exaggerate the gold and balance-of-payments problems to the extent that we are now doing, nor so long as we let these exaggerations interfere with a domestic policy for optimum economic growth and sustained maximum employment, production, and purchasing power.

COMMENTS UPON THE ECONOMIC REPORT OF THE PRESIDENT

As I said at the outset of my statement, there is no need for me to comment extensively upon the Economic Report of the President, because it is entirely consistent with the Annual Report of the Council of Economic Advisers, which I have treated in detail.

My exceptions to the President's Economic Report, in brief

Briefly, I think that the Economic Report of the President is too optimistic, and therefore stresses restraining rather than stimulative measures; that it to a degree substitutes identification of all the things we should be doing for actual dedication of our resources to doing these things in adequate measure; and that it proposes postponement to "after Vietnam" of many things which we ought to be doing now, which we cannot afford to postpone, and which are well within the ambit of our current and growing resources, especially if we put first things first. I do not think that the measures proposed are the best road toward price stability, and that price stability is accorded too high a priority relative to reduction of unemployment, accelerated economic growth, and serving the priorities of our domestic needs. I think that the balance-of-payments problem is also accorded too high a priority for the same reasons.

The 6-percent tax increase is highly undesirable

As already stated, I am opposed to the proposal for a 6-percent surcharge tax increase across the board. Tax increases are highly undesirable and risky in view of current and prospective economic conditions, assuming proposed levels of Federal outlays. If tax increases should prove necessary, and they would be necessary to support the increases in Federal outlays which I deem to be of vital importance, these tax increases should be along progressive lines. They should include increases in the corporate income tax, and increases in the taxes of upper middle and high-income families. The glaring tax loopholes should be closed in any event, and I am dismayed by the lack of attention to the whole problem and to other aspects of tax reform proposed, but not achieved, in 1964.

The prime responsibility of the Council of Economic Advisers

In conclusion, I do not want to appear to be blaming the President for any of what seem to me to be the major deficiencies in his Economic Report. I feel that President Johnson is making an inspiring record of expanding the national identification of national responsibility. This is the greatest service that any President can render, and I believe that President Johnson is doing this with superb courage and discernment.

I have long held that most of the blame for deficiencies in the President's economic program must be placed squarely upon the shoulders of the Council of Economic Advisers. It is true that the President must and should make political decisions which may not be entirely in accord with the advice he receives from his experts. I also agree—and I have had some experience on this point—that his experts must in large measure shape what they present to the public in accord with the policies of the President. All of this is entirely appropriate.

But I have an ever-increasing conviction that the President, the Congress, and the people are being let down by the extent to which the Council of Economic Advisers is doing so much less than it should, and so much in the wrong direction, even within the allowable area of its scope and discretion. The preponderance of the errors of omission and commission embodied in the annual report of the Council, as I have set them forth above, cannot possibly be attributed to any mandate from the President or to any restraints of the political environment. The examples of this are too numerous to list. For one example: The Council is telling the President, he is not telling it, that unemployment below 4 percent is necessarily inflationary, and that a 4-percent economic growth rate is desirably high. If the Council improved its own performance, the President would be in a better position to weigh economic against political considerations. The Council, in my view, is not sufficiently offering the President this choice.

I believe that the Council has a leadership as well as a followship role, and that it has moved too far toward guessing what is wanted rather than asserting what is needed. I believe it has moved too far in the direction of public relations, rather than struck a fair balance between public relations and public responsibility. The Employment Act offers the Council a unique opportunity in world history; that opportunity, in my view, should be much more fully explored.

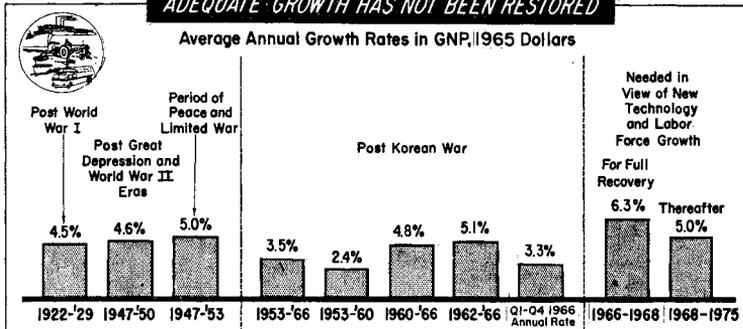
Additional note on U.S. growth rate potential

My estimate that the U.S. economy, without excessive strain, can and should grow at an average annual rate of about 5-percent after restoration of maximum resource use may be challenged on the ground that the 3.5-percent average annual increase in productivity in the total private economy during 1961-66, which (along with the growth in the civilian labor force) yields my 5-percent estimate should be reduced because it is frequently said that there is no increase in productivity among public employees. Thus, if there is no increase in the productivity of public employees, it is argued that the 3.5 percent productivity-gain figure is reduced to a considerably lower figure. I do not accept the validity of this argument. If public programs are carried forward along the lines which I have recommended above, these public programs should in many ways add more to the productivity growth rate of the entire economy than are added by equivalent outlays in other sectors. If this be true, and I think that it is true, then from year to year each hour of input in the public sector should have as beneficial an effect upon productivity gains for the total economy as each hour of labor input in the private sector, even though for technical reasons it is difficult to measure in a conventional way the productivity gains in the public sector.

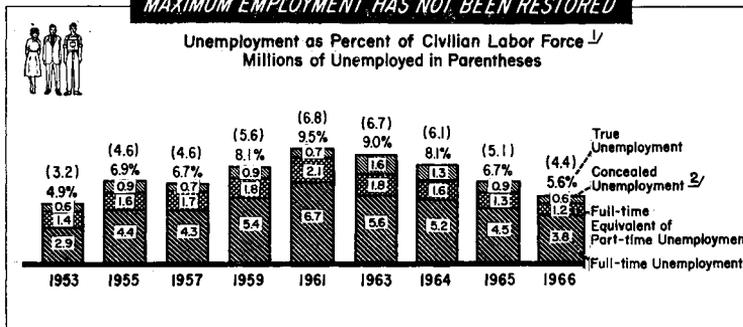
It may also be argued that further reductions in the length of the workweek, in accord with long-term trends, would reduce from 1.5-1.7-percent to 1.2-1.4-percent the average annual increment in labor input. Granted that this is so (although it does not allow adequately for the increased overtime which an optimum-growth environment should bring about), I feel that the 5-percent average annual economic growth rate goal is entirely moderate. For under conditions of reasonably full resource use, as indicated on my chart 3, the average annual gains in productivity in the entire private economy should accelerate considerably above the 3.5-percent average annual rate of increase during 1960-66. And, as I have indicated in the body of my statement, our domestic and international burdens require that we make special efforts to induce optimum rates of growth both in productivity and in the civilian labor force. My chart 1 certainly demonstrates that a 5-percent average annual rate of growth, which we achieved during 1947-53 under conditions much less favorable in terms of technological progress than those we now enjoy, is entirely feasible in the future, after maximum resource use is restored.

BASIC U.S. ECONOMIC TRENDS, 1953-1966

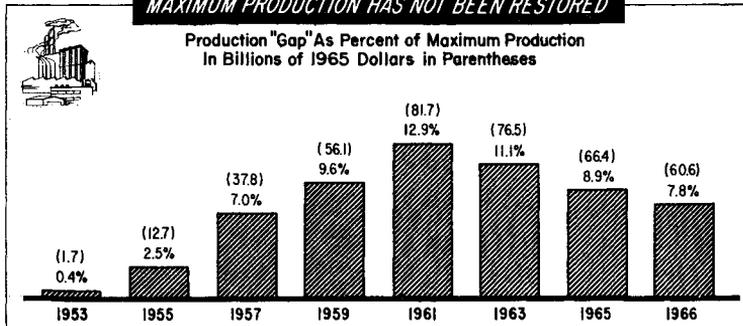
ADEQUATE GROWTH HAS NOT BEEN RESTORED



MAXIMUM EMPLOYMENT HAS NOT BEEN RESTORED



MAXIMUM PRODUCTION HAS NOT BEEN RESTORED



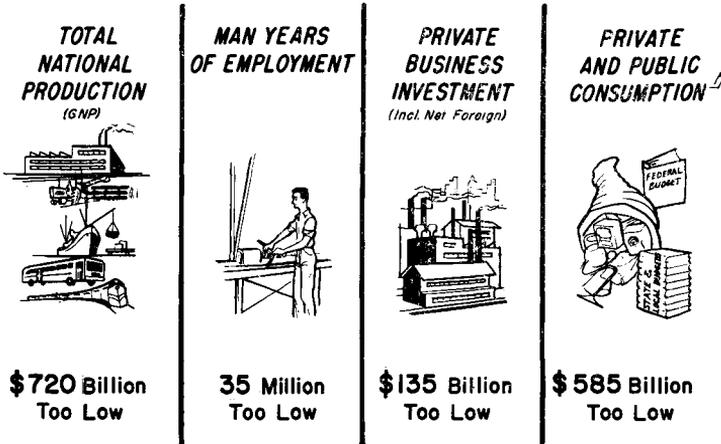
^{1/}In deriving these percentages, the Civilian Labor Force is estimated as the officially reported Civilian Labor Force plus concealed unemployment. Full-time unemployment of 2.9% and true unemployment of 4.1% would be consistent with maximum employment.

^{2/}Estimated as the difference between the officially reported Civilian Labor Force and its likely size under conditions of maximum employment.

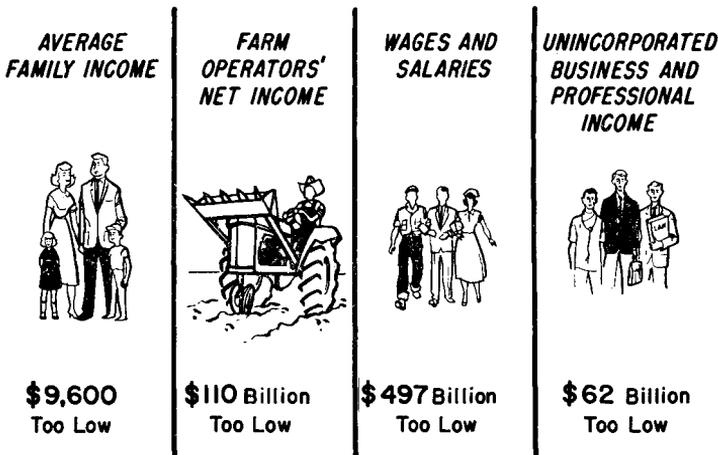
Chart 2

LARGE NATIONAL ECONOMIC DEFICITS DURING PERIOD 1953-1966

Dollar Items in 1965 Dollars



...THESE HAVE LED TO LARGE LOSSES TO ALL ECONOMIC GROUPS

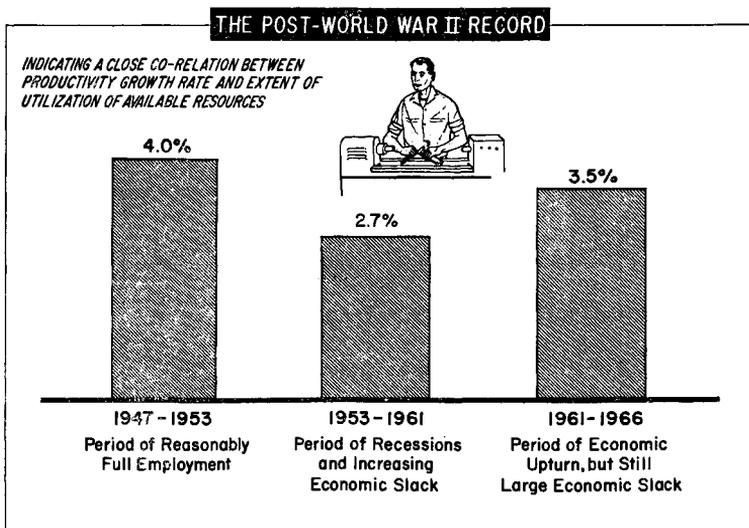
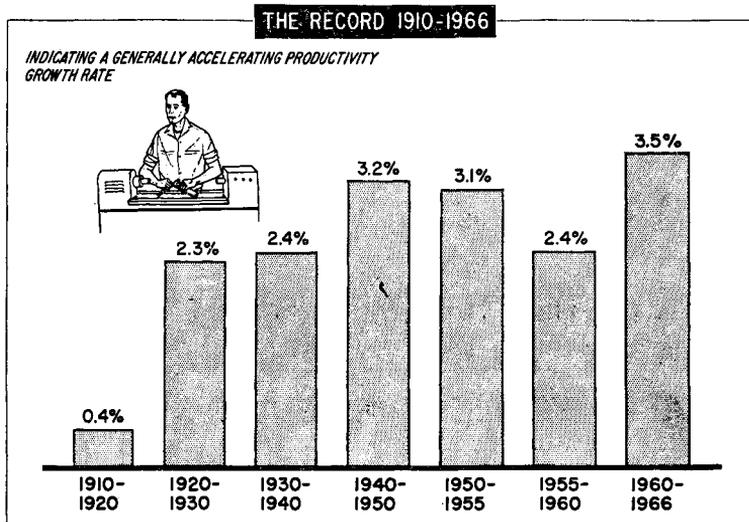


¹Includes personal consumption expenditures plus government (Federal, state, and local) expenditures (\$535 and \$50 billion, respectively)

Chart 3

TRENDS IN PRODUCTIVITY FOR THE ENTIRE PRIVATE ECONOMY, 1910-1966

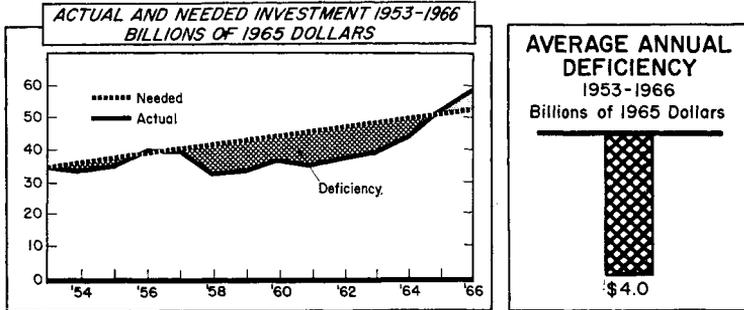
Average Annual Rate of Growth in Output per Man-hour for the Entire Private Economy



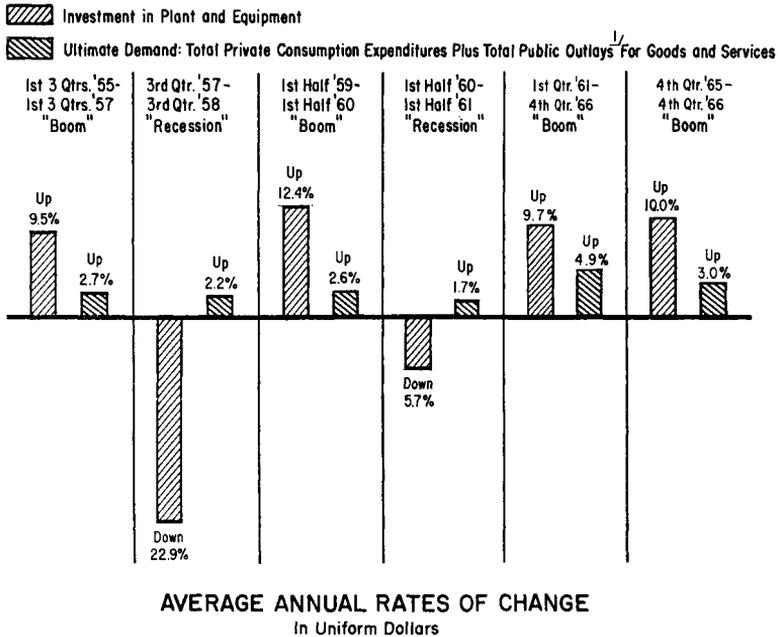
Source: Dept. of Labor estimates relating to man-hours worked (Establishment basis).

Chart 4

INVESTMENT IN PLANT AND EQUIPMENT WAS DEFICIENT, 1953-1966 AS A WHOLE



BUT INVESTMENT IN MEANS OF PRODUCTION AT TIMES OUTRAN DEMAND; HENCE INVESTMENT CUTS AND RECESSIONS

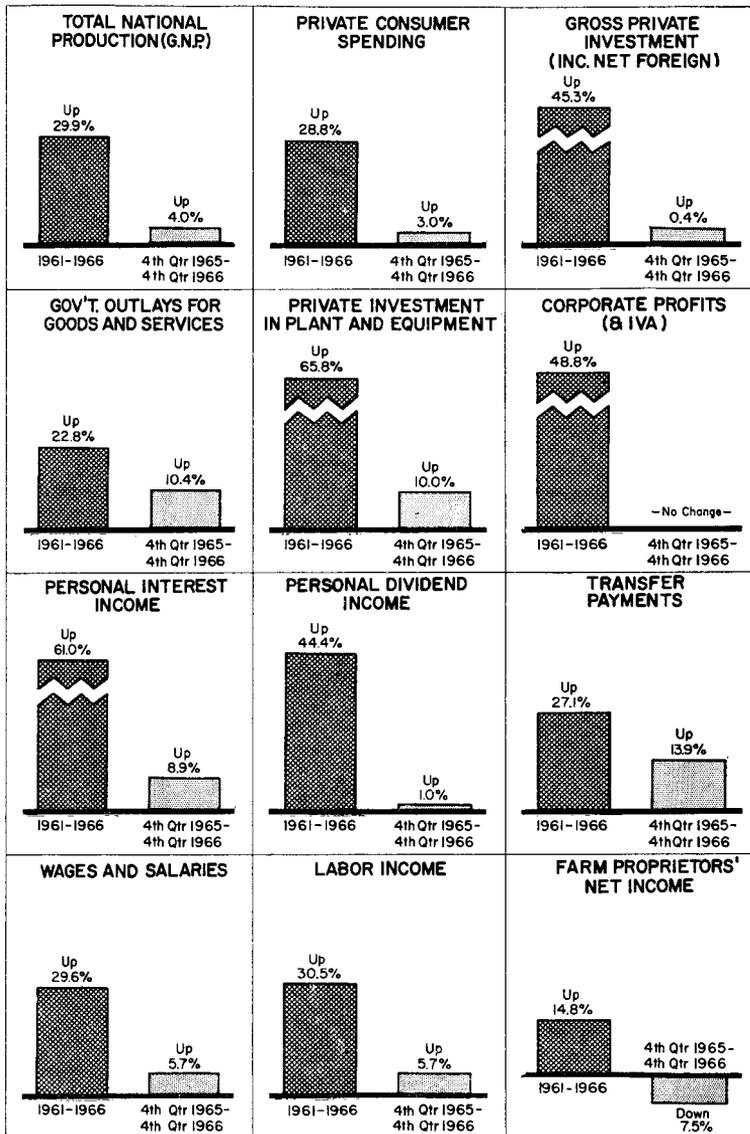


⌞ Federal, State and local.

Chart 5

COMPARATIVE GROWTH IN VARIOUS ASPECTS OF U.S. ECONOMY 1961-1966 ^{1/}

(Uniform Dollars)



^{1/} Based on preliminary data for fourth quarter 1966; corporate profits for fourth quarter 1966 estimated.

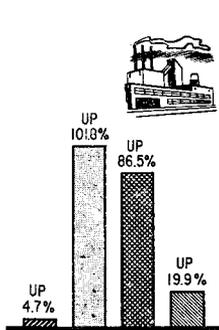
Source: Dept. of Commerce, Office of Business Economics and CEP.

Chart 6

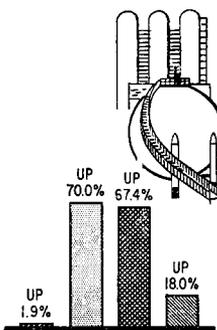
PRICE, PROFIT, INVESTMENT, AND WAGE TRENDS DURING CURRENT ECONOMIC UPTURN

Rates of Change, 1960-1966

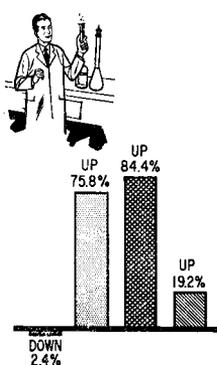
 Prices ^{1/}
 Profits after Taxes ^{2/}
 Investment in Plant and Equipment ^{3/}
 Wage Rates ^{4/}



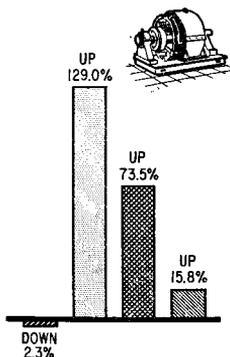
TOTAL MANUFACTURING



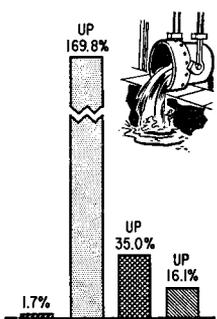
PETROLEUM and COAL PRODUCTS



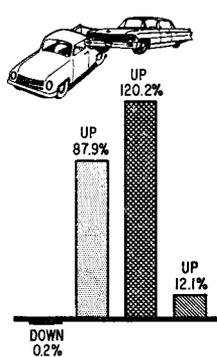
CHEMICALS and ALLIED PRODUCTS



ELECTRICAL MACHINERY



IRON and STEEL



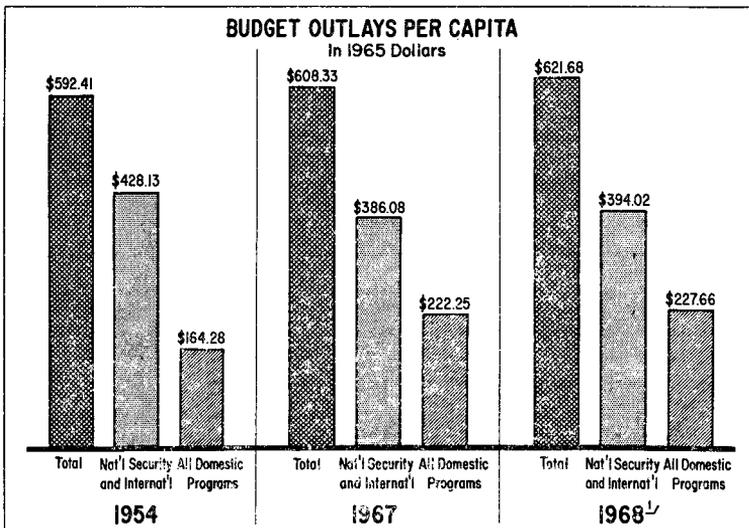
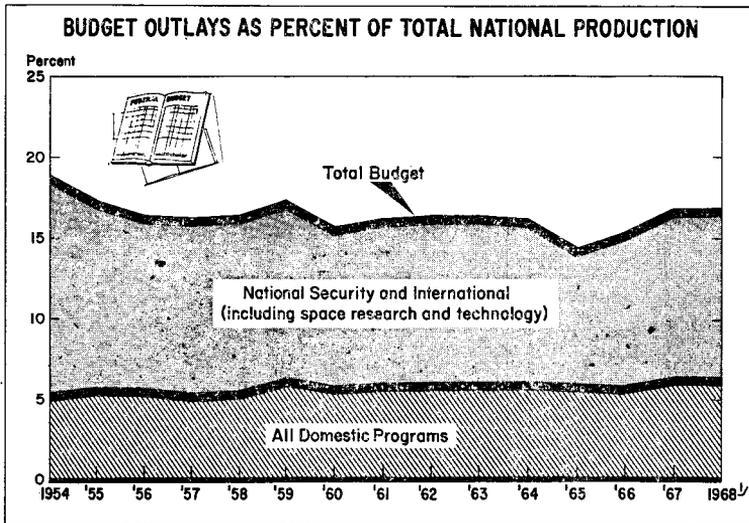
MOTOR VEHICLES and EQUIPMENT

^{1/} Data: U.S. Dept. of Labor, wholesale commodity price indexes.
^{2/} Data: Federal Trade Commission - Securities and Exchange Commission.
^{3/} Data: U.S. Dept. of Commerce and Securities and Exchange Commission.
^{4/} Data: U.S. Dept. of Labor, Bureau of Labor Statistics; Average hourly earnings of production workers.

Chart 7

FEDERAL BUDGET HAS SHRUNK RELATIVE TO SIZE OF ECONOMY AND NEEDS, 1954-'68

Fiscal Years

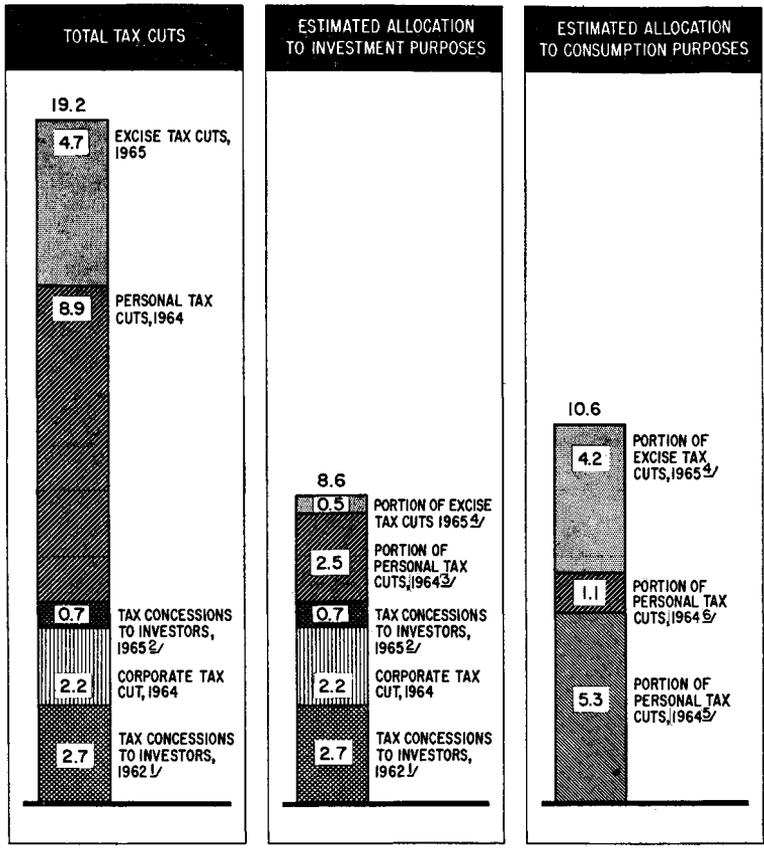


^{1/2}Administration's proposed Budget as of January 1967; GNP estimated by Administration at \$810.0 billion as derived from Budget Document.

Chart 8

ALLOCATION OF TAX CUTS, 1962-1965: INVESTMENT AND CONSUMPTION PURPOSES

(Billions of Dollars)



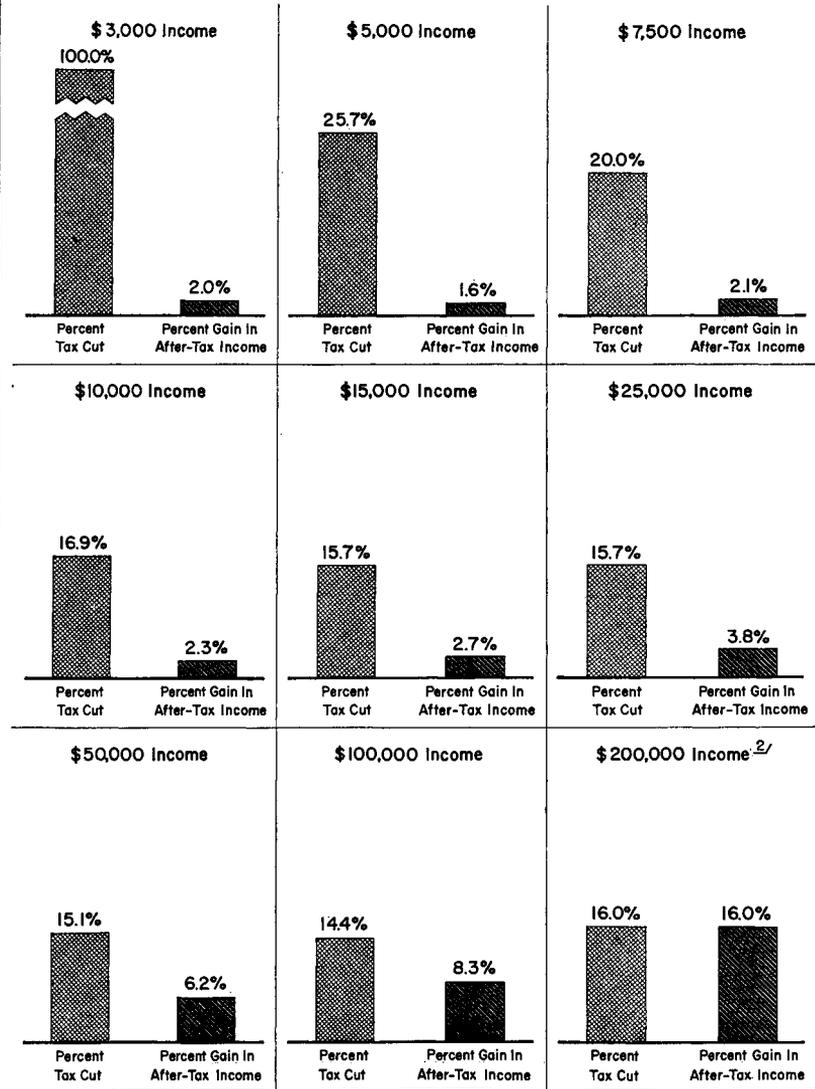
- 1/ Through Congressional & Executive Action
- 2/ Through Executive Action
- 3/ Estimated portion of personal tax cut, for those with incomes of \$10,000 and over, which they would save for investment purposes.
- 4/ Based on estimates of excise tax cuts passed on to consumers through price cuts.
- 5/ Personal tax cuts for those with incomes under \$10,000.
- 6/ Estimated portion of personal tax cuts for those with incomes of \$10,000 and over, which they would spend for consumption.

Note: Estimates of excise tax reduction allocation by C.E.P. (amount might be passed on to consumers by price reductions); however, a large portion of this did not go to low income consumers.

Chart 9

1964 TAX ACT, PERSONAL TAX CUTS

Percent Tax Cut And Percent Gain In After-Tax Income
Married Couple With Two Children At Various Income Levels ^{1/}

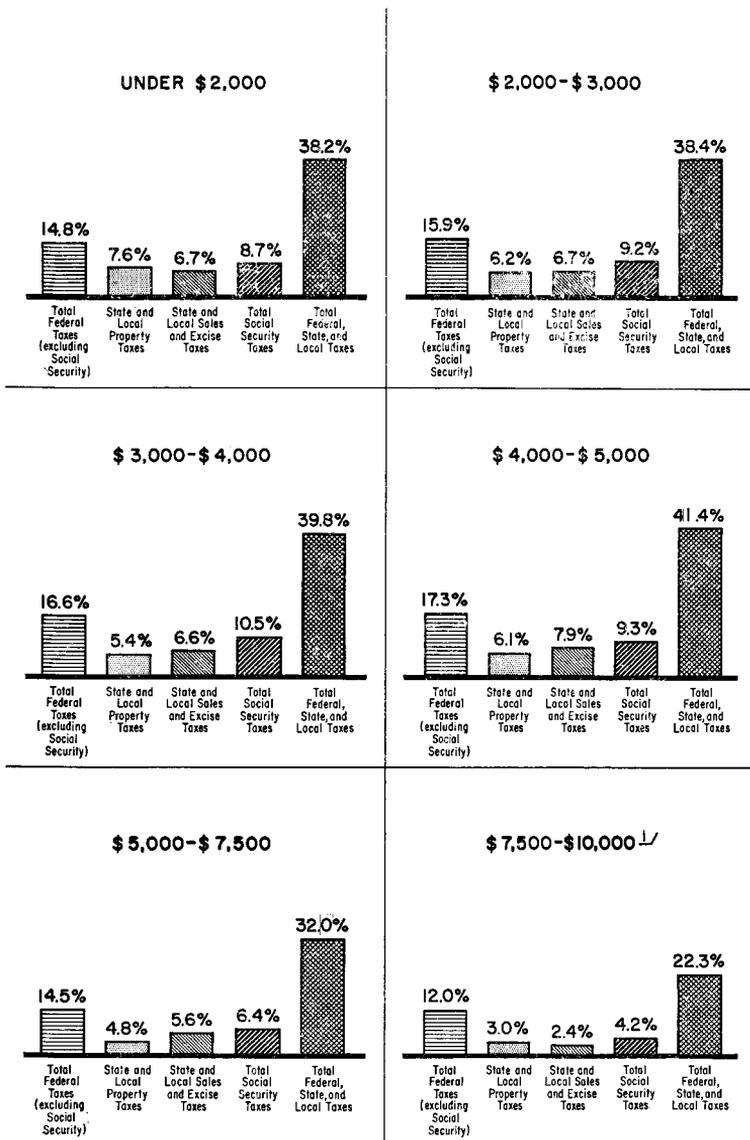


^{1/}Adjusted gross income levels. ^{2/}Estimated

Note: Standard deductions for \$ 3,000 income level. Typical itemized deductions for other income levels.

Chart 10

TAXES PAID AS % OF INCOME, U.S., 1960

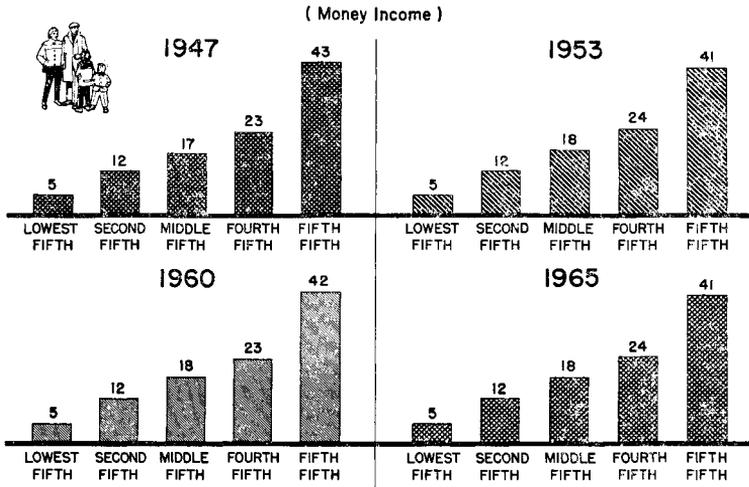


∩ Total Federal, State, and Local Taxes for those with incomes \$10,000 and over, 31.6%.

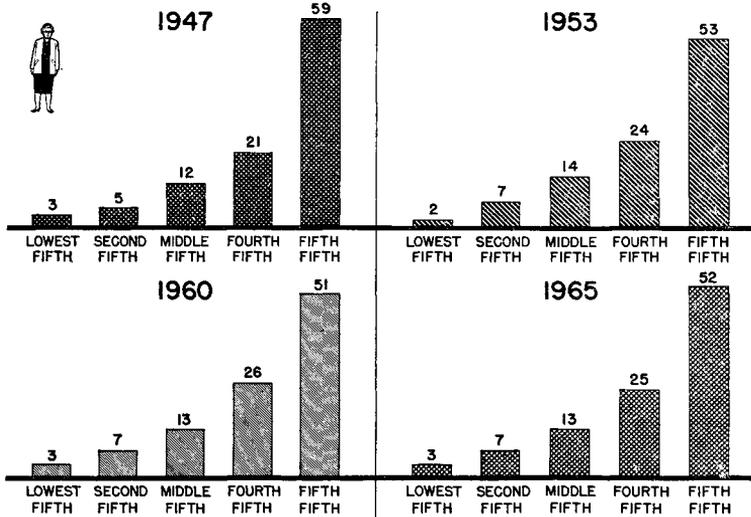
Source: Brookings Institution; income equals the Brookings study's "broad income concept" plus personal transfer payments.

Chart 11

SHARE OF FAMILIES IN TOTAL FAMILY INCOME BY QUINTILES, 1947, 1953, 1960, and 1965



SHARE OF UNATTACHED INDIVIDUALS IN TOTAL INCOME OF UNATTACHED INDIV., BY QUINTILES, 1947, 1953, 1960, and 1965



Data: Bureau of the Census.

Chart 12

COMPARATIVE TRENDS IN GNP AND THE NON-FEDERALLY HELD MONEY SUPPLY, 1955-1966

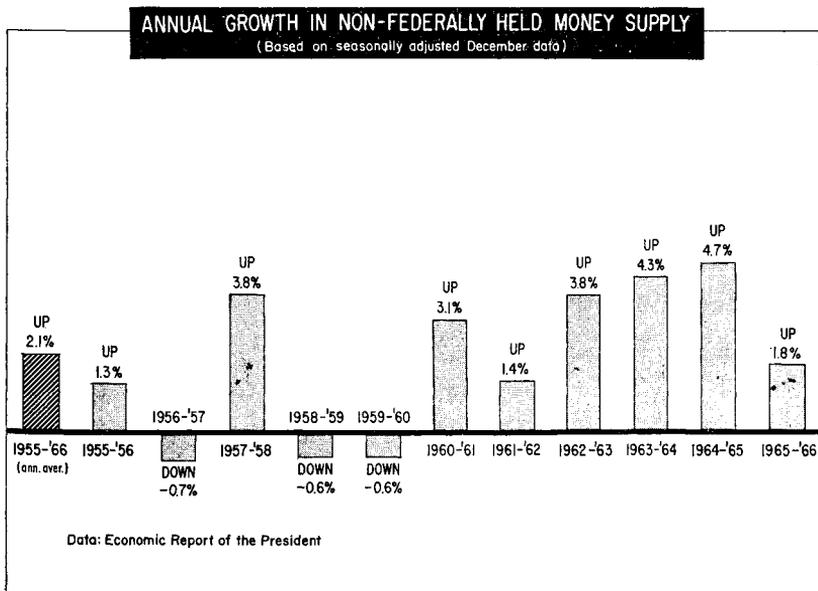
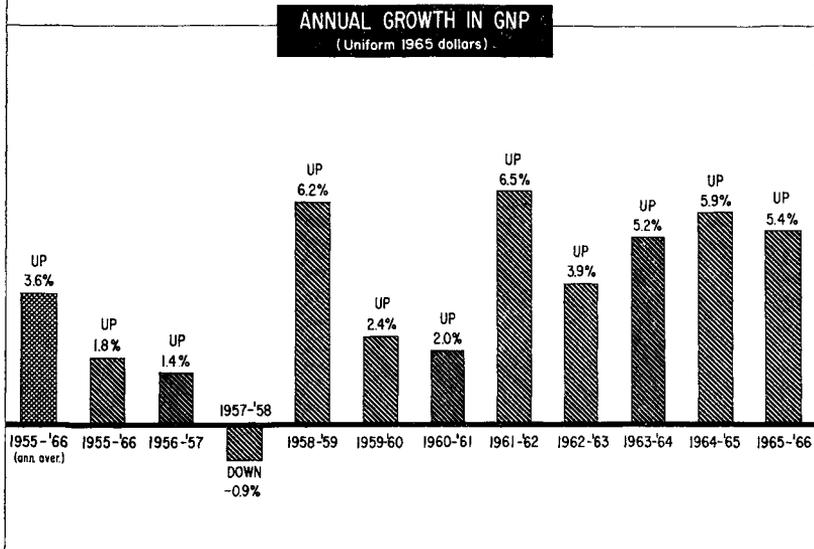
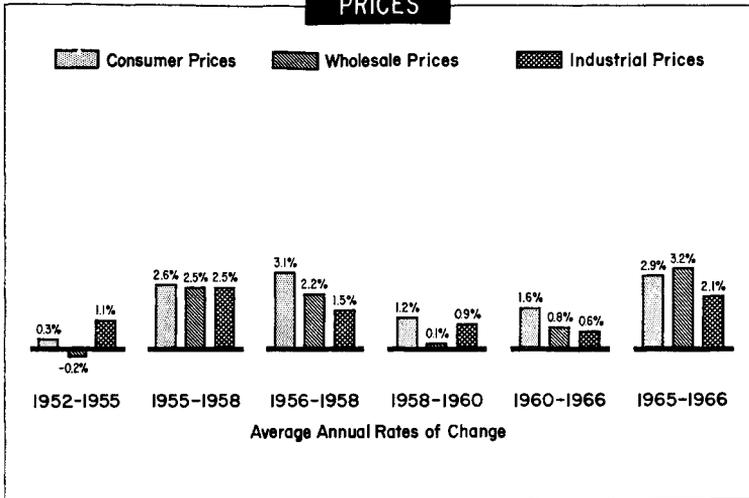


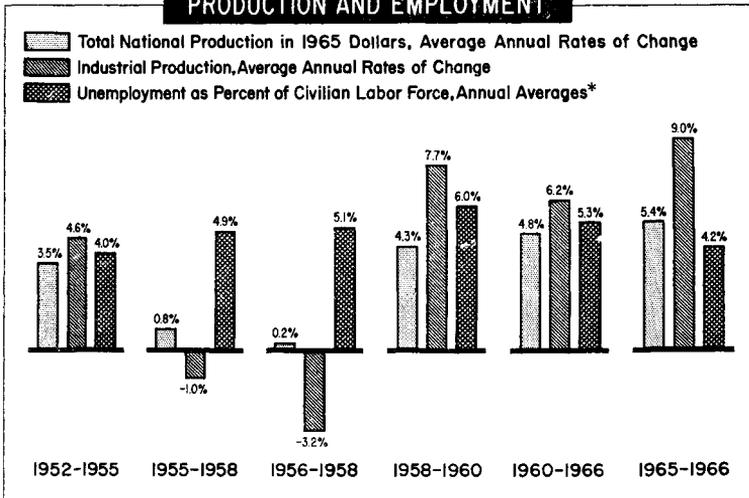
Chart 13

RELATIVE TRENDS IN ECONOMIC GROWTH UNEMPLOYMENT, & PRICES, 1952-1966

PRICES



PRODUCTION AND EMPLOYMENT

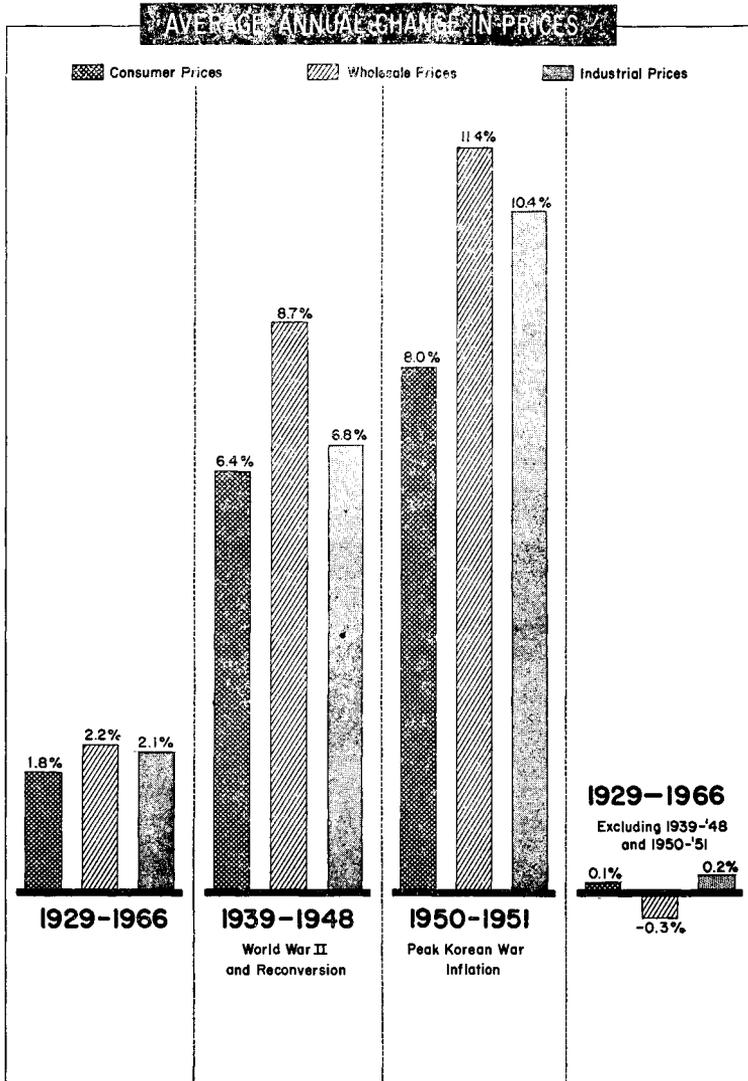


* These annual averages (as differentiated from the annual rates of change) are based on full-time officially reported unemployment measured against the officially reported Civilian Labor Force.

Source: Dept. of Labor, Dept. of Commerce, & Federal Reserve System.

Chart 14

**DURING PERIOD 1929-1966
MOST INFLATION DUE TO WAR**

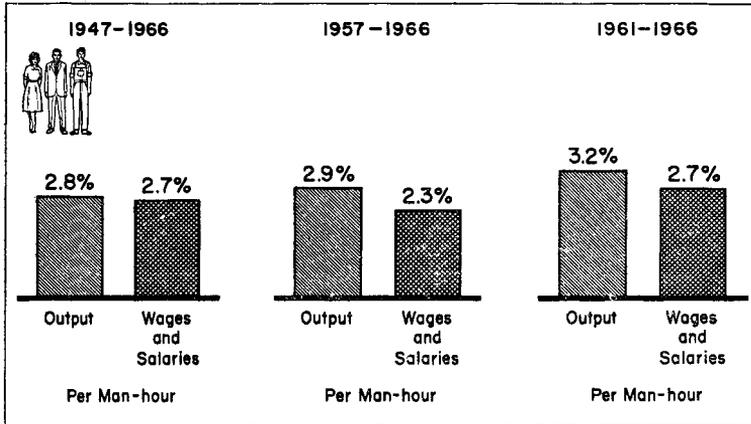


1/ The averages are based upon application of an arithmetic method to the changes from year to year, rather than upon comparisons of end years with allowances for compounding, in order to facilitate the exclusions of certain years as shown on the chart.

Chart 15

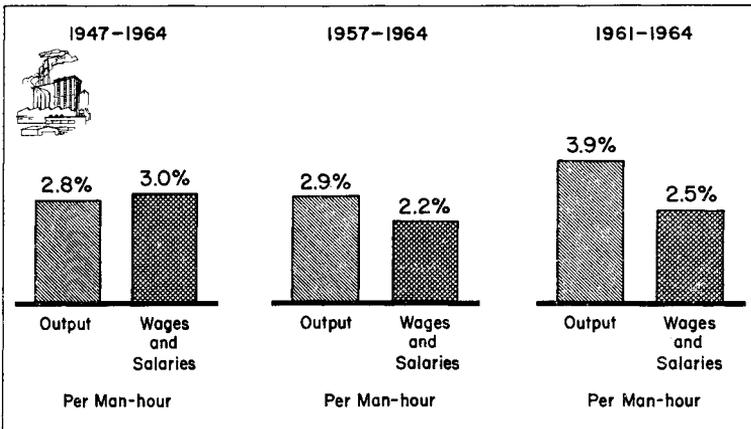
RATES OF CHANGE IN PRODUCTIVITY AND IN WAGES AND SALARIES TOTAL PRIVATE NONFARM, 1947-1966

Average Annual Rates of Change, in Uniform Dollars



RATES OF CHANGE IN PRODUCTIVITY AND IN WAGES AND SALARIES TOTAL MANUFACTURING, 1947-1964^{1/}

Average Annual Rates of Change, in Uniform Dollars



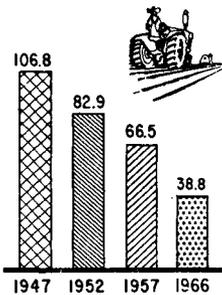
^{1/} Latest available year for comparable data.
Data: CEP estimates based on U.S. Dept. of Labor, Establishment data; data from U.S. Dept. of Commerce, Office of Business Economics; and data from U.S. Dept. of Agriculture

Chart 16

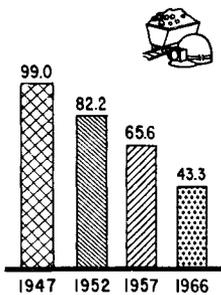
RATIO OF VOLUME OF EMPLOYMENT TO PHYSICAL VOLUME OF PRODUCTION

(1947-1949 Ratio of Employment to Production = 100)

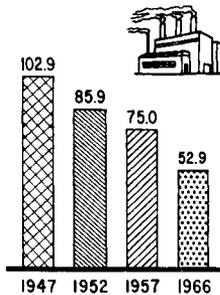
AGRICULTURE



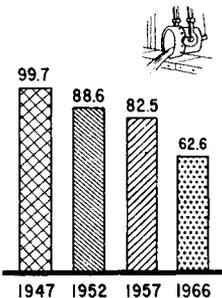
MINING



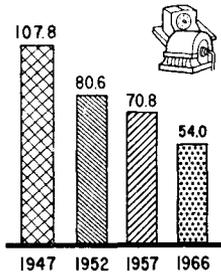
ALL MANUFACTURING



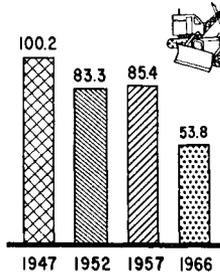
IRON AND STEEL



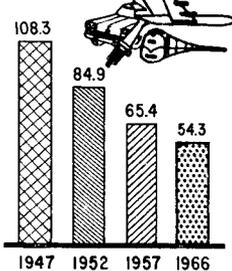
ELECTRICAL MACHINERY AND EQUIPMENT



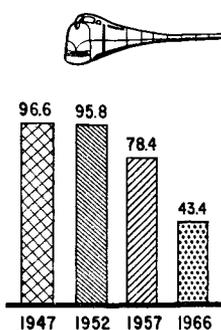
NONELECTRICAL MACHINERY & EQUIP.



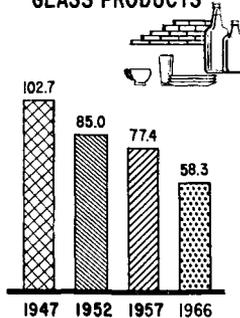
MOTOR VEHICLES & OTHER TRANSPORTATION EQUIPMENT



RAILROADS ^{1/2}



STONE, CLAY, AND GLASS PRODUCTS



^{1/2} Ratio of volume of employment to traffic volume.

Chart 17

GOALS FOR 1970 AND 1975, PROJECTED FROM ACTUAL LEVELS IN 1966

Dollar Figures in 1965 Dollars

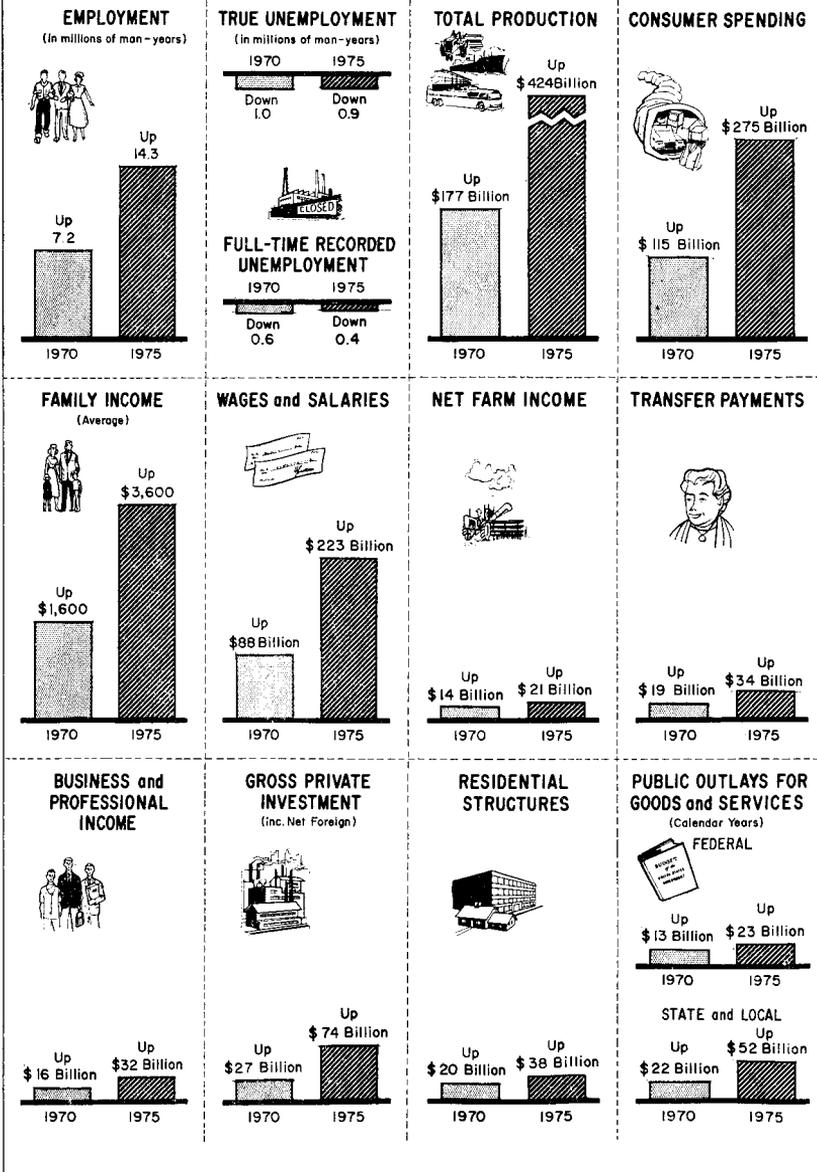
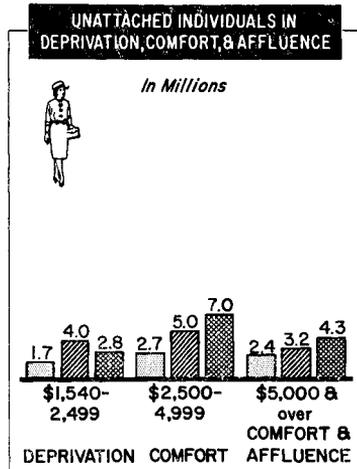
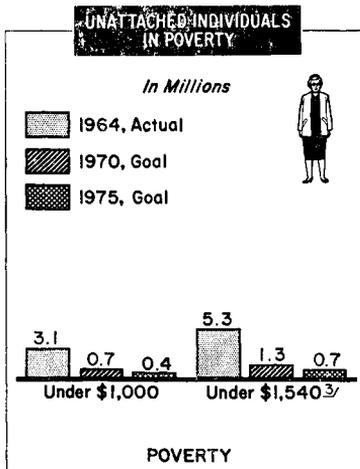
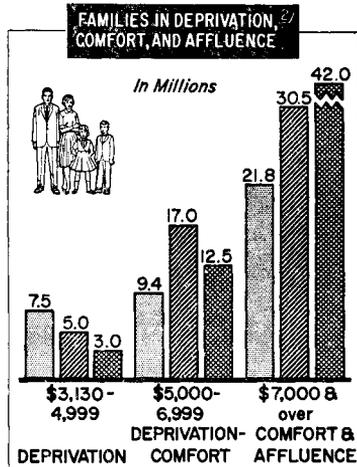
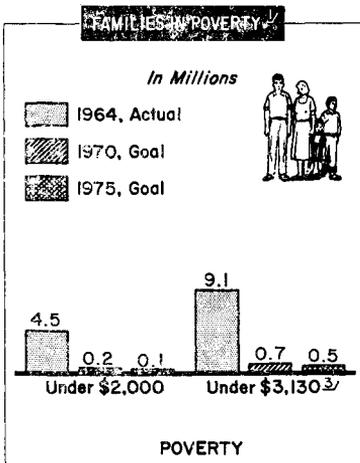


Chart 18

NUMBER IN U.S. LIVING IN POVERTY, DEPRIVATION, COMFORT, AND AFFLUENCE, 1964, AND GOALS FOR 1970 AND 1975

Annual Money Incomes, Before Taxes, in 1964 Dollars



^{1/} The average size of families living in poverty is 3.19, so 9.1 million families involve about 29.0 million people.

^{2/} The average size of families living in deprivation is about 3.5.

^{3/} The figures of \$3,130 and \$1,540 are the most recent estimates of the Office of Economic Opportunity with respect to the poverty-income ceiling.

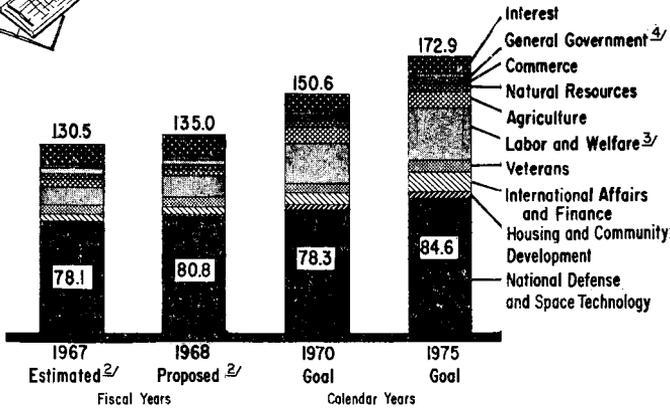
Data: 1964: Office of Economic Opportunity and Bureau of the Census; Projections, "Freedom Budget".

Chart 19

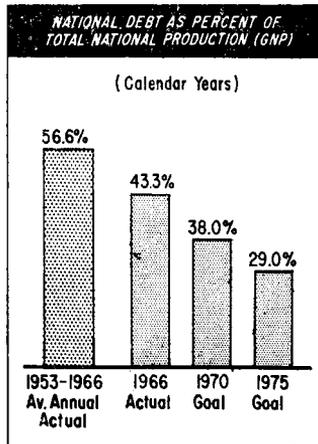
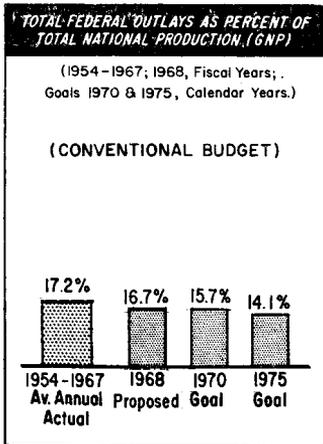
TOWARD A FEDERAL BUDGET CONSISTENT WITH MAXIMUM EMPLOYMENT AND THE PRIORITIES OF NATIONAL PUBLIC NEEDS



All Figures in Billions of Fiscal 1968 Dollars ^{1/}



BURDEN OF FEDERAL OUTLAYS IN A FULLY GROWING ECONOMY WOULD BE LOWER THAN IN RECENT YEARS



^{1/} Dollars of the purchasing power assumed in the President's Fiscal 1968 Budget.
^{2/} As of Budget Message of Jan. 24, 1967.
^{3/} Including education and health services.
^{4/} Including contingencies and less interfund transactions.

Chart 20

GOALS FOR A FEDERAL BUDGET GEARED TO ECONOMIC GROWTH AND PUBLIC NEEDS

1968, fiscal year; goals for 1970 and 1975, calendar years

All figures in fiscal 1968 dollars ^{1/}

ALL FEDERAL OUTLAYS				NATIONAL DEFENSE, SPACE TECHNOLOGY, & ALL INTERNATIONAL				ALL DOMESTIC PROGRAMS			
											
Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)
1968 ^{2/}	135.033	673.54	16.67	1968 ^{2/}	85.584	426.89	10.57	1968 ^{2/}	49.449	246.65	6.10
1970	150.600	726.48	15.69	1970	87.000	419.68	9.06	1970	63.600	306.80	6.63
1975	172.900	772.57	14.11	1975	97.400	435.21	7.95	1975	75.500	337.36	6.16
ECONOMIC OPPORTUNITY PROGRAM				HOUSING AND COMMUNITY DEVELOPMENT				AGRICULTURE; AND NATURAL RESOURCES			
											
Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)
1968 ^{2/}	1.860	9.28	0.23	1968 ^{2/}	1.023	5.10	0.13	1968 ^{2/}	6.691	33.37	0.82
1970	3.300	15.92	0.34	1970	3.700	17.85	0.39	1970	11.200	54.03	1.17
1975	4.500	20.11	0.37	1975	4.300	19.21	0.35	1975	13.400	59.87	1.09
EDUCATION				HEALTH SERVICES AND RESEARCH				PUBLIC ASSISTANCE; LABOR, MANPOWER, AND OTHER WELFARE SERVICES ^{3/}			
											
Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)	Year	Total Expend. (Bil. \$)	Per Capita (\$)	% of GNP (%)
1968 ^{2/}	2.816	14.05	0.35	1968 ^{2/}	4.767	23.78	0.59	1968 ^{2/}	4.677	23.33	0.57
1970	7.600	36.66	0.79	1970	5.400	26.05	0.56	1970	8.400	40.52	0.88
1975	10.600	47.36	0.87	1975	7.900	35.30	0.64	1975	10.700	47.81	0.87

^{1/} Dollars of the purchasing power assumed in the President's Fiscal 1968 Budget.

^{2/} Administration's Proposed Budget as of Jan. 24, 1967.

^{3/} Includes a Federal contribution in 1970 and 1975 of several billion dollars to the OASDHI to help increase benefit payments to the aged.

FEDERAL STATISTICS USERS' CONFERENCE

This statement is submitted on behalf of the Federal Statistics Users' Conference which is an association of 158 member companies and organizations comprised of business firms, labor unions, and non-profit research groups. The conference appreciates the opportunity to express its views regarding certain statistical information contained in the President's Economic Report and the Report of his Council of Economic Advisers. These statistics serve to measure growth, progress and change in the economy, and aid in the making of policy decisions and the implementation of economic programs. Our concern is with the adequacy, reliability, need, and potentials for improvements in the statistical data so that policy decisions can be based upon the best measures of the economy it is possible to obtain.

FSUC also has an interest in helping to raise the level of understanding of the public policy issues involved in these documents and assisting users of them in making more effective use of the information they contain. To that end, it sponsored a one-day conference on February 14, on the President's Economic Report and the Report of the Council of Economic Advisers and on the Federal budget. Speakers were Gardner Ackley, Chairman of the Council of Economic Advisers, and Charles Schultze, Director of the Bureau of the Budget. More than 140 members and guests attended the Conference.

We wish to comment briefly on the following:

WAGE-PRICE "GUIDEPOSTS"

In its comments to this committee 1 year ago, the Federal Statistics Users' Conference statement said:

The continuing debate about the Administration's wage-price 'guideposts' is unlikely to subside in the near future. While statistics on prices and measures of productivity have been improved over the past several years, the current controversy focuses new attention on these data—on their accuracy and reliability. These new concerns about price and productivity statistics suggest that it would be timely for the Joint Economic Committee to examine again the factual underpinnings for these important data—especially of those measures which do not flow directly from collected factual materials.

FSUC does not repeat its comments in order to claim extraordinary insight as to the heightened significance of a "guidepost" policy, nor even to reiterate that the statistical data underlying this policy are not as adequate as they need be. Rather, the conference wishes to take a look forward and share its concerns with the committee.

The conference, and its members, believes that one of the most paramount economic problems facing the Nation is the continuance of an effective wage-price stabilization policy. While the conference claims no competence in the formulation of such policies, it does want to emphasize that, in its opinion, a greater and more reliable fund of data may well be necessary to provide more adequate "measuring sticks" in the wage-price field.

But it now seems that key data provide an even less firm base than previously.

PRICE DATA

The weekly index of wholesale prices has been abandoned and an early preliminary release of the monthly index has been substituted. The conference cannot accept the latter as an adequate substitute. There will still be a month's time lapse between early releases. The conference believes there is need for interim measures of price variation. If the old weekly index was inadequate, the conference recommends that it should be improved and be reinstated.

PRODUCTIVITY DATA

While more data seem to be available on output per man-hour, their effectiveness seems limited at this time. The Bureau of Labor Statistics data based on establishments seem to be moving in an opposite direction from those based on the Household Survey Data (CPS). The conference would hope that these differences can be reconciled and if necessary, resources be concentrated on a single measure that would yield reliable results.

Furthermore, the conference would suggest that more frequently wage-price decisions may well require productivity measures by major industry. The conference recommends that initial steps be taken to develop such measures as soon as possible.

GNP OUTLOOK

In passing, the conference would note an item almost akin to style. The conference was pleased with and impressed by the implications of the use of a range in the Council of Economic Advisers forecast of 1966 gross national product. It regretfully notes that the Council has not chosen to specify the range within which its gross national product estimate for 1967 may fall. In future reports, the conference hopes that the Council will be more willing to share its vast fund of economic insight with those who must use such information for economic decisionmaking.

MACHINERY AND ALLIED PRODUCTS INSTITUTE

A TYPICAL CAPITAL GOODS USER'S VIEW OF FEDERAL POLICY ON THE INVESTMENT TAX CREDIT

The Machinery & Allied Products Institute (MAPI) and its affiliate the Council for Technological Advancement appreciate the joint committee's invitation to present views on the 1967 Economic Report of the President in connection with the current hearings. We shall deal almost exclusively with tax policy, in particular the investment tax credit which is now in suspension, and perhaps in an even more uncertain state.

These views are offered in behalf of an organization which has not only followed the development of the credit from its original concept but has published extensive analyses of this part of the tax system.¹ Moreover, our representation of the capital goods and allied equipment industries puts us in contact with producers of equipment, and perhaps even more important, with the wide range of customer industries served by capital goods producers. Further, our comments are presented against the background of a statement submitted on March 31, 1966, to the Fiscal Policy Subcommittee of this joint committee entitled "The Investment Credit—The Case for Its Permanency," and statements to cognizant committees in connection with the credit suspension legislation.

May we summarize in advance the position of the institute with respect to the investment tax credit :

Suspension of the investment credit was a serious mistake in national policy. The credit was proposed and intended to be a permanent part of the federal tax structure. It is a long-range prerequisite to a modern and dynamic industrial plant in this country. In the light of its inherent characteristics and the long-range purpose of its enactment, it is totally unsuitable for contracyclical manipulation ; indeed, its use for this purpose will have perverse effects on the economy and will do a great deal more harm than good.

Corrective action with respect to the suspension of the credit should be taken by the Congress promptly. Government should not wait for the reinstatement date of January 1, 1968, now provided in the statute. The most desirable method of reinstatement of the credit is to repeal the suspension retroactively to the beginning date of the suspension period, October 10, 1966. In any event, the reinstatement action must avoid the problem of the "air pocket" in equipment orders. The reinstatement action on the credit should be considered on its own merits and separate from the 6-percent surcharge proposal contained in the state of the Union message of President Johnson.

¹ *Incentives to Capital Investment—Two Approaches Compared*, Machinery & Allied Products Institute, 1961.

New Investment Incentives—The Investment Credit and the New Depreciation System, MAPI, 1962.

Incentive Value of the Investment Credit, the Guideline Depreciation System, and the Corporate Rate Reduction, MAPI, 1964.

"The Investment Credit as an Economic Control Device," *Capital Goods Review* No. 67, September 1966.

Also see statements presented to Subcommittee on Fiscal Policy of the Joint Congressional Economic Committee, Mar. 31, 1966, to Committee on Ways and Means, Sept. 14, 1966, and to Committee on Finance, Oct. 5, 1966.

We are taking the liberty of casting the principal part of this presentation in the form of a statement by a typical president of a medium-sized manufacturing company which in terms of its own business is a substantial user² of capital equipment. To pinpoint the issues and the problems involved in the investment credit hiatus, this typical business executive speaks for himself:

I am thoroughly confused, even mystified, by the chronology of events relating to the investment tax credit as I recall its original enactment, its period of application, its suspension, and the present state of limbo in which the credit and my corporate planning are placed.

Capital expenditures planning.—First let me say a few words about corporate planning. I have been reading a great deal about government planning and The New Economics, but I want to talk first about corporate planning, particularly capital expenditure planning.

For many years capital expenditure planning on a long-term basis was almost nonexistent in my business and in most such businesses. We shot from the hip, moving our expenditure programs up and down in what economists would call cyclical fashion and even the cycles were uneven. Then our thinking on this subject began to sharpen and we tried to make longer-range plans. Capital budgeting has been coming into its own and more rationalized systems of investment decision making have been devised and put to work. We also became aware that business had a tendency to peak its capital commitments at the wrong phase of the cycle and this phenomenon has been receiving attention in corporate planning.

From a planning standpoint, therefore, my company, and I believe industry at large, is committed to long-range capital expenditure planning and sophisticated investment analysis techniques. From a company standpoint, and also from a national policy viewpoint, my company and industry in general are convinced that domestic and international competition and the challenge of technological advance require constant modernization of our capital stock on a company, industry, and national basis. And above all, my company and other organizations can't plan or expand on an off-and-on basis. As Mr. George Champion, Chairman, The Chase Manhattan Bank, said in an address on February 16, 1967: "The fact is that capital expenditures cannot be turned on and off like a garden hose. They must flow in a continuous stream if we are to keep our industrial plant and equipment up to date."

Financial resources for corporate programs.—But determination, planning, and investment analysis techniques are not enough. Particularly for a company of our size, financial resources are crucial. Cash flow is critical. After-tax profits must be maximized to permit dynamic application of our new management techniques as to capital investment. In this respect, I don't and shouldn't look primarily to government. Pre-tax profits are my responsibility and so it is with all the ingredients of profit improvement: technological innovation, sound manufacturing techniques, aggressive and imaginative marketing, etc. But—and there is a big but—federal tax policy is government's responsibility and its effect on my company's corporate planning and overall performance is most significant. The aggregate effect on the economy takes on much greater importance.

Conception of the investment tax credit.—So, when even before President Kennedy was inaugurated his advisers in the federal government began to talk and think about capital investment and long-range planning relating thereto, I was most encouraged. Then followed introduction of the investment credit concept and proposed legislation. Some of my business colleagues—I should say many of them—were skeptical about the credit because they feared that it would become a tool of federalized economic manipulation. I felt differently.

²In order to understand the impact of the investment credit, one must examine the equipment-using industries, acknowledging of course that the equipment producer is also a user. The main and broadest impact of the credit is on equipment users or buyers. The credit affects practically every product-producing or service industry in the United States as well as the farmer. (Note that the farmer is a prime beneficiary.) The airlines. The steel industry. The automobile industry. The textile industry. The railroads. The tool and die makers. The plastics manufacturer. The dairies. The newspapers. Etc. Etc. The main thrust of the credit is not to prop up the machinery-producing industries; that is purely incidental in terms of objective and impact. The real impact spreads across the whole economy; as we have said, practically every product on service-producing industry including the farmer is the direct beneficiary when the credit is in effect.

I was convinced that government meant what it said—that its proposal was to be a permanent part of the tax structure—that it was dedicated to support through tax policies *constant* modernization of our industrial plant and equipment.

I was gratified and reassured when this aspect of the investment credit was clarified and the permanency feature documented by assurances to Congress and the business community by top Administration spokesmen. Although there were dissents, Congress acted in accordance with these assurances and the investment tax credit was enacted in 1962.

The long-range commitment of government in respect to the credit was further buttressed when in 1964 the credit statute was liberalized by the repeal of the basis-adjustment amendment. This action further reassured me that *government meant what it said*. And finally, government through official pronouncements frequently reminded me of the favorable effect the credit was having on my company, industry, and the economy at large.

The shock of credit suspension.—Then in 1966 my company and its management—and I believe industry at large—were given a rude shock!! Suspension of the credit was proposed and enacted. Some of the same spokesmen who previously ridiculed the idea of manipulation of the credit for contracyclical purposes now openly advocated it. Others who supported suspension didn't fully embrace contracyclical manipulation but said the suspension would be an extraordinary exception to the permanency commitment and at least implied that it probably wouldn't happen again.

My state of confusion and disappointment later was compounded by the impression created by the Administration that the January 1, 1968, reinstatement date was not firm in the Administration's mind; indeed, it was suggested that maybe it ought to be moved forward or extended depending on economic events. Further, being a practical businessman, I anticipated even greater uncertainty as we moved closer to the reinstatement date. How should I plan in the face of this uncertainty? And thinking beyond my problems, how could my suppliers of equipment expect me and their other customers to act during the 6 to 9 month period preceding the scheduled reinstatement date? Needless to say, these uncertainties had never plagued me when I looked upon the credit as a permanent part of the Code.

Credit caught in vagaries of contracyclical manipulation.—But there seems to be no end to my uncertainty or bafflement. For now I have been reading newspaper accounts—and some full texts—of statements made before this Committee by Administration spokesmen and advisers such as Mr. Walter Heller, the former Chairman of the Council of Economic Advisers. These statements clearly give the impression that government is attempting to engage in "fine tuning" of its tax and economic planning. Government wants to wait until midyear 1967 and see what the economic indicators say—or what they think they say. Government might even wait longer. It is suggested by Mr. Heller that if inflation resumes the credit should not be reinstated; and if operating rates in most industries are well below preferred rates that might also be a negative signal against credit reinstatement.

Impact on business psychology and corporate planning.—I must speak frankly at this point. No businessman, including me, can operate effectively with this kind of uncertainty. Corporate planning for capital investment is dealt a terribly serious blow. Moreover, I can't believe that government can expect to execute such "fine tuning operations" successfully and with beneficial overall results. I don't believe that the record of the last 12 to 18 months evidences that government economic planning is infallible; quite the contrary.

The proposed 6 percent surcharge.—But the picture is even more confused and muddled and intelligent corporate planning is even more hobbled. In his State of the Union Message, the President advocated a 6 percent surcharge on corporations and individuals. The Administration proposed midyear enactment on the basis of an economic forecast that the first half would be soft as compared with 1966 and that the second half would pick up to an important extent. This is qualified by some current statements by government officials that in effect the Administration wants to "stay loose," is not irrevocably committed to the 6 percent surcharge, and will reexamine the question toward midyear. It is understandable that government would want to take such a "second look" and economic trends may preclude the tax increase. The sequence of events and the atmosphere of economic manipulation, however, discourage sound corporate planning to a serious degree.

As I consider all of these developments I become greatly concerned. Above all, everything points now to the Administration's growing acceptance of the credit as a contracyclical tool subject to in-and-out manipulation in complete contradiction to the original commitment and understanding, not only with business but with the Congress. Mr. Heller said at one point in his testimony that "for the long pull, this country is firmly committed to a high-investment policy and the accompanying investment incentives." He and the country can't have it both ways. Government can't embrace such a long-range, high-investment policy and at the same time tamper or play with the incentive structure, including the investment tax credit. Government may over-optimistically try to manipulate its fine tuning control but if the power source of the instrument—in this case capital investment—requires steady handling, the system won't respond dynamically.

The distinguished Chairman of the Committee on Ways and Means made a relevant comment in a speech on February 12, 1967:

"Thus, while fiscal policy and economic policy may be, and frequently are, shifting, and while these may involve variables which either may be planned or unpremeditated, it is essential that tax policy have a certain degree of stability. . . . Changes must not be made merely for the sake of change and not merely just to experiment, but must on the contrary result from a demonstrable need and be carefully and deliberately entered into.

"Let me give an example which the fine ladies in this audience may more readily appreciate than the rest of us. We must not let ourselves be put into the position of raising and lowering the hemline of taxation, from season to season, merely to make the merchandise more saleable. Ours must be a becoming utilitarian style which will wear well and continue to serve its purpose in as attractive a design as we are able to create."

Credit not a practical contracyclical tool.—There is a further very important factor. Knowing my business, disciplines imposed on my business by planning, and having some knowledge about the investment credit and the serious cut-in and cut-out problems if it is manipulated, I am convinced that this device does not lend itself to contracyclical manipulation. Such use will do a great deal more harm than good.

Current business indicators point down.—Now to a few practical observations. While the indicators currently present a mixed picture, I am convinced that probably in late 1966 industrial production passed its peak. The Administration spokesmen seem to agree but in their guesses are optimistic about the second half of 1967. As I read government statistics, machinery and equipment orders, for example, are down 8 to 10 percent from 1966 midyear. There are a growing number of weakening areas or soft spots clearly discernible to me in business. It appears that new orders for machine tools crested and turned downward in the last quarter of 1966; this trend is even more visible from the January 1967 figures just released by that industry. Construction and construction equipment are off. Textiles have clearly softened and in turn are affecting textile equipment. Automobiles and appliances are off. We are in for an inventory adjustment. The economy overall experienced a marked slowdown in January as indicated by a substantial decline in orders for new durable goods (seasonally adjusted) to their lowest levels since November 1965. New orders fell below shipments by some \$800 million. (The overall index of industrial production (seasonally adjusted) declined by a full point in January (1.2 points in the case of manufacturing production). Most if not all indicators are giving us warnings. And if you want a classic example of the effect of suspension of the credit equipment orders, look at the drastic tailspin in railroad equipment orders. (See Dr. Beryl W. Sprinkel's testimony before this Committee and the detailed account in *The Wall Street Journal* of February 27, 1967.)

Now I am not unduly pessimistic. I don't expect a deep recession but the economy is experiencing an adjustment overall and so is my company.

Other important economic facts.—I am sure this Committee is aware of the substantial labor cost increases which almost everyone concedes will be negotiated in the current year 1967. Statements issuing from AFL-CIO meetings in Miami confirm that labor is shooting high and will not be restrained by government pleas for moderation. In a related sense, my attention has been called to the fact that even before those increases take place, the index of labor cost per unit of output in American industry has increased at an accelerated rate since August 1966. The June-December increase in the index from 100.3 to 102.7 was the sharpest increase for any six months since May-November 1959 and the

largest June-December rise since 1957. January data show a further sharp increase in labor cost per unit of output. This overall trend is being felt in my business.

The penalizing effect of the increase in labor cost per unit of output which will be multiplied by the substantial cost increases to be negotiated in 1967 makes absolutely crucial an accelerated rate of modernization of equipment in our plant. Otherwise business will simply not be able to sustain the financial burden of these increases. It is almost incongruous therefore in the face of these facts to tolerate continued suspension of the investment tax credit.

When this consideration is coupled with the continued difficulty we are experiencing in our international trade position and the obvious need to supply the Vietnam war, isn't it sensible to ask why we shouldn't be considering special tax incentives to increase productivity and modernize capacity instead of debating whether the investment tax credit should be reinstated and when.

What to do?—Suspension of the investment credit was a mistake. Business makes mistakes and I believe government makes them too. This mistake could turn into a blunder—aggravating and deepening a turnown, or converting a leveling-off into a turndown.

I believe this mistake should be corrected. Prompt action should be taken to reinstate the investment tax credit and such action should be taken in a way to avoid the problem of an air pocket of orders during the period immediately preceding the reinstatement date. Clearly government should not wait for the January 1, 1968, cut-in date now provided in the statute. Finally, the reinstatement action on the credit should be considered on its own merit and separate from the 6 percent surcharge proposal.

Reinstatement of accelerated depreciation of real property.—Thus far, I have commented exclusively on the question of the investment tax credit. At the time the credit was suspended, on the recommendation of the Administration the Congress also suspended the accelerated depreciation privileges for real property granted under the 1954 Revenue Act. It has been my experience in business that the tax code and tax administration are replete with tax discriminations against industrial buildings. This discrimination is present in the depreciation guidelines and in the basic statute on the investment tax credit.

The real target of the suspension of accelerated depreciation privileges was speculative construction, not industrial buildings, and yet the suspension legislation lumped all buildings and structures together. Obviously, corrective action should be taken in this area also—and promptly.

Having attempted to present the views of a typical capital goods user regarding the investment credit issue—views which, based on Institute experience, discussions, and contacts, are believed to be a composite of capital goods opinion—we turn at this point in our statement to a technical amplification of certain points made above.

UNSUITABILITY OF INVESTMENT CREDIT FOR MANIPULATIVE ACTION

Since March 1966, before the Presidential proposal to suspend the credit, as documented in our testimony before a subcommittee of this committee, MAPI has underlined the reasons why the investment credit is not an appropriate device for economic control or contracyclical action.

A copy of that statement is attached. We reiterated these views during hearings on H.R. 17607 and in September 1966, MAPI Research Director George Terborgh's Capital Goods Review No. 67, entitled "The Investment Credit as an Economic Control Device," was published. A copy of that review is attached. The problems associated with suspension and restoration of the credit are spelled out in this document. It is especially timely at this juncture to quote the review discussion of certain of the perverse reactions which are attendant to restoration of the credit:

The restoration of the credit after a period of suspension is equivalent to a general price reduction of 7 percent. This is worth waiting for.

With suspension to a time certain, there is bound to be a massive deferment of commitments (if the cut-in is on a commitment basis) or of delivery instructions (if it is on an installation basis) as the restoration date approaches. Unless the cut-in comes at just the right moment (right with this deferment taken into account), the resultant "air pocket" in equipment activity will be both untimely and injurious. It will be the more so, of course, the later the cut-in relative to the correct timing.

The chance that a predetermined suspension period will end at or near the right time is very slim. So also is the chance that the preceding "air pocket" in equipment activity will be rightly timed. There is grave risk that the inevitable wait for restoration will serve to aggravate capital goods recessions.

OTHER DIFFICULTIES IN "FINE TUNING" TAX PLANNING FOR CONTRACYCLICAL PURPOSES

In respect to fine tuning, frequently economists in government who theorize about the effect of tax actions and even legislators who act on such recommendations are not fully aware of the practical effects which flow from such legislation and beyond that of the sometimes tortuous, cumbersome, and burdensome problems implicit in administration and compliance. This is particularly true in the tax field because of its inherent complexity and the validity of this conclusion is further underlined by the delays, inconsistencies, and difficulties in the administrative process.

Let us comment briefly on some examples, all pertaining to the investment tax credit. Business witnesses warned the Congress that suspension of the investment tax credit would involve terribly complex and administrative burdens, one of these being administration of the provision in the suspension legislation referring to "binding contracts." The Congress recognized this difficulty and attempted to lay down some guidelines in the congressional reports. Despite this noble effort, the problems of interpretation and application that will arise in this area are almost unlimited.

And to date no regulations have issued from the Treasury Department on the credit suspension. This is not intended to be a captious comment with respect to the Treasury regulations staff. These are difficult regulations to write and the Treasury has been carrying an extraordinarily heavy workload. But the fact is that the regulations are not out yet and this is merely one indicator of the administrative difficulties involved in the process.

An even more glaring example is the fact that regulations have not yet been published under the recapture section of the investment credit provisions of the original investment credit statute passed in 1962. Once again a terribly complex problem, but the fact is that the regulations are not yet available.

The purpose of these comments is to underline the proposition that it is very difficult, if not impossible, to accurately forecast and promptly achieve fine tuning effects when government is attempting to manipulate in the complex tax field a device like the investment tax credit which simply does not lend itself to the process of manipulation.

A further example. By the time the Congress enacted the suspension provision, the capital goods boom had already crested. There is pretty good evidence that the action intended by its proponents to have impact in 1966 is having a delayed effect at the wrong time with the wrong result as far as the general economic picture is concerned.

Taking the process in reverse, with respect to the January 1, 1968, reinstatement, not only will there be an air pocket in orders between now and the January 1 date, but action will have to be taken promptly to move that reinstatement date forward or the adverse elements in the situation will feed on themselves. In a nutshell, the legislative process involving enactment of tax laws, the administrative process related to their administration, and the subtleties of business management decisionmaking, particularly in the field of business investment policy, do not lend themselves to so-called fine tuning objectives of government planning.

INVESTMENT CREDIT SUSPENSION SERIOUSLY AGGRAVATES ADVERSE IMPACT OF OTHER TAX DEVELOPMENTS

As important as the impact of the suspension of the investment tax credit is by itself, the severity of this action becomes even more important in the light of related tax developments.

Corporate depreciation accruals.—Particularly with regard to capital expenditures, one should examine the present posture of corporate depreciation policy in the United States. The institute has been a close student of depreciation policy for many years. It is clear that we are now in a period characterized by a fading effect of tax depreciation accruals on corporate sources of funds and on economic trends. In a study on this subject, entitled "The Fading Boom in Corporate Tax Depreciation," by George Terborgh, the following conclusion was reached:

The great postwar surge of corporate tax depreciation is over. From now on, the increase in accruals will be more closely geared to the long-run growth trend of corporate capital expenditures.

There is considerable reason to believe, moreover, that the rate of increase will actually fall below this growth trend. The future of corporate capital expenditures is of course unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a short-fall of depreciation growth seems probable. The probability arises principally from the prospective fadeout of the relative net benefits from the accelerated writeoff methods of the 1954 Code and from the guideline-life system.

The reserve-ratio test.—Moreover, the depreciation guideline system is hobbled by an administratively unworkable and technically deficient reserve-ratio test. Because of some relief measures taken by the Treasury Department, this test has not yet begun to bite seriously. But when the test again becomes fully effective it may substantially limit the favorable effect of the depreciation guidelines. For the long pull, this situation as to the reserve-ratio test should be corrected administratively or by legislation if necessary—a subject worthy of extensive treatment on its own merits. Here we refer to it primarily to indicate that there are problems other than the investment credit issue which affect the health of plant and equipment in the United States.

Contractional tax action and leadtime.—Moving beyond the investment tax credit as such, the serious problems of leadtime in connection with the manipulation of personal and corporate income taxes received attention in MAPI Capital Goods Review No. 68. The conclusion from that Review is quoted below:

We are interested here in the *technical* aspects of corporate and personal income taxes as instruments of contractional action, not in their *political* aspects. We are glad to leave the latter to politicians.

From a technical standpoint, it is evident that the personal income tax offers distinct advantages. In view of the recognition and legislative lags, of which we spoke earlier, it is highly probable that contracyclical tax action will be taken late—at least in relation to the optimal timing. It can normally be expected to await the actual realization of the conditions it is intended to combat. Under these circumstances there are obvious gains from the use of a tax instrument that minimizes the response lag.

Since it takes several months for corporate tax changes to generate a substantial production response in the capital goods area, and the better part of a year for a complete response, these changes should lead by a substantial interval the attainment of the target conditions. If they do not—and there is practically no chance they will—there is considerable risk that the impact will come too late.

This may not be serious in the case of stimulative action (there should be time to turn around before the next capital goods boom), but it certainly can be so when the action is restrictive. If it comes in the mature phase of a boom, when capital goods commitments have started down spontaneously or are about to do so, it will only aggravate the subsequent decline in production. Even if the action is reversed as soon as the decline becomes evident (and this is unlikely), it is bound to be too late to prevent unnecessary liquidation.

The moral of this discourse, at the very least, is that contracyclical tax action should not be employed without careful regard for the lead time involved.

It should be conceded that the administration apparently views its 6 percent surcharge recommendation as a tax to finance the Vietnam war and contain the budget deficit, and perhaps only secondarily in a contracyclical context. However, the effects of such tax action on the economic picture cannot be ignored and we are sure the administration will weight economic indicators heavily in its final judgment on whether to push for the 6-percent surcharge.

The prospect of aggravating a capital goods decline and perhaps a general recession is therefore a very real problem.

The whole is greater than the sum of the parts.—Turning to more general tax questions, either deliberately or by happenstance, government takes tax actions on a piecemeal basis. This blurs the effect on the viability and resources of business. Some of these actions are quite significant by themselves, but cumulatively they take on an even more deadly significance. It is frequently overlooked in this connection that, for example, a further social security tax rate increase went into effect on January 1, 1967, the new rate being 4.4 percent each for employees and employers and further increases are already scheduled by law. In addition, it is generally conceded that a substantial rate increase and/or enlargement of base will be enacted by the Congress in response to the President's recommendations made in January. It clearly is illusory to treat the social security tax as anything but a part of our total tax burden.

This committee is of course familiar with the substantial acceleration of corporate income tax payments so that in 1967 under the law passed in 1966 corporations are required to be on a current basis, paying taxes quarterly against an estimate for the current calendar year. Now the President proposes an increase from 70 to 80 percent in the relationship the corporation's estimated tax for any year must bear to its final tax liability. In an action with similar effect, in 1966 corporations were required to pay over to the Government on a semi-monthly basis rather than a monthly basis withheld employee income taxes and social security taxes. Other proposals such as the question of integration of pension plans with social security, an increase in the costs of the unemployment compensation system, and of course

the 6-percent surcharge, would further impinge on the ability of American business to operate in a dynamic fashion, to provide jobs, and to maintain a strong industrial base in this country.

The point of this broader review is to emphasize to the committee that the action to suspend the investment tax credit, and the present hiatus with regard to its status and the uncertainty as to reinstatement, take on even more serious implications when viewed in the light of other developments limiting the resources, the flexibility, and the strength of business.

SPECIFIC RECOMMENDATIONS AS TO CREDIT REINSTATEMENT

We have suggested above that the credit should be promptly reinstated; Government should not wait for the January 1, 1968, cut-in date, action should be taken as to the credit on its own merits and separate from congressional consideration of the 6-percent surcharge, if indeed that surcharge should be considered at all.

Turning to the latter point first, as we have repeatedly pointed out, the investment credit was proposed and enacted as a permanent part of the tax structure to facilitate long-term growth of the economy. It does not lend itself to contracyclical manipulation. It should be treated separately from any rate changes to meet war or other emergency conditions and should be undertaken on its own merits. If there are political problems involved in such separate treatment we are sure the administration has the courage and statesmanship to face up to such political complications.

We should not adhere to the January 1 reinstatement date for several reasons. It is our strong feeling that suspension was a mistake in the first place; in correcting that error there is no point in waiting for the present statutory reinstatement date. Furthermore, economic indicators point to the need for immediate rather than delayed action.

Finally, as to the mechanics of the reinstatement, there are several alternatives, but only one clear-cut practical solution. In the spirit of full correction of a mistake and in view of administrative difficulties in merely moving the suspension date forward, the suspension should be retroactively revoked to the original suspension date, October 10, 1966. Moving the date forward will merely retime the administrative problems of restoration including the air pocket in new orders. Other alternatives such as provision for partial retroactivity or the immediate termination of suspension are conceivable. The latter would call for an earlier reinstatement date such as the date of introduction of a bill or an earlier date set forth in the bill itself. But this technique is not as clean and forthright as complete and retroactive negation of the suspension back to October 10, 1966. Further, if the administration should immediately make a recommendation in line with our suggestion, even the fastest possible congressional action will involve some delay; and every day's delay compounds the problem and the economic risk.

This concludes the comments of the Institute to the Joint Congressional Economic Committee with particular reference to the investment tax credit, its suspension, and reinstatement. In a separate presentation, MAPI offers some general comments on certain other

economic issues including (1) government intervention in business decisions affecting private investment abroad and (2) trends in social security policy including proposals regarding integration of pension plans with social security. These are separately filed because of the concentration of our principal statement on the investment tax credit.

THE INVESTMENT CREDIT—THE CASE FOR ITS PERMANENCY*

By CHARLES STEWART, PRESIDENT

We appreciate the opportunity extended by your letter of March 11, 1966 to present the views of the Machinery and Allied Products Institute and our affiliate, the Council for Technological Advancement, on the issues and problems involved in alternative approaches to short-run economic stabilization. Our comments will be directed to the role of the investment credit in the economy and to a consideration of its appropriateness as a countercyclical device. The reason for this concentration is threefold:

1. We believe the investment tax credit as applicable to productive equipment was an imaginative and sound proposal. Further, we believe the credit has worked and has proven its merits as a permanent part of our tax structure.

2. The investment credit is the subject of one of the recommendations of the full Joint Economic Committee in its 1966 Joint Economic Report. To wit: "We should immediately suspend the 7-percent investment credit provision in view of the extraordinary exuberance indicated by investment programs. This is one of the major inflationary threats of this year. This action should be accompanied by a provision that the 7-percent credit would go back into effect at a fixed future date unless Congress acts to extend the suspension."

3. As a national organization representing the capital goods and allied equipment industries, the Institute speaks on behalf of firms who have the unusual vantage point of being at one and the same time both the *producers* and major *users* of the productive equipment subject to the investment tax credit. This vantage point also includes familiarity with the impact of the credit on the wide range of customer industries served by capital goods producers. Finally, from the original conception of the credit, the Institute has studied it closely.

We turn first to a brief discussion of the investment credit in relation to the goals of our economy.

GOALS—ONE THEME WITH DIFFERENT ARRANGEMENTS

After twenty years under the Employment Act of 1946 its goals of "maximum employment, production, and purchasing power" have come to be generally interpreted as full employment, economic growth, price stability, and balance of payments equilibrium. Since it is impossible to maximize everything at once—and since conditions change as well—the individual goals have been given different priorities at different times. Currently, the goal of stability is receiving the most attention and, because of this, there is a strong tendency to analyze and pass judgment upon a particular measure only in terms of its contribution (or lack of it) to this one goal. We make two observations in this connection:

1. There is a great danger that in attempting to avoid inflation and maximize price stability we will sacrifice the progress we have made in achieving present level of full employment, economic growth, and balance of payments equilibrium.

2. The investment credit has played—and can continue to play—a major role in achieving the essential economic goals of full employment, economic growth, and balance of payments equilibrium. Further, it is not without merit in its contribution to reasonable price stability as well.

THE POSITIVE ROLE OF THE INVESTMENT CREDIT

The rationale of the credit.—In the current dialogue on the investment credit it is frequently overlooked that there was a basic and long-run consideration in enacting the investment credit upon the recommendation of President Kennedy.

*Statement presented by Machinery and Allied Products Institute and Council for Technological Advancement to Subcommittee on Fiscal Policy of the Joint Congressional Economic Committee in Connection with Hearings on Short-Run Stabilization Tax Changes, March 31, 1966.

This was brought out at the time by then Secretary of the Treasury Dillon in testimony before the House Ways and Means Committee:¹

"As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind. . . . In the last five years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the 50's. Clearly, we must improve our performance, otherwise we cannot maintain our national aspirations. The pressing task before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.

"I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal. . . . All the information we have indicates that their plant and equipment are considerably younger than ours. Although this difference reflects the rebuilding of the shattered European economies, I think it is important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances and investment credits."

This same point was made even more directly in the statement of the Council of Economic Advisers before the Joint Economic Committee:²

"Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized."

The message is clear. There are long-run advantages to the investment credit for productive equipment that outweigh any use it might have as a device to offset cyclical changes in the economy. What are these advantages?

The case for the credit.—In essence, the investment tax credit is vital to economic health in that it provides an incentive to continued growth of the nation's productive capacity and the modernization and replacement of its existing equipment. In so doing it provides the assurance the economy can—

1. Provide the goods necessary to meet its domestic needs—civilian and defense—and, in so doing, combat inflation;
2. Provide the additional jobs and equipment required by an expanding labor force;³
3. Enable the economy to provide wage increases in accordance with productivity without inducing price increases;
4. Fulfill our international obligations; and
5. Meet the competition for world markets and thus contribute to the solution of our balance of payments problem.

To make its proper contribution to the performance of these tasks, the investment credit should be—as it was originally considered to be—a permanent part of our tax structure. To convert the credit to meet the requirements of a countercyclical tool—i.e., that it be used on an on-again, off-again basis—would run the risk of sacrificing its effectiveness in fulfilling the vital goals for which it is uniquely designed. But even assuming that serious consideration should be given to its use as a countercyclical tool, how will the credit function in that role?

THE CREDIT AS A COUNTERCYCLICAL TOOL

It is generally agreed that the criteria that should be met by any tax used as a countercyclical tool include the following: (1) it must be promptly effective and its economic results consistent with desired effects; (2) it must be equitable; and (3) it must not create uncertainty in business planning, investment, and output. We conclude that the investment tax credit fails on all three grounds and as we understand Assistant Secretary of the Treasury Surrey's testimony before this Subcommittee on March 30, he makes the same judgment.

¹ "President's 1961 Tax Recommendations," 87th Cong., 1st Sess., May 3, 1961, pp. 21, 22.

² "The American Economy in 1961: Problems and Policies," March 6, 1961, p. 49.

³ *Capital Goods Review* No. 61, "Labor Force Growth and Business Capital Formation," MAPI, March 1965.

Delayed effects.—Under present circumstances, there is an average lag of nine or ten months between the go-ahead decision (appropriation or authorization) and the installation⁴ of credit-eligible equipment. This means that the major part of the equipment to be installed during the remainder of 1966 is already in the pipeline. Denial of the credit at this juncture might have some effect on projects authorized but not yet committed, but it would not affect significantly those already on order. It follows that the restrictive effect on capital goods activity would be largely deferred. Most of it would come in 1967.⁵

Perverse reactions on suspension.—Unless the effective date of the credit suspension is definitely and convincingly *in the past*, the legislative consideration of the proposal will trigger a frantic rush to obtain deliveries of credit-eligible equipment before the deadline. This will aggravate the pressure on the equipment producer that it is the object of the suspension to abate.

It appears to be the view of leading proponents of suspension that equipment orders outstanding at the time of suspension must necessarily be exempt from its application on grounds of equity. In this case, the legislative consideration of the proposal—unless again the cut-in date is convincingly *in the past*—would lead to an *orders* stampede. This might not be as harmful as a deliveries stampede, but it could be very disturbing to capital goods suppliers, and is certainly not calculated to relieve the pressure on them in the near term.

Perverse reactions on restoration.—If the restoration of the credit were either dated in advance or anticipated by industry, it would obviously provide a powerful inducement for the deferment of new equipment installations until after the deadline. If the restoration applied to *orders* placed after the deadline, it would have a even more retarding effect. On either basis, the arrangement would produce an artificial depression in capital goods markets at the wrong time and contrary to the intention of its sponsors.

Timeliness.—In view of the delayed impact of a credit suspension on capital goods activity, the question arises whether the move is timely. There are powerful forces of restraint already at work in this area—falling corporate liquidity, increased pressure on internally generated funds, reduced credit availability and higher interest rates, rising costs of capital projects, severe shortages in skilled manpower, etc.—and there is informed opinion that the peak of new authorizations has already been reached. If this is correct, the effect of suspension—especially if delayed for two or three months—would come too late to be of much value. It would have its chief impact after the squeeze is over, and would aggravate any subsequent correction.

Inequity.—In addition to the problem of long “leadtimes” mentioned above, capital expenditures also involve a good deal of preplanning and preparatory expenditures for such items as plant design, engineering work, etc. Any removal of the credit forcing a change in plans obviously results in certain losses or penalties to the company. Further, many such commitments are not only planned long in advance, but are contracted for. Where this is the case a change in plans is no longer feasible and this raises questions of the government’s keeping good faith with the taxpayer.

There is another matter of equity that merits attention here. The credit is a vital and necessary part of our tax system as long as industry is subject to the present extremely high corporate rates which have such a penalizing effect on investment.⁶

Uncertainty.—Frequent reversals of tax policy tend to destroy incentives. Under such conditions there is a reluctance to make capital expenditures when there is uncertainty as to the character and timing of congressional action. This is an important consideration at a time when industry is increasingly

⁴ Note the significance of the “installation” test under the investment tax credit provisions. As Assistant Secretary Surrey said, “Actually, I think people who have advocated suspension of the credit really have an image of its operation that would have it turn on orders rather than installations as it now does. This possibility was explored at the time the credit was originally set up and found not to be feasible.”

⁵ Senator William Proxmire made this same point in his supplementary views in the “1966 Joint Economic Report” at page 23:

“Because there is a considerable ‘leadtime’ in carrying out investment projects; because the investment credit becomes available when assets are put in service and hence present contracts are being undertaken in reliance on the availability of the credit when the project is completed; because suspension of the credit would have to provide an exception for projects already under commitment, but which will be completed in the future; it follows that suspension of the investment credit would generally not alter investment expenditures or tax revenues for a substantial period of time.”

⁶ *Effect of Corporate Income Tax on Investment*, George Terborgh, Machinery and Allied Products Institute, March 1959.

engaging in long-range planning and that planning with respect to expenditures on production equipment takes the investment credit into consideration. Thus, to the extent that the investment credit becomes an on-and-off device its usefulness will be severely impaired.

Summary.—The moral is clear. The investment credit, potent as it is as a device to support and facilitate capital investment, does not lend itself readily to manipulative application because of its inherent limitations as a countercyclical tool.

THE CRUCIAL ELEMENT OF TIMING

The proper tools.—Unquestionably, the practice of economics has become more sophisticated in recent years. We believe that through the efforts of economists in government, academe, and industry we know a great deal more about the economy and we are hopeful that government itself has become somewhat more astute and sophisticated in the use of economic tools. However, at this time it must be admitted that there still remains a good deal to be done in improving our analytical techniques and until this is accomplished we are not in a position to proceed with a great deal of reliability into the niceties of countercyclical fiscal policy.

Where are we now?—There are some who believe that the forces of inflation are severe and will grow much worse. There are others, with whom we are inclined to join ourselves, who feel that although there are some significant inflationary signs, it is unlikely that we confront a runaway situation; indeed, it is very likely that we are near the top of the cycle and may be leveling off. As noted above, there are powerful forces of restraint already at work. These include the tight money situation both as to availability and rates, declining profit margins, and the decline in common stock prices in heavy trading. In terms of capital expenditures, this does not necessarily mean that we are about to face a recession, but rather a significantly slower rate of growth in physical output and a growth rate in plant and equipment expenditures closer to that of the economy as a whole.

Forces at work.—In addition to the “straws in the wind” we have mentioned there are a number of basic forces at work which will increasingly exert a restraining hand on the economy. President Johnson himself has identified these factors. These of course include the Tax Adjustment Act of 1966 which it is estimated will raise some \$6 billion in federal revenue over the next 15 months, the increase in Social Security and Medicare taxes of some \$6 billion at annual rates which went into effect on January 1, 1966, and the recent action of the Federal Reserve Board in raising the discount rate. In addition, it must not be overlooked that Congress can, and we think should, assert a firmer control over federal expenditures and the Executive Department has leeway in certain of its actual *spending* decisions.

Beyond these factors, there is one other that to our knowledge has been overlooked by commentators on this subject; namely, the fading boom in corporate tax depreciation. Since the Institute has documented this at length elsewhere¹ we will simply excerpt the relevant portion of the conclusion of that study:

“The great postwar surge of corporate tax depreciations is over. From now on, the increase in accruals will be more closely geared to the long-run growth trend of corporate capital expenditures.

“There is considerable reason to believe, moreover, that the rate of increase will actually fall below this growth trend. The future of corporate capital expenditures is of course unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a shortfall of depreciation growth seems probable. The probability arises principally from the prospective fadeout of the relative net benefits from the accelerated writeoff methods of the 1954 Code and from the guideline-life system.”

Summary.—In light of the “margin of error” that exists in the application of macroeconomics, the relatively crude state of our analytical tools at this time, and the forces for restraint that have yet to reach their full potential, it would appear precipitous to take action to suspend the investment credit at this time on these grounds alone.

SUMMARY AND CONCLUSION

The investment tax credit was enacted by the Congress upon recommendation by the Kennedy Administration in order to stimulate sound capital invest-

¹ *The Fading Boom in Corporate Tax Depreciation*, George Terborgh, Machinery and Allied Products Institute, 1965.

ment as a means of both increasing our rate of economic growth and making U.S. industry more efficient and thus more competitive at home and abroad. It was later liberalized in the same spirit. The objectives of the Act are just as vital today as when the law was enacted despite some changes in economic conditions.

When the investment credit was proposed and enacted it was in the spirit of permanency. There is a clear legislative record to this effect. To attempt to use the credit as purely a countercyclical tool on an in-and-out basis would be a breach of faith, in addition to interfering with the longer-range goals to which it is addressed.

Most persuasive in terms of the applicability of the credit as a countercyclical device is that it simply would not be effective. The credit is not well suited to such use both because of the "cut-out" and "cut-in" problem and the fact that it will lead to perverse reactions due to the effect of anticipated changes in the credit on behavior of industry.

Frequently the arguments in favor of suspending the investment credit seem to assume that success or failure in the fight against inflation turns on this single proposal. This obviously is not the case. The Tax Adjustment Act of 1966, the increase in Social Security and Medicare taxes which went into effect in January of this year, and the recent action of the Federal Reserve Board in raising the discount rate all have a restraining effect—both directly and indirectly—on capital expenditures and have not yet attained their potential impact. In addition, the supply of corporate funds will be adversely affected by the passing of the postwar boom in corporate tax depreciation, and the prospect of a deteriorating relation between capital requirements and financial availabilities.

The great economic challenge to the U.S. today remains the achievement and maintenance of the most modern technology and industrial plant in the world. It is only in this way that we can conserve the progress we have made, protect our national security and our international competitive position, and insure the highest level of job creation.

This concludes our comments on the role of the investment credit in the economy and its appropriateness as a countercyclical device both in the current economic context and as a general principle. We should like to express again our appreciation of your kindness in permitting us to present the views of the Institute on this subject. If the Institute and its staff can be of assistance to the Committee in its studies we hope you will not hesitate to call on us.

LEAD TIME AND CONTRACYCLICAL TAX POLICY*

In the preceding *Review* we discussed the implications of lead time for one instrument of contracyclical policy, manipulation (suspension and restoration) of the investment credit.¹ We did not, however, discuss its implications for the manipulation of personal and corporate income taxes. This is the subject of the present inquiry. Specifically, we propose to consider the bearing of lead time on the choice of instruments for contracyclical tax action.

By contracyclical tax action, we refer to *ad hoc* measures taken in response to current or immediately anticipated economic conditions. It is true that budgeting is done nowadays on assumptions as to economic conditions during the forthcoming fiscal year, and that in this sense some degree of contracyclical action may be implied in the budget proposals. But since these are submitted six months before the beginning of the year covered, they are necessarily based on tenuous and remote estimates and do not constitute *ad hoc* action in the sense used here. Only when current or proximate conditions are deemed to call for contracyclical tax measures at the time the budget is enacted do we have such action as a part of the regular fiscal routine. Otherwise it calls for special legislation.

Since we are dealing with *ad hoc* tax action, it may be superfluous to observe that we are not concerned with the automatic compensatory effects of the tax structure itself, reflecting the "built-in stabilizers." (Owing to the progressivity of the personal income tax, and the volatility of corporate profits, federal revenues tend to rise relative to national income during economic expansions and to decline relatively in contractions.) These stabilizers are very powerful, and serve greatly to reduce the need for special action, but they do not always suffice to obviate it. In any case, they are taken for granted here.

1. CONTRACYCLICAL TAX ACTION IN THE POSTWAR PERIOD

Before we launch on the main discussion, it may be worthwhile, by way of background, to sketch in a few words the record of special contracyclical tax action since World War II.

During the four completed postwar business cycles, 1946-49, 1949-54, 1954-58, and 1958-61 (measuring from lows), there appear to have been no tax increases for the purpose of restraining booms² and (with one possible exception) no reductions for the purpose of combating recessions.³ Some of the tax changes turned out to be timely for stabilization policy, some untimely, but they were motivated predominantly, if not wholly, by other considerations. Their cyclical effects were largely incidental and haphazard.

After a careful review of *antirecession* fiscal policy in these four cycles, Lewis comments as follows:

"... [I]t is frequently difficult—sometimes impossible—to decide definitely whether or not the motive in particular actions was primarily to counter recession. But, insofar as a distinction is possible, those actions which appear to have been primarily counterrecessionary have been on the expenditure side of the budget."⁴

As for the present cycle, still incomplete, the story is considerably different. Thanks in part to the growing acceptance of the idea of compensatory fiscal policy, in part to the intensive efforts of the Kennedy Administration to popularize the expanded version of that policy now known as the New Economics,

*Reprinted from Machinery and Allied Products Institute, *Capital Goods Review*, December 1966.

¹ "The Investment Credit as an Economic Control Device," *Capital Goods Review* No. 67, September 1966.

² The Korean war taxes may possibly be construed as restraints on an *anticipated* boom, but are more realistically considered noncyclical in nature.

³ The possible exception is the reduction of excise taxes in 1954, described by Lewis as a measure "for which the recession was a frequently advanced but not the only argument." Wilfred Lewis, Jr., *Federal Fiscal Policy in the Postwar Recessions*, p. 18. The Brookings Institution, 1962.

⁴ *Ibid.*

there have been this time several tax actions with avowed economic objectives—the investment credit and liberalized depreciation allowances (1962), reductions of personal and corporate rates (1964), excise rate reductions (1965), and, more recently, tax increases embodied in the Tax Adjustment Act of 1966 and the investment credit suspension.⁵

Notwithstanding the absence of contracyclical tax action in the first four postwar cycles, it is a practical certainty that it will be forthcoming in some fashion from now on. This makes it important to consider problems incident to its application. As already indicated, the one we are concerned with here is the effect of lead time (or, looked at the other way, of time lags) on the operation.⁶

2. THREE LAGS

There are three time lags to be considered, which we may call the “recognition lag,” the “legislative lag,” and the “response lag.” The first results from delay in official recognition and acknowledgement of the need for tax action. The second reflects the time required to get congressional approval after such recognition. The third arises from the delayed response of the economy after enactment. Suppose we say a few words about each.

RECOGNITION LAG

Actual experience with tax increases to restrain booms is very limited (there having been none in the first four postwar cycles, as indicated). It is a safe bet, however, that they will rarely come before the conditions they attempt to combat are fully realized. Repressing booms is a politically painful operation, and can hardly be done on the basis of forecasts, especially when, as usual, the forecasters are divided. Action must await the development of consensus as to its necessity, and this matures only in the presence of conclusive evidence—tight credit, rising prices, labor shortages, fat wage settlements, capacity squeezes, etc. Certainly this has been true in the present boom, when the first identifiably contracyclical tax action (a limited one) was presented to Congress in January 1966, and the second (also limited) in September.⁷

The recognition lag applies also in the reverse operation, combating recessions. Due in part to delay in the availability of figures, in part to mixed indicators in the early stages of recession, it is usually impossible to be sure of a downturn until two or three months after it has started. But this is not all. The incumbent Administration may be reluctant to admit its existence until forced by overwhelming evidence. This is not a mere possibility; delays in official recognition of the turn have characterized to some degree all of the postwar recessions.⁸

LEGISLATIVE LAG

Once the Administration has decided to move contracyclically on the tax front, it is necessary to get a bill through Congress. This adds a second, or legislative, lag to the process.

There are not enough precedents in the record to establish the probable length of this lag. The only clear instances of contracyclical tax action, the Tax Adjustment Act of 1966 and the recent investment credit suspension, are of interest, however. The former took two months from introduction to enactment (signature by the President); the latter, eight weeks. Whether these intervals are

⁵ Among other things, the Tax Adjustment Act raised and extended certain excises, further accelerated corporate tax payments, and imposed graduated withholding of personal taxes. More recently, by administrative action, there has been a step-up in the timing of the payment of withheld Social Security taxes.

⁶ It will be noted that only the last two of the tax actions in the present cycle were contracyclical, the earlier ones being procyclical—designed to accelerate an expansion already underway. The New Economics rationalizes both. While both will doubtless be employed in the future, we shall conduct the discussion in terms of contracyclical action alone. This not only because of its presumptively greater frequency and importance, but also because the associated timing problems are likely to be more acute.

⁷ The Tax Adjustment Act of 1966 on January 24 and the investment credit suspension on September 8.

⁸ See Wilfred Lewis, Jr., *op. cit.*, pp. 101–2, 148, 195–7, 242–4. While the only stimulative actions in these recessions were on the expenditure side of the budget, and were implemented largely through administrative measures, they came late. Lewis concludes that “[d]iscretionary actions have not been in effect before the trough month so that, except for possible anticipatory effects, they have not been a factor in cushioning the decline or in causing turning points.” *Ibid.*, p. 19.

indicative for the future, it is impossible to say with certainty.⁹ In both of these cases controversy in Congress was not widespread, and the substance of the changes was less complicated than might be the case at other times.

We can be sure, in any event, that unless special procedures are set up for the legislative processing of contracyclical tax actions (several of which have been suggested, but none accepted), a substantial legislative lag will be added to the recognition lag, the two together entailing a serious retardation of timing.

RESPONSE LAG

The object of contracyclical tax action is to restrain or stimulate the economy by varying the after-tax income of the affected taxpayers. It is assumed that reductions in such income will curtail demand for goods and services, hence will ease pressures on production, and that increases will expand demand, with stimulative effect.

This assumption may be correct, but it tells us nothing about the *timing* of the production response to the tax action. This can vary widely. It can be immediate, slightly delayed, or long delayed, depending on a number of factors, chief of which is the length of the production period or, as it is commonly called, production lead time. When this period is very short, as with directly consumed services (haircuts, for example), the response of production to changes in demand can be virtually instantaneous. For most nondurable commodities, the period is short enough for a substantial, if not a complete, response in a matter of days or weeks. But when lead time runs to months, or even years, as it often does for capital goods, the response develops very gradually.

Suppose, for example, we have an item with a production period of one year. Suppose further that orders have been running 1,000 units a month and that there are 12,000 units in process. Suppose finally that as a result of restrictive tax action demand is reduced by 10 percent, to 900 units a month. If productive activity is applied to individual items evenly over the one-year period, the overall production response in successive months after the reduction will be the following fractions of the reduction itself: $\frac{1}{12}$, $\frac{2}{12}$, $\frac{3}{12}$, $\frac{4}{12}$, $\frac{5}{12}$, $\frac{6}{12}$, etc.¹⁰ Thus it will take six months to curtail total activity by one-half of the reduction in demand and an entire year (the production period itself) to develop a full response.¹¹ For *stimulative* tax action, the lag is similar, but in reverse.

When we consider the substantial volume of long-lead-time production in the economy, it is evident that the response lag can have a significant bearing on the effectiveness of contracyclical tax action.

3. COMPARATIVE RESPONSE LAGS

Since the response lag is so important, it is pertinent to compare the principal instruments of tax action—the corporate income tax, the personal income tax, and the investment credit—with respect to their associated lags.

Since the last-named instrument, the investment credit, was considered in the preceding *Review*, we need not discuss it here. Suffice it to say that the long response lag to changes in the credit (suspension and restoration) was one of the principal factors in the negative conclusion reached in that analysis:

“The moral of this discussion is clear. The investment credit is not suited to manipulative application. It is not, therefore, an appropriate device for economic control purposes. It was not intended for this use in the first place and should not be so employed.”

With this verdict on the contracyclical use of the investment credit, we turn to the other instruments of tax action, corporate and personal income taxes.

CORPORATE INCOME TAX

Contracyclical changes in the corporate income tax are intended to generate a production response through their effect on after-tax profits. If profits are

⁹ As noted earlier, there have been three *procyclical* tax adjustments during the present cycle, the investment credit of 1962, the income tax reduction of 1964, and the excise reduction of 1965. The legislative lags were 18 months, 13 months, and 1 month, respectively. Since timing is less important for such adjustments than for the *contracyclical* variety, these lags are probably not indicative of what to expect for the latter.

¹⁰ Assuming each month's orders are placed in full at the beginning of the month. On the more realistic assumption that they flow through the month, the progression becomes $\frac{1}{24}$, $\frac{3}{24}$, $\frac{5}{24}$, $\frac{7}{24}$, $\frac{9}{24}$, $\frac{11}{24}$, $\frac{13}{24}$, etc.

¹¹ If, as usual, production is applied more heavily around the middle of the period, the overall response will be even slower at the start.

reduced by a tax increase, this is supposed to curtail productive activity by a like amount; if they are increased by a tax reduction, the opposite effect is expected.¹²

Even granted that these effects are realized eventually, the question is, how soon? The timing of the production response depends on the way the corporate system reacts to the tax change. If it adjusts its inventory position, by varying the flow of commitments for materials and components, the lag should be relatively brief. But if it adjusts its fixed-asset position, by varying in this case the flow of commitments for plant and equipment, the lag is likely to be an extended one. This because of the long lead time involved.

This lead time consists of two components: (1) the production period itself; (2) the period between commitment and the beginning of production. Since there is very little of the second component in the recession phase of the business cycle (there is little "waiting in line" for production to start), total lead time tends to be coincident with production time. In the boom phase, however, it can be considerably longer.

A rough idea of lead time in the present boom may be conveyed by a few figures. The Treasury recently estimated the average order-to-completion period for investment-credit-eligible equipment at 9-12 months.¹³ This excludes buildings and structures for which the period is presumably longer. Commerce surveys (for plant and equipment combined) indicate an average interval between commitment and payment of 8 months for manufacturing and 13 months for public utilities.¹⁴ NICB surveys (also for plant and equipment) show an average of 9-10 months between appropriations and expenditures in manufacturing.¹⁵ These indications are rather fragmentary, to be sure, but they suggest that the overall average lag of completions behind commitments may be around 10 months.

On this assumption, it would take around five months for a corporate tax increase, even if reflected immediately and completely in a reduction of fixed-asset commitments, to build up a production response one-half as large as the increase itself. In all probability it would proceed even more slowly, because of the present backlog of commitments waiting to be put into production. (Where this situation exists, the production response to a curtailment of new orders awaits the prior absorption of this backlog.)

While the absence of a backlog of orders not yet in work might make the production response to *antirecession* tax action (a tax reduction) somewhat more prompt, it would nevertheless take months to develop substantial magnitude. As far as capital goods activity is concerned (the control of which is presumably the principal end sought in the contracyclical manipulation of the corporate tax), the response lag is a long one either way.

There is another point to be made in connection with this lag. Corporate capital investment programs often comprise a mixture of items with long and short lead times. For example, they may include a building and the equipment that goes into it. In such cases the construction contract may be let before the equipment orders are placed. It goes without saying that these orders are likely to be unresponsive to contracyclical tax action; they are in effect mandatory. This contributes, of course, to a further delay in the production response.¹⁶

PERSONAL INCOME TAX

When we come to the personal income tax, we find a different picture. The overwhelming bulk (around 95 percent) of the disposable income of individuals is spent for consumption. The bulk of this expenditure in turn (around 85 per-

¹² This is the "first round" effect, without reference to the subsequent "multiplier," a concept with which we are not concerned here.

¹³ Quoted by Senator Proxmire from a Treasury communication to him. *Congressional Record*, August 23, 1966, p. 19421. It is estimated further that 40 percent of eligible equipment has an *order-to-delivery* period of less than six months, 40 percent between six months and a year, and 20 percent over a year (the average for the last group being about two years).

¹⁴ Department of Commerce, OBE Releases 66-14 and 66-54, March 10 and September 8, 1966. Our computation, based on the relation of the "carry-over" to expenditures in the first half of 1966.

¹⁵ National Industrial Conference Board, *Capital Appropriations*, Second Quarter 1966, p. 15. Our computation, based on the first half of 1966.

¹⁶ It may be appropriate before leaving the subject to mention an incidental effect of *restrictive* corporate tax action. Because of the large backlog of fixed-asset commitments in the production pipeline when the action is taken, the consequent reduction of corporate funds may put additional pressure on credit facilities until the deliveries from these commitments are paid for, thus complicating the task of the credit managers.

cent) goes for services and nondurable goods, for which the production response is generally prompt.¹⁷

Even for durables (automobiles, appliances, furniture, etc.), the response lag averages only a fraction of the lag for producers' equipment. In contrast to the latter—produced largely by job-shop methods, much of it specially engineered to the customer's order—consumers' durables are mass-produced in vast numbers, and on short lead times. The feedback from changes in demand is prompt, and the production response relatively rapid.

We shall not attempt a specific estimate of the overall production response lag to tax-induced changes in disposable income, but there can be no doubt that it is but a fraction of the lag for similarly induced changes in the after-tax profits of corporations. By comparison, personal tax changes are quick-acting medicine.¹⁸

4. CONCLUSION

We are interested here in the *technical* aspects of corporate and personal income taxes as instruments of contracyclical action, not in their *political* aspects. We are glad to leave the latter to politicians.

From a technical standpoint, it is evident that the personal income tax offers distinct advantages. In view of the recognition and legislative lags, of which we spoke earlier, it is highly probable that contracyclical tax action will be taken late—at least in relation to the optimal timing. It can normally be expected to await the actual realization of the conditions it is intended to combat. Under these circumstances there are obvious gains from the use of a tax instrument that minimizes the response lag.

Since it takes several months for corporate tax changes to generate a substantial production response in the capital goods area, and the better part of a year for a complete response, these changes should lead by a substantial interval the attainment of the target conditions. If they do not—and there is practically no chance they will—there is considerable risk that the impact will come too late.¹⁹

This may not be serious in the case of stimulative action (there should be time to turn around before the next capital goods boom), but it certainly can be so when the action is restrictive. If it comes in the mature phase of a boom, when capital goods commitments have started down spontaneously or are about to do so, it will only aggravate the subsequent decline in production. Even if the action is reversed as soon as the decline becomes evident (and this is unlikely), it is bound to be too late to prevent unnecessary liquidation.

The moral of this discourse, at the very least, is that contracyclical tax action should not be employed without careful regard for the lead time involved.

¹⁷ An exception occurs in the case of farm production, where the response may await the next growing or livestock breeding season. The response in the processing and distribution of existing farm products is of course independent of these lags.

¹⁸ See Joseph A. Pechman, *Federal Tax Policy*, p. 60. The Brookings Institution, 1966. We have not mentioned the effect of personal income tax changes on new housing construction (where lead time is longer than for consumers' goods and services), chiefly because this is an area of production dominated by credit policy. Compared with the effects of such policy, any variation in disposable income due to contracyclical tax action (plus or minus 2 or 3 percent) is likely to be of small consequence.

¹⁹ We may add that this risk attaches in substantial degree to the recent suspension of the investment tax credit.

THE INVESTMENT CREDIT AS AN ECONOMIC CONTROL DEVICE*

In the election campaign of 1960, both presidential candidates expressed dissatisfaction with the progress of the American economy and a determination to accelerate its future growth by providing additional incentives for business investment.

The nature of this concern is evident from the remarks of Secretary of the Treasury Dillon in presenting the first incentive proposal of the new Administration, the investment credit.

As we look back over the past century we see that our record of economic growth has been unmatched anywhere in the world. But of late we have fallen behind In the last five years Western Europe has grown at double or triple our recent rate and Japan has grown even faster. While there is some debate as to the precise annual growth rate of the Soviet economy, CIA estimates that their GNP grew at a rate of 7 percent in the 50's. Clearly, we must improve our performance, otherwise we cannot maintain our national aspirations. The pressing tasks before us, then, is to restore the vigor of our economy and to return to our traditionally high rate of economic expansion and growth. I am confident this can be accomplished. But it will require a major effort by all of us.

I have been impressed during recent travels abroad by the great progress our friends overseas have made in reconstructing their economies since World War II and by the highly modern and efficient plants they now have at their disposal All the information we have indicates that their plant and equipment are considerably younger than ours. Although this difference reflects the rebuilding of the shattered European economies, I think it is important to emphasize that it was due in good part to the vigorous policies of the European governments. Tax incentives for investment played a significant role, including accelerated depreciation, initial allowances and investment credits.¹

ORIGINAL CONCEPT

This statement was made during the recession of 1960-61, following several years of relatively low business capital investment (after 1957). It is obvious, however, that the Administration was concerned not simply with the cyclical recovery of investment, but with the broader objective of raising its general level over the long run. The main goal was a higher economic growth rate through increased investment in productive facilities.

This view was well expressed by the Council of Economic Advisers in a report to the Joint Economic Committee:

"Measures to stimulate business investment directly will contribute to our recovery from the present recession, but that is not their main purpose. All who have confidence in the American economy must look ahead to the day when the slack will be taken up and high levels of output and employment will again be the rule. The full benefit of our decision to supplement increases in consumer demand now with a higher rate of capital expansion and modernization will then be realized."²

It is interesting to note that this concept appears to have been shared by the fiscal committees of Congress:

"The tax credit provided by this bill is a complement to the Administration's plans for revising the guidelines for the tax lives of property subject to depreciation. It is believed that the investment credit, coupled with the liberalized depreciation, will provide a strong and lasting stimulus to a high rate of economic growth and will provide an incentive to invest comparable to those available elsewhere in the rapidly growing industrial nations of the free world."³

*Reprinted from Machinery and Allied Products. *Capital Goods Review*, September 1966.

¹ Testimony of the Secretary before the House Ways and Means Committee, May 3, 1961.

² *The American Economy in 1961: Problems and Policies*, March 6, 1961, p. 49.

³ Report of the House Ways and Means Committee on the Revenue Act of 1962, p. 8.

"Realistic depreciation alone, however, is not enough to provide the essential economic growth. In addition, a specific incentive must be provided if a higher rate of growth is to be achieved. . . . The objective of the investment credit is to encourage modernization and expansion of the Nation's productive facilities and thereby improve the economic potential of the country, with a resultant increase in job opportunities and betterment of our competitive position in the world economy."⁴

QUESTION OF MANIPULATION

It will be recalled that the initial reaction to the investment credit proposal was critical, and even hostile, in many quarters. There were a variety of reasons, only one of which concerns us here. It was charged that once in effect the credit would inevitably be manipulated for economic control purposes.

This charge was indignantly denied by the Administration. Its spokesmen insisted that the credit was designed to be a permanent feature of the tax system, that its purpose was to raise the average level of investment over the long pull, and that there was no intent to employ it as a contracyclical device. As for the Congress, the legislative history strongly suggests that it concurred in the Administration position.⁵

At the time the credit was proposed (1961), and enacted (1962), no one was worrying about excessive capital investment. The whole drive was for expansion. Any possible need for restrictive action was obviously far in the future, and except for the Administration assurances just referred to the problem was treated as academic.

RECENT DEVELOPMENTS

We cite this historical record to indicate the original concept and purpose of the investment credit. But conditions have changed radically since then, and the question is now before us of withdrawing or suspending the credit as a means of curbing a capital goods boom in an overheated economy.

Last January Senator Gore introduced a bill (S. 2806) calling for the outright repeal of the credit. Later he proposed an amendment to the Tax Adjustment Act of 1966 suspending it for two years (rejected by the Senate on March 8). Shortly thereafter, the Joint Economic Committee recommended immediate suspension to a future date prescribed by Congress. Numerous economists, including three former chairmen of the Council of Economic Advisers, have joined in urging suspension, usually for a one-year period. Several bills directed to this objective have been introduced in Congress. Recently the Chairman of the Senate Finance Committee, Senator Long, proposed an amendment to the Foreign Investors Tax Act of 1966 (H.R. 13103), providing for indefinite suspension.⁶ Still more recently, the Administration has proposed suspension for 16 months (H.R. 17607).

PRESENT PROJECT

In view of this altered situation, it is an appropriate time to consider the basic question of the merits of the investment credit as any economic control device. Is it suitable for on-and-off application? This question is the subject of the present inquiry.

It is a safe guess that most of the proponents of on-and-off application have not thought through the problems to which it gives rise, if indeed they are even aware of them. They involve questions of fairness, administrative feasibility, timing, and effectiveness. We suggest that until these questions have been confronted it is irresponsible to urge manipulation, whether by temporary suspension or otherwise.

Since temporary suspension appears to be the most favored form of manipulation, we propose to consider the difficulties associated with that form. Because they are somewhat different at the suspension (cut-out) phase of the operation than at restoration (cut-in), we shall discuss the two phases separately, beginning with suspension.

1. PROBLEMS ASSOCIATED WITH SUSPENSION

As a rule, capital equipment has a long production period. Moreover, a large proportion is produced on order. This means that customers must wait during its fabrication, and that there is normally an extended period between the place-

⁴ Report of the Senate Finance Committee on the Revenue Act of 1962, p. 11.

⁵ Witness the committee reports quoted earlier.

⁶ *Cong. Rec.*, August 30, 1966, p. 20321.

ment of orders and their delivery. The interval between orders and the completion of installation (the point at which the credit can be claimed) is of course longer still.

No one knows within a wide margin the current overall average of this order-to-completion period for credit-eligible equipment, but Treasury estimates place it in the range of 9-12 months.⁷ Even if we take the lower limit of this range, we are dealing, obviously, with a very long lead time, the existence of which has important implications for the problem in hand.

FAIRNESS

As just noted, the investment credit is claimable on the completion of installation and the placement of the equipment in service. This means that if the suspension is on the same basis industry will lose the benefit of the credit on outstanding commitments representing say three-quarters of a year's investment in eligible equipment—commitments entered into in good faith in expectation of that benefit.

The unfairness of denying the credit to such commitments was recognized in the Gore amendment, to which we referred earlier, by a provision protecting the eligibility of equipment for which firm contracts had been entered into prior to the effective date. It has been recognized also in subsequent suspension proposals, including the Long amendment and the Administration bill.

To afford complete protection of outstanding commitments, it is necessary, of course, to allow time for them to work through the production pipeline. The Gore amendment allowed one year, a period sufficient for most, but not all, of them to clear. The Long amendment, on the other hand, allowed only *four months*. This is grossly inadequate and would leave a substantial proportion of the carry-over unprotected. The Administration proposal is better in this respect: it imposes no time limit at all.

While the complete protection of outstanding commitments eliminates a considerable part of the inequity at the suspension stage, it does not remove all of it. Industry often makes a heavy investment in the planning and engineering of equipment programs before firm contracts are entered into. To the extent that this investment is conditioned on the availability of the credit, the suspension destroys its value and usefulness. Moreover, there is a large element of chance in the impact of the suspension. The commitment flow of individual companies is extremely "lumpy." The cut-out date is certain to catch some of them with large placements just inside the line and others with similar placements just outside. (For example, the Administration proposal for a cut-out on September 1 finds a large airline with an order dated September 2 for \$410 million worth of equipment.)⁸

Although a partial equity can be secured by putting the credit suspension on a commitment basis, given a sufficient workout period, unfortunately this creates difficult administrative problems.

ADMINISTRATIVE DIFFICULTIES

The completion of the installation of a piece of equipment is ordinarily a clearly identifiable event, but the timing of a "firm contract" for its procurement may not be. For this reason the switch from an installation to a commitment basis presents administrative problems.

This was pointed out by Senator Long in the debate on the Gore amendment: "This rule will open up difficult areas of dispute between the Internal Revenue Service and business firms over what constitutes a binding commitment. I doubt if any mechanical rule can be followed here. Each case will have to be examined on its own merits."⁹

When is a "firm contract" entered into? Is it on the date a purchase order is sent, or when confirmed by the equipment producer? Must the order be noncancellable? If not, what kind of cancellation penalties are required to make it "firm"? Must the delivery date be fixed, or can it be indefinite? What about supplements and amendments? Do they take the date of the original

⁷ Quoted by Senator Proxmire from a Treasury communication to him. *Congressional Record*, August 23, 1966, p. 19421. It is estimated further that 40 percent of eligible equipment has an *order-to-delivery* period of less than 6 months, 40 percent between 6 months and a year, and 20 percent over a year (the average for the last group being about 2 years).

⁸ *Wall Street Journal*, September 9, 1966, p. 2.

⁹ *Cong. Rec.*, March 7, 1966, p. 4972.

order, or must they be broken out? These and other vexing questions are bound to bedevil both industry and tax administrators, giving rise to uncertainty, controversy, and litigation.

There is another aspect of the matter. Suspension on a commitment basis will give rise to deplorable pressure on equipment suppliers for the redating of orders that fall on the wrong side of the line, the shifting of items from later to earlier orders, etc. No one will contend that this is desirable, least of all the suppliers themselves.

As a matter of fact, the Administration explored very thoroughly the possibility of putting the credit on a commitment basis at the time it was first proposed. In the words of Assistant Secretary of the Treasury Surrey, "It was found not to be feasible."¹⁰ If it was not feasible to *introduce* it on that basis, can it be feasible to *suspend* it in the same fashion?

TIMING

Because of the long lead time between orders and delivery, the cutoff of the investment credit at the ordering stage would obviously have a *delayed* effect on equipment production. Senator Proxmire recently commented on the point as follows:

"Because the suspension of the credit would have to provide an exception for projects already under commitment, but completed in the future, it follows that suspension would generally not alter investment expenditures or tax revenues for a substantial period of time. . . . If we repeal the credit today or tomorrow, it would be at least the middle or the end of 1967 before the real effect would be felt. If we acted next March or April, it would have no decisive effect until 1968."¹¹

This means that the suspension should occur long *before* capital investment attains the level at which restraint is deemed desirable. It requires action on the basis of predictions and forecasts. This is not necessarily a prohibitive requirement, but past experience with the application of restrictive measures in a political environment (especially in election years) is not reassuring. The chances are that the suspension will come late, in response to *current*, rather than anticipated, conditions. In some cases, certainly, this will lock the barn door after the horse is gone. Indeed, there is always the risk that the delayed effects will fall in the receding phase of the capital goods cycle, thus aggravating the decline.

PERVERSE REACTIONS

In a parliamentary system, the minister of finance can guard the secrecy of his budget proposals until they are formally presented to the legislature. Moreover, the budget, once disclosed, is practically certain to go through. (If it doesn't, the government falls with it.) In this setup, a measure like the suspension of the investment credit can be imposed as of a date already past, and *there is nothing industry can do about it.*

In the American system, things do not happen this way. Proposals can be tossed into the hopper by any member of the Congress at any time, and it is often difficult, if not impossible, to assess their chances. Even if they progress in the legislative machinery, they are likely to be pending for months, and no one can be sure whether, or in what form, they will finally emerge. Proposals of the Administration must run the same legislative gauntlet, and even if acceptable in principle are commonly exposed for extended periods to discussion and amendment. On many crucial details the final result is often uncertain up to the moment of enactment.

This makes it extremely difficult to suspend the investment credit without triggering perverse reactions on the part of industry. Since the effect of suspension is an across-the-board increase of 7.5 percent in the cost of eligible equipment, the moment of suspension bill is introduced there is an incentive to rush the placements of commitments.¹² Even though the cut-out date is already past, there is no certainty that it will stick; hence prudence calls for protective action. Some other bill with a later cut-out may supersede the first one. Even if the original proposal eventually goes through, it may be some months hence, and the final effective date is unpredictable. The response to these uncertainties

¹⁰ *Hearings* Before the Subcommittee on Fiscal Policy of the Joint Economic Committee, March 16-30, 1966, p. 242.

¹¹ *Cong. Rec.*, August 23, 1966, pp. 19421, 19422.

¹² The 7.5 percent applies to equipment with a service life of 8 years or over. For shorter-lived items, the credit is scaled down.

can only aggravate the pressure on capital equipment suppliers which it is the purpose of the suspension to abate.

But this is not all. If the practice of manipulating the credit becomes established, industry will take anticipatory action even before there are overt moves for suspensions. (This would occur, of course, even under a parliamentary system.) As soon as capital goods activity rises to a level suggesting the imminence of such moves, protective commitments are in order.

These observations assume suspension on a commitments basis, with sufficient time allowed to work off the outstanding backlog. Where this allowance is cut short, as in the Long amendment mentioned earlier (four months), there is an additional incentive for perverse reactions. If the threat of enactment is taken seriously by industry, such a proposal is bound to touch off a stampede for the acceleration of equipment deliveries scheduled after the deadline (its enactment would of course have the same effect). Again the result will be the opposite of that intended.

These considerations raise grave doubts about the *effectiveness* of credit suspension as a means of restraint, quite apart from the administrative difficulties to which it gives rise. It may well prove counterproductive.

2. PROBLEMS ASSOCIATED WITH RESTORATION

It is obvious that the restoration, or cut-in, phase of the temporary-suspension cycle raises in reverse some of the same problems confronted at cut-out. There is again the question of basis: should the cut-in be by installation or by commitment? There is the question of timing: how can anyone tell at suspension whether the scheduled restoration will be timely? There is also the problem of anticipatory reactions: with the cut-in date known in advance, how can perverse effects be avoided?

BASIS

While the average lead time between the commitment and installation of eligible equipment is likely to be somewhat shorter at restoration than at suspension, it is bound to be at least 6 months, and probably longer. This means that if the restoration is on an installation basis it will apply to commitments made long before the cut-in date. If on the other hand, it is on a commitment basis, it will present the difficult administrative problems described earlier in connection with the suspension phase. (In either case it will generate perverse reactions, about which more in a moment.)

Most of the temporary-suspension proposals we have seen contemplate restoration on an installation basis, though in the Administration plan it turns on commitments. Here it is a question of balancing the administrative simplicity of the installation-basis cut-in against the windfall gains conferred on then-outstanding commitments. With a fixed cut-in date, such gains are certain to be far smaller than the windfall losses from the exclusion of existing commitments at the suspension stage. For since the cut-in date is known in advance, most of these commitments will have been made in expectation of the credit. (Where the restoration date is indefinite, more of them will have been entered into without reference to the credit.)

TIMING

If there are timing problems at the suspension stage, they appear also, though in different form, at restoration. No one can tell at the time of suspension how long the period should last. Should it be one year, two years, or three? If the cut-out is likely to come, as we have suggested, near the end of the capital goods boom, even one year may be too long. In other cases it may not be long enough.

Some temporary-suspension schemes allow the President to extend (but not to shorten) the period by proclamation. This gives one-way flexibility, but it introduces an undesirable element of uncertainty in business planning. Until it is known whether the scheduled cut-in date will be deferred, capital budgeting must proceed in the dark. A similar climate of uncertainty will exist, of course, if the suspension is for an indefinite period in the first place.

PERVEESE REACTIONS

It is here that the greatest difficulty arises. The restoration of the credit after a period of suspension is equivalent to a general price reduction of 7 percent.¹⁸ This is worth waiting for.

¹⁸ Again with the exception noted earlier for equipment with a life of less than 8 years.

With suspension to a time certain, there is bound to be a massive deferment of commitments (if the cut-in is on a commitment basis) or of delivery instructions (if it is on an installation basis) as the restoration date approaches. Unless the cut-in comes at just the right moment (right with this deferment taken into account), the resultant "air pocket" in equipment activity will be both untimely and injurious. It will be the more so, of course, the later the cut-in relative to the correct timing.

The chance that a predetermined suspension period will end at or near the right time is very slim. So also is the chance that the preceding "air pocket" in equipment activity will be rightly timed. There is grave risk that the inevitable wait for restoration will serve to aggravate capital goods recessions.

But what if the restoration date is indefinite, subject to the future action of Congress or the President? In this case the basis for the anticipatory deferment of orders or deliveries is uncertain, and the affair turns into a guessing game. Industry will guess when the cognizant authority is going to move and will regulate its capital programs accordingly. The "air pocket" will be less sharply defined than when the cut-in date is known (there will be differences of opinion on the prospects), but it will be present nevertheless. The pendency of the restoration will exert a drag on the recovery of investment (or will aggravate its decline) until the effective date is passed.

3. CONCLUSION

The moral of this discussion is clear. The investment credit is not suited to manipulative application. It is not, therefore, an appropriate device for economic control purposes. It was not intended for this use in the first place and should not be so employed.

The practical alternative that confronts policy makers is either to maintain the credit as a permanent feature of the tax system or to abolish it. As to this choice, we entertain no doubt. It is still as important to accelerate the long-run growth of the American economy as it was when Secretary Dillon made the statement quoted earlier. There are now, moreover, two additional factors that did not obtain at that time: the accelerated growth of the labor force, and the declining growth of tax depreciation deductions. A word on each.

We estimated in an earlier *Review* that the stepped-up growth of the labor force (which began around 1965) will require an annual investment in productive facilities \$5 billion to \$8 billion *larger* than would be needed with a continuation of the labor-force growth rate obtaining previously.¹⁴ Obviously, these expanded requirements will have to be financed somehow.

It is here that the second factor comes in. Over the 20 years 1945-65, the tax depreciation deductions of American corporations rose at an *average* rate of nearly 11 percent per annum, a rate far more rapid than the expansion of depreciable assets (7 percent). But this situation has now come to an end:

"The great postwar surge of corporate tax depreciation is over. From now on, the increase in accruals will be more closely geared to the long-run growth trend of corporate capital expenditures. There is considerable reason to believe, moreover, that the rate of increase will actually fall below this trend. The future of capital expenditures is of course unpredictable, but if they rise over the next decade at the average rate of the past 15 years (about 5.5 percent per annum), a shortfall of depreciation growth below this rate seems probable. The probability arises principally from the prospective fadeout of the relative net-benefits from the accelerated writeoff methods of the 1964 Code and from the guideline-life system."¹⁵

Both of these factors conspire to make the investment credit more, rather than less, urgent than when first proposed. If under present conditions additional measures of economic restraint are called for—a question we do not consider here—there are better ways to accomplish this end than manipulation of the credit. Indeed, if the foregoing analysis is valid, its manipulation is likely to do more harm than good.

¹⁴ "Labor Force Growth and Business Capital Formation," *Capital Goods Review* No. 61, March 1965.

¹⁵ *The Fading Boom in Corporate Tax Depreciation*, Machinery and Allied Products Institute, 1965, pp. 1, 12.

GOVERNMENT INTERVENTION IN BUSINESS DECISIONS AFFECTING PRIVATE INVESTMENT ABROAD*

The report of the Council of Economic Advisers acknowledges, as we all do, that the United States continues to confront a serious problem with respect to the U.S. balance of payments. Secretary Fowler has subsequently issued a report on the status of our balance-of-payments situation. There is a central aspect of the situation involving the balance of payments, however, which we feel is not receiving sufficient attention from a Government policy viewpoint. Once again, a part of the problem is the fact that national policymaking is undertaken on a piecemeal basis and only infrequently is the big picture placed in perspective.

The fact is that partly on the grounds of balance-of-payments considerations, and in the judgment of the institute partly because of what appears at times to be a predilection of the Government to employ controls in this area, this country has been drifting toward a policy of Government intervention in business decisions affecting private investment abroad and the flow of capital on an international scale.

THE INTEREST EQUALIZATION TAX ACT

It is perhaps most illustrative to deal with this question in terms of the Interest Equalization Tax Act, for a proposal for extension of that law and enlargement of its penalty provisions is now before the Congress. The President and the Treasury have asked Congress for legislation to extend the Interest Equalization Tax Act for 2 years (until July 31, 1969) and to authorize the President, when conditions warrant, to vary the statutory rates between zero and a rate double the existing rates. This proposal of an interest equalization tax was first made in 1963 on the basis that it would be a temporary one-shot legislative action. This was not only the basis upon which it was introduced; there were clear and unambiguous assurances from the administration that it was a temporary measure and would not require extension.

To be sure, sophisticated observers of the Federal scene are somewhat skeptical of such assurances because temporary legislation—e.g., excise taxes, renegotiation, etc.—has a way of becoming laid in concrete in our statutory structure. So, the interest equalization tax was extended for 2 years beyond 1965 and the Congress is now being asked to extend it for another 2 years—not only to extend it but to make its bite more severe.

To suggest that the enactment and continuation of an interest equalization tax is inconsistent with the national policy of this country toward free and uninhibited movement of trade and capital is to state the obvious. Moreover, it appears that through this measure, coupled

*Supplemental statement of Machinery & Allied Products Institute on certain additional economic issues.

with certain other actions of Government to be discussed in a moment, we are well on our way to controlling private flows of trade and capital across international borders. It is ironic, of course, that at the very time that this country contemplates a further extension of the Interest Equalization Tax Act, it is frustrated and discouraged by the futile performance of the Kennedy Round of negotiations for further tariff reductions. When in this country are we going to pull the pieces together from the standpoint of national policymaking and decide that the United States on any given issue or national goal cannot march off in several directions at the same time?

But if the interest equalization tax were the only element in this picture of interference with movement of trade and capital across international borders, one could take comfort in the proposition that Government must be flexible and exceptions to a fundamental policy may at times become necessary because of such a sensitive and important problem as the balance of payments. The fact is, however, that the Interest Equalization Tax Act is only a symptom of a much more serious condition. Let's examine the other symptoms briefly.

FOREIGN SOURCE INCOME TAXATION

The foreign earnings provisions of the Revenue Act of 1962 represent the most punishing step that this country recently has taken toward free international trade movements. At the time of enactment, it was taken on the premise that foreign investment contributed materially to our unfavorable balance of payments; a proposition which we feel has been largely debunked since that date. The provisions of the 1962 act impose direct taxation on certain types of foreign subsidiary income but permit a deferral of taxation on manufacturing income. The law discriminates between investment in developed and underdeveloped countries, giving favored treatment to the latter. There is no question that both negatively and affirmatively the foreign earnings provisions of the Revenue Act of 1962 impinge upon private business decisions; indeed, they are intended to restrict private investment abroad through influencing the relative profitability of different investments. Further, since the enactment of the law, American business has been confronted with the problems of administration of these provisions including the issuance of a series of restrictive regulations.

VOLUNTARY PROGRAM OF DEPARTMENT OF COMMERCE

There is another aspect of the tendency toward a desire on the part of the Federal Government to meddle in international business transactions and in international business decisionmaking. Once again the trigger seems to be the balance-of-payments problem. We now have in the United States and have had for some time a so-called voluntary program with respect to investment abroad administered by the Department of Commerce. One can, of course, look upon this program as something better than we might have had as an instrument of national policy; for example, the voluntary program obviously is considerably preferable to a formal system of exchange and investment controls. But that hardly is the way to look at national policy questions. The fundamental question is whether we should have it at all.

And more importantly in this context, whether it is another part of the fabric of control of international trade which has been woven over the last several years. Certainly it is to the credit of Government that this program has been developed with some flexibility; that in large measure it has been administered on a voluntary basis, at least as to corporations, although the Federal Reserve controls on banks in this area are hardly voluntary. But there must be some recognition of the fact that the fine line between voluntarism and compulsion in a system where the Federal Government's influence is as pervasive as it is today is hard to draw. The fact that the program has been tightened in terms of criteria from year to year, has been extended from year to year, and the further fact that the Federal Government does not seem to have any substantial program which would lead to abandonment of this restriction on private investment abroad, voluntary as it may be, should be of concern.

It is also somewhat incongruous that a government which continues to preach the seriousness of the balance-of-payments problem at the same time refuses to depart from the proposition that we must draw an artificial line between developed and developing countries, in terms of balance-of-payments policy. Beyond the Vietnam war, which obviously has balance-of-payments implications and on which the Institute completely defers with respect to Presidential judgment, the United States seems to tend in the direction of committing itself further as to international economic ventures some of which may have an unfavorable effect on our balance of payments.

These latter points are recounted, not for the purpose of implying or expressing a disagreement with any particular policy attached to any particular point. We wish to emphasize the fact that there are so many handles for engaging the issue of balance of payments that to date have been relatively untouched or ignored that one begins to wonder whether the problem is as serious as it is sometimes said to be and whether private investment and the free flow of international capital are absorbing more than their share of burden in dealing with balance of payments. As a matter of fact, we suggest affirmatively that international business and private investment and international flow of capital are indeed carrying too much of the load. Something else needs attention and some further realization of this growing tendency toward control of international trade transactions should be on the high-priority list of Federal policy review.

TRENDS IN SOCIAL SECURITY POLICY INCLUDING PROPOSALS REGARDING INTEGRATION OF PENSION PLANS WITH SOCIAL SECURITY

As indicated at the beginning of this presentation, the institute is addressing itself primarily to tax matters, with emphasis on the investment tax credit. It is, however, our feeling that some additional points deserve to be raised, at least in a limited fashion, beyond the very important investment credit issue. Having commented on the matter of international trade and restrictions with respect to its free movements, we now turn to the question of social security developments including a highly complicated proposal of the Department of the Treasury regarding integration of pension plans with social security.

We have previously suggested that it is illusory to think of the social security tax structure as something apart from the total tax burden borne by corporations and individuals in the United States. Yet for an extended period of years this separation of thinking in terms of impact on the part of the public and perhaps at times in terms of Government policymaking has existed. In justice to national goals and national policy making, we can no longer afford such illogic. One reason is the weight of the financial burden. As of January 1, 1967, including the medicare portion, the individual and the corporations each pay 4.4 percent on a wage base of \$6,600 in social security taxes. The law has already scheduled further increases and President Johnson in his recent message on this subject and in the administration's bill (H.R. 5710) advocates a program which would go substantially beyond this both in terms of rates and the base to which these rates are to apply.

Perhaps more important than the question of sheer financial burden is the fact that by extending the present structure, the built-in inequities between individuals become increasingly aggravated. For example, current contributors pay something more than the discounted value of their own retirement benefits in order to finance the retirement benefits of those who have already retired but who paid less than these benefits would call for.¹ There is the further question as to whether the United States in terms of its social security policy is departing or has already departed from the proposition that this is truly a contributory or earned benefit system. To put the matter in reverse, aren't we now engaged, if the President's program is adopted or the present trend of social security changes continues by other means, in a system of guaranteeing annual income to elderly people without benefits being tied, or even related, to the contribution by the individual. Perhaps to sharpen the proposition even further, isn't the United States now facing up to the question as to whether the social security system is on the verge of being converted into a welfare program of old-age assistance without any tie-in to the tax mechanism; i.e., the payroll tax concept.

We don't believe that these issues should be taken lightly and we think it is incumbent upon the Joint Economic Committee to complete its study, the outline of which was presented in the joint committee print, "Old-Age Income Assurance: An Outline of Issues and Alternatives," November 4, 1966.

There is another aspect of current trends in respect to social security which because of its sheer complexity may not receive sufficient attention. This relates to the question of integration of pension plans with social security. Announcement 66-58 of the Internal Revenue Service issued on September 19, 1966, offered some tentative suggestions with regard to new rules for integrating pension, annuity, profit-sharing and stock bonus plans with social security. These suggestions include the proposal that an employer who has a noncontributory plan of the excess type in order to have it qualified for tax purposes may not provide for a benefit of over 24 percent of compensation in excess of the new wage base of \$6,600, the former percentage being 37½ percent.

¹ See comments by James M. Buchanan and Colin D. Campbell entitled "Voluntary Social Security," *The Wall Street Journal*, Dec. 20, 1966.

The result of such a requirement if it were to be placed into effect would be either to cause reduction of benefits to higher wage employees or increase the benefits to lower wage employees. The estimated cost impact would be quite substantial.

The institute has filed an extensive brief with the Internal Revenue Service with respect to the issues involved in this proposal and, in all fairness, the Internal Revenue Service and the Treasury Department have made it clear that the proposal contained in announcement 66-58 was one for comment rather than a frozen position. But whatever may be the status of Government thinking in this matter in the executive department, it is clear that some rather fundamental questions relating to the social security system and the private pension plan system in the United States are involved. Notably, the direction of the proposal in announcement 66-58 reflects a disposition on the part of the executive department to push Federal regulation against private pension plans and in favor of an enlarged Federal system of social security. It seems rather obvious that if by integration rules or by other means private pension plans become so costly to corporations and mandatory social security costs continue to spiral that the inevitable result will be curtailment or displacement of private pension plans.

These points are developed in some detail in the statement filed by the institute with the Internal Revenue Service referred to above. We enclose a copy of that statement either for inclusion in the record or study by the staff at the committee's discretion.

In any event, we urge that the Joint Economic Committee concern itself with these fundamental questions including the overriding issue as to whether the social security system can maintain its integrity if it continues to be the subject of periodic political sweetening over an extended period of years. It is perfectly clear to use that if the theory of integration between social security and pension plans is to prevail, this sweetening trend must be halted.

Having earlier discussed at some length the question of contracyclical manipulation, we are constrained to observe that it now appears that even the social security system and changes therein are being recruited for economic manipulative purposes. It is pointed out, for example, by administration spokesmen that it is proposed that the increase in benefits recommended by the President under the social security system will take place in midyear 1967 while the tax impact of the increased rates will be postponed until January 1968. This in turn is related to the fact that the 6-percent surcharge is designed to take effect midyear so that to some degree there will be a wash between the increase in income taxes and the increase in benefits for the balance of the calendar year. In the same context, one recalls the manner in which payments of veteran dividends under national service life insurance policies have been changed as to timing for purposes of business cycle considerations. Will the Government next begin dragging its feet in reference to certain payments under Government contract obligations for fiscal year budgetary considerations? Where is the end to this kind of legerdemain?

For what it is worth, our judgment is that no human system even with the aid of computers can possibly engage in this kind of manipulative game in a country which is dedicated in large part to the free market system without endangering the mechanism and above all

without running grave risks of miscalculation and seriously perverse results. The unknowns are too great, the forecasting is too uncertain, and the cost of mistakes too severe.

Returning to the specific proposition of social security and the current proposals for substantial enlargement in its benefits and in its costs, and to the very important but technical question of integration of social security with private pension plans, we strongly urge this committee to take a deep interest in these matters.

ANNOUNCEMENT 66-58: INTEGRATION OF PENSION PLANS WITH SOCIAL SECURITY *

In accordance with Announcement 66-58 appearing in the Internal Revenue Bulletin of September 19, we are pleased to offer our views and comments as "background information" in developing proposed rules for integrating pension, annuity, profit-sharing, and stock-bonus plans with Social Security. The Institute is especially pleased that the Service is taking this careful approach to the difficult issue of the appropriate rule for integration, and we commend you for it.

Before proceeding to an examination of the issues spelled out in Announcement 66-58, we would like to indicate briefly our approach in analyzing the problem. We turn first to a quick look at the private pension plan system and its needs; second to a review of what the Social Security system is today and may become in the future; and third, to an examination of the goal or purpose of the integration rule being reviewed. Following this background discussion, we turn to an analysis of the specific issues involved and offer some suggestions for additional areas of inquiry in the form of possible alternatives. Throughout our review, we refer to pension plans, but we would like to make it clear that the use of this term is intended to cover annuity, profit-sharing, and stock-bonus plans insofar as they are comparable and affected by the integration rules.

One further general comment before proceeding. As representatives of the capital goods and allied products industries, we have always taken what we feel has been understandable pride in the leadership role played by the manufacturing sector of the economy in the establishment and development of the private pension plan system. In this light, we welcome an opportunity to provide our thinking "toward developing constructive ideas and furnishing helpful data." We certainly agree with what we assume to motivate this approach of seeking background information before issuing a proposed rule. Only an open-minded approach will help achieve the mutual goal of industry and government—the growth and development of these private plans which are so important to the general welfare of the nation.

PRIVATE PENSIONS IN BROAD OUTLINE

Key to the narrow discussion of a tax regulation governing permissible Social Security integration with private pension plans for tax qualification purposes is the bigger picture—namely, the *raison d'être* of the private pension plan system. In broad outline, the reasoning behind the establishment of a retirement income or pension program starts with the employer's concern for his employee's welfare. More specifically, it is the employer's intention to provide monetary security for the employee's future and, in a sense, provide a retirement-oriented long-range savings program. From the employee's point of view, the plan provides him with income replacement in future years and thus is a major building block in his personal financial plans.

FUNDAMENTAL PREMISES

This brings us to the first major premise in our look at the integration rule. A private pension plan provides neither the minimum nor the maximum of an individual's financial security after retirement. The floor is the Social Security system. The ceiling lies with individual thrift and what people put aside for tomorrow's wants, e.g., home ownership, bank savings, investments, life insurance, etc.¹

It is the *total* financial support which is all important. Since in most cases Social Security and private savings are not likely to be adequate in themselves,

*Contents of letter sent to Commissioner of Internal Revenue, by Charles Stewart, president, Machinery and Allied Products Institute, Nov. 30, 1966.

¹ A 4th aspect logically would be of a charitable nature—gifts, public old-age assistance, etc. These are, however, in the nature of safeguards as contrasted with earned rewards.

it is clear that there is a public need served in the encouragement of the development and growth of the private pension plan system.

A second significant premise from which we proceed is that a private pension plan is but one of many forms of compensation. To grasp the philosophy behind the installation of a particular plan, it is important to recognize that its primary purpose is as a reward and/or an incentive to employees for a contribution to the success of the firm. Because it is compensatory in nature, it follows that the absolute amounts in terms of levels of benefit will vary according to an individual's input or contribution. In fact, of course, the absolute amounts under a pension plan do vary, the levels usually being related to such factors as earnings and length of service. We raise these points because the integration rule has the understandable goal of preventing "discrimination"; yet compensation in any customary form is inherently discriminatory and rightly so under a free enterprise system.

Related to the points noted above, there is a third obvious conclusion; namely, that a private pension plan should and will vary according to (1) the needs or wants of the employees and (2) the cost or ability of the employer to pay for a particular benefit. When plans are first installed, it is normal to find an emphasis on providing benefits for those approaching retirement age and those with long service who will soon be eligible. As a given plan matures, however, history shows that along with increases in basic retirement pension payment new features are added. For example, we have seen in recent years such new benefits as early retirement, widow's benefits, etc. If history is a guide, such features will multiply and new ones will be introduced.

In terms of impact this means private plans today contain almost a myriad of differing provisions which reflect widely varying purposes. All of these provisions may fit into a pattern for a given employer but only in the light of his entire compensation scheme and the needs of his various groups of employees. An example of this latter point is the development of what amounts to a supplementary pension plan for selected groups of employees. In the context of the "integration" rule, these plans are often considered appropriate because Social Security old-age benefits comprise a larger fraction of the retirement income of lower-paid than of higher-paid employees and this "imbalance" can be corrected only by making additional pension benefits available to these higher-paid workers. The "goal" of both the supplementary plan and the basic plan is twofold: (1) to meet the needs of employees both collectively and in terms of groups and (2) to serve as a recognized reward and/or incentive. From this, we draw at least one obvious conclusion in terms of pensions in general; namely, that it is vital to the employer that there be flexibility in the design of any given plan.

TYPES OF PENSION PLANS

As a final general observation to complete this brief discussion of private plans, in perspective, it seems clear to us that the existing variety in plans employed to achieve a few basic goals makes exact comparisons between types of plans somewhat like comparing apples and pears and plums. To generalize, there are at least three basic formulas—with numerous variations—for determining the amount of pension to which an employee will be entitled. First, there is the unit-benefit method which provides a definite amount of pension per year of credited service. This type of plan obviously provides differing amounts of final pension depending on length of service.

Second, there is the flat-percentage method which provides a percentage of average compensation over a specified period of time. Here it is common to set a minimum qualification for service such as 15 years and to emphasize salary or wage levels by taking a percentage of final years of pay. The aim of this design is to tie pension levels to income achieved just before retirement, presumably the high point for most employees.

A third approach is the money-purchase method in which costs determine the level of benefit rather than the other way around. With this as their primary emphasis, such plans then utilize the concepts of length of service and level of pay to varying degrees.

Since an "integration" rule must fit the variety of plans used, it seems clear that any "certainty" in insuring a goal of reasonable relationship between Social Security benefits and those paid under a private pension plan is made more difficult and perhaps to some extent impossible.

To sum up, a private pension plan is a compensation tool oriented toward the specific retirement needs of the employee. A key aspect in its growth and development is plan flexibility to meet changing employee needs and the employer's ability to pay. Finally, the design of these plans significantly turns on a number of differing considerations including reasonable costs, length of service, and level of pay.

THE "ISSUES" AND THE GOAL

The "integration" rule has its genesis in the Internal Revenue Code which bans a tax-qualified plan from discriminating in favor of higher-paid employees. This ban, however, gives way in logic and equity to an exception so that employers will not be considered to discriminate if they "properly" take into account the pension provided under the Social Security system. At this point the integration rule becomes the vehicle for equating the values under different types of benefit systems for the purpose of establishing factors for comparison. Two questions are raised. What is the nature of the Social Security system which is to be compared to private pension plans? What is the nature of the discrimination being banned?

A LOOK AT SOCIAL SECURITY

To examine these issues in order, it is apparent at once that the Social Security system is quite unlike the private pension system in many of its particulars. Importantly, for example, it has certain aspects of a public assistance project financed by means of a payroll tax. While the right to benefits is tied to a work history, the benefits received by those over 65 are financed almost exclusively from taxes on the currently employed and their employers. One interesting analysis of the system along these lines is as follows:

"That the Old-Age and Survivors Insurance scheme is a current transfer is apparent also. Annual benefits are financed from annual receipts of OASI taxes and interest earnings on the trust fund. Interest on the Federal securities held by the fund is paid out of general revenues. Thus, annual benefits of OASI recipients, whether financed from OASI taxes or interest earnings on the trust fund, are transfers of income from the currently active.

"A number of rationalizations have been invented for the purpose of obscuring the implication of a current transfer. One is the social compact. It is argued that right to benefits is earned by making contributions. However useful this argument may be in political debate it does not alter the simple economic fact of a current transfer. The suggestion that participation in OASI is analogous to the purchase of an annuity is very doubtful. Pension benefits are too loosely related to contributions for the annuity analogy to hold in any meaningful sense. Nor is the program properly insurance. As a consequence of the earned means test, OASI promotes the occurrence of that event against which it "insures," the loss of earned income due to retirement. Should we not recognize OASI for what it is: an acceptance of collective responsibility for the aged"?²

Expressed differently but in effect arriving at a similar conclusion is the following colloquy on the proposal leading to Medicare from the House Ways and Means Committee Executive Hearings on Medical Care for the Aged, 1st sess., 89th Cong. (1965), part 1, p. 20:

Mr. Byrnes. So that fundamentally what we are doing here is not prepaying, but what we are doing here is having the people who are currently working finance the benefits of those currently over 65?

Mr. Myers. I think it can be viewed that way, just as the old-age and survivors insurance trust fund can, or else you can also view that it is prepayment in advance on a collective group basis, so that the younger contributors are making their contributions with the expectation that they will receive the benefits in the future—and not necessarily with the thought that their money is being put aside and earmarked for them, but rather that later there will be current income to the system for their benefits.

Viewed in this light, a number of factors in terms of the "integration" rule can be deduced. First, the actual contribution that a given employee makes *in his own behalf* is zero. Second, the "value" of the system which becomes most readily equated to private plans is the work relationship promise of future benefits—

² "Old Age Income Assurance: An Outline of Issues and Alternatives," Subcommittee on Fiscal Policy of the Joint Economic Committee, 2d sess., 89th Cong. (1966), pp. 7-8.

i.e., the benefits and years of service requirements written into law. Third, the employment relationship itself is a device of only incidental significance to the goal of taking care of the aged; it is the absolute level of benefits which is of critical importance, not the limits on a payroll tax or the actuarial computations as to projected returns for contributions by the mythical "average" employee.

The essence of the Social Security system.—Whether or not one accents in whole the theory posited above—intended by the author of the congressional study simply to raise some questions—there are some facets of the system upon which there can be general agreement. First, the system relies on the pay-as-you-go approach as contrasted to a funding arrangement. In effect this means actuarial soundness *must* be achieved only on a short run basis: i.e., tax revenues collected this year must be sufficient to pay promised benefits for the current year. When the plan is projected into the future, there is an immediate imponderable; namely, the attitude of Congress which has consistently increased benefit payments—and, as a consequence, tax payments—in the system ever since it was first established. In short, this pay-as-you-go approach depends upon short-range soundness; its long-range position is based on congressional intentions.

Second, OASI, in concept, provides both a floor in terms of a minimum subsistence benefit and a schedule of benefits designed to replace some fraction of earnings for the beneficiaries of the system. With respect to the replacement aspect, the system provides disproportionate benefits for the lower-paid as contrasted with higher-paid employees. Thus, when viewed in the context of a pure replacement of income scheme, Social Security "discriminates" in favor of these lower-paid employees.

Mr. Byrnes. In other words, on the theory that if I am going to be asked to pay for a tax today for a benefit that is available to people over 65, then when I get to be 65 somebody who is then working ought to do the same thing for me? Is that it?

Mr. Myers. Yes; I would say that is the way it is, and this is a reasonable group prepayment basis, I think you can call it, because of the compulsory nature of the tax for now and for all time to come on people in covered employment.

Third, the payroll tax device is a technique to tie the benefits to periods of gainful employment. Justification for this normally includes the following reasons:

1. The tax encourages fiscal responsibility on the part of people who are eligible for the benefits.
2. It appears to be an essential element in a system that relates benefits to earnings and bases the right to benefits on the performance of work.
3. The payroll tax makes available to the program a source of financing related directly to a benefit weighted in favor of the low-income taxpayer and visible in terms of its relationship to a contribution to the system.

The maintenance of the purity of the payroll tax device turns on the relationship between work and earned benefits. Based on the 1965 amendments and assumptions similar to those underlying the suggestions in Announcement 66-58, if we project we can see at least some individuals contributing more than they can presently expect in benefits in return. Should this occur, the justification for the system then, as noted earlier, must be in part that the program is a public assistance program, and total reliance on a payroll tax would no longer seem to be a key part of the rationale.

Fourth, a common view of the Social Security program, as noted above, is that it is a basic building block or cornerstone for old-age security. As stated by Wilbur J. Cohen, the then Assistant Secretary of Health, Education and Welfare, before congressional hearings:

"... [T]he concept underlying the philosophy of social security is that it is basic protection to which individuals, employers, unions, private people, can add or should supplement with such additional protection as they wish.

"... The concept... is that you provide ϕ dollars for old-age retirement, then a private employer adjusts his private retirement system to be on top of that. The private pension is the second layer. The third layer is whatever the individual wants to do on his own."³

This concept is significant in the present context in the sense that government at least anticipates that the normal response of employers will be to integrate—in the nontechnical sense—private plans with the public one.

³ House Ways and Means Committee Executive Hearings on Medical Care for the Aged, 1st sess., 89th Cong. (1965), part 1, p. 31.

Fifth, the Social Security program has undergone significant changes since it was first enacted; and if history provides a lesson, it will be changed in the future and probably significantly. The past, of course, needs no clarification; the future prospects on the other hand are not at all certain, but there is today discussion of improved benefits, revision of the wage base, subsidizing benefits from general revenues, tying benefits to cost-of-living indices, and so forth.⁴ Indeed, if there is anything certain about the Social Security program, it is that it will be changed by future Congresses. From both a theoretical and practical point of view, these prospective changes are of great significance. For example, if Congress greatly increases benefits disproportionate to private benefits, the role of private plans will be changed. If general revenues are tapped, the program loses a little more of its "insurance" aspect. This imponderable of future changes makes at least one point obvious—that the task of integrating private pensions with Social Security is not a one-shot problem, nor has it been in the past.

To try to sum up the above views, Social Security is clearly a kind of a hybrid affair which combines some of the elements of a government public assistance-welfare program (i.e., general revenues allocated to the needy in terms of subsistence benefits) and certain of those of a private annuity or insurance program where identifiable contributions or costs add up to specific future benefits. We conclude from this that comparability of Social Security to private plans is not only difficult in practical terms but is difficult conceptually as well. However, there is one basic facet of Social Security that is relevant in the design of private plans without reference to the hybrid character of Social Security; this is the level of benefits provided by law.

WHAT IS DISCRIMINATION

The purpose of the integration rule is to prevent discrimination, but before we can prevent it we should know what we mean by the term. In one context, as noted above, all compensation schemes are discriminatory. Pension plans being work-related income replacement schemes are no different; as presently constructed, they discriminate. But this discrimination is not forbidden by the law; in fact it is fostered in the sense that we deliberately encourage the orientation of both public and private plans as rewards for work performance. At the minimum then we start with the fact that discrimination does not mean simply providing retirees different absolute amounts of pension.

The next inquiry is: What is discrimination under the pertinent IRS regulations? The tax rules raise the question with respect to two categories—"classification of employees" and "contributions or benefits"—providing that there must not be discrimination in favor of employees who are officers, shareholders, supervisors, or highly compensated. It would appear then that if a plan favors these select groups it is discriminatory.

This leads to still another question which is particularly pertinent: How do we define a highly compensated employee? It would seem from the language of the law that these higher-paid employees might include anyone who is on the payroll at a high salary with undefined responsibilities as well as the recognizable "top brass" of a company who simply do not fit the other designations of officers, shareholders, or supervisors. On the other hand, it could be interpreted to include all those who earn more than the median or average wage or salary level for a given company. However, it would seem that the intent of the rule is far removed from employees earning at or a little above the Social Security wage base such as \$6,000 to \$7,000 and the rule should not be read to mean just "higher paid" employees.⁵ At any rate, it is certain these employees would argue that they are not highly compensated.

As a point of fact the "highly compensated" employee will vary from company to company. Nonetheless, if we divide a company's employees into three compensation categories, some pertinent observations can be made. The lower-income employees, such as those earning less than the maximum Social Security wage base, are provided a "protection" against discrimination under Social Security by means of the disproportionate weighting in favor of lower-paid employees built into the system. The higher-paid employees of the firm—the top echelon—have protection outside the pension program since they are pro-

⁴ Another example of suggested change was put forth by Secretary of Labor Wirtz in a recent speech on November 16, 1966, in which he suggested that perhaps "earned" benefits under Social Security might be utilized in advance by beneficiaries to pay for training.

⁵ This view seems to be in keeping with the legislative history of the 1942 Revenue Act by which this discrimination ban was established.

ected by an economic system which provides that compensation be discriminatory in that it is based on the contribution of the individual. The third group, however, the middle income group, appears to fall short with respect to each of these protections. Indeed, a case could be made that this group should be afforded special "discriminatory" protections under the tax laws to offset the discrimination built into the Social Security system for lower-paid people; otherwise, companies will not be able to provide them with adequate retirement income, particularly when the rule we are dealing with seems to categorize them as highly compensated employees.

To sum up our discussion of discrimination, we think there is a clear danger of overstating that which is discriminatory by assuming that a rule prescribing benefit limits defines per se what is discriminatory.⁶ We think this is an oversimplification; while any rule which is developed along these lines may tend to prevent a discriminatory result, it is not certain to prevent it and, as in the case of the middle income group, may even aggravate it. In short, all the goal can ever be is to provide a very rough measure of equity and in a sense create a "ball park" test for rough justice as a means of keeping faith with the generally accepted principle that the tax laws should not be used to further "discrimination" of any kind.

THE CURRENT RULE AND A MATHEMATICAL APPROACH IN GENERAL

Since 1943 the Internal Revenue Service has provided a rule or set of rules setting out the limits governing integration of private plans with Social Security for tax qualification purposes. As Announcement 66-58 indicates, all the current rules stem from a mathematical formula devised to provide a means for comparing Social Security pensions with proposed private pensions. The first question then concerns the sufficiency of this test, currently the 37½-percent test.

To provide a basis for the comparisons that are the subject of the discussion which follows, the factors entering into determination of the current rule are outlined here:

1. Wage base of Social Security tax—\$4,800.
2. Maximum average monthly compensation under the Act—\$400.
3. The maximum "primary benefit" amount—\$127.
4. Total OASI benefits for an employee as a percent of the primary benefit (the former reflects disability, dependents' allowances, etc.)—150 percent.
5. Since the employee's and employer's contributions under the Act are equal, it could be assumed that an employee's contribution would approximate half the cost of the OASI benefits. However, most employees on retirement will have contributed less than half the cost of their own OASI benefits because of increases in OASI benefits since they came under the plan. Hence, an estimate must be made as to "actual" average employee contributions. This currently is 22 percent, making the employer's contribution 78 percent.

Using these "factors," calculation of the formula thus proceeds along the following lines:

1. $\frac{\$127}{400} = 32$ percent.
2. 32 percent x 150 percent = 48 percent.
3. 48 percent x 78 percent = 37.4 percent.

Rounded up, this is 37½ percent—the percentage of earnings above the Social Security wage base to which benefits under the integrated pension plan are limited if the plan is to be tax qualified. It is the rate which has prevailed using similar calculations since the Social Security wage base was at \$3,600. The principal change being suggested in the formula approach in Announcement 66-58 is that the employee contribution percentage be deemed to be 50 percent as opposed to the current 22 percent. Using this figure and basically the same formula approach as above, the rate becomes 24 percent. Although pension and actuarial expertise

⁶ While such a solution has serious drawbacks, the discrimination problem might also be handled on a case-by-case basis without an integration rule. Further, in searching for simplicity, one might turn to the classification rules and argue that if a group receiving a certain level of contributions or benefits is not a discriminatory group under the classification test it should not be discriminatory to provide it with special benefits under a pension plan. These suggestions, however, are not completely satisfactory answers because they are simply another way of saying "forget the integration rule." Such a course would be inequitable to those who have retired or will retire shortly under plans limited by the current rules. Perhaps more importantly, these thoughts are not wholly responsive to the issue to which the Service is directing its inquiry.

may be necessary in order to fully comprehend this calculation, we believe some general comments are appropriate. As noted above, the formula which has been used to derive this 37½-percent rule has the following elements:

1. The relationship of the "primary" Social Security pension benefit to the Social Security base.

2. An adjustment factor to reflect the fact that "ancillary" Social Security benefits are provided along with the retirement benefit.

3. A second adjustment factor to reflect the fact that wage and salary deductions in the form of a tax run to individuals as well as employers in order to provide the fund for paying Social Security benefits.

It is, of course, the adjustment factors that provide much of the controversy because they are the variables subject to the widest fluctuation depending on the assumptions from which one proceeds. However, the first aspect of the formula is of great importance and our discussion starts with it.

RELATIONSHIP OF BENEFIT TO COMPENSATION

The first factor is the percentage ratio of the benefits under the public system to the compensation on which such benefits apply. This first factor has been relatively stable ever since the wage base was at \$3,600. Specifically, this relationship has been as follows:

1. (Wage base at \$3,600)

$$\frac{\text{Primary Insurance Amount (PIA)}}{\text{Monthly Maximum Wage Base (MWB)}} = \frac{80}{008} = 27 \text{ percent}$$

2. (Wage base at \$4,200)

$$\frac{\text{PIA}}{\text{MWB}} = \frac{108.50}{350} = 31 \text{ percent}$$

3. (Wage base at \$4,800)

$$\frac{\text{PIA}}{\text{MWB}} = \frac{127}{400} = 32 \text{ percent}$$

4. (Wage base at \$6,600)

$$\frac{\text{PIA}}{\text{MWB}} = \frac{168}{550} = 31 \text{ percent}$$

Indeed, proposals before the 89th Congress would, for whatever the reason, maintain this stability. For example, H.R. 18420, introduced by Congressman Burke and apparently designed with the President's proposals for the 90th Congress in mind, would provide as follows:

(Wage base at \$7,800)

$$\frac{\text{PIA}}{\text{MWB}} = \frac{208}{650} = 32 \text{ percent.}$$

Another more far reaching proposal put forth by Senator R. Kennedy would show a similar result notwithstanding the fact his measure would raise benefits an average of 50 percent and take the wage base to \$15,000, as follows:

(Wage base at \$15,000)

$$\frac{\text{PIA}}{\text{MWB}} = \frac{382}{1250} = 31 \text{ percent.}$$

This stability is, of course, of considerable significance. First, the ratio reflects a benefit-related approach and is a kind of results test or analysis. Second, it is this primary insurance benefit that is the building block for private plan designers. Third, it appears to be a controllable relationship in the sense that in the way Congress has viewed the benefits there is an implicit long-range "objective" of about 30 percent of the wage base. Fourth, of all the factors in the formula, this is the most understandable and simplest to work out. We stress these points because in just about any formula approach that might be selected this relationship would seem to be appropriate.⁷

However, the suggestion put forth in Announcement 66-58 would seem to unduly complicate this relationship. Specifically, the 1966 relationship (PIA/MWB=132.70/385=34.5 percent) is averaged with the 1965 change in the law

⁷ As we understand it, until 1951 the integration rule was entirely benefit oriented along these lines.

which will not be fully effective until 2004 (PIA/MWB=168/550=30.5 percent) with the result being a figure of 32.6 percent. It is our feeling that the averaging technique simply implies too much. For example, it implies that the year 2004 is meaningful in terms of action taken by Congress effective in 1965. As noted above, it is difficult to accept any assumption positing no further change in the law until 2004. Further, it begs the question raised in the Announcement as to mathematical soundness. We do not really see how it can be argued, or even logically posited, that a precise mathematical calculation will lead to the goal sought by the ban on discrimination. In short, while fully aware of the meaningfulness of the relationship being reduced to percentage terms, the averaging approach seems to us to be an attempt at preciseness in an area where it is neither needed nor possible.

THE SUPPLEMENTARY BENEFIT ADJUSTMENT FACTOR

The second element in the formula is an adjustment factor to reflect the value of the supplemental benefits as compared to the value of the retirement benefits. Since 1943 this has been 50 percent, and the Announcement indicates this relationship would continue, notwithstanding the changes made in the 1965 amendments.

While it is not our intention to be quarrelsome, the rigidity of this adjustment factor following the 1965 Amendments gives us a good deal of trouble.⁸ Certainly the package of benefits tied to Social Security has increased—e.g., the hospital insurance benefit, the changes in the disability provisions, etc. Further, the factor would appear to turn on the correctness of certain assumptions such as a separation of disability and the like from pure old-age assistance benefits. While this approach can be taken, it implies a certainty to the relationship which we feel is bottomed on debatable assumptions. For example, we wonder whether the hidden values of Social Security should not be weighted in connection with this calculation. Specifically, under Social Security there is a degree of portability to the benefits which would be quite unusual for a private plan. We think this portability factor might make the total package, say, a quarter or a third more valuable than the face amounts indicate. And what of disability and medicare? Do they not add both tangibly and intangibly to the value of the Social Security package? Assuming that some weighting has been, or at least will be, given to the tangible impact, what of this intangible value? Is it sound to argue that the value of medical protection at a time when medical needs are most critical can be reduced to a monthly premium figure? Just the fact that it is added on means a kind of foot-in-the-door which should lead to further benefits as has been the case with the disability insurance which, for example, in the last go-round was improved. Might it not be fair to say the intangible value is worth 10 to 30 percent of the total value of the Social Security package?

To sum up, on the grounds that any factor in the formula must be based upon sound and reasonable premises beyond being arithmetically correct, we conclude that there just does not seem to be any mathematical precision possible with regard to this adjustment factor. Logic of course indicates that the primary retirement figure as a percentage of a base wage or salary understates the total old-age security. However, in seeking precision for this calculation, we think the rule becomes a numbers game where the merit of the adjustment factor gets lost because the alternative basic assumptions are subject to question and not conclusive. What might make more sense would be to use a base of 100 percent and simply state that a 50-percent wife's benefit plus other tangible and intangible benefits means the primary insurance amount should be adjusted by a 200-percent factor. While this approach would be controversial, it would follow the logic of the 50-percent test for employee contributions in that it is a "ball-park" figure. Its frailty, as we see it, is that the two adjustments are offsetting. We will deal with this problem later on.

ADJUSTMENT FOR EMPLOYEE'S SHARE

As is certainly not unexpected, the one aspect of the current formula which more than any other is the center of controversy is the measure of an employee's contribution towards his own Social Security benefits. This figure was set at

⁸ Indeed as we piece together the history of these rules, this adjustment has always remained static for unaccountable reasons.

6¼ percent when the wage base was \$3,600, at 20 percent when the wage base was \$4,200, and at 22 percent when the wage base was \$4,800. Announcement 66-58 suggests that, using the calculations applied in the past, with the wage base at \$6,600, this figure should now be 50 percent.

While we think a "theoretical" justification can be made for a 50-percent test, so can a case be made for zero percent or even a hundred percent. In more detail, one argument for a zero-percent (in effect, no adjustment) factor was noted earlier in another context; namely that Social Security is an old-age assistance program with no employee having contributions earmarked for himself in the future. Another argument is that the contribution is employment related; i.e., but for the job there would be no Social Security benefits. In this case it is the employer who is really paying all the tax. This argument is further buttressed by the observation that it is take-home pay which is the yardstick employees use to measure their compensation. When taxes of any kind bite into take-home pay, pressures build and employers inevitably are pushed to replace the tax bite with take-home dollars. In sum, considering Social Security taxes as an employment cost, it might be fair to say that the entire burden is on the employer.

On the other hand, a position might be taken that in the final analysis the employee pays the entire sum because the tax can be considered as a legitimate labor cost which normally would be included in the price of the product or service.

From the layman's point of view, in terms of ready comprehension the 50-percent test is deceptively simple. While, as noted, we think a case can be made for it theoretically, the practical aspects of it do not seem to make much sense. For example, if we accept the theory that the tax is split evenly between the employer and the employee, how do we account for the fact that employers do not get refunds while employees do? To be specific, since a certain proportion of the work force changes jobs during a calendar year, a particular employee may pay more than the maximum and obtain a refund; employers have no such option. A similar situation could occur when the employee holds more than one job at one time.

Further, to arrive at 50 percent, the Announcement looks ahead to 1990—at least 3 new Presidents and 12 Congresses away. Is there any realism in working up the mathematics for Social Security projections this far out? Surely the secret of the system (which is really not a secret) is that the benefit program must trend upward in the future as it has in the past. If we assume also that the rule we are concerned with must be examined periodically, why then make projections to 1990? As we see it, this "average" worker accumulation approach is the least valid of the methods of determining employee contributions. A more realistic method is the "near future retirement" approach or to simply look ahead until 1970 and average out the percentage of contributions for 1965 and 1970. For example, IRS might establish a moving annual index or "average" cost of providing Social Security benefits attributable to employee contributions. If we did this, our guesstimate would be the current figure is in the neighborhood of 10 to 25 percent.

A more basic question is whether there is some usefulness in deriving this figure. We conclude that there really cannot be, principally because the basic assumptions behind it are neither immutable nor even free of controversy. In short, you cannot tree a possum if you cannot agree to what a possum is.

We have alluded to a number of theoretical problems above, but beyond these are some other important ones. For example, how can we account for "interest" on a contribution when no such interest is in reality earned? To do this assumes a system which is equivalent to a funded pension plan which Social Security is not. Another doubtful starting point in the finding that an employee pays for 50 or more percent of his "retirement benefit" based on his contribution is the failure of this approach to credit the employer with provided contributions for such "extras" as administrative costs and so forth. At the same time this approach seems to require acceptance of the proposition that government contributions from general revenues can be equated to employee contributions.

Finally, another puzzling aspect of the mathematics is the fact that there seems to be a need for a methodology which will push the contribution percentage upward. Historically, we have gone from 6¼ percent to the current 22 percent and the Announcement indicates we now should go to 50-plus percent. Apparently one basic assumption behind this is that with a static Social Security system this percentage could go up and up and eventually exceed 100 percent! Indeed, it is somewhat ironic that some opponents of further Social Security expansion have demonstrated this possibility mathematically by taking the situation of

a new labor force entrant and projecting out until his retirement assuming a mature Social Security system, with interest rates, etc. We think all would agree that at this point the "mathematics" have become irrational and must be discarded for a more meaningful solution to the problem of discrimination.

A broader point raised by all these observations is that perhaps today we are in danger if we attempt to translate into mathematics the simple and understandable proposition that to some degree an employee contributes towards his Social Security retirement. Spelled out, this mathematics calculation tends towards a "no integration" rule because the underlying assumptions seem to demand a growing "carve out" for purposes of recognizing the employee's input. What we are therefore doing in this exercise is neglecting the discrimination issue to accommodate this concept. In sum, we might well be letting the tail of the dog wag the dog.

THE SPECIFICS OF THE CURRENT FORMULA

We think that the basic relationship of benefit amounts compared to base wage should be the "exclusive" mathematical consideration in the rule. From this point any adjustments made might most appropriately be designated "tinkering," not mathematical calculations. Such "tinkering" could perhaps be justified either to preserve other rules such as the requirement for downward adjustment because of a death benefit, early retirement, etc., or to reflect some indisputable facts. In this latter category we would include the following:

1. The Social Security benefit is tax free, and the primary insurance amount understates the real worth to an individual.
2. To some, perhaps undefinable, degree the primary insurance benefit does understate the value of the pension.

Finally, we would use the theory of employee contributions as a rationale for "a rule of caution." As long as it is possible to make a theoretical case that an employee contributes to his Social Security pension, we would tend to be conservative in estimating benefits; and where high or low alternatives exist, it might be fair to consider only the low ones to reflect this theoretical factor.

A "TRANSITION" RULE

In the past when changes were made in the integration test, the rule with respect to existing plans was simple. If the plan was qualified, the prior favorable determination letter continued applicable unless withdrawn or modified, or "new regulations" required a change. For the past 15 years, this "grandfather clause" approach has been justified on the grounds that the basic rule—the 37½-percent test—has not changed. Announcement 66-58, however, suggests that transition rules might be in order in light of any possible downward revision to presumably offset any "inequity" created by a drastic change in the rules.

We find some merit in the theory of a transition rule should a drastic new test such as the 24-percent rule be adopted. However, we wonder whether the approach taken really does what it seems to be intended to do. For example, as we understand the application of the transition rule, employers with integrated plans would immediately face the prospect of a gradual reduction of retirement benefits in future years. Certainly, it seems clear that many employers accepting this result would rightly presume that the employees would place the blame for the reduction on the government. In the practical sense then, the approach being suggested amounts to a retroactive reduction of benefits, even though from a technical point of view it does not.

The problem, as we see it, is from the practical viewpoint, and we suggest that a transition rule should be avoided unless it is so obviously necessary it cannot be avoided. Further, in the justification of such a change, it seems only reasonable that minor inequities be ignored. There would seem to be no need to clamp down on the problems of minor variations in benefit amounts for income between the levels of \$4,800 to \$6,600 simply on the basis that there can be no "discrimination" whatsoever. What, in effect, we are suggesting is that consideration should be given to some sort of rough test—e.g., a stretchout to 1970—as opposed to the strict test suggested in the Announcement.

To repeat, however, we think it is clear that the only time a transition rule would ever be necessary is in the case of a drastic change in the basic rule. At this time, we do not see where a case is made for such a change and, therefore, conclude that at the present no transition rule is necessary at all. *In sum, we suggest the old "grandfather clause" is the answer once again.*

THE FORMULA APPROACH IN GENERAL

As noted above, we do not think the adjustment factors have the degree of mathematical certainty that they were perhaps intended to have. With one biasing the result upward and the other downward, an immediate factor of "push and pull" is introduced. If certain assumptions cannot be agreed upon, the result becomes a massive numbers game. We are sure, for example, that having asked for mathematical alternatives the IRS will find a considerable number of letters on its desk providing ingenious formula approaches. Further, we dare say the vast majority will have one thing in common, the result will be close to 37½ percent, almost as if the mathematical world has found the magic all-purpose number. Not that there are not good reasons for this. In fact, we think this result is inevitable because notwithstanding the frailties inherent in the construction of this rule it has been accepted for a long period of time. Further, insofar as it is already benefit oriented—i.e., close to the percentage relationship of the primary insurance benefit and the base wage—it is no worse than a "ball-park" figure. Also from the practical standpoint the 37½ percent test may be a fair estimate as to what the average employer can afford to pay even though "discrimination" might not exist if the test were 40-50 percent or even higher. Finally, setting aside debatable assumptions—or as the Announcement implies, inadequate ones—the fact that the result has been long-range stability seems to indicate at least in part that the government has recognized his real need in terms of the sound development of private pensions.

All of these observations seem to us to suggest one very significant conclusion. The current 37½-percent test, good, bad, or indifferent, *does* provide a result—a result which has had the virtue of exposure for 15 years. If we measure it simply as a result, what do we find? Has the test prevented discrimination?

A BUREAU OF LABOR STATISTICS STUDY OF PRIVATE PLANS

A recent BLS study seems to indicate that the result is in keeping with the goal. More specifically, the Bureau in studying over 25,000 private pension plan reports for 1963 filed with the U.S. Department of Labor's Office of Labor-Management and Welfare-Pension Reports concludes in part:

"Since the social security payment represents a larger proportion of preretirement earnings for workers with low earnings than for those with high earnings and since private plans also tended in the same direction, lower paid workers clearly received a larger total benefit in relation to previous earnings than higher paid workers."⁹ [Emphasis added.]

While the study is much more detailed and does not directly address the issue of the results of the 37½-percent test as applied at the \$6,600 level, the finding above seems to eliminate any great need for concern—a least as to what the test has accomplished in the past. What is more, it suggests to us that perhaps a study of results would be much more meaningful than the actuarial estimating game which is played when the formula itself is the issue every five years. We think all would agree that if the object is to prevent discrimination, however defined, the test of success should be the degree to which such discrimination does or does not exist.

RESULTS OF A MAPI SURVEY

Besides the discrimination impact, we think it appropriate to indicate in brief other likely results of the proposal as suggested in the Announcement. First, as you know, the complexities of the integration rule are such that quick answers as to potential effects are just about impossible, but we have polled our member companies to determine what their initial findings were as to the impact of a 24-percent test.

One clear conclusion resulting from this survey is that the *transition rules* being suggested would mean that virtually all plans would have to be reviewed in detail by experts in the pension field at no small cost to the employers. Further, there will be a tremendous burden on both the government and the same employers because many of these plans, perhaps the vast majority, will have to make some adjustment and be subject to the IRS clearance procedures. Many of these plans are, of course, the result of collective bargaining and required

⁹ "Private Pension Plan Benefits," Bulletin No. 1485, Bureau of Labor Statistics, U.S. Department of Labor, June 1966, pp. 13-14.

changes here would be costly, time consuming, and burdensome. Finally, and perhaps most importantly, the confusion that would exist would be equally staggering, not only on the part of individual employers, but also among employees who would find that their benefit expectations are being or could be adversely affected.

The changes which would be required as a result of a 24-percent test itself would also be extensive. At this time, most employers who would be affected are not sure which course of action they would take. Their alternatives appear to be to (1) increase benefits at an added cost or (2) decrease benefits to maintain present costs with a consequent loss of pension benefits to current employees or (3) strip away some of the fringe benefits or plan "extras" such as death or widow's benefits. While it is still too early for the results of our poll to provide much in the way of cost figures, we think it is a very conservative estimate to state that the cost potential of the proposal is many millions of dollars.

Obviously, a more modest downward revision—say to 30 percent—would bring about a less severe impact but one inevitable result of such a revision, even if a "grandfather's clause" were maintained, would be great uncertainty on the part of employers and their pension experts as to the future and a new-born reluctance to initiate changes, such as new employee benefits, for fear of future downward revisions. It takes little imagination, we think, to see that this could really hurt the growth and development of private plans and work to the long-range detriment to the nation as a whole. Even those integrated plans which would not be greatly affected by this particular proposal might suffer from this hangover impact insofar as the employer believes his future flexibility is threatened as, for example, would certainly seem to be the case if the precedent of a "transition" rule were established.

To sum up the results of this poll of our member companies, we think the proposal as put forth would have a clear and far-reaching impact on integrated plans. Further, this impact would be costly both in terms of current expenditures necessary to change plans to meet the new rule and also with regard to the future of private pension plans in general. Finally, we would like to stress again that this impact does not even deal with the basic question—namely, whether or not the change is necessary to prevent discrimination. We, therefore, reach the conclusion that unless a case can be made that a change is necessary in terms of the purpose of the rule any adverse impact is sufficient reason to withdraw the proposal.

MAPI's SUGGESTIONS

One of the difficulties in looking at a formula approach as we have indicated above is the fact that there is a degree of unreality attached to it because of the variable assumptions from which one might logically proceed. Indeed, the principal difficulty in providing a simple answer to Announcement 66-58 is that much of the analysis is like chasing a ghost or some equally nonexistent quarry.

However the current rule in broad perspective has some attributes on which all can probably agree. First, it is very complicated and, from the businessman's or anyone's standpoint, unduly so. Second, a pension plan is a very significant feature of a company's long-range planning and thus there is a recognizable need for a reasonable degree of certainty. Third, the potential stability of the rule is quite limited if every time Congress amends the Social Security program it becomes incumbent upon IRS to review its rules for integration. Fourth, the significance of the rule is the result it accomplishes, not the "nicety" of its underlying assumptions nor its mathematical precision.

While we might expand on these points, our judgment sense has already led us to some general conclusions. First, we think the "formula" can only be justified on the pragmatic basis of its actual impact. We do not feel it is necessary to change it because mathematically it may appear to be called for. By the same token we would not preserve the status quo if a results-oriented examination indicated it should be so changed. To expand on this point, if the regulations simply incorporated the 37½-percent basic rule absent its involved justification, its permanence or lack of it would obviously be related to its purpose, i.e., whether it prevents "discrimination," and not turn on the elusive issues of ancillary benefit and employee contribution adjustments.

Second, we would tend to keep the status quo unless it was clearly inappropriate because certainty and stability are vitally important to potential beneficiaries whose financial planning is based on current expectations. Moreover, any downward revision of the rule is certain to be costly both in terms of dollars

and as a precedent in tending to restrict the growth and development of new plans and benefit provisions.

Third, we would try to find some clear, but basic, ground rules to guide administrators in the future. Specifically, if it were made clear that the central relationship of importance in the design of the rules was a comparison of the maximum monthly benefit with base wages, much of the mystery, confusion, and complexity of the present rules would be eliminated. Further, if it were understood that the "grandfather clause" arrangement would be kept, there would also be a good deal more certainty. At the minimum what should be avoided is new elements in a formula approach which cannot but be construed as signposts that there will be frequent further changes in the basic rules.

Fourth, to some degree "the monkey is on the wrong back" because Congress makes the changes in the law that lead to the reconsideration of the integration rule. Not so many years ago Congress, of course, was involved in consideration of the rule and perhaps it is time to return the problem from whence it came. We have no fixed view on how this should be handled, but it seems certain that the basic purpose of the rule to prevent discrimination needs review and probably this review should be legislative in nature.

Finally, we think the starting point should be agreement on the principle that the rule should not be changed solely because "the formula" is based on debatable assumptions which in their very nature are not subject to "proof."

In concluding, we would like to say again that we appreciate this opportunity to comment as part of the Service's background review before any proposed rule is issued. If the Institute and its staff can be of any further help in this connection, you have only to call on us.

NATIONAL ASSOCIATION OF MUTUAL SAVINGS BANKS

BY DR. GROVER W. ENSLEY, EXECUTIVE VICE PRESIDENT

In this brief statement on the President's and the Council's 1967 reports, it is necessary to be highly selective in one's commentary. And at the outset, I would like to single out what I consider to be a most significant observation of the Council's report and its implications for policy. The observation is that :

This year, the risks are on both sides, demand could grow too sluggishly or too strongly. A balance of risks is a necessary feature of a full employment economy moving ahead essentially in line with potential.

This is not to say that uncertainty itself is a unique element of the 1967 forecast. It is, of course, an integral part of any forecast, but to varying degree. A year ago, for example, the signs of continued economic growth were quite clear, as was the danger of overexuberance. In my statement on the 1966 report, I pointed out that while a further reduction in unemployment from the "interim" 4-percent target was an appropriate goal of public policy :

This goal must be approached gradually, in view of the increased danger of inflation. In the period ahead, the basic task of economic policy will be to restrain the overall rise in demand, in order to keep it in line with the economy's growth in aggregate capacity.

Surprises did develop in the 1966 economy, most particularly the degree of stimulus provided by our Vietnam effort. Overall economic expansion was thus greater than most forecasters had expected. But few were fooled by the actual direction the economy took.

This year, however, there is great uncertainty even as to the direction of the economy. Such a high degree of uncertainty calls for the greatest degree of flexibility in Government stabilization policies. The Council has rightly stressed the need for flexibility in its report. The President's surtax proposal, therefore, and other fiscal restraints, should be regarded not as rigid recommendations but rather as contingency plans to be reviewed in the light of business conditions at midyear.

The need for maximum short-run flexibility in fiscal policies emphasizes the importance of providing some form of discretionary executive authority over tax rates. Such a proposal is not new, but the need for it is greater than ever in a "full employment" economy where the margin for error in Government policy is so narrow. I recognize, of course, that such a proposal would continue to face formidable political obstacles. But as the Council so rightly points out in its report, continuous pursuit of an active fiscal policy would probably result in relatively small adjustments in tax rates at any particular time.

Furthermore, the Congress could retain its ultimate power over taxes by reserving the right to approve any executive tax action within a stated period of time. In any even, a timely and flexible fiscal

response to changing economic conditions is so imperative that limited discretionary executive authority over taxes, in one form or another, is a question for serious and prompt congressional consideration.

In the midst of uncertainty for the year as a whole, the Council has rightly recognized the value of a stimulative fiscal policy in the first half of 1967. In view of the perceptible slowing and crosscurrents now visible in the economy, the projected first-half deficit of more than \$5 billion in the national income accounts budget, at annual rates, will provide a welcome stimulus. Incidentally, the emphasis on the NIA budget concept both in the Council's annual report and the President's 1967-68 budget is to be commended. This concept needs to be impressed upon the public as a more useful measure of the Federal Government's economic impact than either the "cash" or "administrative" budgets.

The Council's overall view of 1967 prospects corresponds closely with our own NAMS staff forecast published last December. Given an appropriate mix of Federal economic policies—and reasonably good fortune—was anticipate that GNP will rise in 1967 by 6 percent or so in current prices and by slightly less than 4 percent in constant prices. We agree with the Council that the rate of growth in the first half of the year will be retarded, primarily by reduced accumulation of business inventories. But further increases in Government spending and in business capital outlays, and a continued high level of consumer incomes and spending, should keep the economy moving forward. Later in the year, support will be afforded by a strong recovery in housing and related industries. Indeed, recent data suggest that the housing recovery—as we have forecast—is proceeding at a more rapid pace than most observers had anticipated.

As the Council notes, price pressures this year are likely to come more from the cost side than from the demand side, in contrast with the 1966 experience. In this regard, I strongly agree with the Council's recognition that, given the present structure of the economy, policies designed to expand demand cannot lower unemployment much below 4 percent without generating strong inflationary pressures. The proper prescription in these circumstances, as the Council notes, is to direct efforts toward improving the structure of labor markets and the efficiency of manpower training programs. I also strongly agree with the Council's reaffirmation of "the productivity principle" as "the only valid and noninflationary standard for wage advances," and with its opposition to automatic wage increases tied to the consumer price index. It is to be regretted, however, that some of the Council's language regarding wage-price policy in 1967 seems to accept the inevitability of wage increases in excess of productivity gains.

The President's program for increased fiscal restraint and greater monetary ease in 1967 recognizes the desirability of restoring a better balance in the fiscal-monetary policy mix. This balance was lacking in 1966. It is true, as the Council points out, that fiscal policy was used to restrain the economy in early 1966 and that the NIA budget was in surplus during this period. But the surplus should have been larger and the degree of fiscal restraint greater. It is perhaps an understatement that, in the Council's words, "the question of whether a different timing or different magnitude of fiscal actions might have produced a more favorable balance in 1966 will long interest and challenge analysts of economic policy."

Lacking adequate fiscal restraints, monetary policy was forced to shoulder the major burden of restraining inflationary pressures in 1966, with the well-known and not soon-to-be-forgotten results. As the Council notes, the impact of severe monetary stringency, soaring open market interest rates and intensified commercial bank competition for high-yielding savings certificates "fell heavily on thrift institutions," sharply reducing the availability of mortgage funds and causing a drastic decline in new housing activity. One result of these developments, of course, was the imposition of across-the-board ceilings on savings interest rates, for the first time in history.

Looking back at the experience of 1966, it seems clear that monetary policy should never again be forced to assume such a disproportionate role in restraining inflationary pressures in a high-level economy. Hopefully, the painful lesson of 1966 has been learned and fiscal policy will assume an increased and more flexible role in Government stabilization programs.

The 1966 experience has also dramatized the need for other basic changes to improve the long-run stability of the economy. Foremost among these, as the Council states, is the need for structural changes in the financial area that would lessen the vulnerability of thrift institutions and housing markets to the uneven impact of monetary policy. Moreover, as the Council points out, the sharply increased competition for savings from commercial banks since 1957 has "gradually tended to curtail the flow of funds to the mortgage market," adding to the long-run need to strengthen mortgage-oriented thrift institutions. In this regard, I strongly agree with the Council's assessment that "there is every reason to believe that thrift institutions will continue to feel strong competition from banks, and must hereafter operate in a very different environment from that prior to 1957."

Given the short-run vulnerability of mortgage flows to cyclical disturbances and the long-run diversion of funds from the mortgage market resulting from increased commercial bank competition for savings, the Council has correctly emphasized the need for developing new avenues through which the general capital market could be tapped for mortgage funds, and for strengthening the long-run ability of mortgage-oriented thrift institutions to compete for individuals' savings. In this regard, it is gratifying that the President in his 1967 Economic Report has renewed his recommendation, first made in his 1966 Economic Report, that Federal charters be provided for mutual savings banks, in order "to enlarge and strengthen our system of thrift institutions."

Similarly, the Council has noted in its report that "while broadened investment privileges of federally chartered mutual savings banks might initially divert some funds from the mortgage market, such chartered banks would improve the efficiency of thrift institutions, strengthen them in competition with banks, and thereby ultimately benefit the mortgage market." Moreover, through its conversion provisions, the Federal charter bill would provide the most expeditious means for savings and loan associations to achieve investment flexibility. In this regard, it should be noted that conversion into federally chartered mutual savings banks was the route specifically recommended by President Kennedy's Committee on Financial Institutions for savings and loan associations desiring broader and more flexible

investment powers. As the Council indicates in its report, increased investment flexibility would permit thrift institutions to compete more effectively for savings during periods of rapidly rising interest rates, such as 1966, and result in a more stable flow of mortgage funds over all stages of the business cycle.

The need for strengthened thrift institutions and structural improvements in mortgage markets becomes even more urgent in the light of other trends noted by the Council in its report. As the Council indicates, a sharply rising rate of household formation in the years ahead will result in substantial increases in the rate of new home construction and in demands for mortgage funds. Additional heavy demands for private mortgage financing will be generated by expanding Federal programs in the housing area. Recent evidence of improved savings and mortgage flows at thrift institutions should not be allowed to obscure the very real danger of long-run inadequacy in the supply of mortgage funds in the years ahead. Should the economy continue to operate not too far below its potential, as seems likely, yields on capital market investments will probably remain attractive to many savers. Moreover, competition from commercial banks can be expected to intensify, as they increasingly exploit the advantages of "one-stop" banking and begin to institute the electronic money transfer services of the "checkless society." In this environment, thrift institutions may be increasingly hard pressed to meet sharply rising mortgage demands, unless they are able to compete more effectively for individuals' savings.

The need to strengthen mutual savings banks is particularly apparent in view of their leading role in financing Federal housing programs and the steadily widening Federal Government role in meeting national housing needs and stimulating urban revitalization. Despite their narrow geographic confinement to only 18 States, mutual savings banks rank either first or second, nationwide, among private institutional holders of FHA-insured mortgages under each of the following major programs: (1) regular owner-occupied housing; (2) rental housing; (3) urban home redevelopment and relocation; (4) cooperative housing; and (5) servicemen's housing. In addition, savings banks have been major participants in financing other important housing programs in recent years.

As the problems of our urban centers multiply, the leading role of mutual savings banks in these areas assumes increased importance and emphasizes the broad public-interest benefits of nationwide extension of the mutual savings bank system.

In launching its expanded urban effort, it will be crucial for the Federal Government to keep its role in balanced perspective, relative to that of the private sector. In this regard, it is gratifying to see the Council's emphasis upon the need to enlist private enterprise in this effort. It is equally essential, I believe, for private enterprise to recognize that the Federal Government does have a key function to perform in the building and rebuilding of our urban environment.

What we must establish, in essence, is a creative partnership between the private and public sectors, parallel to the "creative federalism" envisioned with respect to Federal and State and local governments. Such a partnership will seek the realization of broadly accepted public goals through maximum use of private means.

The objective of maximizing the participation of the private sector in the revitalization of our cities is more than a basic tenet of a private market system. It is a realistic approach to the massive task involved. It recognizes the practicality of using existing private institutional arrangements, funds, and skills. It recognizes that major reliance on the public sector for needed funds would severely strain the Federal budget and administrative structure.

The broad, basic goal of Federal policy must, therefore, be to encourage and to supplement—not to preempt—the use of private resources. This broad policy goal must also bear allegiance to the basic cost/benefit principle of public finance. Stated simply, this principle requires Federal financial assistance to be openly recognized and disbursed so that costs incurred may be measured directly against benefits achieved. In view of savings banks' leading role in Federal housing programs, enactment of the Federal savings bank bill would be one of the most effective means of insuring substantial private participation in rebuilding a modern, urban America.

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

BY C. WILSON HARDER, PRESIDENT

We appreciate your kind invitation to comment, from the small business standpoint, on the President's 1967 Economic Report and the Annual Report of the Council of Economic Advisers.

We have studied both documents closely. Much of the Council's data is not news to us. It has been reflected for some time in indicators based on our economic surveys. The President's recommendations, based on the Council's findings, equally are not new. Unfortunately and apart from that which indicates thought must be given to contingency plans for peace—a recommendation which we made to Mr. Gardner Ackley on April 12, 1966—we find much in these recommendations which may well harm rather than help future economic growth.

First, however, as to the Federation and its surveys. With a membership of almost a quarter of a million smaller, independent enterprisers the Federation has as a member more than 1 of every 20 small businesses in our country. This membership is broadly representative of all small business, by vocation, size, and geographic distribution.

Our surveys are based on responses received from about 1 of every 60 small businesses yearly, and from about 1 of every 240 small businesses quarterly. Samples from quarter to quarter are comparable.

In any case, the Council pictures strong economic growth to the end of 1965, which, it claims, had to be dampened down. It states that restraining measures undertaken "began to take effect in the spring (of 1966)" and that "By the closing months of 1966, it was clear that the brakes had worked."

Our indicators for 1966 1st Quarter showed the restraining measures taking effect, particularly in the Contract-Construction industry. We are happy to enclose a copy of our April 8, 1966 analysis which reflected our findings. Copies of this report were furnished to your Joint Committee as well as to other Committees and Executive Branch agencies.

As 1966 progressed, and as our 80,000 responses for the year accumulated, indications became increasingly clear that the brakes were in fact working. The question suggested was whether their application had been too uneven or harsh, resulting in a threat to throw the small business vehicle off the road into the ditch of recession.

The trends we found, and which we reported, appeared broadly as follows (we include as yet unpublished indicators for January 1967):

[In percent]

	1966				
	1st quarter	2d quarter	3d quarter	4th quarter	January 1967
Percentage respondents indicating—					
Business volume same as 1 year earlier.....	30	31	31	32	(1)
Business volume higher than 1 year earlier.....	51	48	48	47	(1)
Business volume lower than 1 year earlier.....	17	18	19	20	(1)
Inventories higher than 1 year earlier.....	40	39	39	36	23
Building construction within past year.....	23	22	23	22	21
Purchase of new equipment within last year.....	55	54	53	52	48
Accounts receivable higher than 1 year earlier.....	43	41	41	40	20
Usually able to generate capital from own earnings.....	54	51	51	53	(1)
Difficulties with collections.....	30	30	34	32	(1)
Dependence on banks when outside funds needed.....	66	63	62	60	(1)

¹ Question not part of 1967 survey.

With fewer respondents reporting sales volume higher than 1 year earlier, and more reporting it same or lower—with an increasing percentage reporting difficulties with collections—with a decreasing percentage reporting ability to generate from earnings the working capital needed for operations—as opposed to a decreasing percentage indicating confidence in ability to depend on banks for outside financing, the suggestion was strong that small business was being subjected to an increasingly severe economic squeeze. Judging by indicators available for January, this squeeze has not abated.

Of course, “tight money” contributed to the squeeze. Of all respondents to our survey in January 1967, 46 percent indicated they had applied at banks for loans during the past year—64 percent for working capital purposes, and 37 percent for capital equipment and construction purposes. Of all who applied, 72 percent indicated that their needs had been met in full, 12 percent partially, and 8 percent not at all. Of those whose needs had been met only partially or not at all, 16 percent indicated resort to insurance companies, 16 percent to finance companies, 18 percent to suppliers, and 6 percent to Small Business Administration.

Among those who reported needs met fully by banks, there was a reported average interest charge of 6.6 percent in 1966 against 6.1 percent in 1965. Those who resorted to insurance companies reported the charges as 6.3 percent against 5.8 percent. In the finance company category the reported average charge was 7.5 percent against 6.1 percent; in the supplier category 6.6 percent against 5.9 percent; and in the SBA category (due, no doubt, to a combination of SBA and other help) 6.5 percent against 5.9 percent.

One important effect of this squeeze is seen in trends in small business new job formation. This effect is important because of the fact that small business provides well over 40 million jobs for our country (source: Report by the Library of Congress to the House Small Business Committee) and, according to Senator Winston Prouty, provides a source of livelihood for more than 60 percent of our people.

Throughout this period (and in a measure possibly reflecting also increased tightness in the labor market) there was a steady decline in small business additional job formation. In January 1966, among those small businesses reporting employment levels different from 1 year earlier, the net change reported was +3.5 jobs per respondent. In the following periods, comparable figures were: First quarter +2.7; second quarter +2.5; third quarter +2.2; and fourth quarter +1.8. The figure for January 1967, is +0.9.

Equally, if not more important is the change which has taken place in the mix of respondents reporting their employment the same as, or higher or lower than, 1 year earlier :

Employment	Percentage of respondents reporting each vocation					
	Professional	Retail	Wholesale	Manufacturing	Services	Construction
Higher:						
1967.....	13	13	19	30	15	18
1966.....	20	18	27	36	21	28
Lower:						
1967.....	9	13	15	13	13	24
1966.....	6	8	9	9	10	13
Unchanged:						
1967.....	78	74	64	57	72	58
1966.....	74	74	66	55	69	59

While many factors other than "tight money" are responsible for the current plight of small business, it is interesting to reflect for a moment the description by the Honorable Wright Patman, formerly cochairman of your committee, of how a financial squeeze affects independents. In his print "A Primer on Money," Mr. Patman states that in such climate "(small firms), which would be normally adding to the country's economic growth, not only cannot grow, but must retrench on their inventories, work forces, and so on . . ."

Frankly, we see little in our economic indicators, and in the President's proposals, that will change these trends.

First, Federal spending in fiscal 1968 is planned to be higher than for fiscal 1967. It is proposed, in order to offset the prospective deficit, that there be enacted a 6 percent temporary surtax on business and individual income.

This surtax can but further reduce small business profits already under an intensifying squeeze. At the same time, it seems clear that it will cut into consumer disposable income, with correspondent effects on small business sales volume (which was trending level-down throughout 1966).

Second, adding to this squeeze would be the proposed increase in social security tax rates and the applicable tax base (the cost of which is borne 50 percent by employers) and the proposed increase in unemployment compensation taxes (the cost of which is borne 100 percent by employers).

Third, the council suggests that "private demand is not likely to be particularly buoyant in the first half of 1967" and asserts that "a stimulative stabilization policy is appropriate to support steady expansion during this period." It observes that such stimulus will be supplied by "special costs of Vietnam and further increases in transfer pay-

ments for medicare." Neither of these areas directly affect the bulk of small business.

Fourth, the Council anticipates that employment (now at the "full" figure) should remain essentially the same as in 1966. It is interesting to observe the affects felt by small business while employment, in 1966, was building to its present levels. Among the 8,283 responds to our survey in January 1967, 59 percent stated that in order to hold needed employees, as well as to secure the services of additional employees, it had been necessary for them, during the past 12 months, to increase their wage scales by 5 percent or more (some far more than this).

In connection with the foregoing, in May 1966 we analyzed responses received from 7,246 members to a question whether they expected to be affected by the then proposed (and now coming on stream) increases in the Federal minimum wage and its coverage. Some 55 percent of our respondents, particularly in the South Atlantic, the East and West South Central, answered "Yes."

In other words, increasing labor costs have been, are, and are likely to continue contributing to the squeeze on small business.

Fifth, in what has been obviously an effort to compensate for rising costs through purchase of new equipment, a high (though steadily declining) percentage of our members in 1965 and 1966 indicated purchases in this area. These same members used the 7 percent investment credit heavily. In fact, of the 48 percent of our January 1967 respondents who indicated equipment purchases during the past year, 80 percent indicated that they had used the credit. The average tax saving reported amounted to \$873.

As you know, Congress in October suspended the credit, at least to December 31, 1967. It is true that in so doing it provided an exemption for the first \$20,000 of equipment purchased. This is certain to be helpful. It must be pointed out, however, that indications are that in manufacturing many purchases appear to have been in excess of this figure. The same appears to have been the case in the depressed contract-construction industry. For the length of suspension of the full credit, therefore, there is bound to be higher than former costs to independents needing to modernize.

Sixth, in its report the Council implies hope that action to ease the pressure on money will act as a stimulus to the economy. There is no question but that to a certain extent it will. However, we would point out that even in 1965, when as the Council says, Federal Reserve policy permitted a sufficient expansion of credit to accommodate expanding demands for funds at only moderately rising interest rates, independents in some parts of the country were paying as much as 6.9 percent interest. Obviously, even action to ease the pressure on money, while helpful, would far from resolve the financial pressures on independents.

Frankly, study of the trends pointed up by our indicators, study of the President's recommendations, and reflection on the conclusions reached above, suggest strongly that small business has been all but overlooked in current economic planning.

If this is so, then a serious miscalculation has been made.

We have already pointed out the importance of small business as a job provider, as well as a provider of livelihood for our people. Indicators from both the 1965 and 1966 surveys show that small business,

by expansion and modernization, contributed significantly to the creation of the additional jobs which helped reduce our unemployment rate from 6 percent in 1960 to 3.9 percent in 1966. Ability to maintain current jobs and provide additions for our growing population will become increasingly important as the Nation emerges, hopefully, from the present Vietnam involvement.

Moreover, in the floor speech already referred to, Senator Prouty also pointed out that small business retail sales constitute 73 percent of national retail sales, that its wholesale sales constitute 73 percent of national wholesale sales, that it constitutes 82 percent of our construction activity, 80 percent of our service function, and that it provides 34 percent of the manufactured value added to the economy each year.

Clearly what affects small business affects vitally the entire fabric of our economy, and the lives and hopes of each and every one of our citizens.

For this reason, and in view of the facts previously indicated, we recommend a course of economic action as follows to maintain the strength of this base of our economy, and to build for further needed expansion in the years ahead :

1. That Government adopt spending policies which will permit the country to get by without proposed tax increases.

2. That there be delayed until after the extraordinary demands being made by the Vietnam involvement any action to increase the taxloads for various social programs, including social security and unemployment compensation.

3. An end—at least to completion of the job in Vietnam—of programs of social experiment which have failed, so far, to fulfill the needs for which they were designed.

4. The earliest possible restoration of the full 7 percent investment credit, coupled with action to extend its principle to both increases in inventories and accounts receivable, as well as investments in plant and equipment.

5. Continued independence for the Small Business Administration, coupled with action so far denied by both Houses of Congress, to secure legislative power for the House and Senate Small Business Committees, to assure small business proper recognition in both the executive branch and the Congress.

6. Vigorous enforcement of the antitrust laws to combat, in the words of the Council, "practices which strengthen market power through reducing the number of firms in an industry, which erect artificial barriers to the entry of potential competitors, which delay the introduction of superior products of cost-reducing techniques, or which serve to blunt the effectiveness of competitive price changes."

We are confident that, freed from the enervating cost squeeze to which it is currently being subjected, the Nation's small business community will be able to move ahead, furnishing jobs and purchasing power to our people, and assuring the manufacture and distribution of goods in adequate quantities at reasonable prices—thereby doing its part to build for a greater United States in the years ahead.

POWERFUL CROSS-CURRENTS RUNNING DEEP UNDER SURFACE OF NATION'S SMALL BUSINESS ECONOMY—THEY DEMAND CAREFUL CHARTING

(This is the second of a series of special studies to be released this year on responses by Federation members to our 1966 Fact-Finding Survey which will cover our more than 200,000 members in smaller, independent business and the professions. Other special studies, involving other survey areas, will be released in later months.)

Powerful cross-currents are running deep under the sunny surface of the nation's small business community. Unless they are charted accurately, safe passage of the nation through what could be perilous straits ahead may be difficult, if not impossible.

This is the major conclusion reached in the analysis of the 23,000 signed responses received from Federation members to the current fact-finding survey, "*Independent Business Employment, Investment, Expansion,*" (sample copy enclosed) during 1966 First Quarter.

Although there are encouraging signs of small business continued growth during the past year, there are strong indications that much damage may be done should the 7 percent Investment Incentive be repealed, as suggested by some authorities.

For instance, while 32.6 percent of all respondents during 1966 First Quarter (statistical analysis attached) reported that they had engaged in what they described formally as expansions or modernizations, 55 percent reported they had spent money on purchase of new equipment. Against this, as indicated in other analyses not reported here, only a little more than 20 percent reported they had increased their employment.

These facts indicate a marked probability that small business may be attempting desperately to increase productivity to survive increasing cost and competitive pressures, to hold employment levels, and to move ahead. Obviously, to independents new and more modern machinery is the key to survival and growth.

As to the 7 percent Investment Incentive, this conclusion is extremely significant. The Federation's 1965 Survey proved conclusively that the Incentive—which is machinery oriented—has been of greatest help to small business of all the independent-enterprise tax revisions since 1957. Clearly, repeal of the Incentive would deal a body-blow to the nation's small business structure—with potentially disastrous implications to the economy in the future. Following is the back-drop against which this must be viewed:

Again in 1966 First Quarter, as in the year-long report on the 1965 Survey, and the report for 1965 First Quarter, small business showed itself a major factor in the creation of additional job openings for our growing population. In fact, the rate of new job production indicated during 1966 First Quarter by those who formally reported expansions or modernizations was exactly the same as that reported during 1965 First Quarter—2.0, but below the average 2.7 new job openings creation reported for all 1965 responses.

In today's economy, with its tight skilled labor situation, creation of new job openings is considered by many as a problem rather than a boon. Yet as recently as two years ago the reverse was decidedly the case. Within another two years, granted a settlement in Vietnam or in the cold war generally, the pressing need could be once more for the creation of job openings. Without a vital small business economy, whose continued health depends so directly on continued availability of the Investment Incentive, joblessness could become an extremely grave national problem.

In any case, with coverage generally the same as one year earlier, through First Quarter 1966 some 36.2 percent of all respondents reported formally that they had expended or modernized their operations during the preceding year. This figure compares with an average 33.1 percent expand or-modernization rate reported throughout entire 1965 in last year's survey, and with an average 32.6 percent rate reported in 1965 First Quarter.

Furthermore respondents during 1966 First Quarter reported having spent an average \$23,000 on each expansion-modernization. This compares with a \$20,000 average reported last year for the preceding 12-month period, and with an average \$17,100 reported in 1965 First Quarter to last year's survey. How much, if any, of this difference is due to price firming or price increases was not asked, and is not known.

But even here, the promising surface masks other deep running currents—for small businesses obviously have shared very unevenly in the nation's economic upsurge. For instance, while almost 70 percent of those who reported having expanded or modernized indicated they were enjoying higher business volume than one year earlier, the same report was made by only 40 percent of the much larger proportion which failed to report modernizations or expansions. While it is not contended that in a free competitive economy all business units may be expected to be moving upward, failure of such a large segment of the small business community to generate additional volume to compensate for rising costs or slimming profit margins raises another cautionary signal.

Indications are that almost all of the firms reporting expansions or modernizations purchased new equipment during the preceding year, that over half of them invested in construction of new plant or remodeling of older structures, and that over half increased their investments in inventories and accounts receivable.

Generally, respondents who reported expansions or modernizations indicated less ability to generate funds needed out of earnings, and greater reliance on outside sources (including the Small Business Administration) for capital required than was the case with respondents who did not expand or modernize. This fact, plus the higher rate of inventory and accounts receivable increase, undoubtedly explains their heavier preference—academic as it may be from the standpoint of immediate action—for future congressional enactment of a plow-back allowance.

In answer to the question whether trained labor is available in case additional employees are needed, a little over one-quarter of all respondents answer in the affirmative, but well over half in the negative. In answer to the further question whether they could and would take unskilled people into their operations and train them for vacant positions, from one-half to three-quarters of respondents replied "Yes," while just about one in five responded in the negative.

In summation, the results of the 1966 First Quarter responses lend but further strength to conclusions reached on basis of the Federation's 1965 Survey: that small business is a segment of our economy with tremendous vitality, critically important to the economic strength of our country, and therefore deeply deserving of close, constructive attention and action on the part of all in Government. This is particularly true today because as always it is good "to prepare for peace in time of war." While all effort today is to keep the economy from boiling over, the day is bound to come when, as was the case as recently as 1964, efforts will be directed to heating it up. It is against such day that recommendations for action to maintain the 7 percent Investment Incentive, and to supplement it with a plow-back enactment, as well as in the fields of wage minima, social taxation, antitrust enforcement are directed.

NATIONAL FEDERATION OF INDEPENDENT UNIONS

BY DON MAHON, SECRETARY

Our concern with the Economic Report of the President is centered on the section titled "International Economic Policies." Under the heading "Trade" it states: "This administration is committed to reducing barriers to international trade, as demonstrated by my recent action terminating the 1954 escape clause action on watches, . . ."

We oppose this policy and action as not in the best interests of our country for the following reasons:

Concessions on import rates on watches, watch movement and parts were granted by our Government in a trade agreement with Switzerland in 1936. Thereafter, the domestic watch industry, admittedly efficient, was very seriously injured by imports and in 1954 increases in rates of duties for such articles were increased, permitting the industry to subsist on a minimum level of operations. But in January 1967, the 1954 rates were reduced to those existing in 1936, placing the industry on the threshold of extinction.

In freeing up trade, we have lost valuable production facilities which take 15 years to reestablish. Of 33 integrated plants, there remains only three integrated jeweled watch plants and no fully integrated pin level plants. Only the hard core of a production capability is left of an industry important to our defense.

As stated by the subcommittee of the Senate Armed Services Committee, at stake is an important and efficient industrial capability which contributes very substantially to the military, space, and missile programs; advances the state of the art; and provides a unique pool of skills for industrial and defense needs. Without it, we must rely on the Swiss cartel for our needs; and we have no means of controlling the source of production.

In the Trade Expansion Act of 1962, the Congress provided safeguards to prevent elimination of any industry which we need. More particularly, the Congress considered this problem did not intend that the watch industry be sacrificed in the cause of free trade, and continued its escape clause protection. No such efficient industry as this—which leads the world in technological progress—with electric and electronic watches, the most important development in the art over the past 500 years—should be killed off in contravention of the standards set by the Congress. Administrative action reducing tariffs should be nullified until such time as the Congress changes its mind.

NATIONAL GRANGE

BY HARRY L. GRAHAM, LEGISLATIVE REPRESENTATIVE

The Economic Report of the President and the Annual Report of the Council of Economic Advisers transmitted to the Congress in January of 1967 is of particular interest to the agricultural sector because it reveals the discrepancy between the return farmers receive for their inputs and that received by other segments of the economy, and because the report appears to find satisfaction from the reduction or stabilization of farm prices while it makes various rationalizations for the increase of the wages and profits, ultimately transferred to the farmer in terms of his costs of production.

The importance of agriculture is pointed up in a number of ways. One of them is that of the total of \$28.961 billion of merchandise exported from the U.S. during 1966, \$6.7 billion of this was for agricultural products—some 23 percent of all exports. Indeed, almost 20 percent of the total exports for dollars were from agriculture alone. The disparity between agriculture and the nonagricultural sectors shows that out of a \$42.7 billion realized gross income from farm sources, the net to farmers was \$16.3 billion, and when the reduction in inventory was considered, this dropped to \$16.1 billion.

Despite the fact that the last figure is the highest net farm income in history, we should compare it to corporate profits, showing an increase of 68 percent—\$51.6 billion to \$86.6 billion from 1960 through 1966—while net income was increasing 33 percent.

While the net Federal Government and agency indebtedness increased from \$241 billion in 1960 to \$274 billion in 1966, an increase of \$33.6 billion, farm indebtedness during the same period of time increased from \$25.1 billion to \$42.5 billion, for a total of \$17.1 billion or more than half the increase of the national debt.

Again it should be noted that in output per man-hour in the private economy, 1960 to 1966, farm output rose from 110.7 to 155.8 while nonfarm output rose from 104.4 to 125.3, less than half that of the farm sector. While gross hourly earnings in manufacturing were increasing \$2.26 per hour to \$2.71 an hour from 1960-66, a total of 45 cents an hour; gross hourly earnings in agriculture were increasing from 81 cents to \$1.03 an hour, or a total of 22 cents per hour for the same length of time.

There are many other comparisons that might be made from the tables which are a part of the report, but all of them arrive at the same conclusion; namely that no aspect of farm income has kept pace with the nonfarm segment of our economy. In 1960 we began with an 80 percent of parity figure and ended 1966 with a preliminary estimate of exactly the same amount. However, this does not indicate a sharp drop sustained since September 15, when the parity ratio dropped from 80 to the present 74—the lowest point in 34 years.

The report of the Council, page 74, states:

Prices on most farm products and of many industrial raw materials move more or less freely in both directions. The same is true, though to a lesser degree, of many products at early stages of fabrication, but it is unlikely that past price increases in most other parts of the economy will be reversed as long as the economy remains strong. Moreover, price advances for such items as metals and industrial equipment tend to fan out and become built into the structure of industrial costs. And even temporary increases in farm and food prices, through their impact on consumer prices, materially affect the pattern of wage negotiations. The resulting higher wage settlements also tend to be permanently built into the cost structure.

Consequently, the return to price stability can only be gradual. However, as 1966 grew to a close, there were signs of progress. Prices of farm products and some raw materials had leveled off. Thanks to the enormous strength and adaptability of the economy and skill and ingenuity of workers and management, many of the industrial pressure points have been alleviated.

The statement that prices of farm products and some materials had leveled off, when in fact they had declined by some 11 percent, was used as the basis of deciding there were signs of progress, makes the farm sector raise a question about the intent of the fiscal policy of the Government. The implied or stated approval of the desirability of reducing farm prices is before us again on page 87:

The rise in farm prices was due to the strong expansion of domestic and export demand, combined with only slightly increased or in some cases reduced supplies of important farm commodities . . . To be sure, for some highly-labor intensive products—particularly dairy products and some fruits and vegetables—rising prices may be necessary to attract or hold the necessary labor services. But this is the exception rather than the rule.

We are reminded that there was "corrective action" taken at the highest levels to reduce farm prices during the early part of 1966. Every newspaper, when it made its monthly report of the economic indexes, pointed out that farm prices were rising again, disregarding the fact that they had remained constant for 4 straight years while the rest of the economy was on the rise.

Another area which received increasing attention during 1966 was that of Government procurement. Intensive efforts were made to phase procurement and adjust specifications for both military and civilian purchases so as to minimize the impact on productive facilities and product markets. Arrangements were worked out to this end for the closest possible cooperation and consultation between the Department of Defense and the Departments of Commerce and Agriculture.

Let me quote again for the council report on page 89:

Changes in food prices at subsequent levels of processing and distribution generally follow changes in the costs of raw farm products. These costs, however, account for only 40 percent of the price of delivered food with the remainder reflecting costs of transportation, processing, distribution, and marketing. Over a time, these latter costs have risen steadily reflecting, in part, increases in labor costs, in part, higher quality and better packaging. As a result, even when farm prices are stable, food prices, especially at retail, tend to rise.

Following the decline in farm prices, processed food prices ended the year only slightly above the levels of December 1965. But retail prices remained 3.8 percent above the level a year earlier. The spread between farm and retail food prices narrowed during 1965, but then widened late in 1966. On the average, there is little evidence of an increase in processing and distribution margins. In the months ahead there may be some further decline in retail prices, but the rising trend in intermediate costs suggests that a full reversal cannot be expected.

What the report seems to say is that there cannot be a significant decline in retail unless there is an unusually large decline in farm prices. If stable retail prices are the objective of the council, then it necessarily follows that reduced farm prices are an essential part of this equation.

The council speaks with approval on page 93 of the overall profit record in manufacturing, stating:

During the first three quarters of 1966, after-tax profits for all manufacturing averaged 5.6 percent of sales, the same as in the first three quarters of 1965. As a percentage of equity, however, they were higher—13.4 percent for the first three quarters of 1966 against 12.7 percent a year earlier.

Again we would point out that this was taking place while farm equity was declining by about the same percentage.

Quoting from the report which indicates that stable farm prices is the desirable goal for the country, we note on page 97:

Average wholesale prices in the farm and food sector should be relatively stable, if weather is normal, with advances for some items approximately balanced by reductions for others. However, retail food prices will probably continue to rise, although more slowly than in 1966.

A further inconsistency is revealed in the council's wage-price guideposts beginning on page 120:

The Council proposed a set of standards for this purpose as a contribution to public discussion.

These standards—like those more generally described in the statements quoted above—are based on certain arithmetical relationships among output per man-hour (productivity), wage rates, and prices. These relationships show that, if wage rates increase in line with output per man-hour, prices can be stable while the distribution of income between labor and others contributing to production remains unchanged.

On page 121, the report states the exception to the council's 1962 guideposts.

The Report proposed as a general rule that hourly labor compensation should advance in accordance with the trend increase in productivity in the entire economy. No specific estimate was given of that trend, although a summary of statistical evidence on the long-run growth of output per man-hour was provided.

The general guidepost rule was subject to various exceptions—some explicitly stated and others only suggested. The stated exceptions were these: In the interest of *equity*, wages of workers who are underpaid because of weak bargaining power (or other reasons) should rise faster than the average, while wages of workers who are overpaid because of exceptionally strong bargaining should rise more slowly than the average. In the interest of *efficiency*, wages should rise somewhat faster than the average in industries with a rapidly growing employment (in order to aid recruitment), and more slowly in industries with labor surpluses. Moreover, workers who contributed to an extra rise in their own productivity—for example, by consenting to the relaxation or removal of restraints on the freedom of their employers to change work rules or introduce new methods—should be allowed to share in the benefits of that extra productivity gain.

The Grange respectfully suggests that the action of the Government in relationship to farm prices was in direct violation of the principles laid down by the 1962 guideposts. Not only were farm prices, which had lagged far behind the rest of the prices for the nonfarm sector, not allowed to rise more rapidly in order to be able to obtain some equity, but they were in fact deliberately depressed by economic man-

agement so that exactly the opposite of the stated goals was attained—a drop in farm prices.

At the same time, the council justifies the rise in automobile prices and in cotton textiles, even though “a sharp decline” in the cost of raw cotton would have suggested price reductions.

This was justified on the basis of the excess demand for these consumer goods, precisely the factor pushing up the price of bacon and steaks to such unreasonable heights so rapidly in the early part of 1966. At the same time it admits that “in general terms, the greatest failure of observance of price guideposts lies in the failure to reduce prices on a considerable number of the product lines of a large number of industries.” As chapter 3 has indicated, “a number of the price increases that have occurred in manufacturer and the mining industries undoubtedly had some justification in higher costs. But offsetting price decreases have been far too few” (page 125).

We would close these comments on the direct statements of the council by using only two more. On page 128, they stated in relationship to “recognition of higher living costs”:

The only valid and noninflationary standard for wage advances is the productivity principle. If price stability is eventually to be restored and maintained in a high-employment U.S. economy, wage settlements must once again conform to that standard.

And on page 129:

But the higher minimum wage effective in 1967 will have its principal impact on wages in the unorganized sectors, and in the largely unorganized low-wage segments of manufacturing. Thus there will be some continued pressure on costs and prices originating in wage increases outside of the organized sectors.

This, to us, means agriculture.

The thrust of our argument should be apparent by now. Agriculture has not kept pace with the rest of the economy, except for a very short period of time during 1965-66. The depressing effects of governmental policy on agricultural prices was not matched by equally effective policy in the nonagricultural sector.

Stable farm prices, even in the midst of highly and rapidly increasing farm costs, seems to be a desirable objective in terms of the council's report. The equality of income principle, permitting low-income groups to increase their prices (wages) faster than the high-income groups is denied to the agricultural sector. The reduced purchasing power of American farmers places them in a less competitive position in bidding for, not only labor, but for the land upon which they live, with a direct threat to our owner-operator type of agriculture.

No suggestions were made by the council for alleviating the economic problems facing agriculture, even the recognition of the place that farm programs have had in maintaining income at a level which it has been for the last few years.

In the midst of a growing drive toward the removal of exceptions which have protected agriculture from increased costs, it is increasingly imperative that agriculture share equally in the returns of the American economic system. To weaken the financial stability of agriculture and to weaken the American system of agricultural production by a change into a corporate farm or a socialistic structure which has basically the same results for those working on the land, that is the denying of a share of the profits they create, poses a grave threat to

the national welfare and to the stability of the free world depending on American agricultural production.

We hope that future reports of the council will give increasing attention to the means that may be found within the market system or within Government programs for further reducing the inequality between the farm and nonfarm sector in terms of returns for the same factors of production.

This commentary on the report of the council is not to be interpreted as an indictment of the council or question of their good faith. It is rather a question of whether or not adequate consideration has been given to the importance of the agricultural sector in terms of our own national prosperity, in terms of our relationship to a hungry world and in terms of the dependence of the markets of the free world upon the markets of American agricultural products. The enormous amount of our agricultural exports must have a decisive effect on world prices, and the fact that we are also the largest importer of agricultural products means that we have the possibilities of great good or evil in terms of the markets of those who depend upon us and other nations similar to us for the markets for their products.

We believe that the time is far past when the relative importance of the agricultural plant and producer must be recognized and that the superiority of the American system which we already have established in this country has been adequately proven which in turn would direct our efforts toward the preservation of the best of American agriculture, the adequate protection which it needs being promptly and quickly afforded to it, and the day hastened when our agricultural producers can become a vital and integral part of our American economic life, free from the obligations that come from special favors, and fully able to require and receive for their services, a comparable return to those of the rest of our economic society.

UNITED MINE WORKERS OF AMERICA

BY W. A. BOYLE, PRESIDENT

As we enter the year 1967 we are plagued by the same problems that existed in 1966.

Inflation is still a very real factor of our economic life. Price increases continue to occur, raising the cost of living for the average citizen and hitting hard at the purchasing power of those on fixed incomes.

The cost of the conflict in Vietnam continues to be a terrible burden upon our Nation, not only from the standpoint of human misery, but the drain on our economic resources which we are committing to its prosecution.

Unemployment among the poor, the handicapped, and the disenfranchised remains at a high level in a Nation with the lowest unemployment in many years.

Education—the one real answer to poverty—has not been given the resources which it needs to bring to all Americans an educational level required in our modern society.

The rehabilitation of our cities and the eradication of our pockets of poverty have not kept pace with the growth of the economy so that a growing gulf separates Americans of means from those who live in destitution and want.

Manpower development is a critical national need, with shortages of skilled persons impeding national progress.

But, the unsolved problems of 1966 are not the only ones which we face in 1967.

Soft spots are beginning to appear in the economy. A decline in auto production, an alarming increase in inventories, and a leveling of activity in the private sector point to the possibility of a flattening of the business cycle.

Political decisions in the field of national resources—most notably in air and water pollution—threaten economic dislocation in the energy industries and retardation in the progress of those American industries dependent upon cheap and abundant energy resources.

Postwar reconversion following the Vietnam conflict portends a period of readjustment which could become serious if not handled with care.

Decisions in the wage-price field could do much to turn America away from the freedom of the marketplace which has made this Nation great.

Fiscal decisions based upon questionable economic logic could well hinder the advance of the national economy.

We, of course, must view all of these things against the backdrop of American economic strength. Our Nation's economic capability is beyond the imagination of man and the progress we have made is

without parallel in the history of the world. But, we must continue to progress—to build upon the mighty economic structure which currently exists.

It is essential that we grow without the accompanying inroads of inflation. This can be most effectively done by encouraging the fullest development of the economy and the increased productivity of the American worker. With the most modern tools and the incentive to produce our Nation can achieve forward economic momentum and stable price levels. This has been proven in the coal industry which has the highest paid industrial workers and a price level which has been stable for more than a decade.

In the same vein, we reiterate our rejection of governmental wage-price guidelines, whether they are of the type recently imposed by Executive fiat or drawn up by the Congress. To our minds the guidelines serve merely to impose unacceptable restraints upon the private sector and, in the long run, mitigate against the most efficient working of the economy.

We recognize that it is the prevailing practice in certain quarters to look to national wage and price standards as the answer to the upward movement of our price structure. Yet, it has been our experience and the experience of history that such interference in the free market economy can only lead to an improper allocation of economic resources, restrictive governmental programs and the stagnation of the economic machinery upon which so much depends.

Within the past several years a great deal of activity in the field of air and water pollution has been carried out by the Federal Government and at the State and local levels. Most recently, the President of the United States transmitted to the Congress a strongly worded appeal for legislation on the subject and such legislation is currently being considered. Certainly, the United Mine Workers of America is in accord with the objectives of such legislation. Our union has for many years fought to better the living standards of the coal miners of the United States and in effect to improve the environment of all Americans.

On the other hand, there is a tendency for those charged with air pollution control to ignore the economic consequences of their action on other segments of the economy and upon the general citizenry who must bear the cost of pollution abatement. Presently, proposed regulations for air pollution control on the Federal level would exclude the use of large reserves of bituminous coal. This would have disastrous effects on the coal industry in many of our States. It would mean unemployment and privation for coal miners in these areas and for the families of coal miners who depend upon the production and sale of coal for a livelihood. Further, the ill-timed regulations would mean that the Nation would not have access to large energy resources. This, in a nation so dependent upon energy, is hardly in the public interest.

Obviously, there must be a reconciliation of the twin objectives of pollution abatement and resource utilization. Pursuit of one to the exclusion of the other means economic chaos and wasted resources. Fortunately, there are such avenues open to the Nation. The magic words are "research and development"—research and development which will permit the growth of technology to use all of our natural

resources and yet prevent the further despoilment of our environment. Thus, research becomes an even more important part of the economic fabric of the Nation. We will have more to say on this subject subsequently.

The pressing problems of manpower development occupied much of the Nation's attention in 1966. This preoccupation was divided into two parts.

On the one hand, we were confronted with the familiar specter of unemployment and human need. Programs aimed at correcting the blight of unemployment have been undertaken, although a great deal more remains to be done. It seems a paradox to see pockets of unemployment—in our city slums—in the mountain of Appalachia—in the arid regions of Indian reservations of the West—when our Nation as a whole is enjoying the greatest period of prosperity in its history. It is a national disgrace to see young men and women of minority groups falling further behind the rest of America because they lack the skill, the initiative, and the opportunity to cope with the complexities of modern industry. Surely, it is to us—all of us—that these people look and it is evident that we must not fail them.

At the same time, the demand for men with a high level of skill went unsatisfied in many industries. In coal, for example, a real manpower shortage is developing and steps are already being taken to alleviate the shortage. We feel that an intensification of existing governmental efforts in the manpower area is warranted. For, whether we are attacking structural unemployment in the slums or training a highly skilled coal miner, we are improving upon our most important resource—our people. We must never lose sight of this. Nor should we rest content until every person with the desire to work can find a job which utilizes the full extent of his talents and desire.

The question of Vietnam has been much on our minds in the past months and years. Apart from the losses in lives and the large number of injuries caused by the conflict, the economic effect has been great. In our opinion, much of the dislocation in the economy can be traced to the burden of Vietnam. Further, as the war goes on and becomes more intense, these burdens are certain to grow.

In his state of the Union address, the President asked for an additional tax to take effect around midyear. In our opinion, the only justification for such a tax increase is the financial burden imposed by the war. Surely, if the war were not being waged, the current status of the economy would indicate liberalization rather than a tightening of the Nation's fiscal policy.

As we have pointed out previously, there are several soft areas in the economy. It is difficult for us to fully assess the impact of a tax increase at this time. But we do believe that caution should be exercised before such a tax is imposed, so that the private sector will not be forced into a period of contraction as will it might be. Naturally, if the tax increase is necessary to help finance the war effort, we will, as good Americans, support it. On the other hand, if, in fact, the imposition of the tax will result in a downturn in the private sector, it will be self-defeating and only lead to larger budget deficits than originally anticipated.

But the Vietnamese conflict is troublesome from another standpoint. Some day, hopefully soon, the war will be over. Then the Nation will

face the painful task of reconversion in its economy. At that time steps to cushion the blow will become necessary. We are hopeful that such steps can be taken and that undue hardship to the economy and our people will be avoided. It is our hope that the Joint Economic Committee, as well as the Council of Economic Advisors, will look into the postwar period with a view toward developing sound national policy. In this endeavor they should call upon the leaders in the business community, the labor movement and the academic world. Surely, the United Mine Workers of America will assist in any such program to permit the orderly growth of the American economy.

Growth is the key to our national progress and prosperity. The history of our Nation is the story of growth—of reaching for the prize and securing it by sacrifice, ingenuity, and struggle. Its cornerstones has been resource development. Our Nation is rich in natural resources and we have grown economically, socially, and politically by developing those resources to the fullest extent. Today, as before, resource development is the key to future growth; and research and development is the key to total resource utilization. America is the center of technological progress. From our laboratories comes a constant flow of new products. Such scientific endeavor has made us the envy of the world and has permitted our industry to remain competitive with other nations not so blessed.

But, to our minds a great deal of our research and development work is not properly channeled. Over 60 percent of research and development in the United States is financed by Government. Of that total, over 90 percent is devoted to atomic energy, space, and military applications. We recognize that much of such work is necessary and in the national interest. Conversely, the preponderance of scientific effort in relatively unproductive fields seems inadvisable and detrimental to the development of our resources. We do not refer here solely to the money involved. If that were the only problem it would not be of such importance. But research money employs skilled scientists—men and women who are in extremely short supply and whose talents are vital to the success of any research effort. It is this misallocation of scientific manpower that disturbs us greatly and hinders, we believe, the future growth of the United States of America.

It is true that we need weapons of defense. It is probably true that we require a space program. There may—may—be justification for an effort directed toward the further use of the atom. But, by the same token we also need clean air. Research can provide it. We must use all of the resources available to us. Research can show the way. Our coal, for example, contains treasure awaiting only the genius of the scientist to make it available. It would seem to us that those charged with the formulation of national economic policy would look into this area. From them should come proposals to properly allocate our scientific resources so that they will be truly responsive to our national needs. What is needed, in our opinion, is the application of a cost-benefit analysis to the overall research program by officials with the objectivity and knowledge to make such determinations. Economic criteria are of prime importance for such policy decisions.

We have no doubt that the future of our Nation will be as productive as our past and that we will solve those economic problems which

currently confront us. In moving forward to such solutions, we will have fashioned a better life for all Americans and preserved the economic base upon which is built our free society.

In conclusion, we appreciate the opportunity to present this statement and to express the views of the United Mine Workers of America on the state of the U.S. economy.



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