

Mr. GORDON. I think it is very promising, with one qualification with which I am sure you would agree. I think it would be a mistake to think that measures of this kind would have a very significant effect on the U.S. economy in the short run. Negotiations of the sort you propose—multilateral negotiations, quite complex international negotiations—invariably take a considerable period of time to complete. So I think we ought to be realistic to expect that such negotiations, if we decide to enter them, would not have visible economic effects in the near future.

Representative REUSS. It is equally true, is it not, that the sooner you equip yourself to start negotiations, the sooner you complete them?

Mr. GORDON. Yes.

Chairman PATMAN. Senator Proxmire?

Senator PROXMIRE. The main thing I want to do, Dr. Heller, now that we have indicated that we are not wildly enthusiastic about the higher interest rates, I would like to relate that to the possibility of a tax cut.

You indicate in your statement that taxes and savings would be drawing \$14 or \$15 billion too much, from the economy which would have to be offset by additional investment and Government expenditures for full employment to be attained.

I presume this \$14 to \$15 billion indicates that a substantial tax cut would be necessary in order to correct this situation, but I presume it would be somewhat less than \$14 to \$15 billion, is that correct?

Dr. HELLER. Yes, it is, Senator. We would have to take into account not only the initial impact of the tax cut itself, but the multiplied effects, and the impact on inventory investment, and on investment in plant and equipment and in housing. So these numbers were not meant to suggest in any way, shape, or manner the size of any tax cut.

Senator PROXMIRE. Let me ask you about that multiplier. I won't say you have been quoted, but people have said that the economists on the Council of Economic Advisers indicate one specific multiplier; others say others. I understand from some competent economists that a tax cut of \$10 billion would mean an increase in the GNP of \$20 billion. Others say \$25 billion. Would you have a rough estimate?

Dr. HELLER. It is extremely difficult to tie oneself down to a specific estimate in the absence of test-tube evidence. As was pointed out earlier, a tax cut would show up primarily as an increase in disposable income, quite undifferentiated from any other source of increase in income. In other words, it would not appear to most people as a special kind of income, labeled "Cut in Tax Liabilities." For the most part, it would simply show up as an increase in take-home pay. That touches off spending and re-spending.

Senator PROXMIRE. I understand the multiplier and I certainly agree.

Dr. HELLER. I am trying to get to a rough approximation of the magnitude, without suggesting that we are tied to any specific multiplier figure. Very conservatively estimated, the multiplier effect as such might be one and a half to two times the initial tax cut when it works through the spending stream and on into an increase in GNP.

Depending in part on the level of economic activity relative to capacity, there would be further magnification of the original figure,

through the impact which the higher levels of consumption may have on investment in inventories and plant and equipment. Depending on the conditions in the economy and a number of variables that are terribly hard to tie down, that would increase the total impact from $1\frac{1}{2}$ or 2 to $2\frac{1}{2}$ or 3 times the size of the initial tax cut—and under very favorable circumstances, even more. It depends in large part on conditions that exist at the particular moment the tax cut is made, and in what direction you are moving—that is, whether the economy is expanding, leveling off, or declining.

Senator PROXMIRE. It would vary on the kind of tax cut. For example, if you had an increase in exemptions or if you had further modification of depreciation or investment credit, would these have varying impacts in your judgment on the multiplier? If so, what kind of tax cut would have the greatest multiplier and which the least?

Dr. HELLER. It makes some difference, certainly. But we must not exaggerate its amount. We know that, on the average, persons in low-income brackets spend their entire incomes, while in the highest brackets they save as much of their incomes as they spend. But some studies suggest that the amount spent of an additional dollar of income is not nearly so different across the range of incomes, or at least across the brackets that really account for the bulk of taxable incomes.

Senator PROXMIRE. But I think almost all of the proposals we have here, with maybe a couple of exceptions, there would be a much bigger dollar tax cut with a bigger income.

I was going to say if you have a person with a \$5,000 income and you have a \$4 billion tax cut for individuals, as I calculate it, he would get about a \$2 week increase in income or something in that area; whereas a person with a \$50,000 income would have a somewhat larger dollar benefit.

Under these circumstances, while the dollar differences might be somewhat the same, if you had the same dollar tax cut, you wouldn't have it. Therefore, the difference in spending would be quite marked. You see, I am trying to get at two things, frankly, and my time is limited, so I am going to have to cut short.

The first thing I am getting at is that I am wondering even if a big tax cut of \$6 or \$7 or even \$10 billion is going to give consumers the kind of money in their pocket that is going to result in their buying a house or car or buying anything of that kind. That is No. 1.

No. 2, which is somewhat unrelated but which is the whole point of what the chairman and Senator Douglas and Congressman Reuss and I have been arguing, if you do have a tax cut coupled with higher interest rates, is it not true you will have to have a much bigger tax cut to accomplish the same stimulation of the economy? Isn't it true that, whereas you might be able to achieve what you say you need to achieve on page 10 with a \$7 billion or \$8 billion tax cut, and the multiplier you have described, that if you have an increase in interest rates of the kind we have been reading about overwhelmingly in the news papers, and it seems to be in the cards on the basis of the Federal Reserve and Treasury policy, that you will need a 50-percent higher tax cut or maybe a 100-percent higher tax cut to achieve the same degree of stimulation?

Dr. HELLER. Let me answer the second question first, because I think we can dispose of that very quickly. It is perfectly true that if you

had a tax cut and then proceeded to shrink private spending by the same amount by monetary policy, you would simply nullify the tax cut.

Senator PROXMIRE. That is very important. If you have a tax cut and if you sell bonds to the public to absorb all of the increase in monetary supply or the increase in funds that results from a tax cut, you say you would eliminate much of the effect of the tax cut.

Dr. HELLER. I think it is somewhat more complicated than that. If you sell bonds to the public, you will be in part activating idle funds, so that this would not go all the way to offset the effects of the tax cut. The proposition I was stating was one in which the method of financing would increase interest rates so much as to cut back the amount of private spending by the full amount of the tax cut. Then you would nullify the tax cut. But this would be extremely hard to do and would require a highly restrictive monetary policy—one that actually reduced the money supply severely. Of course, it is true that for any given stimulus to the national product, the size of a tax cut would have to be greater the tighter the monetary policy. That is just arithmetic, and I am only too happy to underscore that arithmetical fact.

Going back to the first question, concerning the impact of a tax cut. If we look at this hypothetical set of figures that we put together for a \$6 billion cut in individual tax liabilities—

Senator PROXMIRE. May I just interrupt to put something in the record? I want to put in the record here, Chairman Martin's reply to Chairman Patman on this very question when Chairman Patman asked him what we ought to do to stimulate the economy with a large deficit. Martin said:

I will return to the simple statement I made earlier. In the event a decision is made which widens or further deepens the deficit we are already running, I want to put the Federal Reserve specifically on record this morning, if I have not already, that I think we must not finance the deficit by bank created funds. It should be financed by bona fide savings and not by writing up the funds on one or the other side of the bank's ledger. It would mean that the expansionary effect of the tax cut would be enormously reduced.

Is my observation roughly correct?

Dr. HELLER. As against other methods of financing that would activate bank funds and increase the money supply, there is not any question that this approach would be more restrictive, and would require a larger tax cut for any given result in employment and production.

I believe, as Congressman Curtis mentioned earlier, that this is an area that requires a great deal of additional attention, partly because we don't know all the facts and partly because there is much misunderstanding and misuse of such terms as "real" saving, bank and non-bank funds, activating idle funds, and so forth.

I would hope that our Council and this committee and others would continue to discuss this problem, because it is one of the critical areas of economic policy.

Chairman PATMAN. Will you yield for a brief observation?

Senator PROXMIRE. Yes.

Chairman PATMAN. You are emphasizing bringing out of hiding some idle funds. Don't you think that the amount of such funds would be so small and so insignificant that they would not be a significant factor in our analysis of the monetary problem?

Dr. HELLER. I am not in a very good position to judge that. I would hate to make a quantitative answer to something for which I don't have the underlying evidences before me.

Representative CURTIS. You said liquidity was low. That would indicate not so much idle funds, would it not?

Dr. HELLER. The extent of liquidity in the economy cannot be measured entirely in terms of the money supply, as conventionally defined.

Senator PROXMIRE. At any rate it would drive up interest rates, and in doing so, tend to reduce the accelerator principle?

Dr. HELLER. It would drive up interest rates. It would reduce the attractiveness of holding inventories and making plant and equipment investment.

Senator PROXMIRE. And the attractiveness of buying a house?

Dr. HELLER. Yes, sir; in the long term, there is no question about it. I would like now to come back for a moment to that earlier question about the stimulating effects of a tax cut, leaving aside monetary policy. The amounts that are involved in table I-3, if you have it in front of you, are really not inconsequential. Take, for example, plan B, which is a 3 percentage point reduction in tax rates.

Senator PROXMIRE. This is on an annual basis?

Dr. HELLER. These are on an annual basis. Either plan B or plan C which is the chamber of commerce proposal, or plan D, which is the \$200 increase in the per capita exemption—all involve some very appreciable tax savings. The fact that they might be distributed in small amounts from week to week doesn't mean they will not have a stimulative effect. They don't have to go into houses, TV sets, and so forth, to have an expansionary effect on the economy.

Finally, apropos of the distributional point, it is interesting that a one point across-the-board cut, as indicated in schedule B costs about \$2 billion of revenue.

Senator PROXMIRE. For \$5,000 income that would be a \$21-a-year tax cut and \$63 for a 3-point cut.

Dr. HELLER. That is right. For \$1.3 billion of each \$2 billion of the across-the-board cut would go to the first bracket. Most of the rest would go to the next few brackets. So that even if you had an across-the-board cut, the great bulk of the tax reduction would go to the first bracket—\$1.3 out of each \$2 billion—and the bulk of the remainder to the next few brackets above the first bracket. I think this is an important factor.

Senator PROXMIRE. Mr. Gallup has conducted some studies and there have been some other studies conducted. The Wall Street Journal had a survey, indicating that the people would not be inclined to spend the increased income received from the tax cut. While the propensity to spend is 92 to 94 percent of income, I wonder if there were not a psychologically adverse effect particularly if there was as much opposition as there is now to the tax cut. People might say this is a forerunner of trouble.

Dr. HELLER. This gets one again into the psychological realm as you suggest.

Past history does not support the results of Mr. Gallup's survey. I think Mr. Katona would have told you this morning that what people say they are going to do with an increase in income, particularly when they are full of good intentions about saving, is not very closely

related to what they actually do with their increase in income when they get it. They are much more likely to spend it than they intended.

Senator PROXMIRE. He indicated that, but certainly the record of past tax cuts is not very reassuring. The tax cut we had in 1926 was followed by a recession. In 1929 we know what happened after the tax cut. That was a major tax cut. We had the worst depression in history. The tax cut in 1948 was followed by a recession. It is true in 1954 and some other tax cuts were followed by an improvement in business conditions. There certainly is not anything automatic in the tax cut itself which can assure us that we will have an expansion in business as a result of the tax cut.

I would say that on the basis of having had 9 years out of the past 40 in which we have had tax cuts and in 3 of those years we had a drop in business conditions and in some of those other years the effects were at best mixed, that is, business was improving anyway, I can't see that we have very good empirical evidence that a tax cut is going to be our solution.

Dr. HELLER. I think we have very good empirical evidence that additions to income result in higher spending and higher investment.

Senator PROXMIRE. Those tax cuts were additions to income.

Dr. HELLER. It doesn't matter whether it comes from a tax reduction or other sources.

Senator PROXMIRE. Do we have any study that indicates what happens when you cut taxes and increase interest rates which seems to be the plan? I know it is not your plan.

Dr. HELLER. If that is the plan, I am not privy to it.

I don't think we have any direct evidence on this point, although it would be interesting to check the 1954 experience when there was a very good economic expansion and a very quick restoration of Federal revenues after a \$7½ billion tax cut. This occurred in a period when monetary ease ruled for quite some time, before tightening occurred in the later phases of expansion.

Senator PROXMIRE. Certainly in 1954, wouldn't you agree, that the impact of the Korean war, although as in all our wars, with a great increase in Government expenditure, with the increase in the size of the Armed Forces, all that kind of thing, pent-up wartime demand of various kinds had a more serious impact perhaps than the tax reductions did?

Furthermore, there was a particular business investment gimmick there, a change in depreciation policies, that resulted in a great deal of the expansion being concentrated in investment by business plant and equipment.

Dr. HELLER. In the early part of that recovery investment was not so much the initiating force. The investment surge developed later, particularly in the 1955-57 period. There was about \$3 billion of individual income tax reduction at the beginning of 1954 and another \$1 billion reduction of excise taxes, and then the \$1.4 billion reductions from the overhaul of the income tax. The efforts of the latter were concentrated mainly on business, and perhaps primarily affected business investment. But overall the larger part of it, or at least half of it, was devoted to a reduction of income and excise taxes on consumers.

Senator PROXMIRE. My time is up, Mr. Chairman.

Chairman PATMAN. We have had you gentlemen here about 3½ hours. That is quite a long time. I wonder if you would not be willing to answer any questions we might submit to you, Dr. Heller, if we get them to you in writing before you correct your transcript? Would you be willing to answer them in connection with the examination and correction of your transcript?

Dr. HELLER. We would be happy to do our best on that score, Mr. Chairman.

Chairman PATMAN. You may submit anything that you think is germane or material.

Chairman PATMAN. Before closing, I think Congressman Curtis has a question.

Representative CURTIS. I have one question. I will have some others. On the questioning of Senator Proxmire on the 1954 cut, I think we are leaving out some factors. There was a \$10 billion and more cut in Federal expenditures.

Dr. HELLER. Which preceded the tax reduction.

Representative CURTIS. Yes, but it occurred right at the time. That was the basis on which we felt we could cut back in Federal revenue because it was not deficit financing that we were engaged in at the time. I was on the committee in writing it. We had the dividend credit there which took a great deal of the release of money and that was certainly in the investment area.

In the consumer area, as far as the income tax cutting was concerned, which was increasing the exemption from \$500 to \$600, we at the same time increased the social security tax, as I was pointing out this morning, which took about a million out of the economy.

Dr. HELLER. Yes, that is a point.

Representative CURTIS. And almost equalized in the consumer area. I think if we examined into it, the only way that would have affected the consumer would have been below the billion dollar figure.

Chairman PATMAN. Thank you, gentlemen, very much. We will submit the questions to you.

Thursday morning we have Mr. Otto Eckstein, professor of economics, Harvard University; Mr. McCracken of the University of Michigan; Mr. Pechman of the Brookings Institution.

Without objection, the committee will stand in recess until 10 o'clock here in this room, tomorrow morning.

(Whereupon, at 5:35 p.m., the committee recessed, to reconvene at 10 a.m., Thursday, August 9, 1962.)

STATE OF THE ECONOMY AND POLICIES FOR FULL EMPLOYMENT

THURSDAY, AUGUST 9, 1962

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

The committee met at 10 a.m., pursuant to recess, in room AE-1, the Capitol, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, and Thomas B. Curtis; Senators Douglas, Proxmire, Bush, and Javits.

Also present: William Summers Johnson, executive director; John R. Stark, clerk; Hamilton D. Gewehr, research assistant.

Chairman PATMAN. The committee will come to order.

The committee continues hearings on the state of the economy and on improvements in policies to help achieve maximum employment, production and purchasing power.

This morning we will consider fiscal policies in general and tax policies in particular.

We have a very distinguished panel of experts on this subject, all of whom are old friends of the committee. Prof. Otto Eckstein, Harvard University; Prof. Paul W. McCracken, University of Michigan; Dr. Joseph Pechman, director of economic studies, of the Brookings Institution. It is delightful to have you, gentlemen.

Each of the panelists may make an opening statement if he has one, and then members of the committee will put questions to the panel under the 10-minute rule.

Dr. Otto Eckstein, you may proceed in your own way. You have a prepared statement, I believe.

STATEMENT OF OTTO ECKSTEIN, PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY

MR. ECKSTEIN. Thank you, Mr. Chairman. It is a pleasure to be back with the committee.

If the reports of usually well-informed reporters are correct, the prospect of a tax cut this year is fading. As has occurred repeatedly through the postwar period, the President and the Congress seem to lean to the view that a tax cut is either not necessary, or that the decision can wait a few more months, until short-term economic indicators cease to be mixed.

The decision has now waited for over 4 years. In the meantime, we have progressively lowered our sights about the performance of our economy, satisfying ourselves with higher rates of unemployment, talking bravely about growth, but, in fact, accepting a rate of expan-

sion which is clearly below the normal rate which the ordinary increase in the labor force and in the stock of capital would produce.

I believe I can best serve this committee and the formation of economic policy by talking about three things today. First, I shall report on some statistical analyses conducted in collaboration with Professor Duesenberry of my department and Professor Lintner of the Harvard Graduate School of Business Administration, about the general economic outlook and the effects of tax cuts.

Second, I shall analyze some of the reasons for our hesitancy to act, and finally I shall give a few preliminary ideas which may be of relevance early in 1963 when we shall face the tax-cut problem again.

PROJECTIONS

Two projections were prepared, not as forecasts but to provide a realistic setting for the evaluation of a tax cut. We projected movements of the gross national product to the middle of 1963 on two assumptions. One, an optimistic set, under which business spends as much for investment in plant and equipment as it said it would spend before the stock market declined; residential construction continues to rise substantially to a rate of \$25 billion a year and then remains at that level; net exports remain high; the increase in the outlays of State and local governments continues at the upper end of the rates of increase of recent years; and the Federal Government spends as much on goods and services as it announced in the recent budget.

If all of these optimistic assumptions come true, an unlikely combination of events, gross national product might reach a level of \$580 billion by the second quarter of 1963.

We also prepared a set of projections making restrained pessimistic assumptions. In this set we assume that fixed investment by business would begin to decline slightly after the middle of this year, and continue to decline at a moderate rate to the middle of 1963; residential construction maintains current levels; net exports fall slightly; State and local governments increase outlays at a high rate but not quite as high as under the optimistic set, and the Federal Government again sticks pretty closely to its announced plans.

This set of projections gives a gross national product of about \$547 billion by the middle of 1963, which is slightly below the current level.

To gain some perspective on these figures, it is useful to estimate that rates of unemployment that are likely to be associated with them. Even the optimistic projection produces no significant improvement in the unemployment rate below its current high level. Under the projection of restrained pessimism, unemployment rises above 7 percent by the middle of 1963.

To see what difference a tax cut would make, we assumed that personal taxes would be cut \$4 billion and business taxes on the order of \$2 billion or so, enough to raise business investment by \$1 billion. By comparing the resultant GNP figures with the above projections, the net impact of a tax cut was estimated.

We find that this \$6 billion tax cut leads to an increase in GNP by the middle of 1963 of about \$12 billion. If the tax cut is added to the optimistic projections, GNP might reach \$592 billion. When added

to the pessimistic projects, it results in a GNP of about \$560 billion. Thus, what we call the multiplier of the tax cut is about 2.

It may also be of interest that of the \$6 billion initial tax cut, something like a third to a half would be recovered through the higher tax yields of improved economic activity. Let me add that we did not suggest that a \$6 billion tax cut was the right amount. Larger tax cuts would have larger effects, of course, but we see no immediate reason to expect the resultant impact on the economy to be greater in a more than a proportionate manner. Thus, a \$10 billion tax cut might improve GNP by about \$20 billion, a \$4 billion tax cut by \$8 billion.

What do tax cuts do to unemployment? The \$6 billion tax cut would lower the rate of unemployment by about 0.6 percent, or 400,000 persons. The improvement in employment would be greater as the labor force returns closer to its normal rate of expansion.

The single most interesting fact about these figures is this: even if the optimistic assumptions come true, that is, if the present supposedly "mixed bag of signals" resolves itself on the side of optimism, a tax cut would still be appropriate, since there is virtually no prospect of a real improvement in the unemployment situation.

If the tax cut were enacted, even under these circumstances, the resultant rate of unemployment would still be above 4.5 percent, and therefore short of full employment. Thus, a tax cut would not be a mistake even if the optimists were correct and things turned out just as well as one could reasonably hope for. The risks of policy, therefore, are not being run with regard to inflation, but recession and depression. For if things really go sour after this lengthy period of under-utilization of capacity and high unemployment and after the large decline in the stock market, no one can foresee just how the decline will occur and when and where it will stop. The prudent action, therefore, is a tax cut.

REASONS FOR INACTION

The diagnosis I have just presented is now held very widely both by economists and by business and labor leaders. It would take someone with a lot more understanding of the political process than I possess to explain the present dim outlook for action in the face of this agreement. Let me discuss a few of the more economic points, however.

First, we are much too preoccupied with the ups and downs of recessions and expansions, and have lost sight of the longer-term trend of the economy in the process. It is indeed a fascinating sport to collect the straws in the wind every week about the immediate direction of movement of the economy.

In fact, however, the business cycle per se has become extremely mild. Inventory movements, as the recent studies prepared for this committee showed, are a large part of the quick ups and downs of recession. As the economy has become more slack and supplies abundant, business has gotten more and more cautious in its inventory policies. The inventory movement of the 1960-61 recession was substantially smaller than in the 1958 recession. Inventory buying during the present expansion was even more hand-to-mouth. Policies for fixed investment have also become more cautious and based on low assumptions of economic growth. These factors make recessions mild,

though one must mention on the other side that the stock market crash is a new factor which may worsen the process of decline when it next occurs.

This mildness of recession militates against the use of fiscal policy. Decisions to pursue an expansionary fiscal policy have only come long after the signs of recession were clear, that is, when the inventory decumulation was fully underway and most statistics were declining sharply. A mild recession, even starting from a low point, does not produce unambiguous short-run indicators. Only a sharp recession does that.

What is important about the present situation is not the direction of movement in any particular week, but the long-term output in relation to the capacity of the economy. Our concern about the direction of movement has distracted us from the longer term deterioration of continued high unemployment and slow growth of the labor force, of low utilization of capital and squeezed profit margins, and of diminishing job opportunities in the face of a rapidly increasing number of young people entering the working age brackets.

If we devoted as much attention to the measurement of the actual trends of the economy as compared to the potential trends as we do to the identification of business-cycle turning points, our fiscal policy might be different.

Let me add I just received in the mail this committee's study of measurement of productive capacity, and I hope this marks a turning point in our focus of attention.

BUDGET BALANCING

Fear of deficits and the desire for an annually balanced budget is another major factor. This is not the place to rehearse all the pros and cons of the balanced budget, but let me point out two salient facts: first, if we really attempted to achieve an annually balanced budget in a deteriorating economic situation, it would plunge the country into depression. Attempts to balance the budget by raising tax rates and cutting expenditures in the thirties were important contributory causes to the magnitude of that disaster.

Second, the only valid reason for favoring an annually balanced budget is the pressure which this principle puts on the President and the Congress to resist the many pressure groups that always want the Government to spend more money. That argument is clearly irrelevant in the present context.

If there is objection to a high volume of spending, a tax cut is much more likely to place a check on expenditures growth than stumbling into recession. A reduction in tax rates will force the Government to scrutinize expenditures more closely in the coming budget, while a recession, if recent history is any guide, will lead to a series of hasty new expenditure programs.

LINKING THE TAX CUT TO AN IMMEDIATE EXPENDITURE CUT

Recently, the idea has been advanced that a tax cut should not be enacted unless expenditures are cut at the same time. As a point of political strategy, of using this opportunity to insist on expenditure reduction, it is not a point for me to judge. But when the same

point is offered by economists as policy advice, it must be judged on economic grounds. I do not doubt for a moment that the United States would be better off if certain lines of Government expenditures were substantially cut. I am also certain that my list would not be somebody else's list. We all have our own preferences about Government expenditures. But I fail to see any logical connection between the desirability of a tax cut which would permit business and consumer demand in the economy to grow in line with potential supply, and the necessity of reduction of Government expenditure programs as a precondition.

I cannot see why a sound tax policy has to await reform of the agriculture program, of veterans' benefits, of urban renewal, of welfare programs, of subsidiaries of business, of defense, or space, or foreign aid, or whatever programs are in the minds of the economists advocating this view. As a matter of general economic policy, the argument is clearly upside down. If expenditures were really cut—even foolish expenditures—this would be a reduction in purchasing power which would have to be offset by further tax cuts. The deficit that would be associated with a policy of joint expenditure and tax reduction would have to be larger than a deficit from a tax cut alone to achieve any given degree of improvement in output and employment.

RELATION TO MONETARY POLICY

Concern has also been expressed that the additional deficit which would result from a tax cut would force up interest rates, which might defeat the purpose of the tax cut. No doubt, a few more billions of deficit that have to be financed by borrowing will add to the demand for funds, and other things being equal, would have some impact on interest rates.

However, I do not believe that this increase in the deficit would in fact be decisive about the trends of interest rates in the coming months. I would not judge the situation heavily on the experience of 1958 and 1959 when a record cash deficit was financed while the money supply shrank, and when interest rates did, of course, reach record levels.

This time, the deficit presumably would be smaller and the money supply would be allowed to increase at some modest rate. Of course, the authorities will have to pass a judgment on the appropriate monetary policy in the coming year and on the methods of financing the deficit. But it is my belief that these decisions will be less influenced by the increment in the deficit that can be attributed to the tax cut than by our international monetary position weighed against the volume of unemployment.

TAX POLICY IN 1963

Let us begin to look ahead to the next moment of decision early in 1963, when, presumably, some tax cut will be made in connection with tax reform. It is now much too early to reach definitive conclusions about proper policy at that date; however, a few simple ideas might prove useful. First, the tax changes at that time must deal both with long-run and with short-run problems.

On the one hand, if economic growth really is a serious objective of policy, the tax system should be further changed in a manner designed to raise the fraction of our gross national product which is invested. On the other hand, consumer purchasing power must also be stimulated. In practical terms, this means that the tax cut must somehow be divided between reduction of upper bracket rates of personal and of business taxes and reduction in the lower bracket personal taxes.

We have already had a liberalization of depreciation allowances which will save business about \$2 billion a year. The investment credit which may be enacted in this session would add at least another billion-plus to business tax relief.

Thus, these two measures alone would reduce corporation income tax payments by \$3 to \$4 billion, thereby increasing the supply of investible funds. If further substantial relief is given in business taxation, while at the same time lack of growth of consumer purchasing power keeps the demand for final products relatively low, there is little chance that the additional savings being made available will in fact be invested.

Thus, a tax cut which only adds to savings may very well do more harm than good in dealing with the central economic problem of our day, which is the short fall of demand below potential supply. On the other side, increased international competition and the need for high long-term growth to meet our obligations requires us to take some additional steps toward raising the fraction of GNP which is invested.

The Congress would be well advised to take with a large grain of salt any advice which would confine the emphasis of a tax cut either to business investment alone or just to consumption. Obviously some balance is the right answer, and what that balance is will depend on the circumstances at that time. The higher the rate of unemployment, the more weight will have to be given to the short-run stimulation of demand, which is best accomplished by stimulating consumption.

Let me add at this point, that in the event that an extensive tax reform bill is going to be tied to a tax cut, it might be wise for the Treasury to get an immediate effect out of such a policy by reducing the withholding tax schedule effective January 1.

As I understand it, they have some administrative discretion about the amount of withholding which they insist on from the first of the year. If, in fact, it is going to be a tax bill which is debated well into the fall, if it is to have any economic impact as far as the short-run problem is concerned, it would be too late. I believe they have discretion to reduce withholding earlier, presumably on the assumption that the final tax bill would contain a tax rate cut.

In conclusion, the history of tax policy reveals one lesson very clearly: most of the time there are reasons for not engaging in a positive tax policy, or for at least deferring the decision over and over again. Our tax system is choking off the growth of the economy. The longer we delay its regearing, the more it costs us in terms of lost output, lost wages and profits, a permanently shrunk workweek, a resistance to technological change, permanently lost capital formation and just plain human suffering.

Chairman PATMAN. Thank you very much, sir.

Our next witness will be Professor McCracken, of the University of Michigan. Professor, we are glad to have you.

**STATEMENT OF PAUL W. McCracken, Professor of Economics,
UNIVERSITY OF MICHIGAN**

Mr. McCracken. Thank you, Mr. Chairman.

First I want to say I very greatly appreciate this opportunity to appear before the committee as it considers the implications of current business conditions for fiscal policy.

I do have a prepared statement, but I am going to read excerpts only since the full statement is somewhat long.

Chairman PATMAN. You may proceed as you desire.

Representative REUSS. Mr. Chairman, I wonder if Dr. McCracken would be good enough from time to time to tell us about what page of his prepared statement he is reading from.

Mr. McCracken. Yes, I shall.

Clearly the first question to pose is this: Does the evidence indicate that the economic situation presently needs to be strengthened in a fundamental way? Obviously there are reassuring aspects in the evidence that we have at hand. And certainly we would all agree that we need to avoid being "nervous Nellies," irrationally rushing into major policy changes each time we get a little bad news or have a little bad luck.

On the other hand, three considerations suggest to me that the economy does need strengthening in a very fundamental way.

First, there is the fact that the economy has for some years been operating somewhat below par. This has been widely recognized and discussed and needs no further elaboration here. The work of this committee has done a great deal, I think, to provide the statistical underpinning for documenting this problem.

Second, the current cyclical expansion, beginning after February 1961, has turned out to be the weakest since the First World War. The facts can be usefully summarized something like this.

The data in table I of my prepared statement show the gains in eight measures of business activity during the first 16 months of each cyclical expansion since World War I. If data were fully available for the entire period, it would be possible to make 64 comparisons of the current cyclical expansion with these others. For each of eight measures of business activity, post-1961 gains could be compared with that during the eight other cyclical expansions. Since, for the earlier period, some data are not available, only 55 such comparisons can actually be made.

It is interesting to note that in 48 of the 55 the comparison is unfavorable to the economic performance since early last year; in 6 there is a favorable comparison; and in one case it turns out to be a tie. There can hardly be any question, therefore, that this is a candidate for the weakest recovery since World War I.

Third, we are beginning to wonder if the present expansion will turn out to be not only the weakest but also one of the shortest in the postwar period. We must, of course, beware of attaching excessive importance to very current data. On the other hand, some facts are undeniably disturbing.

The gain in business activity during June, the last month at the moment for which a full statistical picture is available, was roughly one-third the average monthly gain since the present expansion got underway. There is also some evidence in the data on table II of a slowing down in the rate of the expansion throughout the second quarter. (P. 5 of my statement.)

Finally, leading indicators generally have not been looking strong for some time. New orders for durable goods have been declining since the first of the year, and the June fall was particularly sharp. The length of the workweek moved downward in May and June. In fact, the most recent data available for the 30 leading indicators in Business Cycle Developments show 18 declining and 12 rising. Leading indicators can be affected by capricious developments, and in any case the length of the leads is often quite variable. It would be difficult, however, to give the present pattern a very optimistic interpretation.

If this review of the current economic situation is realistic, we clearly face more than the problem of an off 1 or 2 months in the inevitably irregular pattern of cyclical expansion. It is more accurate to say that we confront an uncertain short-run business outlook following upon a particularly weak cyclical expansion, all of this superimposed upon an economic performance that has been subpar for some years.

What is our problem? There are, broadly speaking, two possibilities. People are either disinclined to spend their purchasing power, or there is a shortage of purchasing power. In one respect there may be a lessened inclination to spend. Consumer attitudes have never regained the levels of buoyancy reached in 1955, and there has been some deterioration since the events of April and May. And the evidence is clear that changes in consumer attitudes do influence the level of spending.

There is also some concern about the possibility that wants have been saturated. There are persuasive reasons for believing that this problem of saturation of wants is not the core of the present situation, and on page 7 of my testimony I have a couple of paragraphs summarizing the rather substantial body of evidence on this that comes from the work of the Survey Research Center at the University of Michigan.

Continuing at the top of page 8—the evidence suggests to me that the problem is a shortage of purchasing power. Since the low quarter of 1961, private incomes after taxes (disposable income plus corporate profits after taxes), have increased \$32.7 billion, but private demand for output has increased \$35.9 billion. Thus private demand has increased \$1.21 for each dollar. This is less than the \$1.32 in the corresponding period after 1958 or the \$1.54 after 1954. But it is still true, in the five quarters following the low point last year, that private demand for goods and services increased more rapidly than income after taxes.

It is, I think, increasingly clear that the economic policies of Government have been making a substantial contribution to the economy's shortage of purchasing power in recent years. At times the monetary authorities clearly have stepped too hard on the brake pedal—for example, in 1957 and again in 1959. It is equally clear to me that

monetary policy has not impeded economic expansion for roughly 2½ years. The reserve position of banks has been easy—and this continues to be true in spite of the slightly recent tightening. Commercial banks are eager to expand their loans, in contrast to the loaned-up banking sentiment in 1957 and 1959. Bank credit has increased 8½ percent during the last year. Reflecting this, interest rates, contrary to the expectation of many experienced market observers earlier this year, have remained relatively low. Bond yields are only slightly above those of the low point of the recession early last year. Whatever quarrels we may have with the Federal Reserve about the details, the evidence does not seem to me to support the view that monetary policy has had very much to do with the current sluggishness of the economy. Nor does the recent slightly less easy credit policy yet constitute much threat to further expansion.

The principal drag has come from the tax side of Government fiscal operations. For years we have pointed with gratification to the stabilizing effect of our tax structure as a major defense against a recession. (Top of p. 10.)

Chairman PATMAN. I assume you will put your whole statement in the record?

Mr. McCracken. I would like to.

Chairman PATMAN. That will be done.

Senator PROXMIRE. I hesitate to interrupt, but I would appreciate it if Dr. McCracken would define "money supply" for us.

Mr. McCracken. Yes, sir, that is a good point, Senator. My definition of the money supply here would include time deposits. I suspect that is the point of your question.

I continue at the top of page 10. That total cash receipts of government (Federal, State and local) have absorbed a large and growing proportion of the national income is well enough known, though the quantitative magnitudes are not always fully appreciated. The ratio of Government cash receipts (on a national income basis) to national income rose from 26.6 percent in 1948 to 33.9 percent in 1960, and it is probably about 34½ percent right now. Now let us look more closely at the last year and one-half to see how this works out cyclically.

Chairman PATMAN. I would like to have one clarification here. You say "ratio of Government cash receipts." You mean all governments, Federal, State and local political subdivisions?

Mr. McCracken. That is correct. And on a national income basis.

Let us now look more closely at the last year and one-half to see how this works out cyclically. From the low first quarter of 1961 to the second quarter of 1962 private incomes before taxes (personal income plus corporate profits) increased \$45 billion. Government receipts, however, absorbed almost 44 percent.

Now the sluggishness of the present recovery and the one in 1958 to 1960 begins to look a little less mysterious. The tax structure, by absorbing 40 to 45 percent of the rise in private incomes, left a gain in incomes after taxes so moderate that, with no special elements of strength present, we could not get an expansion in private demand vigorous enough to carry the economy back to reasonably full employment.

Now if the neutral position of the budget, where revenues and outlays are equal, is at full employment, we should theoretically find it

possible to avoid persistent unemployment, though a tax structure absorbing such large and growing proportions of income increases would still have adverse implications for economic growth. If, however, this neutral budgetary position is at a level of business activity considerably below what would constitute reasonably full employment, we have also a short-run problem.

The fiscal drag would make full employment difficult to attain, which would cause a short fall in revenue, which would make the budget look bad, which might make us disinclined to take needed tax action, and so forth. This, I think, is not an unfair characterization of the present situation.

In the January report the Council of Economic Advisers estimated that at reasonably full employment, the present tax structure would produce a Federal surplus of perhaps \$8 billion this year (on a national income basis), with this full employment surplus approaching something like \$10 billion by the first half of calendar 1963. In short, the budget now moves from a neutral to a restrictive position substantially before the economy reaches reasonably full employment, and with Government receipts siphoning off 40 percent of the addition to income, it has been very difficult to get the needed thrust of increased private demand.

If this diagnosis is correct, what does it suggest for fiscal policy? It means three things. First, the tax structure should be lowered so that the budget does not begin to exert a brake on the economy quite so far below reasonably full employment.

Second, the tax structure now absorbs too large a proportion of increases in the national income.

Third, we must slow down the tendency for Federal Government receipts to absorb a growing proportion of the national income.

Most of my time has been consumed in an endeavor to establish the case that the fiscal operations of Government are an important source of our present economic problem, and vigorous fiscal action must play a major role in this problem. This leaves little time to spell out the specifics. This is not, I think, particularly fatal, because it seems to me there is a rather surprising consensus on what the tax actions ought to be if they can be undertaken.

First of all, budgetary procedures should be modified so that we give more explicit attention to this question: How rapidly should Federal expenditures grow in the years ahead? The excellent work on expenditures at both ends of Pennsylvania Avenue does an effective, and I think unappreciated, job of sifting out waste and unessentiality in the technical sense. It is less well designed to tell us whether these individually well-considered programs add up to more than ought to be spent in the aggregate.

The ratio of Federal budget cash outlays to GNP in fiscal year 1962 was 2.1 percentage points above that of fiscal 1960. Thus, if the rate of increase of Federal cash outlays had been limited to the rate of increase of GNP, Federal outlays last year would have been \$12 billion less. This growth has reduced the scope of otherwise desirable incentive-promoting tax reductions.

It is not unreasonable to expect from the administration an explicit declaration of its longer range policy with respect to total outlays. And the Congress should reexamine its own procedures to see if more

explicit attention can be given to the total on the expenditure side of each year's budget.

Second, the economic situation would benefit from tax actions now that would reduce the level of the structure and move it in the direction of a better system. As I mentioned, fortunately, there is a rather surprisingly narrow range of disagreement on what the elements of such a package might be—some reduction in the corporate income tax and some reduction in the personal income tax. The total package should be such that the resulting tax structure would still produce enough revenues comfortably to cover expenditures at reasonably full employment. On this basis, something like \$7 billion would probably be the outside limit of any tax reduction at this time. The action should not be quickie or temporary in character. We should capitalize on the substantial current consensus in order to move toward a better basic pattern of Federal taxes.

Third, I would, myself, support the proposal that the President be given limited power to alter certain tax rates. This could be hedged with adequate safeguards, limited as to amount and perhaps requiring that the President transmit to the Congress a full report setting forth reasons for his actions. Without this authority, each recession produces inexorable pressures to do something on the expenditure side which, history suggests, will be moving expenditures to a substantially higher level.

This proposal, in other words, would be a step toward fiscal conservatism. In the long run it would make for a less rapid increase for expenditures and more elbow room on the tax side for further needed reform.

One further question. Would tax reduction and reform now be apt to worsen further the already somewhat nervous position of the dollar internationally? This is possible. If the resulting expansion sets in motion an accelerated rise in our cost-price level, and if we insist that the monetary authorities adhere to unrealistically low interest rates, and if needed improvements in profits were seemingly interpreted as evidence of malevolence, the dollar could quickly be in real trouble. And it must be stated flatly that such trouble would then be deserved. If, however, we manage our affairs carefully, there is good reason to think that the international position of the dollar would not be worsened by tax reform and reduction now, and it might well be strengthened. The resulting higher level of national income would, of course, tend to increase imports and that would enlarge the deficit in our international balance of payments.

There are, however, forces that would work the other way. The more active demand for funds would produce higher interest rates in the U.S. money and capital markets. The invigorated pace of economic activity would enlarge the opportunities for more profitable investment of capital in the domestic economy, reducing the incentives to seek investment outlets abroad. The innovational activity that accompanies a more lively pace of economic expansion should, in time, have some favorable effects on U.S. exports. Since in the U.S. economy imports are relatively small and the international capital outflow is relatively large, there is at least an even chance that policies proposed here would help to narrow the deficit in our balance of payments.

Now, there does, of course, remain the potentially adverse effect on psychology and confidence in the dollar both here and abroad. My own view would be that if the tangible, concrete, objective factors can be expected to be at least neutral and possibly helpful, then we ought to be able to manage that.

In conclusion, the becalmed state of the economy at present—coming on the heels of a particularly weak cyclical expansion superimposed on a protracted period of less than reasonably full employment—strongly suggests to me that the economy needs strengthening in a fundamental way, and it also suggests that within reasonable limits this can be done without courting the risk of a disorderly expansion.

The basic problem is the shortage of income and purchasing power, but this deficiency must be remedied in ways that do not increase costs per unit of output and do not produce monetary conditions which would further weaken the dollar. This calls for tax adjustments that lower and otherwise improve the structure. The magnitude of the reduction should still leave us with a tax structure whose revenues would cover expenditures when productive resources are being utilized reasonably fully. Such actions need not weaken the dollar internationally, and there is an even chance they might strengthen it.

In fact, we are fortunate that what is needed to step up the pace of job creation and economic expansion at home could also add strength to the dollar internationally; namely, a more innovative and prosperous and profitable economy.

Chairman PATMAN. Thank you.

(The full statement is as follows:)

TESTIMONY OF PAUL W. MCCracken, PROFESSOR OF BUSINESS CONDITIONS, SCHOOL OF BUSINESS ADMINISTRATION, UNIVERSITY OF MICHIGAN

I

Mr. Chairman, I greatly appreciate the opportunity to appear before this committee to consider the implications of current business conditions for economic policy. Clearly the first question to pose is this: Does the evidence indicate that the economic situation needs to be strengthened in a fundamental way? The situation is not, of course, without its hopeful aspects. Even if this cyclical expansion were to be a bit on the short side, business cycle history suggests that economic conditions should continue to improve for several months yet. By the end of this year the present expansion would still be of only 22 months' duration. Only one upswing since World War I (November 1927, to August 1929) was shorter than this. Moreover, we know that the course of any upswing is irregular, with flat months and air pockets occasionally developing. The fact is that in recent months the economy has been bombarded with an unusual run of bad luck—such as the steel price donnybrook, the stock market break, and recurring nervousness about the international position of the dollar. Good economic policy clearly requires that we not be "nervous Nellies," rashly proposing major changes each time a cluster of bad news or bad luck comes along.

Three considerations suggest that the economy does need strengthening in a fundamental way. First, there is the fact that the economy has for some years been operating somewhat below par. This has been widely recognized and discussed. In his study for this committee (published in 1960) Mr. Knowles estimated for each year from 1909 to date the output that would have represented reasonably full utilization of the Nation's productive resources. In 9 of the 15 years from 1947 to 1961, output was below par (including all years since 1957). By contrast in the 17 years from 1909 to 1929 (excluding the years 1917–20) the

record was notably better. "Full employment" years in those two decades outnumbered those when output was subpar by about 2 to 1.

Interpretations of this experience will differ, but one conclusion is clear. The economy for several years has had an evident lack of bounce and steam. Our current problem is more than just one of those normal momentary air pockets in a cyclical expansion.

Second, the current cyclical expansion (beginning after February 1961) has turned out to be the weakest since the First World War. During the 16 months from February 1961 to June 1962, nonagricultural employment gained 3.6 percent. The average employment gain in the first 16 months of the eight other cyclical expansions since World War I was 11.3 percent, and even following the hardly discernible recession of 1927 employment increased 7.6 percent. The improvement in industrial production this time has been less than in any of the other cyclical expansions since the First World War. The same is true for gross national product. The gain in retail sales has been slightly greater than that following July 1921, and November 1927, but it falls considerably short of those after the other six recessions. The facts can usefully be summarized something like this. The data in table I show the gains in eight measures of business activity during the first 16 months of each cyclical expansion since World War I. If data were fully available it would be possible to make 64 comparisons of the current cyclical expansion with others—for each of eight measures of business activity comparing the post-1961 gain with that during the eight other cyclical expansions. Since for earlier periods some data are not available, only 55 such comparisons can be made. In 48 of these 55 the comparison is unfavorable to the performance since early last year, in 6 there is a favorable comparison, and in one case it is a tie.

That the current cyclical expansion has been a particularly weak and sluggish one is quite evident from these facts. It is the Nation's poorest performance in four decades, and probably one of the poorest in our history. It is, of course, true that expansions after very mild recessions (such as the one in 1960-61) tend to be on the mild side, but the current expansion is weak even relative to that following the 1927 recession.

Third, we are beginning to wonder if the present expansion will turn out to be not only the weakest but also one of the shortest in the postwar period. We must beware of attaching excessive importance to very current data. On the other hand, certain facts are undeniably disturbing. The gain in business activity during June (the last month at the moment for which data are fully available) was about one-third the average monthly gain since the present expansion got underway. There is also some evidence in the data in table II of a slowing down in the expansion throughout the second quarter. Moreover, it is clear that business sentiment has been adversely affected by events in recent months. The stock market break has had a substantial effect on the thinking of both business people and consumers.

Many businessmen were alarmed by the inferences they drew from the administration's handling of the steel price dispute, even though they did not support the actions of the steel industry. It would be reasonable to expect that an already anemic expansion would at least not be helped by the adverse cumulative effect of these more or less fortuitous developments.

Finally, leading indicators generally have not been looking strong for some time. New orders for durable goods have been declining since January, and the June fall was fairly sharp. The length of the workweek moved downward in May and again in June. In fact, the most recent data available for the 30 leading indicators in Business Cycle Developments show 18 of them declining and 12 rising. Leading indicators are, of course, difficult to interpret. They can be affected by capricious developments, and in any case the length of the leads is quite variable. It would be difficult, however, to give their present pattern a very optimistic interpretation.

If this review of the current economic situation is realistic, we clearly face more than the problem of an off 1 or 2 months in the inevitably somewhat irregular path of a cyclical expansion. It is more accurate to say that we confront an uncertain short-run business outlook following upon a particularly weak cyclical expansion—all of this superimposed upon an economic performance that has been subpar for some years.

TABLE I.—Percentage increase in 8 measures of business activity during the 1st 16 months of cyclical expansions since World War I

Indicator	After recession ending—								
	July 1921	July 1924	November 1927	March 1933	June 1938	October 1949	August 1954	April 1958	February 1961
Number of employees in nonagricultural establishments.....	+21.6	+11.4	+7.6	+18.2	+9.4	+11.0	+6.1	+4.8	+3.6
Unemployment rate, total (inverted).....	(1)	(1)	(1)	+35.0	+29.2	+123.7	+43.0	+38.7	+26.6
Index of industrial production.....	+50.0	+27.5	+18.4	+34.5	+47.7	+30.7	+17.2	+18.9	+15.4
Gross national product in current dollars (Q) ²	(1)	+16.2	+11.8	+23.5	+12.0	+23.7	+13.0	+10.4	+10.2
Gross national product in 1954 dollars (Q) ²	(1)	(1)	(1)	(1)	(1)	+13.2	+9.8	+9.8	+7.7
Bank debts outside New York City, 343 centers.....	+11.3	+19.3	+13.0	+22.5	+13.7	+29.7	+16.2	+16.0	+16.0
Personal income.....	+21.0	+12.6	+10.2	+26.5	+10.8	+21.1	+11.5	+8.5	+9.0
Sales of retail stores.....	+4.5	+6.9	+6.4	+20.0	+18.9	+22.1	+11.3	+10.6	+6.5

¹ Not available.² 5 quarters.³ 4 quarters.

Source: Business Cycle Developments. July 1962, p. 57.

TABLE II.—Monthly changes in selected measures of business activity (seasonally adjusted)

1962	Nonagricultural employment	Industrial production	Personal income	Retail sales
(1)	(2)	(3)	(4)	(5)
January.....	-58	-1.3	-\$1.7	+\$9
February.....	+339	+1.3	+3.2	+129
March.....	+128	+9	+2.6	+302
April.....	+359	+1.1	+2.4	+338
May.....	+11	+7	+1.4	-117
June.....	+43	+3	+7	-431
February 1961-June 1962 average.....	+121	+1.0	+2.3	+80

Source: Col. 2, BLS estimates of nonagricultural workers on payrolls (in thousands); col. 3, percentage points for the FRB index of industrial production; col. 4, Department of Commerce (in billions); col. 5, Department of Commerce (in millions).

II

What is our problem? There are, broadly speaking, two possibilities. People are either disinclined to spend their purchasing power, or there is a shortage of purchasing power. In one respect there may be a lessened inclination to spend. Consumer attitudes have never regained the levels of buoyancy that were reached in 1955, and there has been some deterioration since events of April and May. And the evidence is clear from work at the University of Michigan's Survey Research Center that changes in consumer attitudes do influence the level of spending. There is also some concern about the possibility that wants have simply been saturated. This argument has taken many forms—ranging from that of the affluent society to the fear that consumers are so fully in debt that the further expansion of credit necessary to sustain vigorous prosperity cannot take place.

There are persuasive reasons, however, for believing that the problem is not primarily saturation of wants. Research evidence is fairly clear on this point. The simple fact is that as levels of living rise, levels of aspiration rise also. The achievement of one scale of living sets the stage for the desire to stage an assault on the next. Periodically during the last decade the University of Michigan's Survey Research Center has probed people about their needs and whether they would like to make special expenditures in the coming year. In their 1962 monograph the center summarizes the evidence as follows:

"1. Today, as they did 10 years ago, the great majority of American people express wishes and desires for consumer goods. This is true in all income groups. Those who do not express such wishes are most commonly old * * * or poor * * *. The proportion having no wishes and desires has not increased in the last 10 years. Being well stocked with goods, or having made large expenditures recently, does not make for 'needlessness.'

"2. The kinds of things desired have changed substantially in the postwar period. Desires for summer houses, boats, travel, and various hobby expenditures have increased in frequency. At the same time, desires for automobiles have not diminished in frequency (partly as the result of an increase in desires for second cars). Because people have a great many wants and desires, they feel they must economize and shop carefully. (There was, therefore, a change in the kind of automobile desired.)"¹

The evidence suggests to me that the problem is a shortage of purchasing power. Since the low quarter of 1961 private incomes after taxes (disposable personal income plus corporate profits after taxes) have increased \$32.7 billion but private demand for output has increased \$39.5 billion. Thus private demand has increased \$1.21 for each dollar increase in private incomes after taxes. This is less than the \$1.32 in the corresponding period after 1958, or the \$1.54 after 1954, but it is still true that in the five quarters following the low point last year private demand for goods and services has increased more rapidly than incomes after taxes.

To some a shortage of purchasing power is synonymous with the need to accelerate the rise in wage rates. This approach would, of course, be self-defeating because it would also raise costs of production and, therefore, prices. And if the price line were held, the resulting deterioration in profits would give us a more acute case of the economic anemia we were trying to cure. On this our experience of the last several years is quite clear. The fact that costs per unit of output rose more rapidly than prices after the mid-1950's, with the consequent sharp decline in profits per unit of output, unquestionably played a major role in the sluggish performance of the economy in that period.

TABLE III.—*Indexes of corporate income and output in manufacturing*

[1955=100]

Year	Output	Employment costs	Profits	Per unit of output	
				Employment costs	Profits
(1)	(2)	(3)	(4)	(5)	(6)
1955.....	100.0	100.0	100.0	100.0	100.0
1956.....	102.9	107.9	94.0	105.0	91.5
1957.....	103.3	112.9	91.6	109.0	88.7
1958.....	96.5	108.9	73.2	112.8	75.9
1959.....	109.0	119.0	101.5	109.1	93.2
1960.....	112.0	123.5	96.0	110.1	85.6
1961.....	112.5	124.0	94.0	110.1	83.5

Source: Column (2), Federal Reserve Index; columns (3) and (4), basic data from Department of Commerce; column (5), column 3 divided by column 2; column (6), column 4 divided by column 2.

It is, I think, increasingly clear that the economic policies of Government have been making a substantial contribution to the economy's shortage of purchasing power in recent years. At times the monetary authorities clearly have stepped too hard on the brake pedal, e.g., in 1957 and again in 1959. It is equally clear, however, that monetary policy has not impeded economic expansion for roughly 2½ years. The reserve position of the banks has been easy. Commercial banks are eager to expand their loans, in contrast to the "loaned-up" banking sentiment in the tight-reserve eras of 1957 and 1959. Bank credit has increased 8½ percent in the last year. Reflecting this, interest rates (contrary to the expectation of many experienced market observers early this year) have remained relatively low. Bond yields are only slightly above those at the low point of the recession early last year. Whatever quarrels we may have with

¹ George Katona, Charles A. Lininger, James N. Morgan, and Eva Mueller, "1961 Survey of Consumer Finances" (University of Michigan, Survey Research Center, 1962), p. 98.

the Federal Reserve about details, the evidence does not support the view that monetary policy has had much to do with the current sluggishness of the economy.

The principal drag has come from the tax side of Government fiscal operations. For years we have pointed with gratification to the stabilizing effect of our tax structure as a major defense in a recession. The large volume of tax collections relative to national income and the tax structure's progressive nature have meant that much of the decline in incomes has been at the expense of the tax collector. Incomes after taxes tended to stay put—to be stabilized. We are all familiar with this story. For some curious reason we have not seemed to perceive fully the implications of this for expansion, even though we usually recited the right words.

The fact is, however, that a tax structure which stabilizes incomes after taxes during a recession also "stabilizes" them in an expansion, i.e., it retards their expansion. That total cash receipts of government (Federal, State, and local) have absorbed a large and growing proportion of the national income is well enough known, though the quantitative magnitudes are not always appreciated. The ratio of Government cash receipts (on a national income basis) to national income rose from 26.6 percent in 1948 to 33.9 percent in 1960, and it is probably about 34½ percent now.

TABLE IV.—*Government receipts and gross national product at postwar cyclical peaks*

[Dollar amounts in billions]

Year	National income	Government receipts	
		Amount	Percent National income
1948.....	\$223.5	\$59.2	26.6
1953.....	305.6	94.9	31.1
1957.....	366.9	116.3	31.8
1960.....	415.5	141.0	33.9
1962—2d quarter.....	1 457.0	1 158.0	1 34.6

1 Estimated.

Source: Basic data from the Department of Commerce.

TABLE V.—*Change in private incomes before taxes and Government receipts 5 quarters after recession lows*

[Dollar amounts in billions]

	1958-59	1961-62
Private incomes.....	\$49.6	\$45.0
Total Government receipts.....	\$20.5	\$19.6
As percent change, private income.....	41.4	43.5
Federal Government receipts.....	\$16.5	\$15.7
As percent change, private income.....	33.3	34.5

Sources: Basic data from Department of Commerce.

Let us now look more closely at the last year and one-half to see how this works out cyclically. From the low first quarter of 1961 to the second quarter of 1962 private incomes before taxes (personal income plus corporate profits and the inventory valuation adjustment) increased \$45 billion. Government receipts, however, absorbed 44 percent of this increase. Now the sluggishness of the present recovery, and the one in 1958-60, begins to look less mysterious. The tax structure, by absorbing 40-45 percent of the rise in private incomes, left a gain in incomes after taxes so moderate that (with no special elements of strength present) we could not get an expansion in private demand vigorous enough to carry the economy back to reasonably full employment.

If the neutral position of the budget (where revenues and outlays are equal) is at full employment, we should theoretically find it possible to avoid persistent unemployment—though a tax structure absorbing such a large proportion of

increments to national income would still have important adverse implications for economic growth. If, however, this neutral budgetary position is at a level of business activity considerably below what would constitute reasonably full employment, we have also a short-run problem. The fiscal drag would make full employment difficult to attain, which would cause a short fall in revenue, which would make the budget look bad, which might make us disinclined to take needed tax action, etc.

This is not an unfair characterization of the present situation. In their January report the Council of Economic Advisers estimated that at reasonably full employment the present tax structure would produce a surplus (on a national income accounts basis) of perhaps \$8 billion this year, with this full employment surplus approaching \$10 billion by the first half of calendar 1963. In short, the budget now moves from a neutral to a restrictive position substantially before the economy reaches reasonably full employment, and with government receipts siphoning off over 40 percent of additions to income, it has been very difficult to get the needed thrust of increased private demand.

III

If this diagnosis is correct, what does it suggest for fiscal policy? It means, I think, three things. First, the tax structure should be lowered so that the budget does not begin to exert a brake on the economy quite so far below reasonably full employment. Second, the tax structure now absorbs too large a proportion of increases in the national income. Third, we must slow down the tendency for the Federal Government's receipts to absorb a growing proportion of the national income secularly.

Most of my time has been consumed in an endeavor to establish the case that the fiscal operations of Government are an important source of our present economic problem, and that vigorous fiscal action must play a major role in any program to deal with the problem. This leaves little time to spell out specifics. Even so, it may be useful to indicate briefly the nature of a fiscal program that might contribute to a stronger economy.

First, budgetary procedures should be modified so that we give more explicit attention to this question: How rapidly should Federal expenditures grow in the years ahead? The excellent work on expenditures at both ends of Pennsylvania Avenue does an effective and, I think, underappreciated job of sifting out waste and unessentiality in the technical sense. It is less well designed to tell us whether these individually well-considered programs add up to more than ought to be spent in the aggregate. The ratio of Federal budget cash outlays to GNP in fiscal 1962 was 2.1 percentage points above that of fiscal 1956. Thus, if the rate of increase of Federal outlays had been limited to the rate of increase of GNP, Federal cash outlays last year would have been \$12 billion less. This inevitably has reduced the scope for otherwise desirable incentive-promoting tax reductions. It is not unreasonable to expect from the administration an explicit declaration of its longer range policy with respect to total outlays; and the Congress should reexamine its own procedures to see if more explicit attention can be given to the total on the expenditure side of each year's budget.

TABLE VI.—*Ratio of Federal cash budget outlays to gross national product*

[In percent]

	Fiscal year 1956	Fiscal year 1960	Fiscal year 1962
National defense.....	10.0	9.3	9.5
Others.....	7.8	9.8	10.4
Total.....	17.8	19.1	19.9

Second, the economic situation would benefit from tax actions now that would reduce the level of the structure and move it in the direction of a better system. Fortunately, there is considerable agreement about what would constitute such a package—a reduction of three to five points in the corporate income tax; a cut-off of the personal income tax at around a 65-percent top rate, with reductions of perhaps two percentage points back down through the normal tax; and a rationalization of our motley array of excise taxes (which could be done with

no loss of revenue). The total package should be such that the resulting tax structure would produce enough revenues comfortably to cover expenditures at reasonably full employment. On this basis something like \$7 billion should probably be the outside limit of any tax reductions at this time. The action should not be "quickie" or temporary in character. We should capitalize on the substantial current consensus about what ought to be done to move toward a better basic pattern of Federal taxes.

Third, I would myself support the proposal that the President be given limited power to alter certain tax rates. This could be hedged with adequate safeguards—limited as to amount, and perhaps requiring that the President transmit to the Congress a full report setting forth reasons for his actions. Without this each recession produces inexorable pressures to "do something" on the expenditure side which, history suggests, will be moving expenditures to a substantially higher level. This proposal would, in short, be a step toward fiscal conservatism. In the long run it would make for a less rapid increase in expenditures and more "elbow room" on the tax side for further needed reforms.

IV

One further question: Would tax reduction and reform now be apt to worsen further the already somewhat nervous position of the dollar internationally? This is possible. If the resulting expansion sets in motion an accelerated rise in our cost-price level, and if we insist that the monetary authorities adhere to unrealistically low interest rates, and if needed improvement in profits were seemingly interpreted as evidence of entrepreneurial malevolence, the dollar could quickly be in real trouble. And, it must be stated flatly, such trouble would then be thoroughly deserved.

If, however, we manage our affairs carefully, there is good reason to think that the international position of the dollar would not be worsened by tax reform and reduction now, and it might well be strengthened. The resulting higher level of national income would, of course, tend to increase imports and that would enlarge the deficit in our international balance of payments. There are, however, forces that would work the other way. The more active demand for funds would produce higher interest rates in the U.S. capital markets. The invigorated pace of economic activity would enlarge the opportunities for more profitable investment of capital in the domestic economy, reducing incentives to seek investment outlets abroad. And the innovational activity that accompanies a more lively pace of economic expansion should in time have some favorable effect on U.S. exports. Since in the U.S. economy imports are relatively small and the international capital outflow is relatively large, there is at least an even chance that policies proposed here would help to narrow the balance-of-payments deficit.

There does remain the potentially adverse effect on confidence in the dollar, internationally and domestically, of tax action now. If, however, the tangible, concrete, objective forces can reasonably be expected to beat least neutral and probably favorable, and if we give evidence of capacity to manage sensibly such things as monetary and wage-cost-price policies, we can probably deal with the psychological aspects of the problem.

CONCLUSION

The becalmed state of the economy at present, coming on the heels of a particularly weak cyclical expansion superimposed on a protracted period of less than reasonably full employment, strongly suggests that the economy needs strengthening in a fundamental way; and it also suggests that within reasonable limits this can be done without courting the risk of a disorderly economic expansion. The basic problem is a shortage of income and purchasing power, but this deficiency must be remedied in ways that do not increase costs per unit of output and that do not produce monetary conditions which would further weaken the dollar. This calls for tax adjustments that lower and otherwise improve the structure. The magnitude of the reduction should still leave us with a tax structure whose revenues would cover expenditures when productive resources are being utilized reasonably fully.

Such action need not weaken the dollar internationally, and there is an even chance that it might strengthen it. In fact, we are fortunate that what is needed to step up the pace of job creation and economic expansion at home could also add strength to the dollar internationally—a more innovative, more prosperous, and more profitable economy.

Chairman PATMAN. Our next witness will be Dr. Joseph A. Pechman, director of economic studies at the Brookings Institution.

We are glad to have you, sir. You may proceed in your own way.

STATEMENT OF JOSEPH A. PECHMAN, DIRECTOR OF ECONOMIC STUDIES, THE BROOKINGS INSTITUTION

Dr. PECHMAN. Thank you, Mr. Chairman. I am happy to have this opportunity to appear before the Joint Economic Committee to discuss the economic situation and its fiscal policy implications. In this statement, I propose to review the economic outlook, try to explain why the expansion seems to be petering out, and suggest policies that might be adopted to restore our economic momentum. The views I shall express are my own and do not necessarily reflect those of the trustees, officers, or other staff members of the Brookings Institution. Since I agree with practically all of what my two friends said before me, you might call my statement "Variations on the Eckstein-McCracken Theme by Pechman."

THE ECONOMIC OUTLOOK

There is no question that the economic expansion which began early last year has been disappointing. Perhaps the most telling figure—certainly the one which should concern us most—is the rate of unemployment. In July, the unemployed were 5.3 percent of the labor force, after adjustment for seasonal variation. This is a much poorer performance than those of the first two postwar recoveries, and roughly similar to the unsatisfactory 1958-60 performance.

At the same stage in the cycle, unemployment was 3.4 percent in the 1949-53 expansion and 4 percent in the 1954-57; it was 5.6 percent in the same stage of the 1958-60 expansion, but this figure was unusually high at the time because of the prolonged steel strike. The distressing fact about the unemployment situation is that it will get worse if the economy rises by anything less than about \$7 billion per quarter at an annual rate.

It is not difficult to demonstrate that the expansion is not only disappointing, but also that it has lost most of its momentum. In the first place, the difference between actual GNP and potential GNP at an unemployment rate of 4 percent has remained at about \$30 billion during the past 9 months.

Second, GNP in real terms rose at an annual rate of 8.6 percent in the first three quarters of the expansion; in the last two quarters, the rise has been at the rate of 3.2 percent.

Third, gains in employment, personal income, and industrial production have slowed down almost to a creep. In June, employment rose only one-tenth of 1 percent; personal income, two-tenths of 1 percent; and industrial production, three-tenths of 1 percent.

Fourth, retail sales fell in May and June. The drop was particularly steep in June, perhaps reflecting the impact of the sharp break in the stock market. Although sales appear to have increased again in July, they will probably turn out to be lower than the peak reached in April.

Thus, none of the broad indicators of business activity suggests that the economy is going anywhere very fast. But the gloomy evi-

dence on the business outlook comes from the leading indicators. Manufacturers' sales have exceeded new orders since March. This means that order backlogs are going down and, unless the trend is reversed very soon, production is bound to fall.

Inventory investment declined sharply in the second quarter of the year, suggesting that businessmen are already anticipating a slowdown in demand. The decline in inventory investment is not all due to the unusual steel situation; other industries are also exhibiting the same tendency. Fortunately, fixed investment—particularly construction—has continued to rise, but new orders of firms manufacturing machinery and equipment have been sliding off since January. This implies a weakening of investment demand and is perhaps the most disturbing sign of all.

I am not trying to suggest that a downturn in business activity in the near future is a certainty. We have had slowdowns before without experiencing a recession. The two most recent cases were 1951 and 1956—but, in both cases, there were good reasons for the pickup.

In 1951, defense expenditures continued to rise rapidly as the Korean war continued. In 1956, private investment remained strong and defense orders rose sharply while industry generally was operating close to capacity. Today, Federal expenditures are still rising, but at a declining rate; excess capacity at current rates of output is widespread; and there are no signs of a strong upward movement anywhere in the private economy.

We have had a good year in autos and housing, but these industries are hardly likely to go much higher with personal incomes leveling off. Inventory investment will continue to decline unless retail sales pick up, and the latter is not likely to happen unless incomes go up faster.

Profits are already falling, even though some specific companies have reported record earnings for the first half of the year. With the large amount of excess capacity throughout industry, it is hard to believe that we are about to see a significant increase in investment demand. (The more liberal depreciation allowances will certainly be helpful and so would the investment credit if it were enacted, but their effect probably will not be immediate.)

In brief, the situation looks more like mid-1957 than 1951 or 1956. Then, as now, inventory accumulation was low, manufacturers' new orders were declining, and order backlogs were going down. Without implying a forecast for this year, I simply record the historical fact that the peak of that cycle was reached in July 1957.

WHAT WENT WRONG?

Since proper diagnosis is an essential prerequisite to prescription, it is important to explain the premature slowdown in the rate of expansion. Until the turn of the year, the recovery was going along on schedule. There were differences of opinion over the outlook, but practically all informed observers expected the rise to continue vigorously at least until midyear.

In this situation, the administration submitted a budget for fiscal year 1963 that would be roughly in balance if the 1962 GNP turned out to be \$570 billion. It is to be noted that the balanced budget was

expected to materialize only if, given the projected Government spending and taxing programs, demand in the private economy would be large enough to produce a total GNP of \$570 billion.

Developments in 1962 clearly indicate that Government fiscal policy is too restrictive to permit the economy to achieve the projected levels of output. The degree of restriction can perhaps be fully appreciated if the figures used in the budget are translated to a full employment basis (which is ordinarily defined as employment of 96 percent of the labor force.) At full employment and projected levels of Government spending, the administrative budget surplus would probably amount to about \$4 billion in fiscal year 1963. When translated into the more economically meaningful national income budget, this is equivalent to a surplus of about \$8 billion. Full employment will not be reached this year because private demand is not strong enough to permit the Government to drain off that amount from the private economy.

In fact, as events have turned out, private demand is not even strong enough to permit the Government to plan on a budget which would be barely balanced at a 1962 GNP \$15 to \$20 billion short of full employment.

It is noteworthy that the original budget estimates for every one of the past 5 years projected some surplus, yet deficits were actually realized in 4 out of these 5 years. As the following table shows, the original estimates for the 5 years aggregate to a cumulative surplus of \$8.1 billion, but the period ended with a cumulative net deficit of \$24.2 billion. This sad record was due primarily to the reduced receipts from levels of business activity that turned out to be substantially lower than those estimated.

(The table referred to follows:)

*Comparison of original budget estimates with actual results, fiscal years
1958-62*

[Billions of dollars]

Fiscal year	Administrative budget surplus (+) or deficit (-)	
	Original estimates	Actual
1958.....	+1.8	-2.8
1959.....	+ .5	-12.4
1960.....	+ .1	+1.2
1961.....	+4.2	-3.9
1962.....	+1.5	-6.3
Total.....	+8.1	-24.2

The so-called "squeeze" on corporate profits is principally a reflection of this lackluster performance of the economy. Recent research by econometricians has indicated that the brunt of a short fall in the gross national product below full employment potential is felt by corporate profits. The short fall of profits below the level it would reach at full employment will amount to at least \$8 billion in 1962 alone. Even larger amounts were lost in several recent years. We cannot allow this to continue much longer. A prolonged period of disappointing profits inevitably reduces investment incentives and retards the Nation's economic growth.

The United States cannot hope to approach the growth rates experienced in Europe and Japan during the last decade without a higher rate of investment, and we will not achieve a higher rate of investment unless businessmen expect growing markets for their products.

The lesson to be learned from the economic record of recent years in this country is that planning for a surplus, without regard to the strength of private demand, may very well produce unsatisfactory rates of employment and output and create deficits besides. When demand is strong and appears to be pressing hard on available resources, a surplus may be essential to insure balanced growth and stability in the general level of prices.

But when demand is recovering from a recession and when unemployment is still large and capacity still greatly underutilized, too vigorous a movement toward a surplus may repress the recovery and prevent the growth in output and income upon which the expansion of Government revenues was predicated.

In short, efforts to reduce the deficit too quickly are likely to be self-defeating.

Does this mean that the United States is doomed to have deficits for an indefinite period? The answer to this question cannot be given with any degree of certainty by responsible economists, simply because we do not know the strength of private demand out of the incomes that would be generated at full employment.

It is my own view that, at full employment, demand would be strong enough to require a surplus in order to prevent prices from rising, and that a full employment level of activity is likely to generate that surplus at the expenditure levels now contemplated, even with somewhat lower tax rates than those now in effect.

But to reach full employment, we must first remove the restraints under which the economy has been operating in recent years. Except for an easy money policy which is ruled out because of our balance-of-payments problem, no other policy is available to restore our economic momentum than fiscal policy.

POLICIES TO RESTORE ECONOMIC MOMENTUM

Private demand can be stimulated through fiscal policy either by increasing expenditures or by reducing taxes. Congress is now completing action on the President's expenditure requests for this year. These requests contemplate a rise in Federal expenditures (as measured by the national income accounts) amounting to \$5.8 billion in fiscal year 1963. Further expenditure increases of any substantial magnitude would require considerable advance planning as well as congressional action and would therefore not be effective soon enough. Expenditure policy should, in any case, be geared largely to the long-run needs of the economy and to the demand for public services.

Under the circumstances, tax reduction would be the best and most effective method of providing a strong and immediate stimulus to the economy. In the past, consumers have consistently spent about 92 or 93 percent of their disposable incomes. There is no reason to suppose that they would respond very differently to the added take-home pay from a tax cut than they would from a straight increase in their wages. (In fact, as a result of withholding, the additional take-

home pay from a tax cut is indistinguishable for the vast majority of wage earners from the additional take-home pay due to an increase in wages.)

This addition to consumer spending would increase employment and incomes, leading to further rounds of spending. Moreover, the improvement in sales expectations would have effects of its own on business expenditures. It would, in the first place, probably reverse the decline in inventory investment; second, it would also promote additional fixed investment. Together, the effects on consumer and business spending could well provide the stimulus needed for a rapid advance to full employment provided the tax cut is large enough.

I do not not agree with the view that a tax cut should be delayed until after a recession has begun. The weakness of investment in the last few years is a reflection of the slow growth of demand and the continuation of excess capacity. There is substantial danger that businessmen will come to regard a slack economy as a normal state of affairs.

Under these circumstances, our economic recoveries will become even more disappointing than they have been in the last two cycles and our rate of growth will become chronically depressed. A prompt tax cut would very quickly be translated into higher business sales and break these bearish expectations.

Since the economy is already \$30 billion below potential and the prospects are that it will lose ground in the months ahead, strong medicine is needed to overcome the effect of the disappointing performance in recent years. Even if it is assumed that the tax reduction will have a substantial direct effect on business spending, a cut of at least \$10 billion would be required to close the gap between actual and potential output. In arriving at this judgment, I assume that the effect of the tax cut would not be offset in whole or in part by expenditure reduction. If expenditures were reduced, the size of the tax cut needed to reach full employment would increase by more than the cut in expenditure.

I believe that what the economy needs is a permanent reduction in tax rates, because it is now clear that the present rates choke off expansions long before high employment is reached. However, consideration of a permanent change in tax rates would trigger off a national debate that could not possibly be completed in this congressional session.

Moreover, any permanent revision in the rate structure should be carefully adapted to the tax reform program scheduled for congressional consideration next year. For this reason, I would suggest the enactment of an equal percentage-point cut in individual and corporate income tax rates effective October 1 for a year or 15 months, with the understanding that these rates would be superseded by a new rate structure which would be included in next year's tax reform bill.

A reduction of one point in all individual income tax rates would cost \$2 billion a year; the same reduction in the corporate rate would cost \$0.5 billion. Accordingly, a 4-point reduction in the individual and corporate rates would amount to a total reduction of \$10 billion at an annual rate; of this, \$8 billion would go to individuals and the remaining \$2 billion to corporations.

This package would meet the requirements of simplicity and size, and would have the added advantage of maintaining the present differential between top and bottom bracket individual income tax rates and between individual income tax rates generally and the corporate rates. It would also give the administration and the Congress the necessary flexibility to coordinate the proposed tax reform with permanent rate reduction.

The effect of this tax reduction on the budget for fiscal year 1963 would be much smaller than the full-year effect. I estimate that the deficit would be increased by approximately \$6 billion before taking into account any recoupment from the effect of the tax cut on business activity. It should be emphasized, however, that this increased deficit in fiscal year 1963 would lead to a smaller deficit, or perhaps even a surplus, in fiscal year 1964.

Although the case for an immediate tax cut is strong, I realize that the odds against the enactment of such legislation during this congressional session are very heavy indeed. If Congress does not cut taxes this year, an alternative program should be devised to give the administration sufficient power to cope with the problems that may arise before Congress is organized and ready for action next year. In my opinion, a minimum program would include the following:

First, the President should be given the authority he requested early this year to make a temporary reduction in individual income tax rates of up to 5 percentage points. The cut would take effect 30 days after submission, unless rejected by the Congress. If the Congress is not in session when the cut is proposed, it would take effect immediately but terminate 30 days after Congress convened.

If the Congress is reluctant to yield this authority to the President on a permanent basis, it might extend the authority until the end of February 1963, when it will be organized to act quickly if necessary.

Second, provision should be made for the use of Federal funds to extend unemployment compensation benefits for a limited period to workers who exhaust their benefit rights under the regular State unemployment compensation laws. Similar legislation has been enacted during the past two recessions, and has proved to be an effective countercyclical measure. Since it is too late to process a permanent law, the temporary law which expired in April of this year should be reenacted for another year, for humanitarian reasons alone, if not for reasons of purchasing power.

Third, the capital improvements program for distressed areas which has already passed the Senate and is now being considered in the House should be enacted before Congress adjourns. The legislation is designed to provide funds especially for relatively small local projects on which work can be started quickly. The amount of money involved is modest enough to insure that the funds would be spent on useful projects.

Finally, the administration should plan now to submit a budget for the coming year that would yield a much smaller surplus at full employment levels of income than the surplus implicit in the budget for fiscal year 1963. Although it has been reduced somewhat since 1960, the full employment surplus for the first half of calendar year 1963 which is implicit in the current budget is of the order of \$10 billion (on a national income basis).

The Economic Report stated that "if demand falls short on current expectations, more expansionary policies will be pursued." It is clear that the signs were set too high early this year and it is to be hoped that budget planning will be more realistic the next time around.

In closing, I should like to recall to the committee that, when I last appeared before you in December 1960, the economy was in a contraction that was already 6 months old. Nevertheless, many people denied that there was sufficient evidence to justify immediate action to stimulate demand.

It was also said that caution was necessary to avoid unbalancing a budget that was already becoming unbalanced because of the reduction in employment and incomes. And there was a great concern about the inflationary consequences of a vigorous fiscal policy at a time when there were large reserves of idle men and machines waiting to be productively employed.

Although the economy is not in a recession now, our rate of growth continues to be inadequate by any standard and there is very little, if any, steam left in the current expansion. But we are still told not to prejudge the situation; more concern is expressed about the condition of the budget than about the condition of the economy; and we are still warned of the dangers of inflation even though unemployment is high and inflation has long since subsided.

As an economist, I cannot explain the defensive attitude which has gripped the Nation in recent years. I can only express the hope that this committee, which has done such excellent educational work in economic affairs since it was established more than 15 years ago, will help alert the country to the needs of the times.

Chairman PATMAN. Thank you, sir.

I would like to know about the basic premise on which you reach conclusions as to the kind of tax cut which you think we should have. Of course, I know we want to raise the level of savings, the level of investment, the level of income, and the level of consumption, raise all levels, but my question specifically is this: Relative to consumption expenditures as defined in the national income account, are savings too low or too high? How would you, Dr. Eckstein, answer that? Would you say they are too low or too high?

Mr. ECKSTEIN. Sir, in the present short-run context they are obviously too high. Not in the long run.

Chairman PATMAN. What do you say, Dr. McCracken?

Mr. MCCracken. The proportion of income being saved does not seem to me to be greatly out of line with our historical trends.

Chairman PATMAN. Do you consider it too low or too high? Which would you say, if you can answer it categorically.

Mr. MCCracken. They are, I suppose, too low in the sense that obviously we need a step-up in the demand for output, though I do not think this gets very close to the heart of the present problem.

Chairman PATMAN. How would you answer?

Mr. PECHMAN. I agree with Professors Eckstein and McCracken.

Chairman PATMAN. I would like to call your attention to two charts prepared by Dr. Roy Moor of the committee staff. They show how the income which would be made available to individuals under the tax cut would be distributed among the various income brackets under

the different methods of reducing individual income taxes. The chart on the left is self-explanatory. It shows the average tax reductions. Can you read those figures from where you are? Looking at the additional money that would be made available to individuals having adjusted gross incomes of between nothing and \$5,000, the relatively low income class, we see that the different methods make quite a difference in the amount of money which would go to these individuals.

The figures show the distribution, by class of a \$6 billion overall reduction in taxes. If we split the first income tax bracket, setting up a bracket of between zero and \$1,000, and applied all the cut in that new first bracket, individuals with less than \$5,000 of income would on the average have a net gain of \$75. If we increase the personal income exemption from the present \$600 to \$800, individuals in this group would gain \$76. If we applied all of the tax cut in the present first bracket, individuals in this group would benefit by \$60. If we had an across-the-board cut such as has been frequently suggested, individuals in the lowest income group would benefit by only \$42.

Looking at the families with incomes of over \$50,000 you may notice that the different methods also give different results. If we increase the personal income exemption these individuals would receive an extra \$300 of disposable income, but if we had an across-the-board these individuals would receive an extra \$1,680 of disposable income.

But the chart on the right is probably more significant for our considerations of how a tax cut would affect the economic activity. This shows the percentage increase in the aggregate income of each income class which would be brought about by the different methods.

For example, if we increase the exemption the lowest income receivers would have their disposable incomes increased by 2.8 percent, while the aggregate income going to families with over \$50,000 of income would be increased by six-tenths of 1 percent. To take the other extreme, however, an across-the-board cut, we find that the aggregate incomes in the lowest income group would be increased by only 1½ percent, while aggregate incomes of the group of over \$50,000 would be increased by 3.3 percent—more than twice the rate of the lowest income families.

Would the members of the panel care to comment on whether these different methods of reducing taxes would have important differences in their effect on savings, investment, consumption and overall economic activity? Would you start, Dr. Eckstein?

MR. ECKSTEIN. Of the points to be made in this connection, I think one very obvious point in this: That a \$6 billion tax cut will not accomplish miracles in any event because the increase in income accruing to anybody is only 3 percent, which is not exactly a revolution of the economy.

Second, in general, it is my belief that this kind of an issue—that is, the proper distribution of the tax burden—is largely a noneconomic issue and elected officials are the people properly to pass judgment of this sort. On the effect on saving, what studies have been done on this problem tend to suggest that people in the lower income brackets have somewhat higher spending propensities than the upper brackets, but the total impact of any change in the tax burden can at best make a small contribution to total expansionary policy.

**Average Tax Savings per Individual
Under Various Methods of Making a \$6 Billion Reduction
in Individual Income Taxes***

**ADJUSTED GROSS
INCOME CLASSES**

Reduce Rate in Half First Bracket 7.5 Percentage Points

\$0 - 5,000	\$75
5,000 - 10,000	\$142
10,000 - 20,000	\$142
20,000 - 50,000	\$150
over 50,000	\$112

Increase Personal Exemption \$200

\$0 - 5,000	\$76
5,000 - 10,000	\$132
10,000 - 20,000	\$168
20,000 - 50,000	\$300
over 50,000	\$300

Reduce First Bracket Rate 4.6 Percentage Points

\$0 - 5,000	\$60
5,000 - 10,000	\$148
10,000 - 20,000	\$175
20,000 - 50,000	\$185
over 50,000	\$138

Reduce Each Individual Rate 3 Percentage Points "Across the Board Cut"

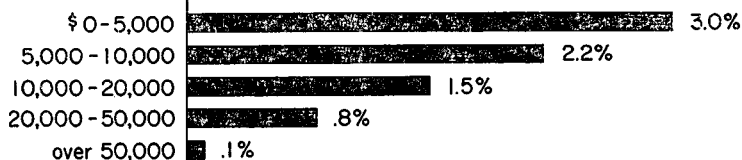
\$0 - 5,000	\$42
5,000 - 10,000	\$114
10,000 - 20,000	\$288
20,000 - 50,000	\$762
over 50,000	\$1680

* Estimated for 1962 on basis of 1960 data of Internal Revenue Service

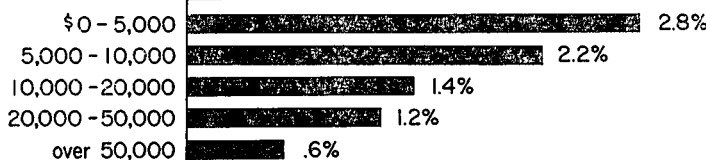
Percentage Increase in Taxable Incomes, After Taxes,
of the Different Income Classes Under Various Methods
of Making a \$6 Billion Reduction in Individual Income Taxes*

ADJUSTED GROSS
INCOME CLASSES

Reduce Rate in Half First Bracket 7.5 Percentage Points



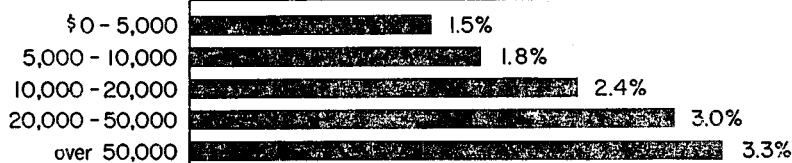
Increase Personal Exemption \$200



Reduce First Bracket Rate 4.6 Percentage Points



Reduce Each Individual Rate 3 Percentage Points "Across the Board Cut"



*Estimated for 1962 on basis of 1960 data of Internal Revenue Service.

Chairman PATMAN. Thank you, sir.

I will not insist on answers to these at this time. I will put the questions in the record. I wish each one of you would comment on them when you review your transcript and extend your remarks, if you please, or insert anything else that you feel is germane. An across-the-board tax cut would increase disposable incomes of families in the high-income brackets a great deal more than it would for those at the lower end of the scale. If you felt that our basic problem is one of inadequate rate of savings, I could understand this kind of proposal. But if you think that the problem is underconsumption, then I should think you would want to give the largest cuts to the low-income groups, or at least keep things even. In other words, an across-the-board cut would tilt the income distribution in favor of the high-income families. Do you have any distribution by income classes of the percentage of family income going into consumption and the percentage going into savings? I will ask you to submit an answer when you review your transcript.

Next, have you experts made any estimates which would show how much reduction in taxes would be required to produce a given amount of stimuli under each of the alternative methods: raising the exemptions, making the cut in the first income tax bracket and making the cut across the board? This is a question that concerns me. If we had an across-the-board cut in taxes; that is, a cut which would change the income distribution in favor of the top bracket income receivers, would we not have a worse fiscal structure after the period of the deficit is over? In other words, would it not, in the long run, increase the troubles which the tax cut is intended to cure?

With reference to the economy of Western Europe, I think I can see that there are peculiarities in the situation which would enable these economies to operate at full employment even where a large share of income is going into savings and investment. A dynamic rebuilding or reconstructing of the whole European economy is going on. They are building modern plants to replace handicraft plants in anticipation of future consumer demand for the output of those plants. But I wonder, in a situation like ours, if we can have full employment with anything like the percentage of income going to capital in Europe; that is, the high profits and high interest rates of Western Europe.

Could you comment on that? I will ask you to do that when you look at your remarks. But I think those charts make out a convincing case for the tax savings going to the low-income groups. Certainly if our problem is underconsumption, the answer is obvious.

(Information submitted by Otto Eckstein, Harvard University, follows:)

The major studies of the effects of income distribution are the following: Harold Lubell, "Effects of Income Redistribution on Consumers' Expenditures," *American Economic Review*, XXXVII (March 1947), 157-70, XXXVII (December 1947), 930.

M. Bronfenbrenner, Taro Yamane, and C. H. Lee, "A Study in Redistribution and Consumption," *the Review of Economics and Statistics*, XXXVII (May 1955) 149-59.

Alfred H. Conrad, "The Multiplier Effects of Redistributive Public Budgets," *the Review of Economics and Statistics*, XXXVII (May 1955), 160-73.

Lubell and Bronfenbrenner do not attribute much expansionary effect to changing the income distribution; Conrad comes to a more optimistic conclusion.

As a first approximation, I would assume that all of a tax cut accruing to individuals with incomes below \$5,000 would be spent, and between one-half and three-fourths of a tax cut on incomes over \$15,000. Applying a multiplier of 2, every \$1 of low-income tax cut would raise GNP \$2; the figure for high-income tax cuts would be \$1 to \$1.50.

(Responses by Mr. Pechman to the questions raised by the chairman:)

1. I would rank the four illustrative tax cuts in the following order as regards their effect on personal consumption expenditures: (a) an increase in the personal exemptions; (b) a reduction in the rate in the first half of the first bracket; (c) a reduction in the rate applying to all of the first bracket; and (d) an across-the-board cut of equal percentage points. However, the difference would not be very large. Although average consumption is a higher proportion of income in the lower income brackets than in the high-income brackets, differences in consumption out of increments to income are probably much smaller.

2. There are no current estimates of the consumption-saving patterns of families in different income classes. But earlier studies have all indicated that consumption declines relative to income as income rises. There are no data on the proportions of additions to income that might be consumed at various levels of income.

3. I do not agree that the fiscal structure would be distorted in any way as a result of an equal percentage-point tax cut. As I indicated in my statement, such a cut preserves the rate of progression and might therefore be more acceptable as an interim measure than a reduction in taxes applying mainly to one part of the income distribution. Since the consumption effect would be substantial in any case, I would support an across-the-board cut under present circumstances.

Chairman PATMAN. I have probably taken up my time, and I will yield to Mr. Curtis for questioning.

Representative CURTIS. Thank you, Mr. Chairman.

I find myself in a difficult position to ask questions because all three presentations start on a premise with which I disagree, a very fundamental premise, that our economy is stagnant. The very symptoms that I think you all use to substantiate your view that the economy is stagnant are what I would interpret as growing pains. We have had this argument before, Dr. Eckstein and I. I think it comes to two things. One is a question of whether or not we feel that an economy does move forward through business cycles, as we call them. Do we agree it does, that that is normal, to go forward in periods of expansion and then contractions like the peristaltic action, if I can be a little earthy? Is that a natural thing? If it is a natural thing what are we trying to do—interfere with a natural process? Rather should not we be understanding it and working with it? Could I ask that question?

Is it a natural process, or is it something that you want to eliminate? Do we want an economy moving like that and so we feel it moves up and down?

Mr. ECKSTEIN. Congressman, I doubt a little bit whether this is in my statement. Actually, the business cycle itself has been becoming milder of its own accord. The 1960-61 recession was a very mild one, more so than 1958. Even that was very small by prewar standards. I think our concern is that the little ups and downs have so preoccupied us, especially with the immense amount of statistics and figures which come out every single day, that we have tended to lose sight of the longer run trend.

Representative CURTIS. Do we agree, is it a natural thing? Is this the way an economy moves forward, through contraction and ex-

pansion? Again, to use the earthy illustration, of the peristaltic action, in actual life so many things move forward in that way. Do you think that is a natural state? If it is, we should not be trying to destroy it, should we?

Mr. ECKSTEIN. Our economy has always grown with cycles.

Representative CURTIS. It has, but is it natural and is it the way it should be, that is the question? I think some of you economic theorists are treating something that is natural as if it were a disease.

Mr. PECHMAN. I will try. What I do not like is your use of the term "natural." You use it in a way which suggests that, once you have said it, that is all there is to be said about the cycle.

Representative CURTIS. No.

Mr. PECHMAN. You said that 2 years ago, Mr. Curtis, when you were talking about growing pains, about business cycles. We never got back to high employment then. The real question is not—

Representative CURTIS. I will get to that because I happen to think, and this was the next question—maybe I better interject this—you see in your concept of this gap theory that Dr. Eckstein and Dr. Heller and apparently most economists, and your paper seems to buy, is on the assumption that there is failure to have full utilization of our productive resources which includes the labor force, which includes plant capacity. What I suggest that you are failing to realize is part of this natural thing, particularly in a dynamic economy which is innovation—and that to me is the real reason—

Mr. PECHMAN. Are you satisfied with the economy as it is today?

Representative CURTIS. On innovation?

Mr. PECHMAN. Yes.

Representative CURTIS. I am never completely satisfied but let me say this, that the innovation as near as we can figure reveals that 25 percent of the goods and services now on the market were not even known 5 years ago. There is a test of innovation. How much money is going into research and development? How much is going into retraining? Here is what I wanted to say. Part of the natural process, as I see it, is retooling, actually junking obsolete equipment. That applies to human beings, to taking skills that have become obsolete and retraining for new skills in demand. So a lot of what you people, I am afraid, call unemployment and unused capacity is part of a natural process of dealing with obsolescence.

Mr. PECHMAN. I must confess I have heard you say this a number of times, Mr. Curtis, and I would like to understand your position. Particularly the position that everything is going along all right.

Representative CURTIS. I did not say that. Because I am critical. If I had time, and I do not here, but I will come around in the second round, to point out where I am critical.

Incidentally, we all agree on one thing, the need for tax reform, and the fact that our budgetary process and fiscal policy is interfering with this natural, I say, process. You all for other reasons advocate the same approach. No, I am not satisfied with our economy. I never am. I do feel it is a basically sound situation and what we have got to do, in my judgment, is understand it a little better.

Mr. PECHMAN. There is no question about that. The problem, it seems to me, is that in recent years we have not utilized the tremendous resources of this country to the fullest advantage. For the last 5

years our rate of growth has been falling farther and farther behind the rate of growth in other industrialized economies. We are now taking a back seat to some of the smaller and less advanced countries. If this continues over a period of years, I do not think we will be able to survive the competition that we will be subjected to.

Representative CURTIS. Your statement in my judgment begs the question that is at issue. You are measuring growth in terms of gross national product which I have tried to point out is not an accurate measure of growth. You have to dig into the component parts, such as innovation and new goods and services to test whether there is real growth. As I have tried to point out, the shift we have seen in our economy from the manufacturing sector to distribution and services, the amount of increased leisure time, the percentage of time spent by an individual human being in education; those are measures of real growth, not gross national product, which is simply a measure of economic activity in a given year.

Mr. PECHMAN. Do any of the measures that you suggest indicate that we are doing better now than we did in 1960?

Representative CURTIS. Certainly so.

Mr. PECHMAN. Would you suggest some?

Representative CURTIS. Yes, one is measurement of school construction. Incidentally, one of the most glaring inadequacies of this administration is the fact that the school bonds in 1961—new school bonds voted—went down from \$2.2 billion to less than \$1 billion. It went down to \$850 million. But take the cycle from 1950 to the present, President Kennedy said we had to double the amount we are spending on education in the next 10 years. My comment was, "Why slow down?" It has been more than two and a half times from 1950 to 1960. That is what I regard as significant growth.

Mr. PECHMAN. I agree we need more schools.

Representative CURTIS. I am talking of a sample of measurement.

Mr. PECHMAN. We could afford to build more schools if we had higher GNP, the measure you do not like.

Representative CURTIS. I disagree with you. We are building them and the local districts are doing this because one of the essential sound things in our economy has been the real estate tax, the property tax.

Mr. PECHMAN. Every time they build a school it goes into the GNP.

Representative CURTIS. My time is up.

Chairman PATMAN. You mentioned the bonds not being offered for sale for school purposes. Do you not think that the people concerned have refused to vote them because the interest rates were too high?

Representative CURTIS. No, as a matter of fact, let us get our indicators here and let us know what we are talking about. These are the Health, Education, and Welfare indicators of July 1962. The charts here are very interesting, and I think need to be followed. The first chart on page 25 is public educational construction, bond elections, bond sales and contract awards, and shows first bonds voted upon in public school election bonds, and then the number passed.

Chairman PATMAN. What percent?

Representative CURTIS. The percent passed ranges, beginning in 1957, 74 percent, 78 in 1958, 62 in 1959, 83 percent in 1960, and then dropped to 69 in 1961, and it is ranging around there. But here is the point. The amounts of bond issues voted start out 1.3 billion, go up to 2.2 in 1960, and then drop down to 851 in 1961.

Chairman PATMAN. I urge you to look that over more carefully and evaluate it more carefully with this in view: that the people turned down these bond issues because the interest rates were too high. More of the local people pay taxes on what they owe than what they own because of the ad valorem system. They are very careful about levying these extra costs on themselves.

Representative CURTIS. I might say to the gentleman that an examination reveals that is not so. I think I can tell you why this drop. It is because they are waiting for a Federal program.

Chairman PATMAN. What year was that? That was during the preceding administration.

Representative CURTIS. 1961. The other figure on this thing, if we go on to the next page, you get your public education construction, interest, cost of bonds, and educational construction put in place.

Chairman PATMAN. Senator Douglas, we are intruding on your time.

Senator DOUGLAS. Not at all. We have the interest rate on long-term bonds, Federals; the movement of the State and municipals is very similar; in 1953 the rate was around $2\frac{1}{2}$ percent, and it has been rising to 4 percent more or less as of the present time, or a relative increase of 60 percent during this period. Dr. McCracken, in your statement you state that the reserve position of the banks has been easing. You mention this as an indication that monetary policy has not impeded economic expansion. I wonder what evidence you have for the statement that the reserve position of the banks has been easy.

Mr. McCracken. I would make two or three points here. First of all, there is the simple fact that the net free reserve position has continued at a very substantial level. Even with recent changes free reserves are still in excess of \$300 million.

Senator DOUGLAS. May I stop you right there. Dr. William Moor of the committee staff has charted the free reserves for a number of years. The chart shows, in brief, that in 1961 the average free reserves for the year were above \$500 million; probably a closer figure for the year as a whole would be \$550 million. The average free reserves for the year thus far have been around \$375 million.

Mr. McCracken. That is right.

Senator DOUGLAS. Or a decrease of some \$150-\$175 million. A further analysis indicates that almost the entire amount of these free reserves is in the country banks where only a small proportion of the demand for lending actually takes place. For instance, in the figures for the end of June, the free reserves in the country banks amounted to \$371 million. In the Reserve city banks, there was a minus \$5 million. In Chicago, a reserve of minus \$3 million. In New York, a minus \$12 million. The actual "free reserves" were thus entirely in the country banks, where, as I have said, a very small fraction of the total loans originate.

We should also remember that a few years ago we made vault cash a part of the reserves. You have to have cash for cashing checks and so forth and so on. So it would seem to me that in practice free reserves are virtually nonexistent. It puzzles me, therefore, when I read these statements—and yours is not the only one—that the reserve position of the banks has been easy because free reserves are plentiful, when they have declined absolutely and as a matter of fact are con-

centrated almost exclusively in the country banks and consist almost exclusively of vault cash.

Mr. McCracken. Nonetheless, the evidence supports the conclusion which I stated in my testimony.

Senator Douglas. Are my figures erroneous?

Mr. McCracken. This is what I want to comment on. In the first place excess reserves historically tend to be concentrated in the country banks. This is not new. Larger banks keep even temporarily surplus funds quite fully employed in such things as bills or the sale of Federal funds.

In the second place, while the net free reserve figure, like any other simple figure, is subject to limitations, it is a useful quick way of getting some indication or some impression of the pressure on the banking system. It indicates at present a condition of relative ease, an impression confirmed by collateral evidence. I happen to be a director of a bank and spend some time in banking circles. There is a vast amount of difference in the sentiment of the bankers so far as their lending policies are concerned, or particularly so far as their interest in building up their loans, relative to that in 1957 or 1959. There is not the loaned up sentiment that there was in those years. Moreover, there has been an 8½ percent increase in bank credit during the past year. That is double the normal needed gain to support vigorous economic growth. So, as I look at the evidence, I do not see it supporting the position that the major problem that we face at the present time is in the area of monetary policy.

Senator Douglas. I wish you would take another look at these figures, because it may indicate that free reserves are virtually nonexistent. The second question I want to ask perhaps applies to all three of you, although I came in late and did not hear Dr. Eckstein's statement. Dr. McCracken and Mr. Pechman seem to believe that the balance-of-payments problem requires relatively high interest rates. Yesterday, we brought forward facts indicating that so far as the short-time rate is concerned that the American rate is above the Swiss rate, which is only 2 percent. It is above the French rate which is about 2½ percent. It is above the Dutch rate, which is just about 2½ percent. It is below the French, British, and Canadian rates.

But, if you take the arbitrage costs into account, it is approximately equal to the French rate, and the British rate, and I think there are charts here to demonstrate that. It is below the Canadian rate, but I can hardly believe that people would transfer American dollars to Canada in view of the shaky situation in Canada which has caused them to devalue their dollar.

Now, then, just what is it that you are afraid of as far as the situation is concerned? Is it the fact that our balance of payments is against us? Is that the point?

Mr. Pechman. I would be concerned about substantially lowering the interest rate, particularly the short-term interest rate.

Senator Douglas. How about the long-term rate?

Mr. Pechman. I would like to keep the long-term rate at the present level, or even lower it a bit. The short-term rate controls short-term capital flows, which are particularly sensitive to interest rates. I think we have to keep short-term rates at a higher level than we kept them during the early postwar period.

Senator DOUGLAS. Is there a drain from Switzerland?

Mr. PECHMAN. No, but I am afraid that, if we pushed the rates substantially lower than they are today, it might stimulate a large flow of liquid funds abroad.

Senator DOUGLAS. Don't we have a real margin of safety on this and need we be concerned with speculative outflows of gold in search of higher interest rates abroad? That is what I am trying to say. What are you afraid of: that the balance of payments is against us and Europe may not be content with leaving their balance on deposit in dollars?

Mr. PECHMAN. Both factors are involved. I do not want you to misunderstand me, Senator. I do not want a higher level of interest rates.

Senator DOUGLAS. I understand. But you do not want a lower rate.

Mr. PECHMAN. That is right. In other words, I am saying that we have done fairly well in monetary policy up until recently. I am a little concerned about the noises being made on monetary policy, though I cannot say that the action has been as bad as the noises. If these noises are followed up by action, I would be terribly concerned, as you would.

Senator DOUGLAS. Here is the point. Recently the Federal Reserve sold Government securities and depressed the price and consequently raised the yields. The result has been a rise in the short-term rates and a lesser rise, but some rise, in long-term rates.

On the question of the unfavorable balance of payments, must we accept eternally those inadvisable items which turn a favorable balance of trade into an unfavorable balance of payments, which turn \$3 billion surplus in commodities to a $1\frac{1}{2}$ to 3 or 4 billion unfavorable balance because of the so-called inadvisable items. Are we committed indefinitely to continue maintaining military divisions in Europe? Are we committed indefinitely to the attendant costs of expenditures of dependents? Are we committed indefinitely to the existing level of foreign aid if the other countries do not contribute? Are we committed indefinitely to the present flow of capital abroad when virtually every other country imposes some controls upon the export of capital. I mention all these things. Can we take the existing unfavorable balance as something we cannot do anything about?

Mr. PECHMAN. I agree with the implications of what you said. A great many of these things have already been done and a lot more perhaps should be done. Certainly we should not have a domestic policy that would prevent us from getting back to high employment merely because of the balance of payments. I think that is the important lesson of your remarks.

Senator DOUGLAS. That is the point I was making. My time is up, but if any of you wish, you may volunteer a reply.

Mr. McCRACKEN. May I make just one comment, Senator Douglas.

The point of that part of my testimony where I commented on the balance of payments problem was simply this. We hear a great deal of discussion that the nature of our rather precarious balance of payments problem makes it impossible for us to consider expansionist fiscal policy action. Precisely the point that I was trying to develop here was that if we manage an expansionist economic policy correctly, there is reason to think that this kind of action at least would be

neutral in its effect, and I think personally there is at least an even chance that it might improve our balance of payments.

Senator DOUGLAS. You say "correctly," what do you mean?

Mr. McCracken. If the expansion of business activity that we got sets off a very substantial rise in the price level, or if we gave the economy a surfeit of liquidity, then this would probably work out to have adverse effects. But in the technical sense, the adverse effect on our balance of payments of a higher level of business activity because of the higher imports, would, I suspect, be largely offset by favorable effects on the large capital outflow—and ultimately even a strengthening of U.S. exports.

Senator DOUGLAS. I was not speaking of commodities.

Mr. McCracken. I understand.

Senator DOUGLAS. I was speaking of the military and dependents' expenditures, foreign aid, capital investment abroad.

Mr. McCracken. All of that would help. Some reduction in these is an essential part of the solution.

Chairman PATMAN. Senator Javits?

Senator JAVITS. Gentlemen, I notice an interesting consensus among all three with respect to a tax cut which is very interesting in view of the fact that the press and public and Mr. Heller all assume the matter is decided and that there will be none. Therefore, I notice, also, an interesting consensus among you—certainly two of you explicitly, and perhaps I missed it in the third, suggest that we give the President the authority to make a tax cut. Suppose I should tell you, just for the sake of this argument, that is equally impossible. Just as the President can decide that he would not ask the Congress for a tax cut, the Congress can decide that it would not give him authority to make one. I have little doubt, and I state this unilaterally, that is just as sure by now as the fact that he is not going to ask for one.

Representative CURTIS. Surely.

Senator JAVITS. I think the Congressman is right. Where does that leave us in view of the fact that your recommendations, Dr. Pechman, are directed essentially toward governmental action? I notice at pages 7 and 8 where you say that what we should do, if we cannot get a tax cut, is to give the President authority. I tell you unilaterally, and I think it is sound, that is just as unlikely and impossible as the other.

Then really you boil down to recommendations to extend unemployment compensation benefits, and to deal with the capital improvements program already passed by the Senate. I do not think you put that very high on your list, or that the administration submit a new budget. Again it is not too decisive a form of action. So really we get down to extending unemployment compensation benefits for a year. I could not agree with you more. I thoroughly agree with you.

Now I would like to ask you all this question: Are there not many other things which could be very helpful—assuming now that notwithstanding your view and mine, as you know widely advertised, that there should be a tax cut, that it should be now and it can be now and it makes a lot of sense, and the fact that we are not going to give the President this authority, which I asked you to postulate, and the fact that perhaps we would not even do this unemployment thing much as I agree with you. Are there any things which the Presi-

dent could do other than that which would help our situation, not necessarily only in the governmental line? For example, do you think that some effort should be made to deal with the business problems in making the transition to automation and in financing that transition—something which the President might very well generate through his Labor-Management Advisory Committee? Do you think that some action on the part of the Congress concerning the rash of big strikes that seem to be imminent on the railroads, to deal more effectively than we do under the Taft-Hartley law, with the problem of national interest strikes might be something to which we ought to direct our attention? Do you think that some declaration by the Department of Justice as to its policy in respect of the antitrust laws might be an important factor?

Somebody here suggested that the President ought to make a decisive statement of the view of the country on business profits, and their desirability and importance. In short, do you have any suggestions which go to the only clue to this proposition I find in your statements, that of Professor McCracken's paper which at page 5 says that businessmen were alarmed by the inferences they drew from the administration's handling of the steel price dispute? Then he says on page 6, consumer attitudes have never regained the levels of buoyancy they reached in 1955, and there has been some deterioration since events of April and May, which I would imagine refers to the same events. What do you say about that, gentlemen?

My time is up and I have asked you a long question, because I am a lawyer.

Mr. ECKSTEIN. I think this country has many problems and accomplishments and there are lots of things the Government might do and lots of things the Government might stop doing. One thing the Government might well do is to create a more certain business environment with regard to areas of regulation, antitrust and so on. Even if policy is tough, business is better off knowing it is going to be tough than not knowing at all and having to deal with a rather erratic kind of situation. Other than that, I do not think a little bit of action on these longrun structural problems, such as depressed areas and automation, is any kind of a substitute for the kind of massive fiscal action which is called for. I will even go so far as to say that in some way it distracts us from the main problem.

These structural programs, which I agree are very much needed to ease the introduction of technological progress into the economy, will be much more successful if the overall situation is healthier.

Senator JAVITS. Thank you very much.

Mr. McCracken. May I make one comment?

Senator JAVITS. I would like to have you all comment, if you would.

Mr. McCracken. I do not think any reasonable estimate of the magnitude of the economic effect of action in these other areas would be equal to the kind of stimulus we could get from tax reform and reduction. Now, if these are ruled out, however, then the question becomes: Do we just sit on our hands, or are there other things to do? There is no question in my mind but that something constructive could be done along the lines you have indicated in your question. It would be very helpful to try. It certainly would not hurt to try.

Senator JAVITS. Thank you.

Mr. PECHMAN. I agree that the longrun problems that you suggested ought to be tackled and it would be helpful from the standpoint of business and consumer confidence to know that they are being thought about constructively. But I also think that the point made by Professors Eckstein and McCracken is quite right. I know of nothing that would equal the potency of a very substantial tax cut. But I have worried about your question and that is why I have a program at the end of my paper.

Since you foreclose the possibility of Congress giving even temporary authority to the President to cut tax rates, I am sure that when you have your hearings next February on the Economic Report you will find that unemployment is no lower than it is today. It may even be higher. And you will be lamenting the fact that we wasted another 6 months, and that the rate of growth of the economy will have been further reduced; in other words that we will still be where we were 2 or 4 years ago. I think the quicker we start solving these long-run problems, the better.

Senator JAVITZ. Gentlemen, you have given me encouragement and fortitude to continue my campaign for an incentive tax cut. Thank you.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. A question first of my colleague, Mr. Curtis. Did I hear you right—you attribute the fact that a smaller total of local school bond issues was voted in 1961 than in the period, 1958–60, to President Kennedy's advocacy of Federal aid for education?

Representative CURTIS. It was the unsettled condition, yes. The school districts thought they might get it free or get it from the Federal Government.

Representative REUSS. Then I did hear you right.

Representative CURTIS. That is correct.

Representative REUSS. How do you account for the fact that school districts voted larger amounts for local school bonds in the period 1958–60, when President Eisenhower was advocating aid for school construction? Was that because they did not believe him?

Representative CURTIS. I guess so.

Representative REUSS. A question for the panel——

Representative CURTIS. If the gentleman would yield. You made a wisecrack.

Representative REUSS. How long do you want me to yield?

Representative CURTIS. Just to comment. I would say it could be that. I do not know. It certainly deserves explanation or contemplation. I merely suggested that this could be the reason. I think it probably is.

Representative REUSS. A question for the panel: Leaving aside, for the moment, the politics of tax cuts, monetary policy, and other methods for dealing with our economic lag, what is the difference in economic effect of a tax cut of, say, \$6 billion and increased Federal expenditure of \$6 billion? The increases in Federal spending in my example would be for schools, hospitals, urban rapid transit, urban redevelopment, antipollution work, and other necessary public works. Is there, in your opinion, anything different economically between one method and the other? They would both increase the deficit by \$6 billion in the period immediately ahead. Would one method give more impetus to the economy than the other?

Let us also leave to one side, the point that the construction work required by a public works program takes a bit longer to translate into actual expenditure.

Would you each give me your opinion?

Mr. McCracken. Certainly I would not take any Procrustean view with regard to Federal expenditures or taxes that one is all evil and one is all virtue. It would seem to me that on the "first round" the rise, in Federal expenditures might very well have a slightly more expansive immediate effect than a decline in taxes. With a tax reduction some part of the resulting increase in income would presumably be saved. On the other hand it is not easy to effect an immediate, large upward displacement in the trend of Federal spending.

Representative Reuss. I assume you are comparing the average saving by consumers of 7 to 8 percent of their disposable income with the fact that a million dollars spent in building a school is by definition spent.

Mr. McCracken. In the first round, yes. On the other hand at this stage of the game the evidence is quite clear, to me, that the time has come when we do need some action on the tax side in order to start moving toward a level and structure of taxes that would be somewhat less of a drag on economic expansion and growth secularly, quite apart from the very immediate period.

Mr. Eckstein. Congressman, the total Federal purchases of goods and services outside of defense in 1960 were \$8.6 billion. Of that, a very substantial fraction is agriculture. The rest was defense.

Representative Curtis. Federal?

Mr. Eckstein. Federal goods and services. Only \$8.6 is nonmilitary. And that includes space. To effect a substantial increase in that would be very difficult. The Federal Government simply does not buy that many civilian goods and services to make it an instrument of the same magnitude as a tax change.

Representative Reuss. I suggested some areas of public expenditure where the needs today are very great. However, I am putting to one side the question of whether increased expenditures are politically feasible, socially just, or economically desirable in terms of resource allocation. What I want to know is, would you get the same economic impetus by spending \$6 billion more as you would by taxing \$6 billion less?

Mr. Pechman. I want to agree with the point you are making. The ratio of taxes to expenditures that is too high. You can reduce this ratio either by reducing taxes or increasing expenditures. If we got businessmen and consumers to spend as much as is necessary to get us to high employment, today's tax structure would not greatly impede the rate of growth.

I think there are things that can be done to improve our rate of growth, but the rate of growth that we can achieve at high employment is awfully tough to budge. We would have to make many changes to increase the growth rate. One of them would be to reform the tax structure to the extent that it impedes incentives.

Representative Reuss. Then, what you three gentlemen contend is not that we need a tax cut as such but that we need a budget imbalance at the present time for various reasons. In economic terms, am I not right that it is not the level of taxes alone, but the level of taxes in

relationship to Federal spending which chokes off the economy before full employment is reached? If the budget tends to balance before full employment is reached, the ailment could be cured by either of two methods.

Dr. McCracken says, "Cut taxes." Galbraith might say that public expenditures should be increased.

Mr. PECHMAN. I agree.

Representative REUSS. I have used your names rather freely. I hope I have not misinterpreted your positions.

Mr. McCracken. No. Clearly the two sides of the budget must be taken into account. I would agree with this. A tax cut would temporarily mean an enlarged deficit. If, however, tax reforms will really strengthen the economy (as I think they can) we can be ahead of the game in the long run on renewals of the deficit.

Representative REUSS. There has been much talk recently about a tax cut as though it were the only way out. Actually, budgetary balance seems to me to be the real problem. I am not suggesting what fiscal policy mix we should have, except to say that the best mix is one which combines relatively easy money and low interest rates, a tax cut and spending for the Nation's needs. An aggressive trade policy would also help.

Representative REUSS. Dr. Eckstein, in your statement on page 8, you refer to the argument which says,

Why cut taxes now, since this will cause interest rates to rise and to cancel the benefit of the tax cut? The growth rate will not increase, but we will have a larger deficit.

Your reply is that, although the monetary authorities actually shrank the money supply and increased interest rates in the 1958-59 recession, they will now allow the money supply to increase at some modest rate. Why do you think this will be the case, particularly in view of Mr. Martin's recent testimony that he would not permit any of the deficit resulting from a tax increase to be financed by the banks.

Mr. ECKSTEIN. It would certainly be far beyond my capabilities to analyze why our central bank does what it does when it does. However, what I am really trying to say is this: The tightness of money and the level of interest rates in 1963 will be largely determined by the policy choices made by the Federal Reserve and the Treasury. I do not know whether they will do the right thing or the wrong thing, but the extra few billion of deficit which will have to be financed, I doubt will be the decisive considerations. It would obviously raise interest rates somewhat. But I do not believe that additional financing alone would reverse the basic tone of the capital markets.

Could I also take another moment while I have the floor? When I read my statement I also made a quick comment on the possibility of lowering withholding schedules effective January 1. I stand corrected on that. It would take congressional action to lower the withholding rates.

Representative REUSS. I am glad you made that point because I was about to ask you. More administrative flexibility in the withholding provision might be desirable, but it does not now exist.

Senator PROXMIRE. I would like to ask Mr. Eckstein, Senator Javits indicated there is not much prospect of a tax cut. Yet Senator Javits

advocated a tax cut the other day which he said would be a \$7 billion tax cut. He included in that the \$1½ billion reduction in tax burden the administration has already achieved because of the adjustment of the depreciation. Now, as he pointed out, it appears that the Finance Committee with that monster they are about to report out, is going to further reduce taxes, and as far as the investment credit would seem to provide an additional \$1 billion tax cut.

FOR BUSINESS SPECIFICALLY IN CASH FLOW

So is it not true that during this year of 1962 if Congress takes no further action, there is likely to be, in effect, a tax cut for business of about \$2½ billion?

Mr. ECKSTEIN. That is correct.

Senator PROXMIRE. Since you advocated a \$6 billion tax cut, this is 40 percent of the way.

Mr. ECKSTEIN. No. Our analyses took those for granted.

Senator PROXMIRE. You are really advocating \$8½ billion tax cut if we want to include everything?

Mr. ECKSTEIN. If you want to include all the previous relief, yes. The Treasury is supposed to get a little bit of the investment credit back in revenues from loophole closing. They are not to get all of it.

Senator PROXMIRE. Very little the first year—A net cut of a billion dollars in taxes.

Mr. PECHMAN. May I just interpose that I am distressed to see so much pessimism about some of the things that were not included in the Finance Committee bill. I should hope for example that an effort would be made to restore withholding on the floor.

Senator PROXMIRE. It will be made but it does not have much chance.

Mr. ECKSTEIN. To answer your question more to the point, the additional savings that will be made available by these measures will certainly have to be considered in making up the next tax package. It is a fact that the cash flow of corporations will have been augmented by between \$2½ and \$4 billion. I do not think anybody knows where in that range. And for any tax bill in the future, it would not make any sense to keep pouring more and more money into that area alone.

Senator PROXMIRE. That is right. From what you say I take it this is one area where we are probably less in need of a tax cut. This relates to a vote that we may be about to take on the floor of the Senate in the next few weeks, whether or not we should have an investment credit. I am inclined to feel that the cash flow increased before the improvement in the depreciation policy of the administration. Now the cash flow is going to be abundant, and perhaps superabundant.

There is an additional loophole in this investment credit to permit for the first time a depreciation exceeding a hundred percent which would seem to have some equity disadvantage. I am wondering whether in your judgment, Dr. Eckstein, if this is a sensible proposal now under the present circumstances.

Mr. ECKSTEIN. I am still an optimist that even if not now within the reasonable future we will get the short-run problem straightened out. Maybe that is foolish, but I believe we can, and there is a reasonable prospect we will. If you really look at it as a long-term question,

I do believe that we have something to learn from the experience of Western Europe and Japan, and that tax devices will raise the total rate of investment.

Senator PROXMIRE. Yes; but is this the right kind of tax device? In the first place, business has not indicated any enthusiasm. McGraw-Hill said this will have the result of increasing investment by \$300 million although the Federal Government will lose a billion dollars. A survey by the Wall Street Journal, with 68 big firms queried, only 1 said they would change their investment policy. It is a nice windfall, but one they do not expect to influence policy and do not want it.

Mr. ECKSTEIN. This will not be very effective as long as the aggregate rate of activity does not lead to anything like optimal utilization of capacity. I would not attach too much significance to the immediate answers of businessmen. I think most of them did not understand what the credit was about. I have explained it to a few small businessmen and in some cases they very clearly told me, that it certainly would help them quite a bit.

Senator PROXMIRE. These were the biggest firms in the country and people who had very distinct ability, and understanding in this area. They have sufficient specialists so they should be competent on something of this kind. Let me ask Dr. McCracken, you assumed the same thing Dr. Heller did yesterday: That the supply of money should include time deposits. We did not have a chance to pursue it on this, but I want to take the few minutes I have left to pursue it with you.

Dr. Heller seemed to ignore his own indicators which show on page 26, money supply, total, and under total it does not include time deposits. It does include currency and demand deposits which have been the traditional definition of money supply. Then it shows related deposits or time deposits separately. On this basis, and I think you can make a good argument that time deposits are not money, it is clear that money supply has been dropping very rapidly in relationship to the gross national product, whereas in 1953, it was 35 percent; 1958, 31 percent; a year ago, 27 percent; now it is down to 26 percent. This does seem to represent a real squeeze which is being directly reflected in rising interest rates, as Senator Douglas demonstrated so well, and by the drop in free reserves.

Mr. McCracken. I would define the money supply differently from the Federal Reserve or the concept as included in the Economic Indicators. There is no one definition which is uniquely and clearly and unambiguously vastly superior to another. The assets that people hold are really a continuum, ranging all the way from currency, the most liquid asset, to demand deposits and time deposits and for corporation short-term securities, which serve for them a function virtually the same as cash. One important function of money is to serve as a reserve of purchasing power for unforeseen contingencies. Certainly time deposits serve this function well, and practically are immediately convertible into demand deposits. In any event one can say this. In the last year total bank credit has increased over 8 percent, half of which has occurred since the turn of the year. Perhaps that is a better measure of the monetary influence on economic activity. As a matter of fact, in my opening statement I used the figures on bank credit, rather than the money supply, because it was not until after my

prepared statement had been mimeographed that I got the July Federal Bulletin with the new seasonally adjusted data.

Senator PROXMIRE. To follow up on this, would you not all agree that if the Federal Reserve Board and the Treasury continued to follow a tight money policy, if they continue to push up interest rates, if they continue to shrink reserves, and the Chairman of the Federal Reserve has indicated he might very likely adopt such a policy, and action on the part of the Treasury has indicated they are moving in the same kind of direction, then we are going to need a bigger tax cut to get the same stimulation in the economy? Furthermore would you agree that it is conceivable that if we have a relatively modest and small tax cut with a substantial increase in interest rates, that the economy might not move at all. It might stand still or even retrogress.

Mr. PECHMAN. I would agree that, to the extent interest rates are raised, a larger tax cut would be necessary. However, I would hope that, if we had a substantial tax cut, it would not be accompanied by higher interest rates.

I certainly do not think that we ought to permit long-term interest rates to rise and to reduce investment at the same time that we are trying to promote investment. That would be ill-advised policy under present circumstances.

Senator PROXMIRE. I would like to ask Drs. Eckstein and McCracken one more question:

In reply to what Mr. Reuss said about cutting taxes and increasing expenditures, you indicated that the expenditure side of the budget, Dr. Eckstein, was pretty difficult to expand. In Dr. McCracken's presentation he said on page 14, this proposal for a tax cut would be, in short, a step toward fiscal conservation. In the long run it would make for a less rapid increase in expenditures and more spacing on the tax side for further needed reforms. I know that Dr. Eckstein said that a reduction in tax rates will force the Government to scrutinize expenditures more closely in the coming budget.

I believe in economy in Government. I wish I could subscribe to your view that taxcutting will lead to expenditure reduction. But I feel when economists are talking about deficits and asserting that we need bigger deficits, this destroys the discipline Government has. You can make a strong argument if you accept your basic assumptions for almost unlimited spending. Services are needed and wanted. There is a lot of pressure for them. What is a poor Senator or Congressman going to do when he gets that kind of pressure and when the economists say it will be greater for economy if you cut taxes and increase spending? It is wonderful for the politician if he accepts that viewpoint. When you do that you get in the position where you could have a very bad misallocation of resources, and where you have no real discipline to exercise prudence in Government spending. This directly contradicts what both of you gentlemen said in your statement. Does not this concern you at all?

Mr. ECKSTEIN. I think you would agree with us, would you not, sir, that in general a tax cut would lead to less spending than no tax cut.

Senator PROXMIRE. In old days, yes. But now when a tax cut is justified not because spending has been reduced or spending can be reduced, but although spending is increasing and has been increasing,

the argument is made we need a deficit to move employment up. I say under these circumstances the tax cut will not restrain expenditures.

Mr. ECKSTEIN. Historically, in recent years has it not been like this? The Budget Bureau and the President have been very tough when there was no recession. When there was a recession the lid was off, so to speak, and new programs began. Everybody got a little bit more money in all fields.

Senator PROXMIRE. Now there is no recession and believe me nobody is very tough and Congress is spending money with record rapidity.

Mr. ECKSTEIN. There are a lot of structural issues both in taxation and expenditures. Obviously, there are some tax cuts that would be worse than some expenditure increases and vice versa. A lot of people, including, I think, the three up here this morning presently favor a tax cut, because they really feel it is impossible to prepare a high quality expenditure program of the requisite magnitude within the time schedule in which events are occurring.

Mr. McCracken. The importance of maintaining the concept of fiscal discipline, to which you have alluded, seems to me to be exceedingly important. While clearly the advocacy of a tax cut is suggesting a program that would make the deficit larger, I prefer to put this in terms of getting toward the kind of tax structure which would seem to me to be more consistent with increasing the vitality of the economy.

Now, how does one reconcile these two? I would reconcile them on a basis that has received substantial attention recently. The important thing is always to compare the relationship between our expenditures and the volume of taxes which the present tax structure would produce at reasonably full employment. I would be very reluctant, under any circumstances short of a real emergency, to suggest a tax cut which would leave the tax structure not comfortably covering expenditures at full employment. If this is our approach to the budget problem we do not surrender concern about fiscal discipline. So our tax action should leave us with a tax structure that will always comfortably cover expenditures, assuming that we have reasonably full employment of our productive resources.

Senator PROXMIRE. My time is up, but I would like to say that is an awfully theoretical goal as compared to balancing the budget, which is precise and with all its weaknesses you can still arrive at some arithmetic precision. To talk about a full employment balance—you can argue on vague generalities a long time.

Mr. McCracken. There is no question about this. I suppose to some extent the function of a professor is to be theoretical and explore things that may not have immediate applicability. But it does seem to me that there is validity to this way of looking at the budget problem, and I suspect that we shall hear more about it.

Mr. PECHMAN. I just want to agree with what Professors Eckstein and McCracken said, although I did not make this point explicitly in my statement. In reply to your question, I believe that expenditures would be lower if we had a tax system that next year produced \$90 billion rather than \$95 or \$98 billion. In other words, I do think that the prospective level of the tax receipts exercises a restraint on spending. The existence of a large deficit, which is your alternative hypothesis may relax restraints.

As a matter of fact people do not understand that a deficit indicates one of two things; either the economy is not operating up to full capacity or expenditures are wasteful and too high. We have had deficits during the past 5 years because we have not reached full employment.

Representative CURTIS. I want to get into another question, but first I want to lead into this. The thing I have not understood and I have asked all the witnesses before the Ways and Means Committee, and this committee, is this: How does this theory of a tax cut in a period of a deficit already relate to the economic problems it creates in the debt-management area?

As a member of the Ways and Means Committee I have always had to be concerned about how we market our bonds. If you take \$5 billion, let us say, and give it or transfer it from the governmental sector to the private sector in the nature of a tax cut and then market \$5 billion of bonds in the private sector, why do people suppose that stimulates the economy? Maybe there are some reasons. Occasionally I have gotten answers to the effect that the transfers involve different people. I say let us go into that. But we have not had very much discussion on that subject.

Dr. Heller yesterday had only one little paragraph on the problems of debt management in his prepared statement—simply to say they are great and very difficult, and we have to be very careful about whether we market the bonds to the consumer or whether we use the Federal Reserve System. I said if you are going to use the Federal Reserve System and simply create more money, in effect you are not talking so much of the tax cut effect as you are talking about the fact that inflationary forces of this nature would stimulate the economy. Would any of you care to comment on that?

Mr. ECKSTEIN. It is certainly an extremely difficult question on which economists have pondered and reach no definitive conclusions. There are some things you can say. First, if economic activity expands as a result of the tax cut, some normal increase in the money supply should go along with it.

Representative CURTIS. Let me stop you there, if I may, Doctor. You say, "If it does." To me that begs the question. What we are talking about—does it? Will it?

Mr. ECKSTEIN. Let us take that question first. I take that for granted. Would that tax cut be spent? That is the first question.

Representative CURTIS. That is correct, but nothing should be taken for granted.

Mr. ECKSTEIN. The evidence on that, and there is some disagreement among the experts, I would say it would be fair to summarize it this way. As far as consumers are concerned you would find—and there is an immense amount of statistical work done—people would say somewhere between 60 and 80 cents of every dollar would be spent within a year.

Representative CURTIS. We have never done this. This has always been theory, as I understand. There is no place we can look where we have cut taxes for the purpose of this kind of economic stimulation. I am just taking your aggregate. You take \$5 billion here in tax cuts and then you take it back in bonds. Dealing in aggregates I do not see what you have done, unless there is something about the mix in here.

Suppose you sold it in E-bonds. The purchasers then are the consumers. Then they would not have \$5 billion to spend. You have taken it right back from them. Suppose some goes to investors, as some would, then they do not have that to invest. The Government has taken it.

Mr. ECKSTEIN. Sticking to the tax side, a tax cut on business, I think most people who have tried to make studies of it tend to say in the long run the larger part of additional cash flow would be spent. Then you get to the other side of the question—to what extent is spending reduced by the bond financing? Mortgage money and other long-run money is presently not terribly scarce. It is not rationed even though interest rates have moved up. It seems to me that it is up to policy whether long-term investible funds other than internally generated funds are going to be made very scarce or not. That is a question of Federal Reserve policy.

So we have that side of the coin under somebody's control to some extent also. Of course, the Federal Reserve could run a policy which is so tough that they could completely undo the effect of the tax cut.

Representative CURTIS. Particularly with the balance-of-payment problem. To me these are the issues we should have been discussing in the Ways and Means Committee. Yet the witnesses who appeared before us were unprepared to discuss it. It was improvising, instead of the prepared papers being on that point. I thought that everyone was begging the question. The question is, Will a tax cut which increases deficit financing and puts an added burden on debt management in the condition we are now in, balance of payments and so forth, stimulate the economy, even if it would work at other times under different circumstances? This is an untested theory at best. At any rate I wanted to pose that.

The one thing I particularly wanted to ask a question on here is this: I have just recently got my ducks in a row on it. I know you are all interested in new economic phenomena. I think we have a beauty here. To me it is an amazing thing and one that requires real study and explanation. That is the fact that the civilian labor force, and I have the figures back to 1929, has continually increased each year except for war years. With the total labor force which includes the Armed Forces it continued to increase. But for the first time since 1929, in the year 1962, the civilian labor force actually has not increased and yet our population figures would indicate that there would be an increase of around 1 million.

I average out the figures from 1929 to 1959; we increased on an average about 700,000 a year. In the figures that we have here from 1955 to 1961, we increased almost a million a year. We were able to ask questions on this. Dr. Ewen Clague sent in a letter to the committee saying his statistics were right. I had raised the question whether the phenomena could be explained as statistical errors. Secretary of Labor Goldberg yesterday said that this is a phenomenon to which they just do not know the answer. I have been trying to fit it into my theory of what I think is the test of real economic growth and my belief that we are not stagnant and it does make sense to me that we are having people withdraw from the labor market because they do not want that extra income or balancing in their minds whether they would rather have the leisure time or the income. People did go into the

labor force apparently, women, so that their family could get another car or downpayment on homes, and so on. Maybe that is it. I do not know.

Certainly this gap theory, if you apply this million group, you must put it into the unemployed area, and so the gap has widened. I do not adhere to the gap theory, but to those of you who do, I would think this would be very worrisome because then your gap is increasing.

Mr. ECKSTEIN. I have tried to make a little bit of inquiry on this problem. I gather that the lack of growth of labor force is not concentrated in any one group. I think originally the thought was it might be earlier retirements because of the improved social security benefits.

Representative CURTIS. The figures showed it to be in all age groups and not by men or women, either.

Mr. ECKSTEIN. There are a lot of different phenomena and so far nobody is in a position to put them together. Certainly one thing that does happen in a depressed area, you do slowly over the years evolve a new way of life in which people drift out of the labor force and draw relief and make a living without working. It takes several years of not much prospect for employment where you are located before you get this kind of effect of people just sort of drifting out of the labor force and finding some other way of getting along.

Representative CURTIS. Even in the depression years of the thirties, the civilian labor force increased each year. I did want to point that up. The final thing, and I just want to get this more or less on the record; to me the places that we have to get into in reforming our tax structure are not just rates. Yes, I am very much interested in rate reform. I want to point up some of the specific things in our tax laws I think are impeding economic growth. They seem small, but I do not think they are in economic effect, only in revenue. One is a tax law which works against labor mobility. The law as it presently is says that a man's residence is where his job is. This may have been true in the 1920's and even 1930's. As a matter of fact, our laboring group now, 80 percent of them own their own homes. So their residence is where their home is. This archaic law has an effect on the tax of those individuals if they have to follow a job. If they are technicians, like from McDonnell Aircraft, men going down with their missiles, from St. Louis to New Mexico, and they are in New Mexico over a period of some months, what is a per diem allowance becomes taxable income according to the Federal tax laws. Likewise, when you shift a plant, like Chrysler did from Evansville to St. Louis, the workers cannot immediately sell their homes. They follow their jobs and they are commuting back and forth. They cannot deduct the cost of maintaining two residences from their taxable income. This is a reform badly needed. In my estimation, one of the greatest problems in our dynamic economy is matching skills with jobs and encouraging labor mobility, to bring this about. This tax law encourages labor immobility.

The second point, our tax laws work against training and retraining. Another great problem in a dynamic economy going places, as ours is, is in upgrading skills, training, and retraining. The tax law says if you study to hold your job you can deduct the cost from

your taxable income. But if you go to improve yourself by training for a better job, you cannot. Yet the process today is such, if my interpretation of this dynamic economy is right, that if you have a skill, it can become obsolete in 5 years. Formerly, in father's time, you could have a skill that would last you a lifetime. Really, to maintain yourself you have to be in a position of upgrading your skill, retraining constantly, and yet our tax laws work against this process. Third, our tax laws on research and development are out of date and working against economic growth.

You have to tie the actual research and development into a marketed product to get a tax deduction. Yet today pure research which is not tied to a product must be conducted if we are to move forward, and our tax laws work against that. Our tax laws work against equity financing, giving an undue preference to retained earnings and debt financing. We started to reform that in 1954, one step out of three was taken. But even this modest reform was so hit on the head, I would say, in a demagogic fashion, by people who refused to look at the problem, saying we were giving tax cuts to rich people, that we have been hard put to hold the little progress we made, let alone take the next two desirable steps. The purpose of the stock dividend tax credit was to try to relieve the double tax burden on new equity financing of growth on the theory that new equity financing was a more effective way to promote economic growth, than retained earning and debt financing. This reform actually works against the rich investor in favor of the smaller investor and encourages the noninvestor to become an investor.

And then finally I must mention the burdensome taxation we impose on profits which has had a lot of discussion here. This is an out-and-out tax on incentive, the well spring of human progress, economic or otherwise. I simply want to put those matters on the record. So much talk has been spent on economic aggregates that we tend to forget the components where we will find the source of our problems. You call them structural when I refer to them in this way. I think if we would get to work on these structural things which mean little as far as the revenue is concerned, we would move forward. It would mean a great deal to economic growth because we would be removing some of these impediments to economic growth. We would help to match up the unused labor force with the jobs that are going begging. I am convinced there are more jobs going begging today, than there are unemployed, which is traditional, not unusual, in America. In other words, we have a labor shortage. We have not matched the human beings with the jobs that are going begging.

Thank you.

Senator DOUGLAS. There very well may be a tax cut, if not in 1962, in 1963. In connection with that, the chairman asked me to read certain sentences from the report of the commission on money and credit set up by the CED, which certainly is not charged with being a radical commission. These are from pages 134 and 135:

As in the proposal for formula flexibility—
said the commission—

the most appropriate choice for shortrun discretionary changes in taxes is the first-bracket rate of the personal income tax. They are least likely to open

up controversial questions of income tax structure. The legislative and administrative problems in making such changes would be relatively simple. No uncertainty would be encountered in complying with such changes.

That is the end of the first quotation.

Then the second quotation was the italicized summary on page 135:

The commission, therefore, concludes that when discretionary tax adjustments are used to promote shortrun economic stabilization, they should consist of variations in the first-bracket rate of the personal income tax.

Thank you very much, gentlemen.

The committee will reconvene at 2 o'clock.

(Whereupon, at 12:30 p.m., the hearing in the above-entitled matter was recessed, to reconvene at 2 p.m. the same day.)

AFTERNOON SESSION

Chairman PATMAN. The committee will please come to order.

We have as our first witness this afternoon Mr. Leon H. Keyserling, economic consultant, Washington, D.C. Mr. Keyserling is well known. He has been around Washington a long time. He has been a witness many, many times before this committee, before the Banking and Currency Committees of the House and Senate, and others.

Mr. Keyserling, we are glad to have you, sir, and I notice you have a prepared statement. You may proceed in your own way. After you finish we will have Mr. Saulnier and then after he finishes we would like to have the panel interrogate both of you.

We will interrogate you together instead of separately, if that is all right. You may proceed.

STATEMENT OF LEON H. KEYSERLING, FORMER CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS, ECONOMIC CONSULTANT, AND PRESIDENT, CONFERENCE ON ECONOMIC PROGRESS, WASHINGTON, D.C.

Mr. KEYSERLING. Mr. Chairman and members of the committee, I think the most expeditious method would be for me first to read some brief highlights of my conclusions, which will take only a relatively few minutes, and then I have some supporting materials in the form of charts which I would talk from orally.

Chairman PATMAN. All right.

Mr. KEYSERLING. Beginning with my prepared statement, I have been asked to speak about fiscal policy. But naturally, fiscal policy derives from the condition of the economy, and ties in with other economic policies. So, while I shall concentrate on fiscal policy, I shall try to relate it to the matters which determine what it is and what it ought to be.

I think the members of the committee are familiar with the method I use, which is to prepare over the years a rather complete description of the economy in action, and also what I call my model of an economy operating consistent with maximum employment, production, and purchasing power under the Employment Act of 1946.

Then, I constantly test the actual condition of the economy against the model, and try to discern where relationships went wrong and where the difficulties appeared. This has given me a rather full view,

and I think has helped me to arrive at some forecasts which have turned out to be moderately accurate.

I want to call attention to just a few of these before this committee, only for the reason that this has a bearing upon what I shall say about the future now.

In 1954, before this committee and elsewhere, I forecast an average annual economic growth rate of $2\frac{1}{2}$ percent from 1953 through 1960, which turned out to be accurate, and also forecast the growing levels of unemployed plant and manpower which would result. This, also, turned out to be reasonably accurate and, therefore, more or less vindicated my assumed needed growth rates, because if my assumed needed growth rates had been too high, the actual unemployment of plant and manpower would have been lower than my forecasts.

Second, in 1957, before this committee and elsewhere, when people were generally concerned about inflation, I was very concerned about the oncoming recession, which very shortly thereafter appeared, and similarly in early 1960. In early 1961, before this committee and elsewhere, and in a publication in May 1961, and in a meeting with about 150 Members of the Congress, I said that I thought that, with the policies then in being, the economic growth rate under the new administration would be no better than under the old one, for the simple reason that in my nonpolitical view you could not change an economy much without changing policies much. I said that I thought that the economic growth rate in 1961 and in 1962 would be only about half as high as what we would need to get back to reasonably full employment and production; that it would probably be the shortest recovery of all; and that it would probably convert into stagnation and recession more quickly than the others because of the cumulative effect of the uncured imbalances. Unfortunately, this has come to pass to date, though the recession still lies ahead.

Senator BUSH. You are speaking of the current recovery?

Mr. KEYSERLING. I am saying that the current recovery is the weakest since World War II.

Senator BUSH. You are not indicating that you think it is finished, are you?

Mr. KEYSERLING. I will deal with that specifically in my statement, Senator.

Senator BUSH. All right.

Mr. KEYSERLING. In support of my feeling that we need immediate and extensive changes in national economic policies—this is my first point—U.S. economic performance has been highly unsatisfactory since early 1953. Since then to date, our average annual growth rate has been only about 60 percent of the needed rate; we have at no time had maximum employment and production; and, through a recurrent pattern of inadequate upturns, recessions, and stagnations, we have moved inexorably in the long run toward rising levels of idle manpower and plant.

In second quarter 1962, the true level of unemployment averaged about 6.5 million, or almost 9 percent of the civilian labor force, taking into account full-time unemployment, the full-time equivalent of part-time unemployment, and the concealed unemployment representing inadequate growth in the labor force due to scarcity of job opportunity. I will demonstrate that in detail with my charts.

Similarly in second quarter 1962, total national production was about \$73 billion or almost 12 percent below maximum production. Let me say, parenthetically, that Chairman Heller in his statement yesterday said that national production was about \$30 billion below the true level. He obtains this figure by projecting a 3½-percent growth rate from 1957 or 1955 as being consistent with maximum employment and production. I have shown before this committee, on other occasions, and will show again, that this is a very much lower growth rate than can possibly absorb the new technology and the growing labor force.

As a matter of fact, the reason why the recovery in the first three quarters of 1961 came so far short of getting us back to full employment, and why the economy has done so much worse since then than was anticipated by many of the forecasters, including the Council of Economic Advisers, is that they have persisted in understating the growth rate needed to regain and maintain maximum employment and production.

In other words, the underestimate of the size of the problem is the first step toward taking inadequate remedies.

Since late 1961, we have been in still another period of economic stagnation, with an annual growth rate of only 3.5 percent from fourth quarter 1961 to first quarter 1962, and only 2.8 percent from first quarter 1962 to second quarter 1962. Of course, those figures cannot be related to the 5-percent growth rate that I think is needed in the long run, because you need a much higher growth rate than 5 percent when you are in a recovery period. That rate would merely hold you where you are with respect to unemployed plant and manpower.

And many indexes of activity tend to reveal an overall growth rate even lower if not negligible or negative in June and July. All signs now are that this latest stagnation will end up in the fourth recession since 1953, and trying to guess—let me underscore this—trying to guess whether this will happen later this year or in 1963 is a sad and fruitless misdirection of energy.

In view of the dismally consistent long-term record since early 1953, we are closing our eyes to reality and playing with fire when we ask for another few weeks, and then still another few weeks, to see where we are going, or when we look at every little ripple from week to week in order to squeeze consolation out of the inconsequential. We have done very badly for long enough; the time to start reversing the course is now.

I do not share CEA Chairman Heller's apparent view, expressed in his testimony yesterday, that the fast rate of upturn during the first three quarters of 1961, or how much better we have done in recent years than in the 1930's, may have some bearing upon where we are now and what we should do.

With reference to my analysis of the causes of our chronic economic difficulty, which is my second point, the central cause of this difficulty is that ultimate demand, composed both of private consumer outlays and public outlays for goods and services, has failed consistently to keep up with our increasing power to produce, as generated by business investment, improvements in technology and automation, and enlarged worker and managerial skills. In second quarter 1962, measured as an annual rate, a deficiency of about \$56 billion in private consumer

outlays, and some deficiency in public outlays, were the dominant factors in the deficiency of about 73 billion in total national production at an annual rate.

While there was also a deficiency in gross private domestic investment, and in investment in plant and equipment, during second quarter 1962 and during the period 1953 to mid-1962 as a whole, this deficiency was caused by the deficiencies in ultimate demand which led to vast idle plant capacities and therefore dissuaded private investment.

During the upturn or boom periods which have occurred since 1953, investment in plant and equipment has tended to race forward at a nonsustainable rate when measured against ultimate demand and unused plant capacities. Throughout the whole period, prices and profits and other funds available for investment have been ample or excessive, in that they have always been adequate to spark a level of investment as high or higher than justified by ultimate demand. This is true even today, despite the exaggerated talk about the "profit squeeze"; most profits now are very rewarding, and where they are inadequate it is only because of deficient ultimate demand and the extraordinarily high level of unused plant capacities. Profit-sales ratios indicate clearly that what business really needs is more sales.

CEA Chairman Heller's testimony of yesterday, in its citation of facts and indeed in its general analysis, powerfully reinforces what I have just said; that is, that profits are good and in many instances advancing; that funds available for investment are ample or even redundant, especially when cash flow is taken into account; and that only unused capacities and deficient ultimate demand stand in the way of more ebullient investment.

Under these circumstances, I might fairly construe Dr. Heller's continued support of still more tax concessions for investors as evidence of his proper responsibility to keep in step with existing administration policies. Meanwhile, I cannot understand fully why the administration is still debating what kind of tax cuts we need, or even leaning toward a composition of tax cuts which would exacerbate the imbalances between investment in the means of production and ultimate demand by favoring corporations and high-income individuals unduly, at the expense of those middle- and low-income consumers who spend for consumption a larger part of their aftertax incomes.

My third point is with respect to tax policy—and let me say that my discussion follows the very penetrating questions in the statement which the chairman of this committee put out in announcing the hearings—dawdling or delaying with respect to tax reduction has no justification, in the face of a chronic economic ailment which is now being confirmed rather than alleviated. And in view of the central reasons for the chronic economic ailment, the proper nature of the immediately needed reductions in taxes is clear as day. Tax policy since 1953 has aggravated the imbalances in the relationship between investment in the means of production and ultimate demand; recent Treasury revisions in tax regulations move in the same direction; and passage of the 7-percent tax credit would move still further in the same direction.

To restore a better balance throughout the economy, large and immediate tax reduction should concentrate upon increasing the after-tax incomes of low- and middle-income consumers, who have a propensity to spend a much larger proportion of their disposable incomes than higher income families.

Senator BUSH. May I just ask parenthetically how do you define the middle-income group?

Mr. KEYSERLING. There is no one definitive definition. In my recent studies, it is indicated that the middle-income group are those, let us say, with family incomes from \$4,000 to about \$8,000 a year.

Senator, I would be very glad to provide you with a study which shows the exact compositions of the number of families falling within the different sectors.

Senator BUSH. I just wanted to get what you meant. You spoke of the low-income group and then the middle-income group. I am not quite sure what you meant by middle.

Mr. KEYSERLING. For a multiple-person family, I would say below \$4,000, at least in urban areas, is low and from \$4,000 to \$8,000 or thereabouts is middle.

Senator BUSH. I see.

Mr. KEYSERLING. These tax cuts should have an annual value of about \$7 billion in fiscal 1963. Let me emphasize what I am saying now. These kinds of tax cuts would be good, not only for the short run, but also for the long run; they would be sound long-term reforms, in addition to their immediately stimulative effects; and thus the claim that we should wait until next year in order to develop systematic "reforms" in the tax structure is in my view specious.

In other words, once you accept my basic proposition, which I think to be sound, that we have a chronic economic problem of 9½ years duration, then it follows that the situation really hasn't changed fundamentally, and looking at all the little or short ups and downs and saying that each one is a change in the situation is, as I have said before, looking at a man whose head is bobbing up and down in the water, and every time his head comes up, saying he is up again. The economic trouble is chronic.

We should be particularly on guard against adopting, in the name of "reform," revisions in the tax structure which would aggravate rather than remedy the fundamental imbalances in the economy which have existed since 1953 and still exist. Such tax reforms as closing loopholes, while ultimately desirable, should be deferred, because efforts to enact them now would forestall the top priority tax action which is needed now.

I have noticed the very interesting article in the New Republic this week by Senator Douglas. I wish that he were here. There is no man in Congress for whom I have a higher regard, and I have not yet recovered from a debate which I had with him in 1952. Nonetheless, I do differ with him in this particular instance.

I agree that we should wait for tax reduction until we "see the whites of their eyes," but I have been seeing the whites of the eyes of the chronic economic trouble for many years. It depends on what you define as the whites of their eyes. If you are concerned only in an antirecessionary policy after the event of recession, then you should wait for tax reduction until you have a recession. But if you are

concerned with the fundamental, long-range problem of an inadequate growth performance, of chronic economic stagnation, of our competition with the rest of the world, of all the matters about which the President so eloquently has spoken on so many occasions, then the whites of their eyes are right up at the crest of the hill now.

With respect to Federal spending policies, I have this point to make. The proposition that any immediate cuts in tax rates should be counterbalanced by comparable cuts in Federal spending is so obviously wrong in the context of our whole economic problem that it should require no analysis. We are so far short of maximum employment and production and have such a long and difficult road to travel to get there and then to stay there, that we need both tax cuts and increased spending now. We also need increased spending, because of the grave neglect of many priorities of national need.

The current and prospective economic situation, in my view, calls for Federal spending in fiscal 1963 about \$3 billion higher than the administration proposes. Thus, my proposed tax cuts and spending increases would have a combined annual value in fiscal 1963 of about \$10 billion. This would provide total stimulation to the economy, including indirect effects, of about \$25 to \$30 billion. Of course, various economists will suggest a different product mix between the tax cuts and the spending increases. I would like to call your attention to the number of economists whose overall figure converges pretty close to the \$10 billion that I suggest.

Some of them suggest it all in tax cuts. I personally can't see how, as a great nation, we can concern ourselves only—

Senator BUSH. You say it would provide a stimulus to the economy, including indirect effects of about \$25 to \$30 billion. In what would that be reflected? The gross national product, or the gross national income?

Mr. KEYSERLING. This is the gross national product, Senator. This is merely the so-called multiplier effect of the changes in fiscal policy.

Senator BUSH. Thank you.

Mr. KEYSERLING. On the subject of balancing of the Federal budget, I make this point, which is my fifth.

Let me say clearly here that it is a complete misconception to think that I am in favor of an unbalanced budget. I am in favor of a balanced budget in a balanced economy.

We now have, and since 1953 have had, a spending and tax policy which is grossly erroneous and self-defeating, because it attempts to balance the Federal budget at levels of economic activity woefully short of maximum employment and production. In consequence, despite constant declarations of intent to balance the Federal budget, we have run an aggregate Federal deficit of \$30.7 billion from the beginning of 1953 through the middle of 1962. In vivid contrast, and I will demonstrate more clearly with my charts, if the expenditure side of the Federal budget during this period had been enough higher to fulfill its appropriate share of the task of maintaining maximum employment and production, the application of actually existing tax rates to an economy functioning at maximum levels of activity would have yielded an aggregate budget surplus estimated at \$14.3 billion from the beginning of 1953 through the middle of 1962. In other words, the net difference between the deficit of \$30.7 billion and the

\$14.3 billion surplus which I estimate would be about \$45 billion. This implies that we should have had lower tax rates, as well as higher spending, during this period as a whole, and indeed both would in fact have been necessary for maximum prosperity.

Under the Federal budget for fiscal year 1963 as now officially proposed, I estimate that our total national production during fiscal year 1963 will be at the very deficient level of not more than \$565 billion, and might well be only \$555 billion or still lower. At this particular point, most of the other estimates are about the same.

This would mean a Federal deficit of \$4 to \$7 billion, or even higher. The changes in tax and expenditure policy which I recommend would result, according to my estimates, in total national production close to \$600 billion for fiscal year 1963 and a Federal deficit of \$6.5 to \$7 billion. Thus, the true alternative is between choosing a planned deficit that will be highly beneficial to employment and production, and stumbling once again into a deficit through neglect of the needs of the economy, just as we stumbled into a \$12 billion deficit in one year recently, and I think about \$6.3 billion during the fiscal year just ended. Some people seem to think if you stumble into a \$6.3 billion deficit it has the same accelerating effect upon the economy as if you plan a \$6.3 billion deficit. This, of course, is not correct. In one event you are starting out at the beginning of the year with a fiscal policy that is stimulatory to the economy. In the other event you are starting out at the beginning of the year with a fiscal policy that is repressive of the economy and you stumble into the deficit because the economy suffers. It is not the same thing at all.

Moreover, the program which I recommend would offer a realistic prospect of reasonably full production and employment by 1964. This condition, along with the closing of some tax loopholes when the time is more propitious than now, and this is what some people call a practical consideration or a political consideration, would yield enough revenues to balance the budget even with the reduced tax rates and increased spending which I propose.

As a matter of fact, on this matter of tax reform, I have said above that I think that the kind of tax reduction which I propose is really the most basic, and long-range, and fundamental kind of tax reform, and that, so far as the tax reform of closing loopholes, such as depreciation allowances and so forth, I would like to do some of that but it is entirely secondary now. It isn't going to stimulate the economy if you do it. It may give some people a sense of moral fervor. I would like to see it done ultimately. It may be important, when we are wedded to the concept of getting as close as we can to a budget balance, but such kinds of tax reforms in my mind are entirely secondary, and I think that they should be put aside so that with less acrimony and more dispatch we can get down to the job of the kind of tax reform that we really need now in the interest of the whole economy.

MR. REUSS. Mr. Keyserling, when you say 1964, do you mean fiscal year 1964?

MR. KEYSERLING. I would say calendar year 1964. I don't believe that, where we are now, we can get to full employment by fiscal year 1964, except by changing my \$10 billion compound to \$15 billion, and for what I call practical reasons I have held it a bit below that.

Senator JAVITS. Mr. Chairman.

Chairman PATMAN. Senator Javits?

Senator JAVITS. If the chairman would allow me—I may not be able to stay but a few minutes as I have a bill on the floor and I have to go back—I didn't quite get, Mr. Keyserling, your point about taxes when you talked. Would you mind making your point again?

Mr. KEYSERLING. My point about taxes is that I think we need an immediate tax reduction, and I want to commend the Senator on what he said about that, although we don't agree on the exact composition.

I think, also, that his statement about the lack of vigor in pressing for this now is correct. I say that we need an immediate reduction in taxes because we have been suffering from a chronic economic ailment for 9½ years and that, therefore, waiting another 2 weeks, or 4 weeks, or 6 weeks for another little inconsequential ripple has little to do with the case.

Such delay bespeaks a continual attention only to very short-range developments, which negates the very concept of the chronic ailment.

Senator BUSH. Tell him also about your schedule of reduction.

Mr. KEYSERLING. Then I say, and here the Senator and I do not have exactly the same program, that the program should concentrate very heavily, if not entirely, upon the reduction of consumer taxes in the middle and lower income brackets, on the ground that this would provide the most immediate stimulus to consumption, and in other parts of my testimony I analyze why the other forms of tax reduction are not needed now.

Senator JAVITS. I thank my colleague and I am very grateful to the chairman.

Mr. KEYSERLING. On the subject of rates of saving and family incomes, which is one of the other questions raised by the committee chairman, I say this: Federal tax and expenditure policy since 1953 to date, along with other developments in the economy, have resulted generally in too high a rate of personal saving, and too low a rate of consumer expenditures, measured against total personal incomes after taxes.

May I say here that I do not measure the appropriate rate of personal saving, and here I differ from some economists, primarily by historic records in the past. I measure it primarily by looking at the economy and seeing whether as a matter of pragmatic observation investment and consumption have been kept in balance or whether one has outrun the other, and since the function of savings is to spark investment or to feed investment and the function of consumer spending is to add to ultimate demand, I derive the conclusion that the rate of savings has been too high from the fact that, generally speaking, investment has outrun ultimate demand and resulted in vast unused capacities.

I might call this the functional approach, or the real wealth approach, or the ultimate performance of the economy approach. This condition is the natural counterpart of the imbalance between investment in the means of production and that portion of ultimate demand which is represented by consumer spending.

The appropriate remedy is to reverse the regressive trends in income distribution which have been persistent in recent years. May I point out that, since I put out my income study a few months ago,

there have been two very good books on the subject, one by Robert Lampman and one by Professor Kelso, which support what I have been saying all along: under conditions of low economic growth and high unemployment, we have had a regressive redistribution of national income in recent years.

The appropriate remedy is to reverse the regressive trends in income distribution which have been persistent in recent years, and which cause too much saving relative to consumer spending because higher income families save more while lower income families spend more relative to the size of their incomes.

I am not talking here about a share-the-wealth program or equalitarian program, but I think it is always the function of national policy to improve the equity of income distribution. This has been part of our long-range progress, and whether this is the purpose or not, every tax policy, every monetary policy, and every other basic economic policy, does affect income distribution, so we might as well look at what we are doing. The kind of tax cuts which I propose would be part of this appropriate remedy. Increased Federal spending would also be part of the remedy, because many of the public programs which need enlargement, such as in the fields of education, health, housing, and social security, improve the absolute and relative incomes of low-income and middle-income families. They also provide a great new mass market for business.

A vigorous trend in this direction would also be highly desirable on social grounds, which I have never regarded as outside the scope of national economic policy, in view of the fact that about two-fifths of all Americans now live in poverty or in some lesser degree of deprivation.

On the subject of monetary and credit policies, I would say this: I agree entirely, I may say here, with the very eloquent statement made by Senator Douglas in the New Republic this week, excoriating, if I judge him correctly, the recent and current monetary policy. It has been very much too tight. It has been wrong, all along.

I do not believe, however, that monetary policy is a substitute for fiscal policy. Also, monetary policy can be used much more easily to repress the economy rather than to expand it, because it is easier to pull a string than to push it. If you don't have the fundamental levels of demand about which I have talked, the mere amplitude of credit and money doesn't expand investment much and does not expand the economy much. I get to that in my analysis of the profit question.

Monetary and credit policies, since 1953 to date, have been too stringent to float an adequate rate of economic growth and, therefore, have contributed substantially to the chronic rise of idle manpower and plant. As an avowed brake upon inflation, when inflation was actually in process, the stringent monetary and credit policies have been a failure, because the structure and behavior pattern of the modern U.S. economy is such that tightening up on money and credit translates into repressed or reduced levels of employment and production long before it impacts upon the price structure.

For example, during the period of reasonably adequate economic growth, 1952-55, the average annual growth in total national production was 3.5 percent, the average annual growth in the nonfederally

held money supply was 3.6 percent, consumer and wholesale prices were virtually stable, and the average annual increase in industrial prices was only 1.1 percent. But during the period of economic stagnation, 1955-57, the average annual increase in total national production was only 1.7 percent, induced substantially by an average annual increase in the nonfederally held money supply of only 2.5 percent, while there was an average annual increase of 2.5 percent in consumer prices, 3.1 percent in wholesale prices, and 3.6 percent in industrial prices. This whole analysis, which defies some of the conventional economic analysis, is based upon the simple proposition that you may have inefficiency resulting from too high a rate of economic growth or from too low a rate of economic growth. You may have inefficiencies resulting from an economy that is excessively taxed—I don't mean taxed in the technical sense—I mean has excessive pressures on it, or from an economy that is insufficiently pressured, just like a car going too fast or too slow burns too much gas per mile.

Most economists have only lately come to realize increasingly this point that I have been making, that an economy that is constantly moving up and down, that has a high level of unemployment and a high level of unused plant, tends thereby to be more inflationary than under fuller utilization, aside from the fact that you lose scores of billions of dollars of national product.

Moreover, the tight money policy and rising interest rates contribute mightily to the regressive redistribution of national income, repress desirable lines of activity far more than they affect the relatively excessive periodic booms in investment relative to ultimate demand, reduce the funds available to governments at all levels for essential public purposes by increasing the interest charges and by making it impossible for States and localities to borrow, and therefore contribute to all of the chronic imbalances in the economy.

The open declaration in recent weeks by spokesmen for the Federal Reserve System that they will tighten up on monetary and credit policies, especially if immediate tax cuts are undertaken to stimulate the economy, is an open declaration of war upon the programs which the Nation needs, and represents an almost unbelievably gross inconsistency in national economic thinking. This declaration of war, by the Federal Reserve System, while it does not say so openly, is tantamount to continued adherence to the indefensible proposition that large volumes of idle plant and manpower are indicia of economic health and are necessary to fight inflation.

I find it difficult in this connection to follow the logic of CEA Chairman Heller's discussion of monetary policy in his testimony yesterday. I understand he improved it some in response to questioning. He says this:

Fiscal policy and monetary policy are tightly interwoven, indeed are in part substitutes for one another. A given stimulus to the economy can be achieved by a relatively easier fiscal policy coupled with a relatively tighter monetary policy, or vice versa.

Let me try to translate that into simple language. It is like saying that, if you take four steps forward and two steps backward, you are still taking two steps forward. But it is nonetheless true that the two steps backward cancel out two of the steps forward, and if you reduce taxes by \$20 billion and tighten up on the monetary policy,

you may still have a net forward of \$10 billion, but why should you cancel out the effect of one with the effect of the other, and if you have a relatively smaller reduction in taxes, the tight money policy can cancel it out entirely.

Representative REUSS. Did you underline the "vice versa" because you want to emphasize it?

Mr. KEYSERLING. I underlined the "vice versa" because it is underlined in Dr. Heller's direct testimony. In other words, I would have to ask him.

Representative REUSS. Is the policy combination implied in the "vice versa" more offensive to you than the alternative?

Mr. KEYSERLING. They are both offensive.

I believe it far more pertinent to point out that fiscal and monetary policies should in general reinforce each other; they should in general be complements, not substitutes. When general inflation threatens, both should be relatively tight or tightened; when there is very large economic slack, both should be loose or loosened. I have great respect for Dr. Heller, but in this instance I think that, instead of attempting to rationalize the perverse and damaging policies of the Federal Reserve System, he might well have called upon that System to bring its policies into line with the real economic situation as he understands it so well and with the policy implications thereof which he comprehends so fully.

Here I want to commend many members of this committee, including Senator Douglas, as I have said before, for their full realization of this point. The Federal Reserve System does not need a pat on the back; it needs a good jolting.

Fundamental conflict between fiscal and monetary policy, recurrent in recent years, is an anachronism. Indeed, at another point in his testimony, Dr. Heller admits that "monetary * * * policy must continue [sic] to aim at providing ample credit and liquidity to support needed recovery and growth." But Dr. Heller then delimits the force of this valid observation by saying that all this must be "consistent with the requirements of balance-of-payments policy." This brings me to the subject of the balance of payments and gold problem.

Senator PROXMIRE. I am sorry that you didn't hear all of the things that I said about the pernicious uses of a tight money policy to cancel out the effects of tax reductions.

On the balance of payments and gold problem, which is the final question raised in the chairman's announcement: I am sorry I can't analyze this one in more detail, because I don't know anything on which there is more national confusion. Our balance of payments and gold problem, while a real one, has been exaggerated and misused and subject to the wrong remedies, very analogous to the way in which the inflationary problem was exaggerated and misused and subjected to the wrong remedies in earlier years since 1953. The central reason for our unfavorable balance of payments and gold problem is not to be found in the record of our international exchange of goods. In this category, we have been averaging a very favorable excess of exports over imports, and our record in this category might be even better if we achieved the real improvements in productivity and costs which are frustrated by large economic slack and encouraged by fuller utilization of production resources.

A main reason for our balance of payments and gold problem has been the perhaps excessive movement of American capital to Western Europe (although I think this too is exaggerated) I am not quite sure that I am absolutely clear as to why we should move toward a philosophy of free exchange of goods based upon marginal efficiency but not allow capital to flow where the manager of the capital, so long as we believe in a free system, thinks it will be most efficient. I think we are a little mixed up on this score, but I haven't got time to get into this in detail.

A main reason for our balance of payments and gold problem has been the perhaps excessive movement of American capital to Western Europe, and the excessive withdrawal of foreign funds from the United States. Both of these trends are to be explained mainly by the higher rate of economic growth, the lower levels of unemployment, the freedom from economic recessions, and consequently the more favorable opportunities for sustained investment and profits, in some countries of Western Europe contrasted with the United States.

It follows inescapably that those of our national economic policies are absolutely upside down which attempt to cure our balance of payments and gold problem by repressing economic growth, employment, and production in the United States. Variations in interest rates, comparing here with overseas, are a relatively inconsequential factor. And in any event, it shows a fantastic lack of perspective to saddle the whole \$550 billion American economy with the incubus of rising interest rates in order thereby to effectuate some slight changes in our balance of payments and gold position.

In addition to the main remedy of restoring and maintaining maximum prosperity in the United States, we need to improve the development of international mechanisms which would serve as a clearing-house and set off short-range against long-range claims. In long-range terms, our balance-of-payments position has in general been satisfactory.

Now, Chairman Heller, in his testimony, and others have brought up the point that maybe we should try to hold down the long-term interest rates because of our domestic needs, and let or help the short-term interest rates go up in order to take care of the capital flow problem. I have been trying to convince committees of Congress for a long time, and I think unfolding developments have helped me a little bit, that it is absolutely impossible as a basic proposition to do these two things at the same time because interest rates interrelate. Most interest rates are fixed by other interest rates, and that is why I went before the Senate Finance Committee in 1957, when they were talking about raising the interest rates on savings bonds because other interest rates were going up. I said, "You have created a mess. You start raising some and you have to raise others, and you are on an escalator that will never come to an end."

It is absolutely impossible to do these two things at the same time. One of the reasons why the recent effort of the Treasury to float long-term bonds, at even what I consider a rather high coupon interest rate of $4\frac{1}{4}$ percent, didn't work out very well is because we are getting into a situation where you are going to have to pay 5 or 6 percent interest to borrow anything, even on the supreme credit of the Government of the United States.

Anyway, why should we be freeing such high interest rates into long-term borrowings?

Coming to the needed changes in the national policy, which is my last point, during the 9½-year period from the beginning of 1953 to the middle of 1962, we forfeited about \$387 billion in total national production—measured in 1961 dollars—compared with what we would have achieved at the maximum rates of economic growth called for by the Employment Act of 1946. I don't say we could have done that well. But for goodness sakes, we should have done at least half that well. Over the same span of years, the true level of unemployment aggregated about 24 million man-years higher; in other words, well over 2½ million higher annually on the average, than it would have been under conditions of sustained maximum employment.

The record during the past year and a half indicates no fundamental change in the chronic ailment, although fortuitously we have been in upward movement during most of this short period. In fact, I think it is getting worse because of the uniquely weak character of this recovery and the fact that we are already in stagnation.

We are now in another stagnation, and confronted with the ominous threat of another recession later this year or next year. If our average annual growth rate 1963-66 averages no better than during the past 9½ years, and I do not think that it will average appreciably better without drastic changes in national economic policies, and I think it could even average worse because these imbalances feed on themselves, we could forfeit another \$290 billion of total national production, and suffer another 17 million man-years of excessive unemployment, while we talk about the great worldwide contest in which we are engaged and about the needs of our own people and about the need for economic growth.

Neither domestic nor worldwide conditions permit us to countenance even the possibility of such development. We must act, and act at once.

In one sense, Mr. Chairman, and members of the committee, there is never an "immediate" need for anything, except carrying somebody to the hospital who has been hit by an automobile. You may quibble about whether we should act now or wait until next winter, but once you analyze this problem correctly, we are 5 or 6 years late now, and it is getting later every minute.

We won't know any more a few months from now, unless we have a catastrophe. I don't expect a catastrophe within the next few months. I don't see any obstacle in the way of action now that will disappear a few months from now, and this whole business of looking at a few weeks at a time, or a few months at a time, or at the little upturns and downturns, is the greatest manifestation, in my view, of the immature nature of our economic policy and our national purposes in times when we should be thinking over the long-range.

This completes my summary answers to the policy questions that the chairman has raised. I would appreciate a little chance to document this with some of my pictures, which I think I can do rather quickly now that I have laid the contours of the argument before you.

Chairman PATMAN. You may go ahead and present the charts that you have. I suggest that you confine it to probably 10 or 15 minutes if you can.

Mr. KEYSERLING. Yes, I certainly believe that we can, because the questions will come later. I think I can do it very quickly. My first chart simply shows the long-term record from 1953 through 1962 estimated, the recurrent series of booms, recessions, and upturns. The first sector shows the record by years.

The second sector of the chart shows the short-term record quarter by quarter, 1961 and 1962, showing a high rate of upturn during the first three quarters of 1961, and the progressive deterioration since.

The third sector of the chart measures this on an annual basis from first quarter 1961, to first quarter, 1962, and so forth, and finally from fourth quarter 1961 to fourth quarter 1962, estimated.

In other words, we are experiencing a progressive shrinking in the rate of the upturn, more ominously than during previous upturns since World War II.

Senator BUSH. What are those figures in the bottom chart?

Mr. KEYSERLING. The figures on the bottom sector of the chart are yearly rates of change from first quarter 1961 to first quarter 1962, actual.

Senator BUSH. In gross national product?

Mr. KEYSERLING. In gross national product; second quarter 1961 to second quarter 1962, actual, third quarter 1961 to third quarter 1962 estimated, and fourth quarter 1961 to the fourth quarter 1962 estimated.

My second chart shows the three types of unemployment. The bottom part of each bar shows full-time unemployment. The middle part shows the full-time equivalent of part-time unemployment. The top part factors in what I call the concealed unemployment resulting from the phenomenally low growth of the labor force in recent years. In other words, people aren't looking for jobs because the jobs are not there, and I was very interested that Senator Douglas stressed this in his recent article.

The top sector of this chart shows the rising level of true unemployment. The second sector shows this unemployment as a percentage of the civilian labor force. Just by glancing at the chart, you can see how much more massive the bars are in the later years than in the earlier years. In first half 1962, which is a stagnation period, and not a recession period, the true level of unemployment was almost 9 percent of the civilian labor force, compared with only 5 percent in 1953, although you had a recession occurring in the middle of 1953, and this shows the prolonged and pronounced upward trend.

My third chart shows the high volume of idle plant and machines. The lower half of the chart shows that, in first quarter 1962, which are the latest figures I have, 18 percent of steel capacity was idle, and about 17 percent of manufacturing capacity was idle. The top part of the chart shows, as of the end of 1961, the tremendously high volume of idle capacity in a wide range of major industries.

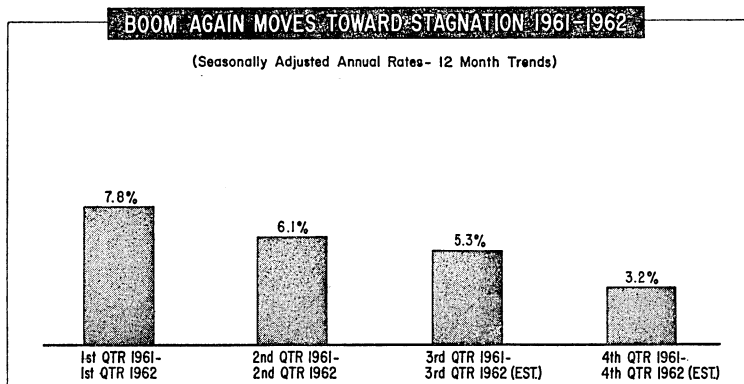
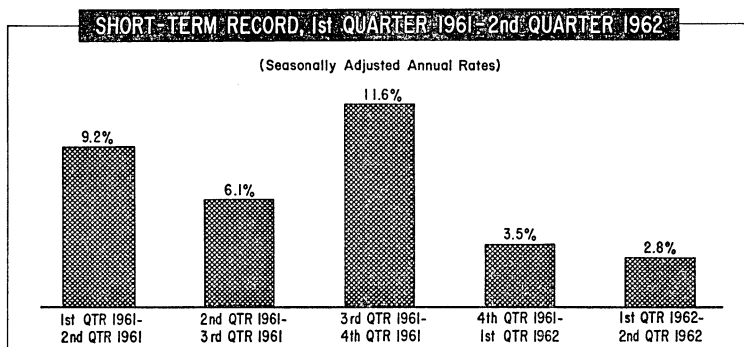
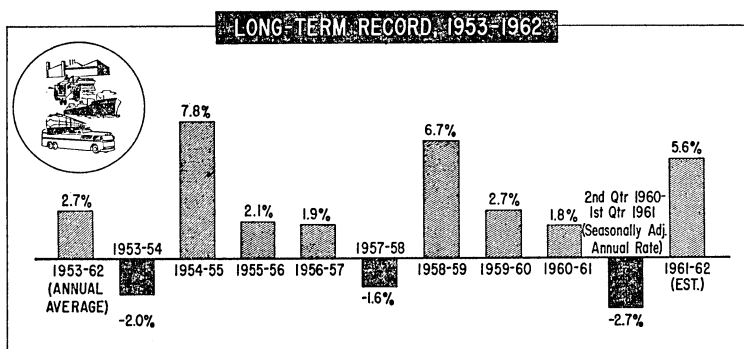
Senator BUSH. Where do you get those figures?

Mr. KEYSERLING. The sources are cited below, McGraw-Hill, and Steel Institute. All the sources are at the bottom of the charts.

Chairman PATMAN. Without objection the charts will be put in the record.

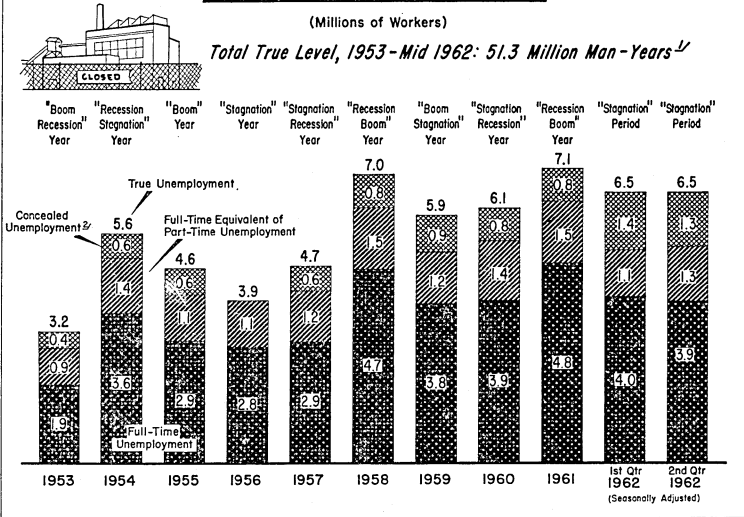
RECESSIONS, BOOMS, STAGNATIONS, 1953-'62: RATES OF CHANGE IN G. N. P.

In 1961 Dollars

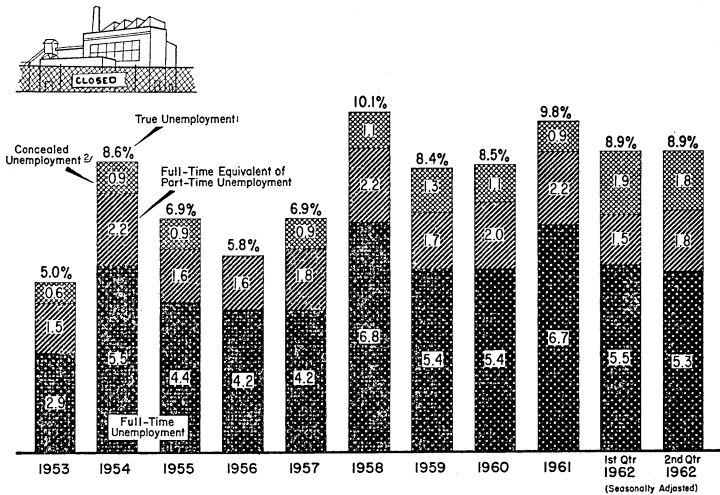


CHRONIC RISE OF UNEMPLOYMENT, 1953-1962

TRUE LEVEL OF UNEMPLOYMENT



UNEMPLOYMENT AS PERCENT OF CIVILIAN LABOR FORCE^{3/}

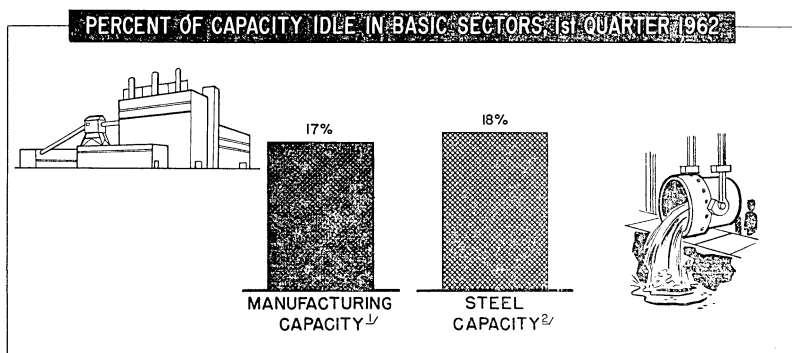
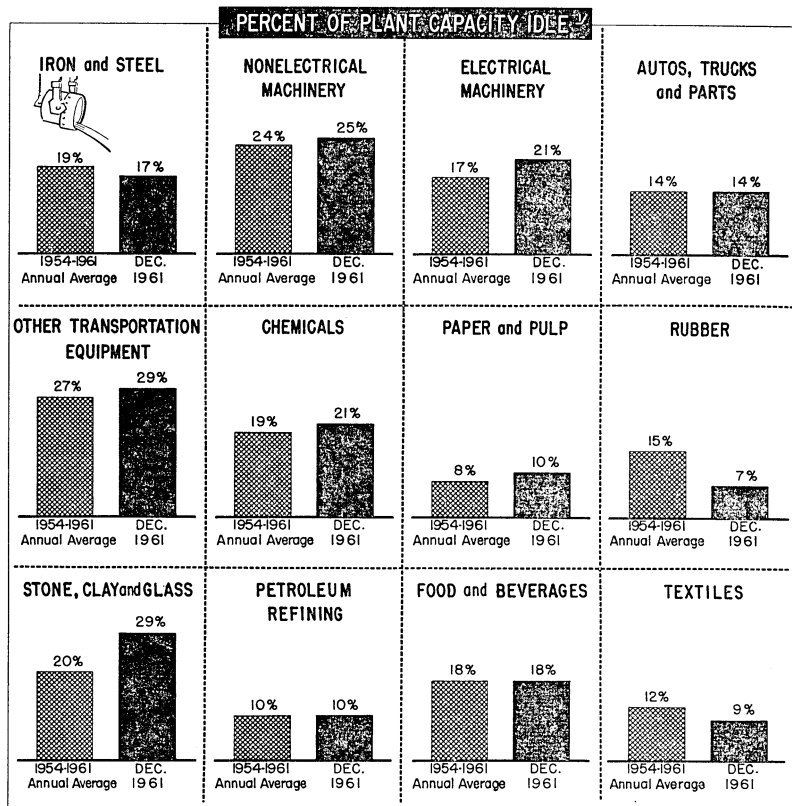


^{1/} The man-year figure for first half 1962 is one half the figures shown for the half year. About 27 million man-years of unemployment (true level) would have been consistent with maximum employment.

^{2/} Estimated as the difference between the officially reported civilian labor force and its likely size under conditions of maximum employment.

^{3/} In deriving these percentages, the civilian labor force is estimated as the officially reported civilian labor force plus concealed unemployment.

THE HIGH VOLUME OF IDLE PLANT AND MACHINES — 1954 — 1962



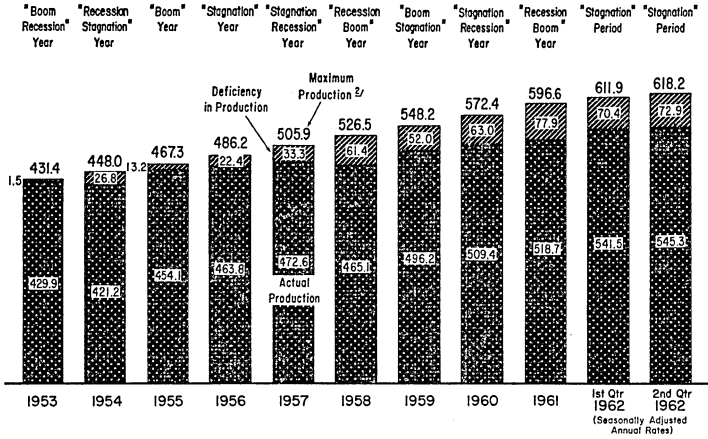
Source of Basic Data: ^{1/} McGraw Hill Annual Surveys; ^{2/} Est. based on Am. Iron and Steel Inst. data.

CHRONIC RISE OF OUR UNUSED PRODUCTIVE POWERS (G.N.P.), 1953-1962

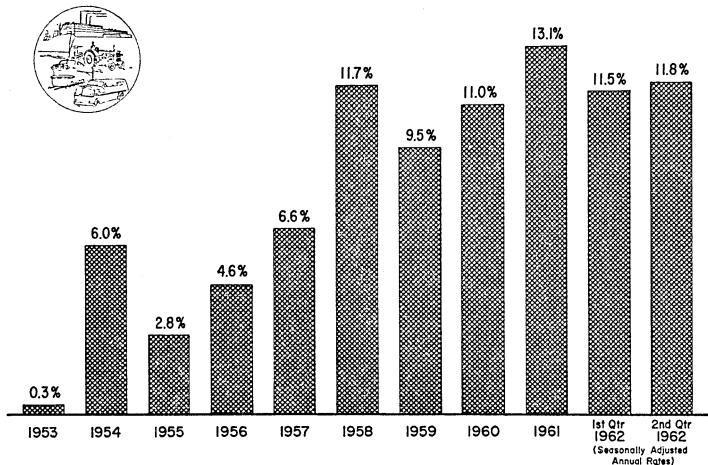
ANNUAL DEFICIENCIES

In Billions of 1961 Dollars

Total Deficiency, 1953-Mid 1962: 423 Billion Dollars^{1/}



ANNUAL DEFICIENCIES AS PERCENT OF MAXIMUM PRODUCTION



^{1/} The deficiency for first half 1962 is one half the figures shown for the half year.

^{2/} Based upon sufficient annual rate of growth in G.N.P. to provide full use of growth in labor force, plant and productivity under conditions of maximum employment and production.

Mr. KEYSERLING. My chart five, taking into account unused plant and unused manpower, estimates the size of the deficits in total national production. The chart shows a deficit, as I have said, of about \$73 billion, annual rate, by the second quarter of 1962, coming to almost 12 percent of maximum production capacity. These are really underestimates, because I have no way of estimating the underutilization of manpower in the plants when they are running at 50 or 60 percent of capacity.

I have no way of estimating the accelerated technology and productivity which would result from full use, so these are very conservative estimates.

Now I come to an analysis of the basic reasons for the trouble, and this gets very closely into the matter of tax policy. My view is that the deficiencies in total national production have occurred mostly because of deficient private consumer demand. The three parts of the economy which make up total national production are consumer demand, public outlays, and investment.

Taking consumer outlays first, my fifth chart shows in the bar on the far left in the job sector, the needed rate of growth in consumer outlays, and in the following bars the actual rate which, as you see, has been very much lower. In the bottom sector, I attempt to show the portion of the total deficiency in national production which is made up of the deficiency in consumer outlays. For example, in the second quarter of 1962, the deficiency of about \$73 billion in total national production includes a deficiency of about \$56 billion in consumer outlays. If necessary, I will develop these figures more on questioning.

Moving over to my sixth chart, some people think that consumers aren't spending because they don't want to. Indeed, the rate of saving is too high. But nonetheless, the basic reason is income deficiency. The top sector of this chart compares the actual levels of consumer spending and income. The bottom sector makes an estimate that, for the 9½ year period as a whole, the deficiency of over \$250 billion in consumer outlays correlated roughly with the deficiency of about \$337 billion in consumer incomes before taxes, allowing for taxes and allowing for savings.

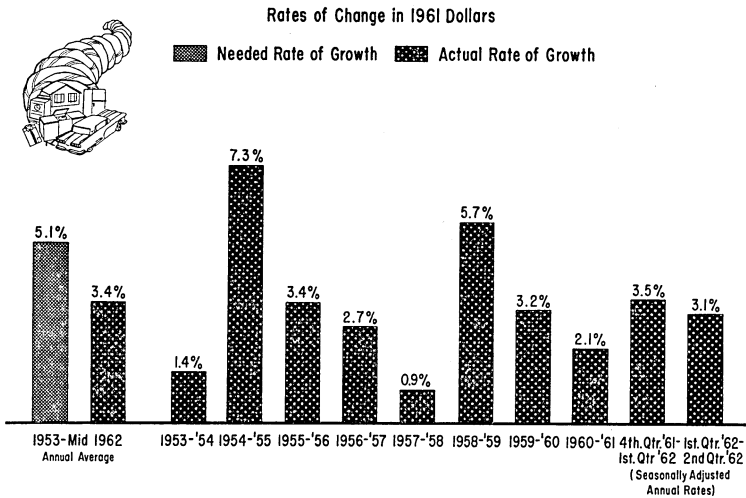
My seventh chart shows that there has also been some deficiency in public outlays, mostly at the Federal level. The top sector of the chart shows the declining size of the Federal budget, relative to the size of the national economy. The second sector of the chart shows in uniform dollars the declining level of per capita outlays.

The first is a measure of the economic problem. The second is a measure of the national need.

Coming to my eighth chart, the Federal budget reflects national economic deficiencies, and I brought this out earlier in my testimony. The top sector of the chart shows the annual deficiencies in national production over the years. The middle sector of the chart shows the actual condition of the Federal budget, and, as you see, it was generally in surplus very early in the period and generally in deficit later in the period.

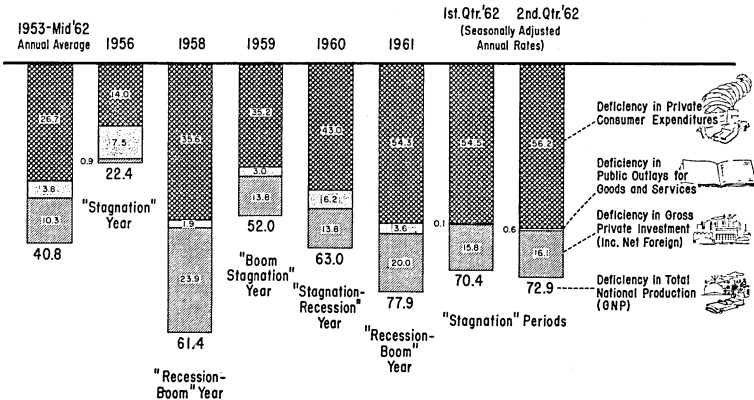
The third sector of the chart compares the size of the deficits in national production with the condition of the Federal budget, and shows obviously that as the national production deficit has increased, the Federal budgetary deficits have become larger.

DEFICIENT RATE OF GROWTH IN PRIVATE CONSUMER SPENDING, 1953 - MID '62



THE PRIVATE CONSUMPTION DEFICITS DOMINATE THE DEFICITS IN THE TOTAL ECONOMY

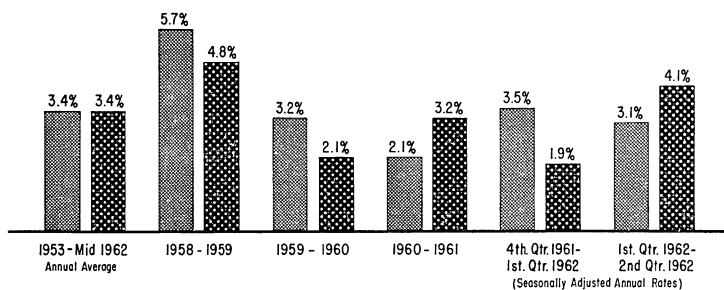
Billions of 1961 Dollars



LOW GROWTH IN PRIVATE CONSUMPTION REFLECTS LOW GROWTH IN INCOMES

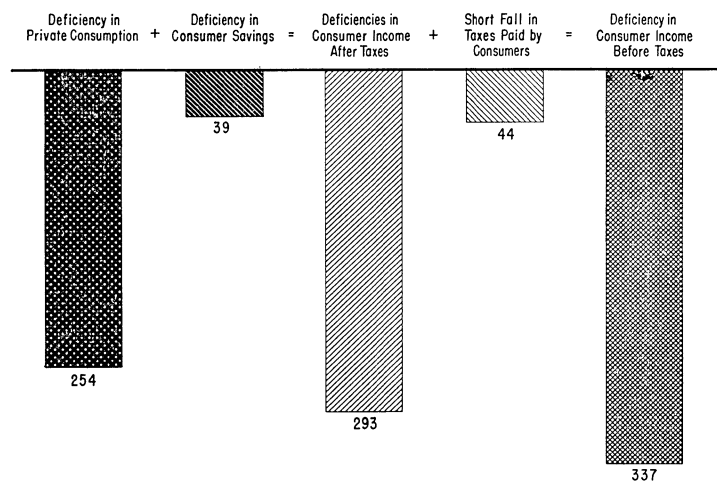
Rates of Change in 1961 Dollars

■ Total Private Consumer Spending ▨ Total Personal Income After Taxes



THE PRIVATE CONSUMPTION DEFICIENCY OF \$254 BILLION, 1953-MID 1962, REFLECTED A \$337 BILLION INCOME DEFICIENCY

Billions of 1961 Dollars



The last period is 1958—mid-1962, with an annual average deficit of \$64.5 billion in national production, and an annual average deficit of \$4.3 billion in the Federal budget, both cash and conventional.

My ninth chart illustrates what I said earlier in my testimony. The first sector of the chart is the actual Federal budget over the years, showing the predominance of the deficits. In the second sector of the chart, to show that my notion is not taken out of thin air, I have plotted the level of Federal expenditures appearing in my model maximum prosperity budget, somewhat higher each year than the actual, because I think they were too low. Then I have calculated carefully what actually existing tax rates would have yielded at maximum production and it shows, of course, a surplus during most of the period, with a deficit in 1953-54, due mostly to the high level of expenditures during the Korean war.

Now, coming over to my 10th chart, this brings me to the matter of private investment. This has a great deal to do with tax policy. I am for private investment. I am for private profit. I wish they were higher. They would be higher if our economy were performing better, and I have no objections to tax reductions for private investors and for corporations when there is room for them.

I do object to throwing billions of dollars out of the window for this purpose, when our narrow margin of capacity for tax reductions could be used to much better purposes and when we are wedded for one reason or another to trying to keep the budget somewhere near balanced.

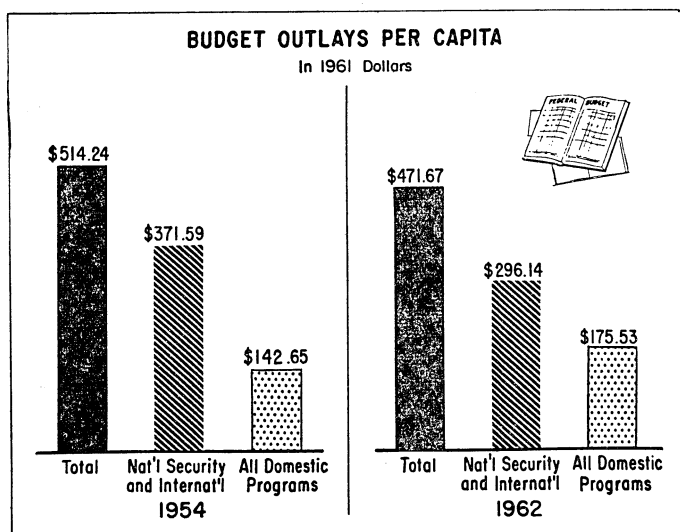
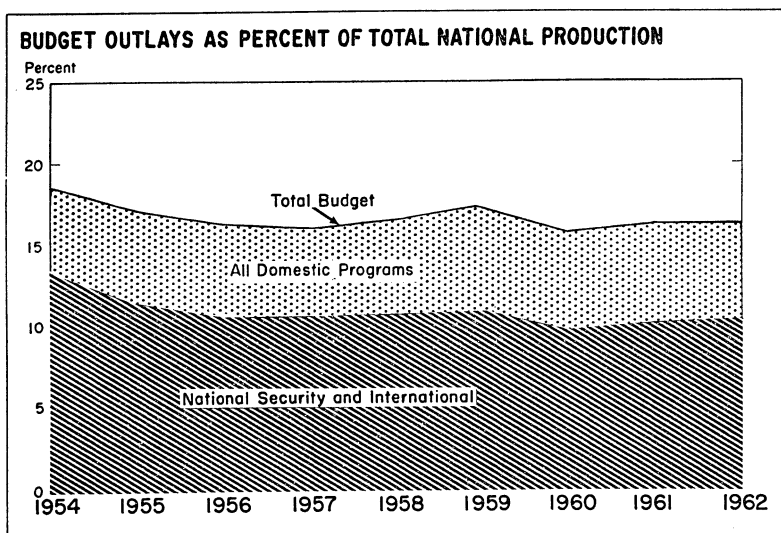
In my 10th chart, I show in the top sector that, during the 9½-year period as a whole, there was a deficit in gross private investment and there was a deficit in plant and equipment investment. In fact, the deficit averaged \$10.3 billion a year in the case of gross private investment and about \$7 billion a year in the case of plant and equipment investment. But how did this occur? It did not occur in anything like a straight line. It occurred in a succession of very rapid upturns when private investment far outran ultimate demand and led to large unused plant capacity, and then, because of the large unused plant capacity, the investment was cut way back so there was a low average for the period as a whole. But if one who wants to understand the equilibrium problem, to understand how this happens, one must look at these separate periods.

From the first three quarters of 1955 to the first three quarters of 1957, before the 1957-58 recession, investment in plant and equipment went up 9 percent and ultimate demand, in the form of both private consumption and Government outlays, went up less than 3 percent.

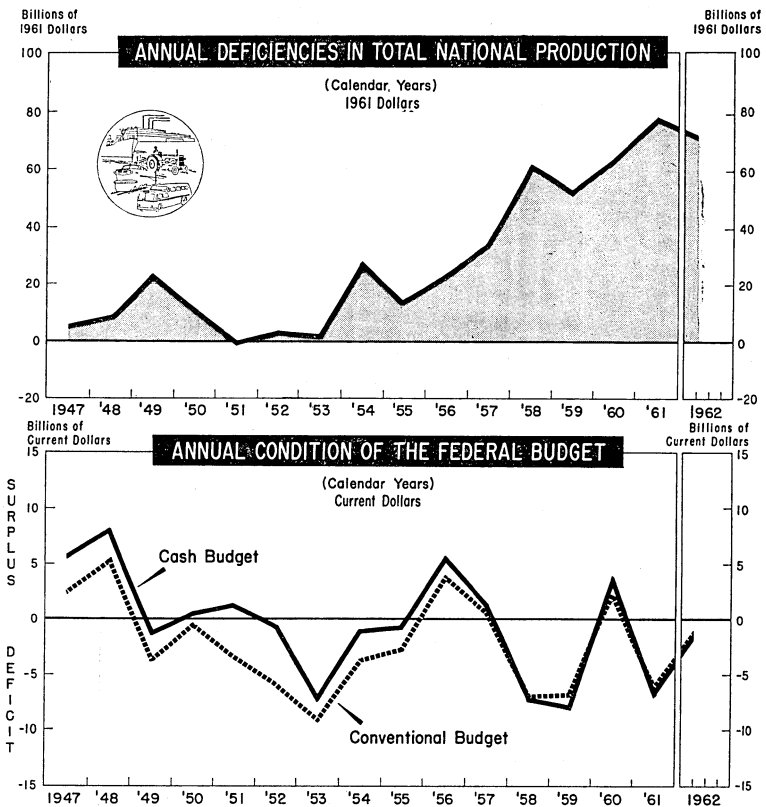
Then there was a very sharp investment cutback in the recessionary period. Naturally, being more volatile, investment went way down. Then, from the first half of 1959 to the first half of 1960, before the 1960 downturn, investment went up 11.6 percent and ultimate demand only 2.6 percent. Then there was another recession and another big cutback. I haven't chosen these periods arbitrarily. I have chosen these periods carefully on the basis of when the changes in the trends actually started to occur. From the first quarter 1961 to the first quarter 1962, there was a slowdown in the rate of investment increase during the upturn period, due to the cumulative effects of all the unused plant capacity. This means that, most recently, we have been

FEDERAL BUDGET HAS SHRUNK RELATIVE TO TOTAL OUTPUT AND NEEDS, 1954-1962

Fiscal Years

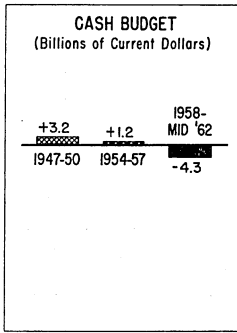
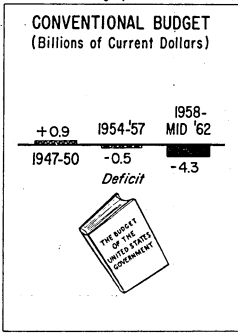
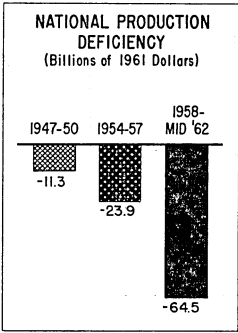


THE FEDERAL BUDGET REFLECTS NATIONAL ECONOMIC DEFICIENCIES

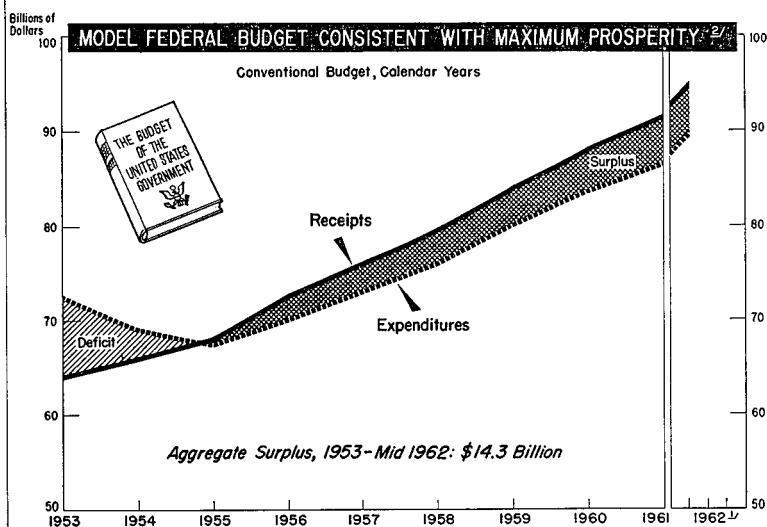
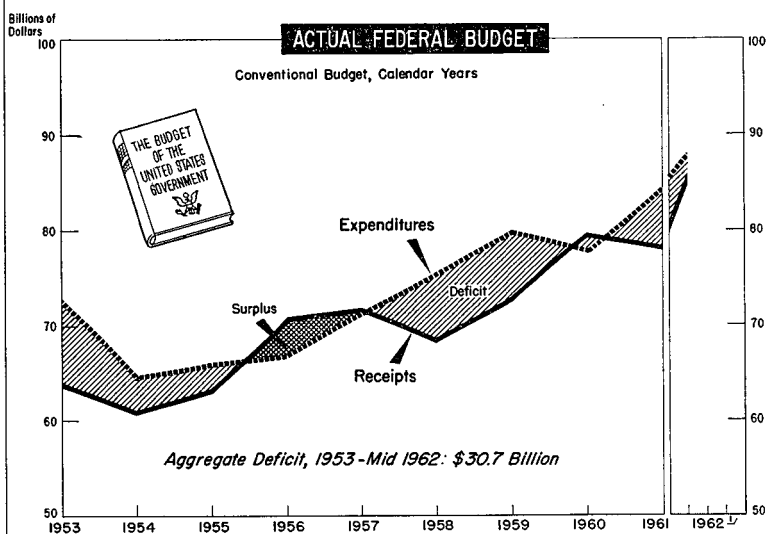


FEDERAL DEFICITS GROW WITH NATIONAL ECONOMIC DEFICIENCIES

(Annual Averages, Calendar Years)



A BALANCED FEDERAL BUDGET DEPENDS UPON A MAXIMUM PROSPERITY ECONOMY



^{1/} First half year 1962 shown at annual rate, seasonally adjusted.

^{2/} Expenditures are shown as actual expenditures plus estimated deficiencies in expenditures during the period. Receipts are estimated by applying actual tax rates to maximum prosperity levels of economic activity.

getting a lower rate of investment expansion, even in the upturn period, and Dr. Heller pointed this out, because finally business says: "My goodness, how much more are we going to increase excess plant capacity?" This slowdown in the rate of investment increase is very serious, and it is one of the reasons why this most recent upturn is shorter and less satisfactory than earlier ones, because due to the cumulative effect of excess plant capacity and inadequate demand there is less propulsion in the investment upturn. But to deduce from this that the factor militating against investment is the tax policy or the profit rate doesn't comport with analysis of actual developments.

My 11th chart shows these actual developments. It shows the trends before the 1957-58 recession, as to prices, profit, and investment. We see prices rising, profit rising substantially, and investment in plant and equipment rising enormously more in various key industries.

Coming to my chart 12, before the 1960-61 recession, although prices were generally down slightly and although profits were generally down, nonetheless there was a tremendous investment splurge because of the appraisal of business that the potential markets were there to justify this level of investment. This indicates that the downturn in prices, the downturn in profits, was on the basis of a more than adequate profit margin to stimulate investment when the other envioning conditions were there, and probably indicated that the prices and the profits had been much too high in the previous period. But be that as it may, the investment boom again occurred, and, as I showed on my 10th chart, it very far outran ultimate demand.

Coming to my 13th chart, here is the situation from first quarter 1961 to first quarter 1962. Here you have a somewhat downward trend in prices generally. In the case of the iron and steel industry you also had a downward trend in investment, because of the enormous unused capacity. Generally speaking, though, and in steel also, there was a rather pronounced upturn in profits. And generally, there were upturns in investment, though not as large as in the previous upturn periods for the reasons I have given.

This leads me to the conclusion that the conditioning factor, with respect to investment, is neither the tax structure nor the profit position, but rather the condition of ultimate demand and the amount of unused plant capacity. Let me say, Chairman Heller in his testimony yesterday supported this absolutely and completely. He talked about the fact that profits in the first quarter of 1962 were higher than in the first quarter 1961. He talked about the effect of cash flow. He said the only thing that they need in order to have a still more rewarding level of profits, is more markets, and until they get that they are not going to invest sufficiently.

In fact, he said they are overcashd and undermarketed. That is a paraphrase of exactly what he said.

Of course, I don't understand why, after saying this, he shifts over to the proposition that, having given one and a half billion dollars in the form of tax credits through Treasury regulations, and moving toward giving another billion in the form of the 7 percent credit, there is need to move on to give another large portion of any future tax reduction to the same investors. I don't understand the apparent

dichotomy between the analysis of the facts and the policy conclusions.

Representative REUSS. Before you leave this chart, I thought I heard you say in this period steel profits went down. It was steel investment that went down, not profits, was it not?

Mr. KEYSERLING. Yes. As the chart shows, steel investment went down.

Representative REUSS. Profits went up.

Mr. KEYSERLING. Yes. In the first quarter of 1962 they went up.

Representative REUSS. I thought I heard you say they went down.

Mr. KEYSERLING. I may have misspoken.

The next series of charts relate to the wage question. As wages are a basic factor in consumption, and investment is a basic factor in enlarging our productive capacities, I want to show for these periods the relative trends of wages and investment.

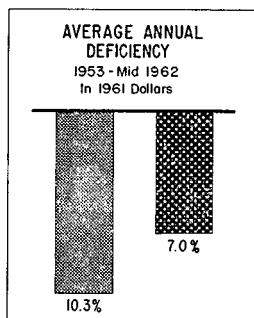
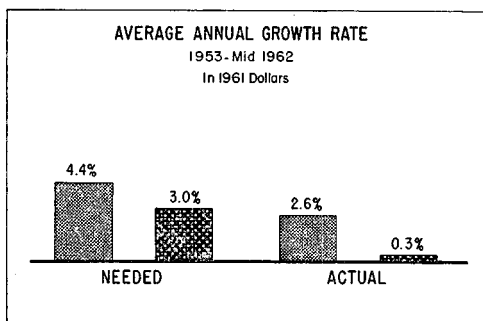
As you will see on my chart, before the 1957-58 recession, wage rate changes lagged generally far behind profits and phenomenally behind investment. What this means very simply is that, as corroboration of my earlier charts, the power to consume was not increasing anything like as fast as the power to produce, and I think that this is very important to stress, because of the widespread misimpressions about wage trends in recent years.

My 15th chart shows how the rate of increase in plant and equipment outran the rate of increase in wage rates during the period from the first half of 1959 to the first half of 1960, before the 1960-61 recession. And my 16th chart shows how again, from the first quarter of 1961 to the first quarter of 1962, the rate of increases in profits and in investment in plant and equipment generally outran the rate of increases in wage rates.

I also have another few charts, which analyze wage trends in the perspective of the whole economy. My 17th chart shows in the top sector the deficient rate of growth in wages and salaries for the 9½-year period as a whole. The lower sector of this chart shows that the deficiencies in wages and salaries have constituted the dominant portion of the deficiencies in total consumer income before taxes. My 18th and 19th charts show that, for the period 1947 to mid-1962 as a whole, with respect both to the entire nonfarm economy and manufacturing, wage rate increases and productivity increases were about in balance, and that during the most recent 5 years, wage rate increases in both cases have lagged very seriously behind productivity increases. These data lend no support to the popular impression, and the impression of many economists, that wage rate increases have outrun productivity increases and therefore forced up prices. The truth of the matter is that profit margins per unit have been too high, after allowing for all business costs including wage costs, which means that prices have been too high. The inadequacy of profits at times, as I have already demonstrated, relates entirely to the low level of operations and the high amount of unused plant capacities, which in turn are attributable to the deficiency in ultimate demand caused in large measure by the deficiencies in total wages and even in wage rate increases.

GROSS PRIVATE DOMESTIC INVESTMENT WAS DEFICIENT DURING 1953-MID 1962 AS A WHOLE

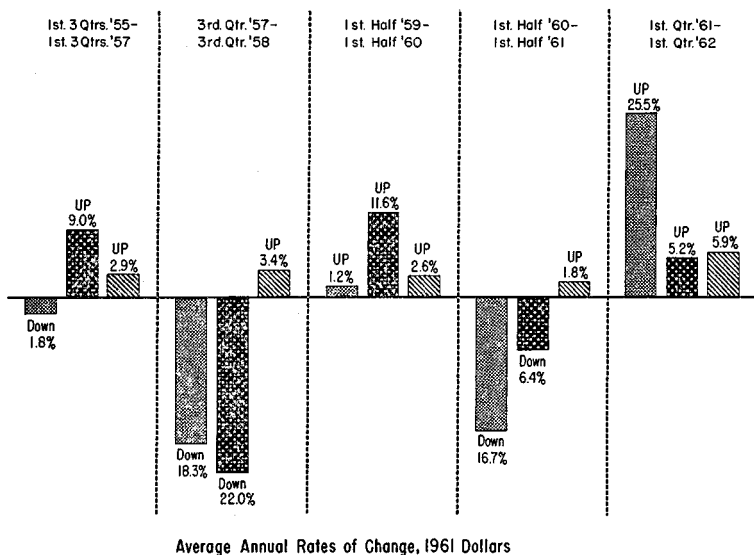
■ Gross Private Domestic Investment ■ Investment in Plant and Equipment



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

■ Gross Private Domestic Investment ■ Investment in Plant and Equipment
▨ Ultimate Demand: Total Private Consumption Expenditures

Plus Total Public Outlays (Federal, State and Local) for Goods and Services

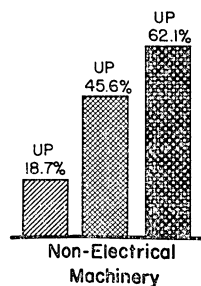
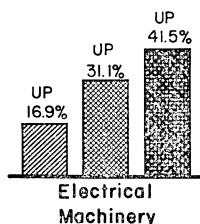
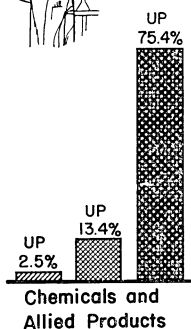
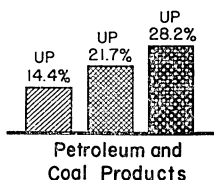
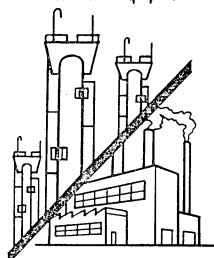
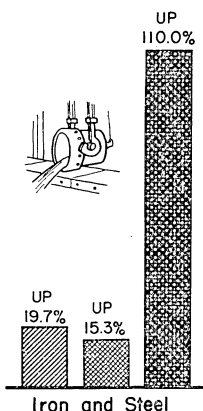
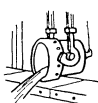
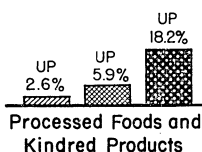
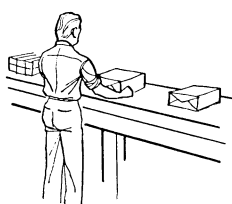


RISING PRICES, PROFITS, AND INVESTMENT BEFORE THE 1957 - 1958 RECESSION

The Investment Boom Before the 1957 - 1958 Recession

First Three Quarters 1955 - First Three Quarters 1957

 Prices,^{1/}
 Profits after Taxes;^{2/}
 Investment in Plant and Equipment^{3/}



^{1/} Bureau of Labor Statistics, (U.S. Dept. of Labor), Commodity Wholesale Price Indexes.

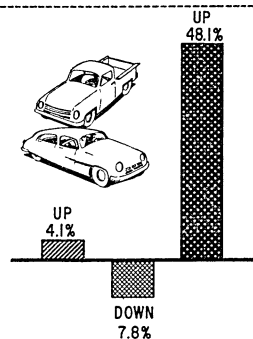
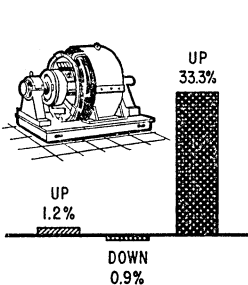
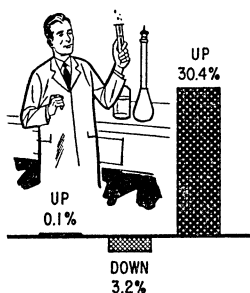
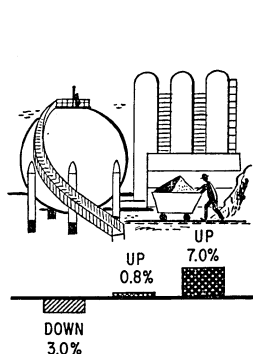
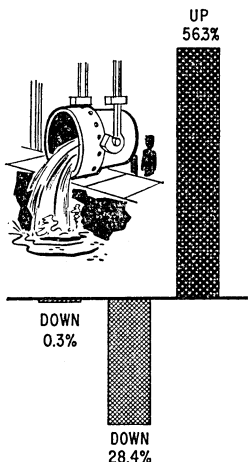
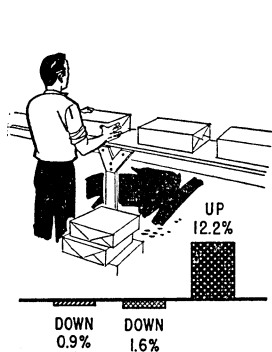
^{2/} Securities and Exchange Commission, Profit Estimates.

^{3/} Securities and Exchange Commission estimates of expenditures for plant and equipment.

INVESTMENT BOOM OCCURRED AGAIN BEFORE THE 1960-1961 RECESSION DESPITE REDUCED PRICES AND PROFITS

First Half 1959 - First Half 1960

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



^{1/} U.S. Dept. of Labor, Bureau of Labor Statistics, commodity wholesale price indexes.

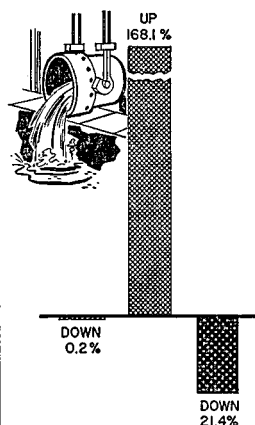
^{2/} Securities and Exchange Commission, profit estimates.

^{3/} Securities and Exchange Commission, estimates of expenditures for plant and equipment.

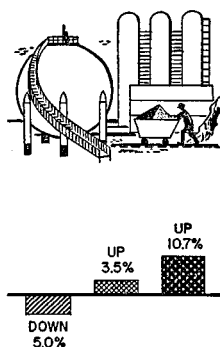
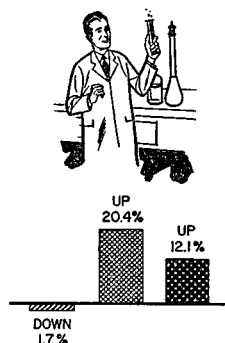
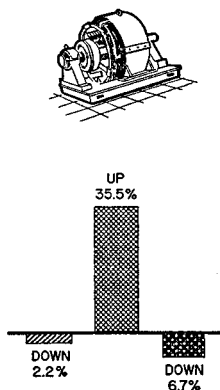
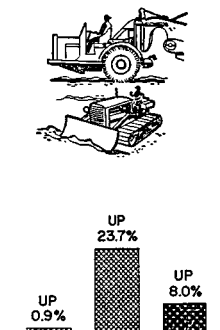
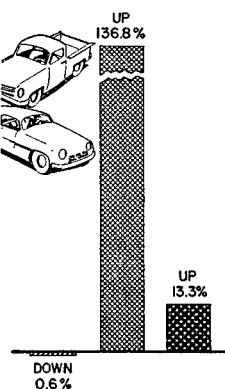
PRICE, PROFIT AND INVESTMENT TRENDS DURING CURRENT ECONOMIC UPTURN

1st Quarter 1961-1st Quarter 1962

 Prices $\downarrow$
 Profits $\uparrow$
 Investment $\uparrow$



IRON and STEEL

PETROLEUM
and COAL PRODUCTSCHEMICALS
and ALLIED PRODUCTSELECTRICAL
MACHINERYNON-ELECTRICAL
MACHINERYMOTOR VEHICLES
and EQUIPMENT $\downarrow$ Data: U.S. Dept. of Labor, wholesale commodity price indexes. $\uparrow$ Data: Securities and Exchange Commission. $\uparrow$ Data: U.S. Dept. of Commerce and Securities and Exchange Commission.

On top of all this, the material which I have thus far presented measures actual wage rate increases against actual increases in productivity. But the actual increases in productivity have been repressed by the large economic slack and consequent inefficient use of plant and manpower. Wage rate increases, to fulfill their proper consumption function, should be related to the technological changes in productivity, which means the changes in productivity which would occur under conditions of reasonably full utilization. My chart 20 demonstrates this proposition by comparing rates of actual productivity growth under varying degrees of economic utilization, and therefore substantiates my conclusion that the lag of wage rate increases behind technological change has been severe indeed, and thus has been one of the main factors in the poor character of our overall economic performance.

Chairman PATMAN. They will all be in the record.

Mr. KEYSERLING. The main point is that there is nothing wrong with our productivity, whenever there is adequate ultimate demand. One day we hear that our productivity is increasing so fast that we are never going to be able to expand ultimate demand enough to use all the labor force because technology and automation are advancing so fast. The next day we hear from the same people that productivity and technology are increasing so slowly that we are at a competitive disadvantage all around the world. Both statements can't be generally true.

The fact of the matter is that productivity and technology are increasing faster than we dare to realize, both in the factory and on the farm, and the great problem is to expand distribution apace. There is nothing wrong with American productivity, or American inventiveness, or American managerial skills. This is an economic problem and not a technological problem.

This brings me back to the question about profits that Congressman Reuss asked. My 21st chart shows profits in some key industries, showing in the final bar of each box the first quarter of 1962. This does show iron and steel profits, up again in the first quarter of 1962, although not above the alltime peaks of some of the earlier years.

In the case of motor vehicles, as we have all read in the papers recently, the profits are enormously above any previous time, and in the case of other key industries they are either at or above or very near alltime peaks.

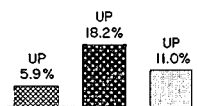
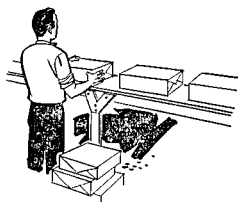
Let us remember that there is at the same time a very low utilization of capacity, as I showed.

My 22d chart bears upon this. When you look at profit sales ratios, you see that they have held up very well, and that most of them have increased, which simply means that, if there were a higher level of operations, if there were a higher level of ultimate demand, profits would soar, and quite properly would soar, far above their recent levels, which in themselves have been very rewarding and quite high.

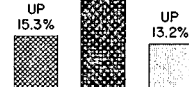
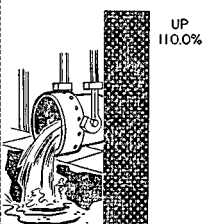
BEFORE THE 1957-1958 RECESSION, PROFITS AND INVESTMENT OUTRAN WAGES-BASIC TO CONSUMPTION

First Three Quarters 1955-First Three Quarters 1957

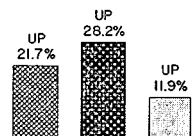
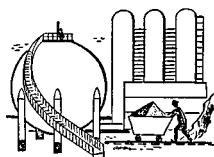
■ Profits ^{1/} ■ Investment ^{2/} ■ Wage Rates ^{3/}



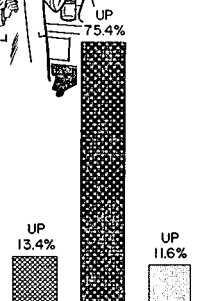
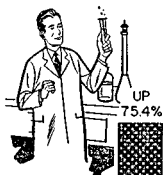
**PROCESSED FOODS
and KINDRED PRODUCTS**



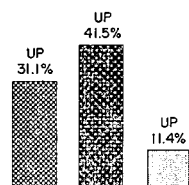
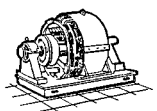
IRON and STEEL



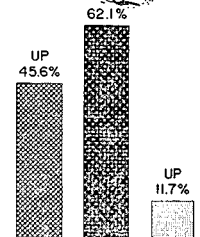
**PETROLEUM
and COAL PRODUCTS**



**CHEMICALS
and ALLIED PRODUCTS**



**ELECTRICAL
MACHINERY**



**NON-ELECTRICAL
MACHINERY**

^{1/} Data: Securities and Exchange Commission.

^{2/} Investment in plant and equipment. Data: U.S. Dept. of Commerce and Securities and Exchange Commission.

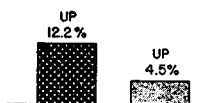
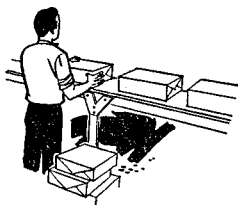
^{3/} Average hourly earnings of production workers. Data: U.S. Dept. of Labor.

BEFORE THE 1960-1961 RECESSION INVESTMENT AGAIN OUTRUN WAGES-BASIC TO CONSUMPTION

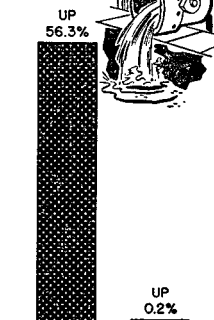
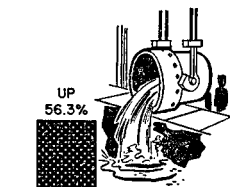
First Half 1959-First Half 1960

 Investment ↙

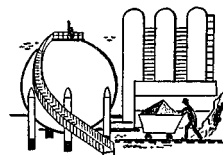
 Wage Rates ↗



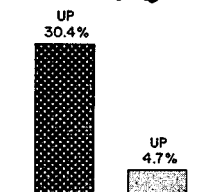
**PROCESSED FOODS
and KINDRED PRODUCTS**



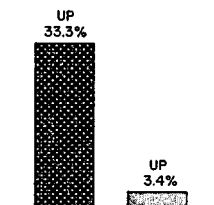
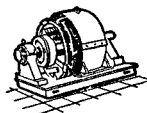
IRON and STEEL



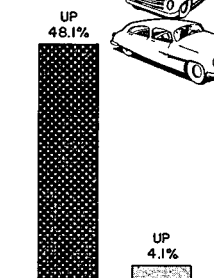
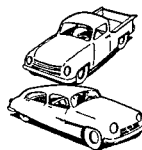
**PETROLEUM
and COAL PRODUCTS**



**CHEMICALS
and ALLIED PRODUCTS**



**ELECTRICAL
MACHINERY**



**MOTOR VEHICLES
and EQUIPMENT**

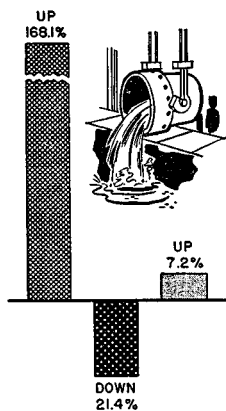
↙ Investment in plant and equipment. Data: U.S. Dept. of Commerce and Securities and Exchange Commission.

↗ Average hourly earnings of production workers. Data: U.S. Dept. of Labor.

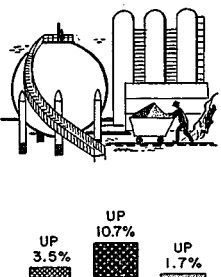
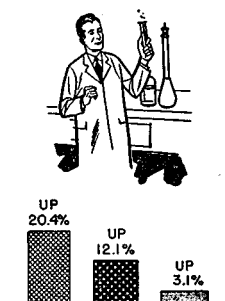
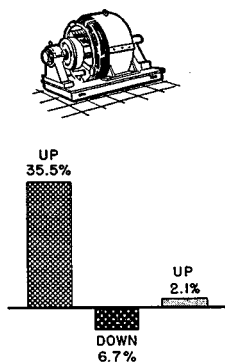
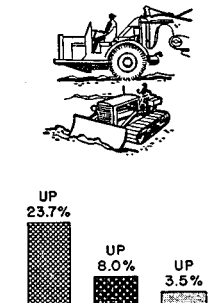
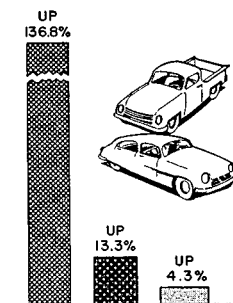
PROFITS AND INVESTMENT DURING CURRENT ECONOMIC UPTURN OUTRUN WAGES-BASIC TO CONSUMPTION

1st Quarter 1961-1st Quarter 1962

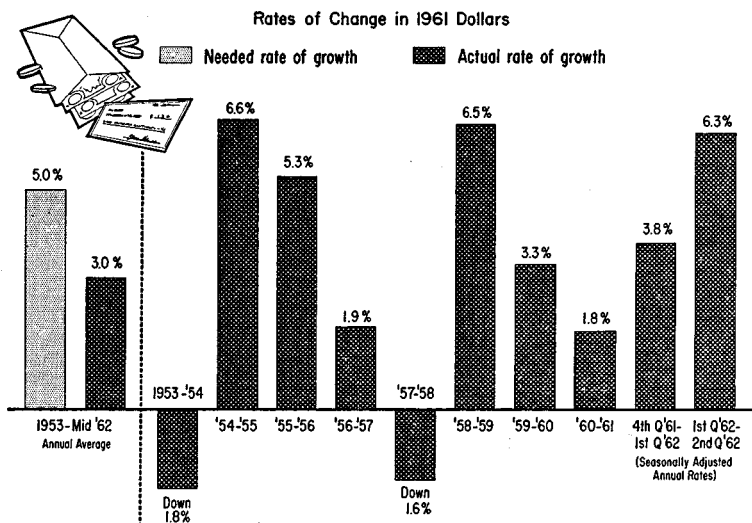
Profits ^{1/} Investment ^{2/} Wage Rates ^{3/}



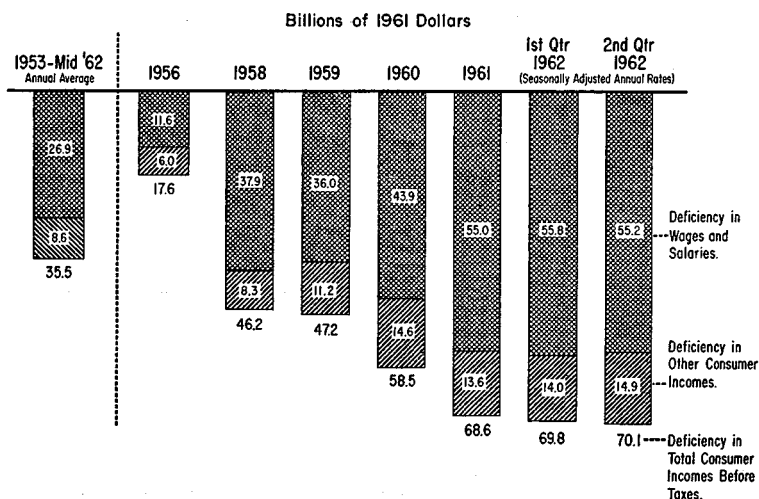
IRON and STEEL

PETROLEUM
and COAL PRODUCTSCHEMICALS
and ALLIED PRODUCTSELECTRICAL
MACHINERYNON-ELECTRICAL
MACHINERYMOTOR VEHICLES
and EQUIPMENT^{1/} Data: Securities and Exchange Commission.^{2/} Investment in plant and equipment. Data: U.S. Dept. of Commerce and Securities and Exchange Commission.^{3/} Average hourly earnings of production workers. Data: U.S. Dept. of Labor.

DEFICIENT RATE OF GROWTH IN WAGES AND SALARIES, 1953-MID 1962



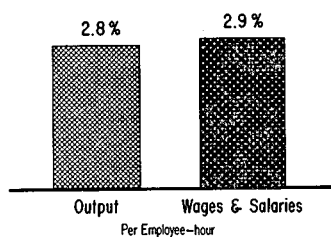
DEFICIENCIES IN WAGES AND SALARIES ARE LARGE SHARE OF DEFICIENCIES IN TOTAL CONSUMER INCOMES BEFORE TAXES



RATES OF CHANGE IN NONFARM OUTPUT, AND IN NONFARM WAGES AND SALARIES, PER EMPLOYEE-HOUR, 1947-1962 ^{1/}

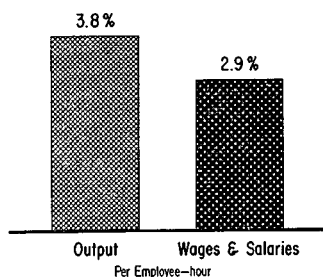
Annual Average Rates of Change, Measured in Uniform Dollars

1947-1962



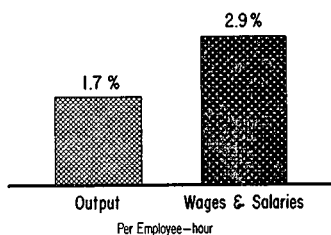
1947-1950

(Pre-Korean War)



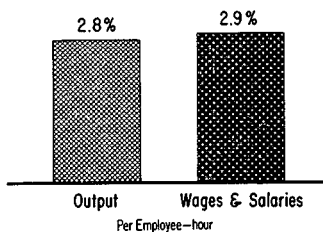
1950-1953

(Korean War)



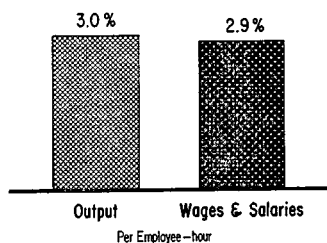
1953-1962

(Post-Korean War)



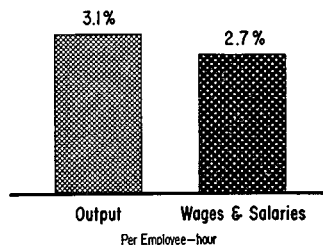
1947-1962

(Excl. Korean War Years 1950-1953)



1957-1962

(Most Recent 5 Year Period)

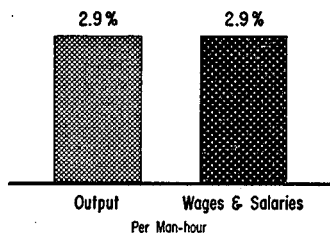


^{1/} 1962 estimated

RATES OF CHANGE IN MANUFACTURING OUTPUT, AND IN WAGES AND SALARIES, PER MAN-HOUR, 1947-1962 ¹

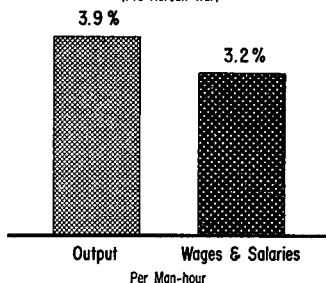
Average Annual Rates of Change, Measured in Uniform Dollars

1947-1962



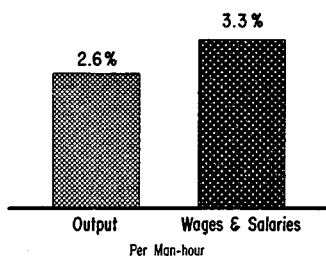
1947-1950

(Pre-Korean War)



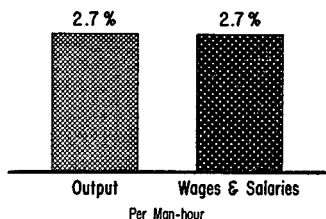
1950-1953

(Korean War)



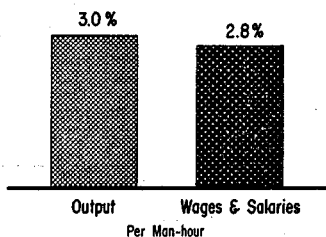
1953-1962

(Post-Korean War)



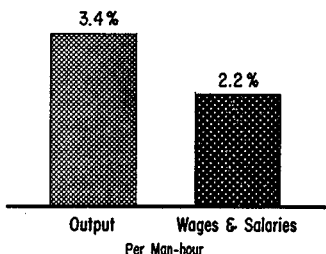
1947-1962

(Excl. Korean War Years 1950-1953)



1957-1962

(Most Recent 5 Year Period)



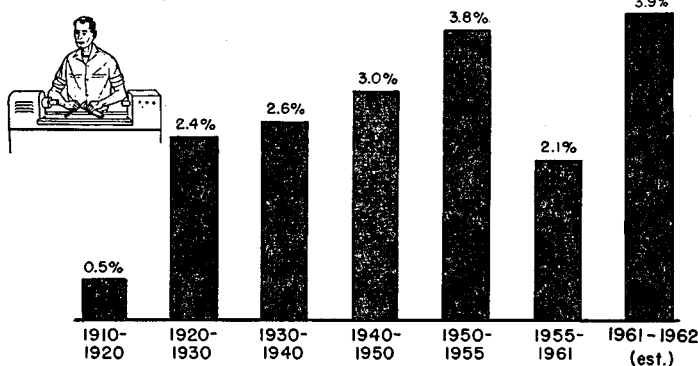
¹ 1962 estimated

TRENDS IN OUTPUT PER MAN-HOUR -OR PRODUCTIVITY-1910-1962

Average Annual Rate of Productivity Growth
for the Entire Private Economy

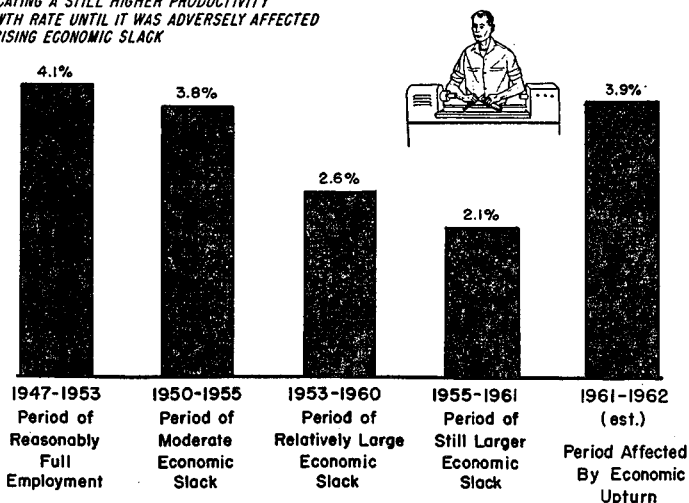
THE RECORD 1910-1962

INDICATING AN ACCELERATING PRODUCTIVITY
GROWTH RATE UNTIL 1955-1961



THE RECORD SINCE WORLD WAR II AND RECONVERSION

INDICATING A STILL HIGHER PRODUCTIVITY
GROWTH RATE UNTIL IT WAS ADVERSELY AFFECTED
BY RISING ECONOMIC SLACK



Note: Based on U.S. Department of Labor estimates, relating to man-hours worked.

Let's now look at my 23d chart. This shows that, in addition to the profit factor, there is the cash flow factor. In other words, even the high profit figures under conditions of low capacity utilization do not represent the real availability of funds for corporations. Here I analyze the organization of financing from internal sources, which is done through various types of internal sources, including depreciation, amortization, retained profits, and depletion allowances, so that what is actually happening is that even in some of the cases where there seems to be a profit squeeze, the Federal tax policy has been so liberal that really, for all practical purposes, there have been more investment funds available than at some earlier times when the figures were showing a better profit picture.

I have had an opportunity to analyze this difficulty for the railroad industry, and the difference between the figures when you just look at the profit trends for the railroads and the figures when you look at their true financial position, is fantastic in the case of some of these very large rail companies which are seeking merger on the ground that they are on the way to bankruptcy.

My final series of charts indicate the magnitude of the economic task confronting us. My 24th chart shows the needed increases in total national production, in various components of national production and income, and in employment. The goals for 1964 bring home how far current programs, and programs under active discussion, are short of the minimum requirements for restoring maximum employment and production even by 1964. My 25th chart shows the difference, 1953-56, between the high and the low growth rates. My 26th and 27th charts portray the nature of a Federal budget which would exert its appropriate role in an effective nationwide effort to restore and maintain maximum employment and production, and in helping to meet the great priorities of our public needs.

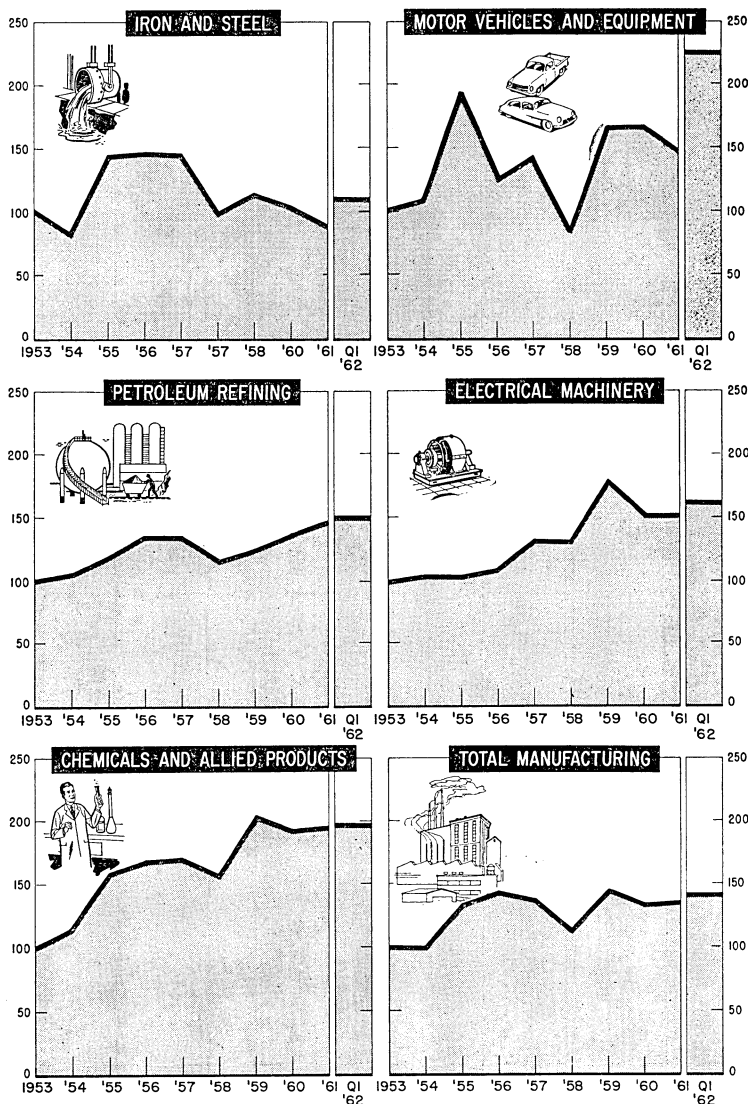
Now, what do all these charts show in substance, as I see them, as they bear upon fiscal policy? As they bear upon fiscal policy, they show first, that the problem in the American economy since 1953 has been the age-old problem of not being able to distribute what we can produce. It is an anomaly that almost everybody agreed to this a few years ago, and almost everybody has forgotten it now.

Businessmen, conservatives, liberals, economists, were all saying the American economy has a genius for production, but doesn't know how to distribute what it could produce. Ultimately and basically, this is what unused plant and manpower mean, that we don't distribute what we can produce, and it certainly isn't because we are an affluent society. It certainly isn't because we don't have poverty in our midst.

Even since the great depression, we haven't learned to distribute what we currently can produce, and yet our economic policies during the last 9½ years, if I may say so, under Republican and Democratic administrations almost alike, have been wedded to a monetary policy, a tax policy, an interest-rate policy, and other policies which have aggravated rather than remedied these basic imbalances in our economy.

KEY PROFITS AFTER TAXES ARE HIGH DESPITE LARGE UNUSED CAPACITIES

1953=100

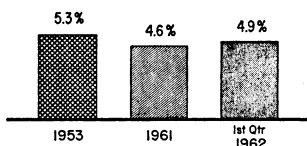


Note: First quarter 1962 figures shown at annual rate, not seasonally adjusted.
Data: Federal Trade Commission-Securities and Exchange Commission.

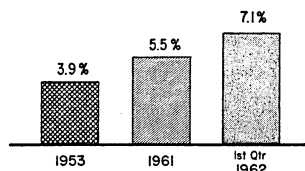
PROFITS-SALES RATIOS INDICATE STILL HIGHER PROFITS WILL RESULT WHEN CAPACITIES ARE MORE FULLY USED

Manufacturing Corporations' Profits after Taxes, as Percent of Net Sales

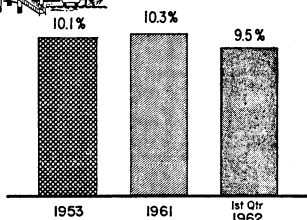
IRON AND STEEL



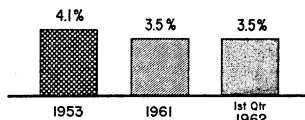
MOTOR VEHICLES AND EQUIPMENT



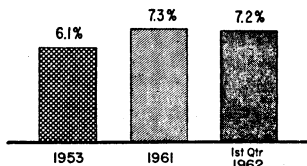
PETROLEUM REFINING



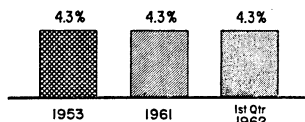
ELECTRICAL MACHINERY



CHEMICALS AND ALLIED PRODUCTS



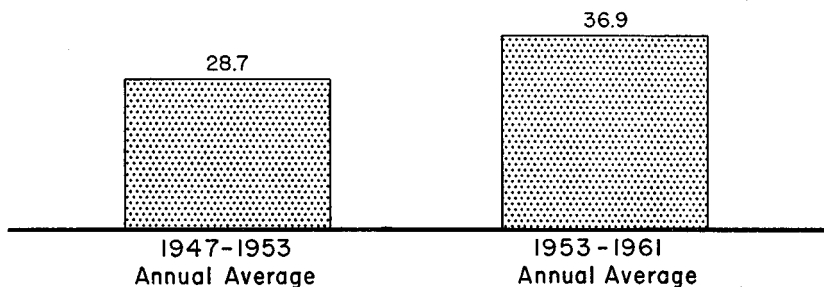
TOTAL MANUFACTURING



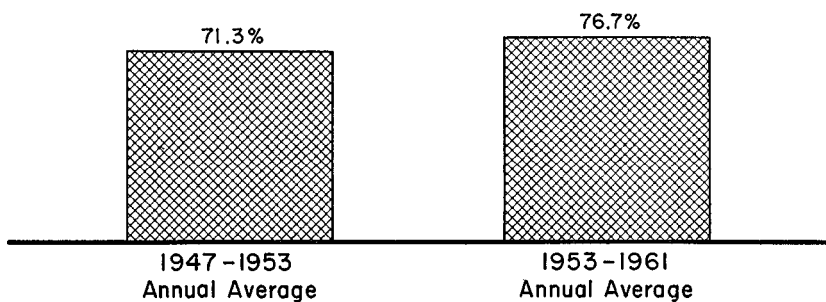
Data: Federal Trade Commission, Securities and Exchange Commission.

TOTAL FUNDS USED BY CORPORATIONS HAVE INCREASED

Billions of Current Dollars

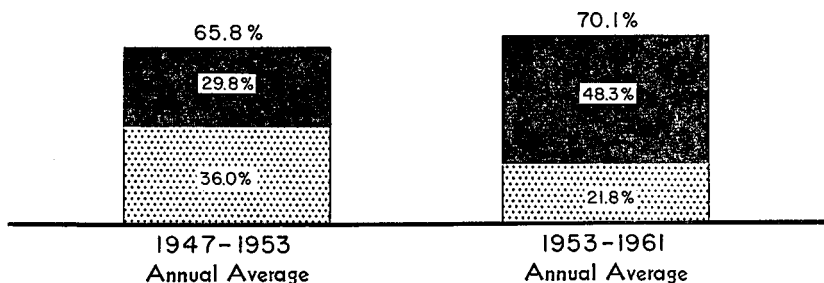


PORTION OF THESE FUNDS USED FOR PLANT AND EQUIPMENT HAS GROWN



PORTION OF CORPORATE FUNDS DRAWN FROM INTERNAL SOURCES HAS RISEN

■ Depreciation and Amortization ▨ Retained Profits and Depletion Allowances

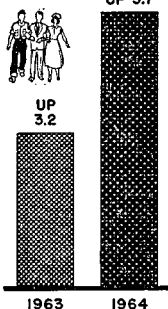


Data: Department of Commerce.

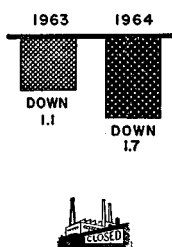
GOALS FOR 1963 AND 1964, CONSISTENT WITH LONG-RANGE GOALS THROUGH 1966

1963 and 1964 Goals Compared with Estimated 1962
Dollar Figures in 1961 Dollars

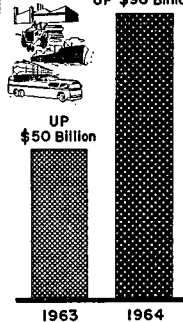
EMPLOYMENT (in millions of man-years) UP 5.7



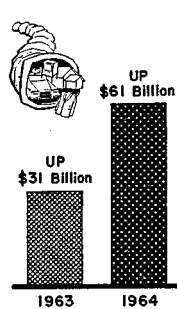
UNEMPLOYMENT (in millions of man-years)



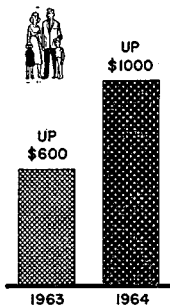
TOTAL PRODUCTION UP \$96 Billion



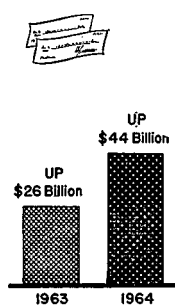
CONSUMER SPENDING



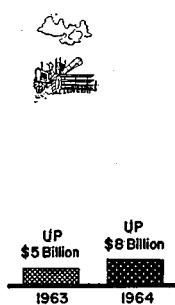
FAMILY INCOME (Average)



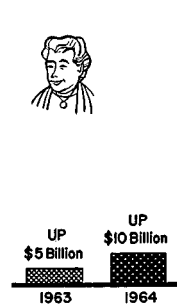
WAGES and SALARIES



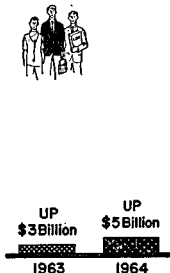
NET FARM INCOME



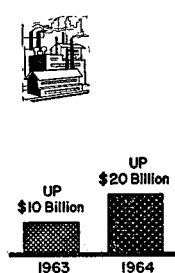
TRANSFER PAYMENTS



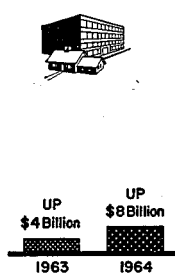
BUSINESS and PROFESSIONAL INCOME



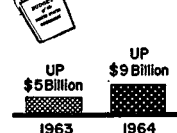
GROSS PRIVATE DOMESTIC INVESTMENT



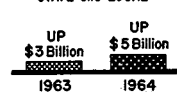
RESIDENTIAL NONFARM CONSTRUCTION



PUBLIC OUTLAYS FOR GOODS and SERVICES (Calendar Years) FEDERAL

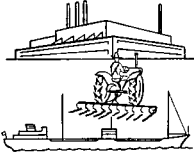
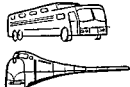
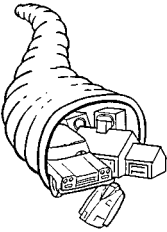
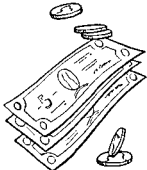
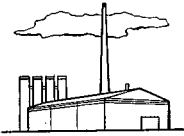
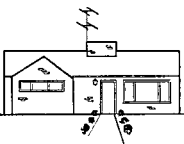
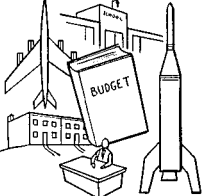


STATE and LOCAL



DIFFERENCES IN RESULTS OF HIGH AND LOW ECONOMIC GROWTH RATES, 1963-1966

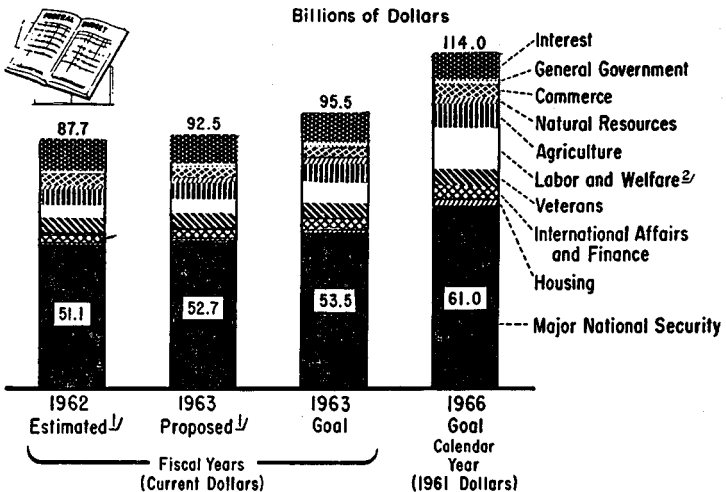
Bold face - Difference in 1966; *Italics* - Difference for four year period as a whole
Dollar figures in 1961 dollars

EMPLOYMENT ^{1/} (In millions of man-years)  5.6 <i>16.8</i> UNEMPLOYMENT ^{1/} (In millions of man-years) 3.7 <i>10.9</i> 	TOTAL PRODUCTION   \$104 Billion <i>\$291 Billion</i>	CONSUMER SPENDING  \$65 Billion <i>\$180 Billion</i>	PERSONAL INCOME  \$82 Billion <i>\$229 Billion</i>
FAMILY INCOME (Average)  \$1,200 <i>\$3,600</i>	WAGES and SALARIES  \$50 Billion <i>\$145 Billion</i>	NET FARM INCOME  \$16 Billion <i>\$43 Billion</i>	TRANSFER PAYMENTS  \$11 Billion <i>\$31 Billion</i>
BUSINESS and PROFESSIONAL INCOME  \$5 Billion <i>\$15 Billion</i>	GROSS PRIVATE DOMESTIC INVESTMENT ^{2/}  \$27 Billion <i>\$76 Billion</i>	RESIDENTIAL NONFARM CONSTRUCTION  \$10.3 Billion <i>\$27 Billion</i>	FEDERAL, STATE, AND LOCAL GOV'T OUTLAYS FOR GOODS AND SERVICES  \$12 Billion <i>\$35 Billion</i>

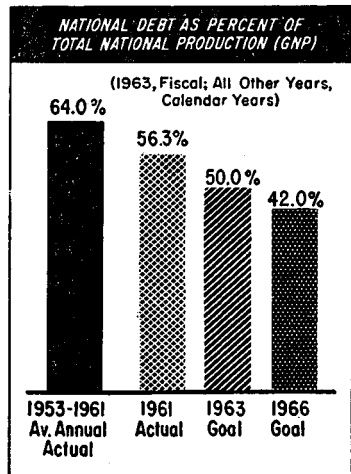
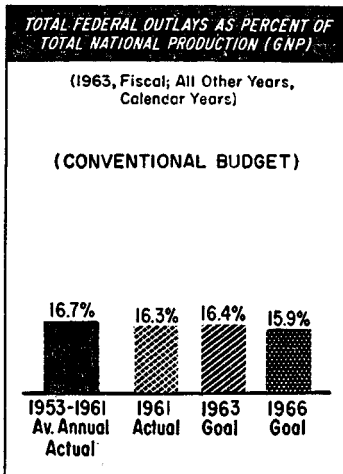
^{1/} High growth rate would draw more persons into the labor market than low growth rate.

^{2/} Including net exports of goods and services.

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



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



^{1/} Based upon Budget estimates as of July 20, 1962.

^{2/} Including education and public health.

A FEDERAL BUDGET GEARED TO JOBS FOR ALL AND ADEQUATE PUBLIC SERVICES

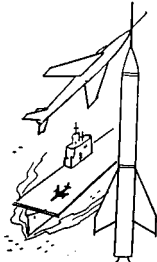
1962 and 1963, Fiscal Years; 1966, Calendar Year
Per Capita Outlay in 1961 Dollars

TOTAL FEDERAL OUTLAYS



Year	% of Total Output	Per Capita
1962 ¹	16.25	471.67
1963 Goal	16.41	502.37
1966 Goal	15.96	569.43

NATIONAL DEFENSE, SPACE TECHNOLOGY AND ALL INTERNATIONAL



Year	% of Total Output	Per Capita
1962 ¹	10.20	296.14
1963 Goal	10.21	312.47
1966 Goal	9.85	351.65

EDUCATION



Year	% of Total Output	Per Capita
1962 ¹	0.20	5.79
1963 Goal	0.31	9.46
1966 Goal	0.67	23.97

HEALTH SERVICES AND RESEARCH



Year	% of Total Output	Per Capita
1962 ¹	0.21	6.00
1963 Goal	0.31	9.46
1966 Goal	0.48	16.98

PUBLIC ASSISTANCE



Year	% of Total Output	Per Capita
1962 ¹	0.45	13.10
1963 Goal	0.52	15.78
1966 Goal	0.52	18.48

LABOR AND MANPOWER, AND OTHER WELFARE SERVICES



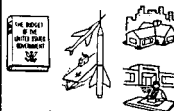
Year	% of Total Output	Per Capita
1962 ¹	0.16	4.71
1963 Goal	0.15	4.73
1966 Goal	0.14	5.00

HOUSING AND COMMUNITY DEVELOPMENT



Year	% of Total Output	Per Capita
1962 ¹	0.06	1.80
1963 Goal	0.19	5.78
1966 Goal	0.34	11.99

ALL DOMESTIC PROGRAMS AND SERVICES



(Includes also
Agriculture;
Natural Resources;
Veterans; Commerce;
Interest; General
Government, etc.)



Year	% of Total Output	Per Capita
1962 ¹	6.05	175.53
1963 Goal	6.20	189.90
1966 Goal	6.11	217.78

¹/Budget estimate as of July 20, 1962

The reason I have analyzed so carefully—I hope carefully—this whole profit picture and investment picture during these recurrent boom periods that collapsed so quickly, is because I have been asked why they collapsed. They didn't collapse because they were not making enough profits. They did not collapse because the tax policy was too severe. They collapsed because, even with a giveaway tax policy, practically, and extremely high profits, they still won't continue to go ahead when they saw more and more that they couldn't sell what they could produce, and this is true in the last year as well as in the period preceding the last recessions.

The reason we are now moving into stagnation and recession again, is precisely the same reason as in these previous periods, namely, there were plenty of cash flows, plenty of profits, a very favorable tax situation, but they still would not go ahead with adequate investment, and in fact are willing to go ahead now even less than previously, because now more than ever before they are confronted with unused plant capacity. Business Week, on the 28th of April—and this is my final point, Mr. Chairman—these business magazines amuse me. They have an editorial page in favor of more tax concessions for business. Then they have a fact page or an analysis page which recognizes the opposite.

There was a long article, based upon the McGraw-Hill survey in Business Week, which said they had plenty of cash flow, plenty of profits; that the reason they are slowing down their investment is that the investment of tomorrow is based upon the customer of today; and if only they could get the customers, they would have the markets and would make the investments.

I think this is a guide to tax policy, I think it is a guide to monetary policy, and I think it is a guide to general economic policy.

Thank you very much for your attention.

Chairman PATMAN. Thank you, sir. You may keep your seat there if you desire, and we have our next witness, Mr. Saulnier.

Will you come forward, please?

I believe, Doctor, you have a prepared statement. You may proceed in your own way.

**STATEMENT OF RAYMOND J. SAULNIER, PROFESSOR OF ECONOMICS,
BARNARD COLLEGE, COLUMBIA UNIVERSITY, NEW YORK CITY**

Mr. SAULNIER. Mr. Chairman, I have a prepared statement, copies of which I believe have been distributed to the committee.

Chairman PATMAN. Yes; they have been distributed to the members.

Mr. SAULNIER. This statement was prepared rather hurriedly and I have already detected some points I would like to correct. I hope you will give me an opportunity to correct them before the statement is, as I expect it will be, printed.

Chairman PATMAN. You may correct them as you go along, or if you desire you can wait until you examine your transcript of testimony.

Mr. SAULNIER. Thank you, Mr. Chairman.

Chairman PATMAN. You certainly will be given permission to correct it.

Mr. SAULNIER. I will read the statement, if I may.

I want, first, to commend the committee on its decision to hold open hearings at this time on economic policy and to thank you for inviting me to participate in them.

Certainly, the hearings are timely. Although the economy is far from being in distress, things have not gone very well and certainly not as well as was expected. The 1961-62 recovery and expansion was not up to par, much less than having been an improvement over earlier recoveries. And there was those who think that after only 17 months of recovery and expansion a downturn is imminent. It also adds to the timeliness of these hearings that they come at a point when the Federal budget is being shaped up for the fiscal year 1964, and I would assume that work on the legislative program for 1963 will soon be under way in the executive branch.

In short, the time couldn't be more appropriate for an open discussion of economy policy. I think it would be agreed, also, that such a discussion is needed.

As I understand it, you have already received testimony setting forth the salient facts on the economic situation. I will try not to duplicate any of this, but before I comment on policy matters I must give you my own conclusions regarding the present position of the economy and the near-term outlook, for these are critical to my policy recommendations.

It is widely acknowledged that for some time now the indicators to which we look for clues as to the economic outlook have been far from encouraging. Warnings of a slowdown in the rate of economic advance began to be visible early this year. Month by month these warnings were confirmed; but the evidence for the month of May went beyond this and suggested a strong possibility of a downturn occurring before the end of the year. If anything, June darkened the outlook a bit.

July was another matter. Not very much data are available yet, but what there is suggests that the economy steadied itself and improved a bit. Indeed, for a month that is often hard to interpret, I would say that the evidence of improvement in July is pretty clear. Certainly, if we look at the month's developments from the point of view of their policy implications there is no doubt but that they destroyed any case there may have been for an emergency tax cut.

And perhaps I can best express my estimate of the near-term outlook by saying that I doubt that developments in the next few months will warrant emergency tax cutting.

But it would be a mistake to think that the danger of a downturn has been altogether averted. I don't think one can say at this time that it has been any more than deferred. The economy has shown resistance and strength in the last few weeks but the record for the recovery as a whole obviously suggests a lack of the kind of liveliness one would like to see.

The way I read the record, it is saying that there is no need for emergency antirecessionary tax cutting, but that there is an urgent need to strengthen the underlying forces that make for growth in our economy and to remove obstacles to growth. And I would say that the record is telling us, also, that we don't have an unlimited amount of time to shape and adopt the needed measures.

The performance of the economy in the last few years, and in particular the disappointing record of the present recovery, provide important guidance as to the kinds of measures that are needed. Four points in this record are especially noteworthy.

First, it should be clear from recent experience that we can't produce the economic growth we want merely by the increase in Federal spending. The fact is that in the fiscal year just completed net budget expenditures of the Federal Government rose by more than \$6 billion.

This followed an increase of \$5 billion in the fiscal year 1961, of which nearly 80 percent was incurred in the last 6 months of that period. And I would judge that more increases are in prospect. The budget presented to the Congress in January 1962 projected a rate of expenditures for fiscal 1963 which would be about \$6 billion higher than the fiscal 1962 rate.

Thus, we have had a \$10 billion increase in Federal expenditure rates in the last year and a half; and if things turn out as projected in January, we shall have had a \$16 billion increase in 2½ years ending June 30, 1963. There has been a sharp increase, also, in spending by State and local governments. The economy has lagged, but no one can say it has lagged because it got no boost from Federal spending.

Second, not only have we had a sharp rise in Federal spending but it has been deficit spending, which is widely regarded as being a very strong tonic for the economy. But if a deficit in the Federal budget with expenditures rising will stimulate the economy, then we should be enjoying a good deal more stimulation than we are feeling right now. There was a deficit in the conventional budget of nearly \$4 billion in the fiscal year 1961, and a deficit of \$6.3 billion was registered in the fiscal year just completed. And still the economy lags.

There are all kinds of reasons why our country, with its heavy responsibilities in the free world, should keep its financial housekeeping in strict order, but if we were to put all of these powerful arguments aside and simply look at the record as pragmatists I don't see how we can escape the conclusion that the Federal budgetary deficits just don't work the magic they are reputed to perform.

Third, it is not easy, either, to see a ground for complaint that consumer buying power has not increased rapidly enough. Between the first quarter of 1961, which was the trough quarter of the 1960-61 recession, and the second quarter of this year, disposable personal income rose more than did personal consumption expenditures. Reflecting this fact, the annual rate of personal savings went up by about \$3 billion, and the savings ratio rose from 6.7 to 7 percent.

Fourth, the record shows very clearly that the one major element in our economy that has been really lagging is the volume of expenditures by private business concerns on plant and equipment. While other major categories of national product have been increasing very well, and some, such as governmental spending, have been rising sharply, producers' expenditures on durable goods have hardly increased at all.

They rose in the recovery period, but not nearly enough; and, looking at their behavior over a longer period, they were barely larger in the second quarter of 1962 than they were in the second quarter of 1960.

Furthermore, if the amounts spent were expressed in constant rather than in current prices I expect it would be found that the physical amounts of goods involved was actually less in mid-1962 than it was 2 years ago.

When one goes over the whole record, it is pretty clear that the lag in our economy is in private investment activity, and that our major need is to create an environment that will favor a more rapid increase in this category of expenditures. What we need is a program of action that will bring this about.

In a moment I will outline a plan of policy which, in my judgment, would fit the present situation, but, before I do that, let me say that a plan of economic policy, like any broad strategical plan, must respect the constraints that are inherent in the situation in which it is intended to operate. There is no point in talking about what it would be helpful to do if only the situation were not what it is.

In the present case, it is futile, and, worse than that, to talk about policy without regard to the fact that we have a substantial and continuing deficit in our balance of payments. When I appeared before this committee last January, I said that I thought this was our No. 1 problem.

I think that is still a correct appraisal of the situation. We should shape our policy plans in the understanding that we do have a precarious international financial position; and, to the fullest extent possible, our plans should be designed to help improve that position.

Further, it is not very helpful to talk about policy plans, fiscal or otherwise, as if there were no deficit in the Federal budget. I have heard suggestions that the Federal Government is not collecting enough money to pay its expenses, even in an advanced stage of business expansion. If the advocates of this kind of tax cutting have either overlooked the existing deficit, which hardly seems possible, or they have been persuaded that tax cuts which create deficits will give such a strong stimulus to growth that they will pay for themselves with very little delay.

As I have shown, there is nothing in our recent experience to suggest that deficits, as such, will do this.

In any case, the policy program I am going to propose does respect the facts of our international financial position and our Federal finances.

Let me outline the major elements of a program.

First, it would be helpful, if this committee, and the administration, would reaffirm the budgetary policy which has been previously stated; namely, that our object in budgetary planning is to achieve a balance over the cycle, with surpluses in periods of cyclical expansion offsetting deficits during cyclical recessions. Any doubts on this should be put to rest.

Second, it is essential, in my judgment, to initiate at the earliest possible opportunity a program of tax reforms designed to stimulate a higher rate of business capital expenditures. The steps recently taken by the Treasury to liberalize depreciation allowances were a good start. The investment credit would be helpful, too, though my preference would be for a still more liberal depreciation allowance.

Beyond these steps, we ought to get the corporate income tax rate down. The 42-percent limit proposed in the Baker-Herlong bill would

be very helpful, of course, but we might set 47 percent as an interim goal. Also, we should eliminate the near-confiscatory rates imposed on the upper brackets of individual income.

Again, I would like to see these reduced over a period as contemplated in the Baker-Herlong bill, but 50 percent would be a reasonable interim goal.

Quite apart from other effects, these tax changes would be tremendously helpful to our 4 million small- and medium-sized business concerns. The task we face of providing jobs in this decade for a rapidly increasing number of young people is going especially to require a vigorous body of small- and medium-sized companies. Many will find employment in large nationwide organizations, but we should leave no stone unturned to help the small- and medium-sized companies in which large numbers of young people will find their most interesting and rewarding employment opportunities.

Third, although I want to see us do every bit of constructive, growth-promoting tax reducing that we can do, I believe we should limit what we do to what can be counterbalanced, in its immediate revenue-reducing effects, by expenditure reductions and possibly by some sales of Treasury-held financial assets.

If rate reductions of the type I have proposed promote growth to the extent that I think they will, they will eventually pay for themselves, but in the interim we should plan to pay for them in some quite tangible way.

I suggest that we go about the task of financing constructive, growth-promoting tax cuts as follows:

- (1) As guidance for the fiscal 1964 budgetmaking process the President should set a ceiling on Federal spending. This ceiling should not be higher than the projected spending level of fiscal 1963 and if possible should be lower.

- (2) With that ceiling as a preliminary guide, an effort should be launched at once to reduce spending on low-priority programs. The economies achieved from this budget review need not go exclusively to financing tax reductions. On the contrary, they might be divided about 50-50 between this purpose and increasing expenditures on truly high-priority programs. By high-priority programs I mean those that give clear promise of enhancing our capability for achieving a vigorous rate of economic growth.

- (3) Although I would depend mainly on the reduction of low-priority spending to offset the immediate revenue cost of tax reforms it should be possible to offset some part of this budgetary impact from the proceeds of the sale of portions of the huge amount of financial assets which the Federal Government has accumulated over the years under its various direct loan programs.

It was estimated in the January 1962 budget message (special analysis E) that outstanding direct loans of major Federal credit programs at the close of the fiscal year 1962 would come to nearly \$27 billion. Obviously, one should not press a program of this kind too hard lest it raise borrowing costs in the long-term capital markets. But it should be possible to distribute significant amounts of these assets on terms that would be fully protective of the public interest and without any material effect on long-term borrowing costs.

Something between \$2.5 and \$3 billion would be a reasonable beginning goal for tax reductions of the sort I have proposed; and I believe that this immediate impact on revenues could be offset by some combination of the means I have indicated. If more can be done, so much the better.

It is my considered judgment that a statement to the effect that this is the direction of policy to be followed in tax and expenditure matters would have a very stimulative effect on our economy. But I would emphasize that it is very important to get the program underway soon. Accordingly, the tax aspects should be presented, in my judgment, in a form that will minimize the time required for consideration prior to enactment. From this point of view, the simpler the bill, the better.

(4) This brings me to the question of monetary policy, which is especially important at this time because of our international payments position and because of the lag in our economy.

No one wants a money policy that will retard the correction of our balance-of-payments position, much less a policy which would actively worsen that position. On the contrary, money policy should contribute to the needed correction. But if monetary policy is asked to carry too much of the burden of correcting, or even of protecting, an international payments position which, like ours, is traceable in good part to governmental programs it could very well be so restrictive as to offset all the stimulating effect which we could hope to produce through fiscal measures.

The risk of our getting into such a policy dilemma is reduced, of course, to the extent that we succeed in efforts such as those being pressed by the administration in connection with procurement under our military and economic aid programs. Vigorous application of these efforts to conserve dollars is an absolute requirement of policy at this time.

This requirement is underlined by the fact that free reserves seem to have been trending down recently, that the money supply currently seems to be shrinking, and money rates and bond yields have recently taken a rather sharp turn upward. Considering all elements in the situation, as the reserve authorities are in a position to do, these developments may be both necessary and beneficial.

All the same, I would hope that considering the position of the economy at this time and the extent of the more direct measures being taken to help correct our balance of payments, it will not be necessary to tighten credit conditions over their present position. Actually, some easing would be helpful to the economy, especially in the long-term section of the market.

At an earlier point in this statement I suggested the sale of some part of the financial assets currently held by the Treasury as a technique for meeting part of the cost of a growth-promoting tax-reduction program. I realize that this could have a tendency to raise long-term borrowing costs, though I should think the program could be managed so as to limit this effect to a very small amount and hopefully to avoid it altogether.

But if long-term borrowing costs have to be lifted, and in the last few weeks they have been lifted in the corporate bond market, I should think it would be better to do this as part of a program to

finance growth-promoting tax reductions than as part of a normal Federal Reserve open market operation.

(5) Finally, let me say a few words on the relation of costs and prices to economic growth. Mr. Bolling of this committee will perhaps remember a letter I wrote him a few years back responding to certain questions he put to me and in which I stressed the importance of cost increases, and particularly of labor-cost increases, as a force behind rising prices. This was not a widely held view at the time, but it has gained a good many followers since.

Indeed, not so long ago it was not even fashionable to believe in the necessity of a reasonably steady price level as a basis on which to achieve sustainable and meaningful economic growth. But views on these matters have undergone very considerable change. Nowadays, there is broad agreement that a reasonably stable price level is the only basis on which a workable economic strategy can be built.

I subscribe fully to this view, though I must confess that the conversion to it has been more rapid and more widespread than anything I had expected to witness. But this is good, and I am happy to see it; all that concerns me is that we do not overlook the fact that once price level stability has been made the basis of an economic strategy, one automatically accepts certain other requirements, too.

The most important of these is that, in the most general case, production costs must not increase by amounts that cannot be fully offset, in their effect on unit cost of production, by improvements in productivity. If this requirement is not respected, the result is a suppression of profit margins and eventually a suppression of the rate of economic growth.

There is wide agreement, I believe, that for some years we have, as a Nation, been failing to respect this requirement. Competitive conditions, and to some extent governmental pressures, have pretty much fixed a ceiling on prices; currently, many industrial prices are being reduced. But we have been less successful in limiting increases in costs. One way to put this is to say that price inflation, at least for the time being, has been checked but that cost inflation continues.

I believe that it is this inconsistency, which reflects itself in narrower and narrower profit margins, that is the major factor behind the lag in our economic growth. And I want to state quite clearly that although I believe we can improve our economic performance through appropriate monetary and fiscal policies, we must follow appropriate wage-price-profit policies or we will undo all the good these other measures can accomplish.

This is obviously what the President and his Council of Economic Advisers had in mind in setting forth certain wage and price guidelines in the January 1962 Economic Report.

There is a good deal that can be said pro and con on the idea of setting guidelines in this fashion, but without going into these arguments I must express a reservation about the wage guideline as currently defined. The principle that labor cost increases should be equated to productivity improvements does not, in my judgment, suit our present situation.

What we need now is a chance to achieve an improvement in profit margins and some reductions in prices. If we keep our economy competitive enough, which is a requirement underlying any strategy for

an enterprise economy, we can be sure that profit improvement will not go far beyond what is reasonable before it is translated into lower prices.

But in order to achieve profit margin increases and price reductions, production cost increases must be kept well within productivity improvements, not equated to them. The guideline, in my judgment, should be revised to this effect.

It would be helpful also to have a better understanding as to how these guidelines are to be enforced. Certainly it is clear that there is very little to be gained from enforcement procedures of the sort that were employed in the steel incident. I have four suggestions to make in this connection.

First, on the application of wage-price guidelines, I suggest that the executive branch limit its role to (i) annual descriptive and analytical reviews, presented in the Council's year-end Economic Report, of the major developments affecting wages, prices, and profits; and (ii) a critical evaluation by the President, in his year-end economic message, of wage-price-profit developments during the year.

If it should be the President's judgment that developments have not been consistent with the national interest he could state the respects in which he believes mistakes have been made and the lines along which adjustments should be made. There is ample opportunity in the medium of these two messages for the facts to be set forth and analyzed for their meaning and significance and for guidance, which I believe should be couched in general terms, to be given for the year ahead.

Short of emergency conditions, and in these connections I would interpret "emergency" quite restrictively, I believe our economy will work better if the executive branch avoids direct intervention in specific wage-price decisions. In the meantime, efforts should be pressed, as I believe they are by the President's Special Commission on Labor-Management Relations, to explore ways of improving the balance of bargaining power in labor markets.

Second, I suggest that conferences such as the one sponsored this spring by the Secretary of Labor on national economic issues be held regularly every year. Conferences of this kind are an excellent way to encourage discourse and to improve understanding among labor, management, and Government on economic policy questions.

Third, it would also be helpful to provide for the expression of views from the public on wage-price-profit developments. To this end, the Joint Economic Committee or possibly the Council of Economic Advisers might plan to have open hearings every January or February devoted specifically to this range of questions and in particular to the guidelines, if these continue to be set out by the Council and the President. As far as possible, the effort should be to give an opportunity to be heard in these hearings to all those who have potentially useful contributions to make to the discussion.

This would be a kind of annual economic town meeting. I come from New England, and I know that it is sometimes not as easy to get such meetings stopped as it is to get them started, but I think this can be managed and, in any case, the open discussion of stated public policy is always a healthy thing in a democracy. Open discussion is certain to help us find our way to an understanding of the kind of wage-price

policy, shaped through free collective bargaining and competitive markets, under which we can achieve the kind of economic performance we all desire.

Fourth, I suggest that this committee make a special point, possibly through the scheduling of special hearings, of examining into the ways in which Government itself may be putting direct upward pressure on costs and prices. I have in mind, particularly, the Government's procurement and contracting activities and the programs under which it makes minimum wage determinations as authorized by the Walsh-Healey and Davis-Bacon statutes.

We should be quite sure that these programs are administered in ways that are consistent with the kind of wage-price policies which, under the guidelines procedure, we hope to have followed by all labor groups and business units. I would judge, drawing upon my experience in 1956-60 as Chairman of the President's Council of Economic Advisers, that there are responsible businessmen who would say that the programs tend to inflate costs. The problem needs close study.

I have limited myself in this statement to fiscal, monetary, and wage-price policies. There are, of course, other parts of a strategy of economic policy that also deserve attention. But the three I have commented on are the crucial ones. If I have overlooked points in which members of this committee have a particular interest, I shall be happy to respond to questions on them.

Thank you very much.

Chairman PATMAN. Thank you, sir. I would like to ask Mr. Keyserling a question.

This is a question that concerns me, Mr. Keyserling. If we had an across-the-board cut in personal taxes, that is, a cut which would change the income distribution in favor of the top bracket income receivers, wouldn't you have a worse fiscal structure after the period of deficit is over?

In other words, wouldn't you, in the long run, increase the troubles which the tax cut is intended to cure?

Mr. KEYSERLING. That is the way I feel about it very definitely, Mr. Chairman. I think that the equitable thing to do in taxation is the thing that is best for the whole economy—wage earners and investors, high-income groups, middle-income groups, low-income groups. The thing that is best for the whole economy is to have the economy operating fairly consistently at maximum levels of employment, production, and purchasing power.

Certainly, nobody has to worry about the adequacy of profits under such conditions and certainly nobody has to worry about how well the high-income groups do under these conditions. I don't think that the taxes on them are "confiscatory." I get around the country quite a lot, and certainly most of them, who haven't inherited great fortunes, couldn't live the way they do, and they live that way honorably, if they were really paying 91-percent taxes on the portion of their incomes which fall within that tax rate.

The fact of the matter is that our tax policy is much too hard, both directly and obliquely, on middle and lower income groups, who haven't got ways of honorable tax avoidance. Therefore, I think you are entirely correct that, when one analyzes what has actually been happening to the economy and where the deficiencies have occurred

which have hurt everybody, a larger spendable income on the part of middle and lower income families would do much for the whole economy than a larger spendable income on the part of the corporations and higher income people, not because I have any objection to their having these higher incomes, but because they translate more largely into savings than can be absorbed in investment.

The savings cannot translate fully into investment when there is inadequate ultimate demand, and, therefore, they become frozen savings, which are merely another expression for unused plant capacity and rising unemployment of plant and manpower. So I agree completely with your implication, and I feel very strongly that a mal-adjusted, improper change in the composition of the tax burden which would be represented by a so-called across-the-board tax cut, would in many respects leave us worse off than we are now.

Chairman PATMAN. Thank you, sir.

Would you like to comment on that, Mr. Saulnier?

Mr. SAULNIER. Yes, I would like to comment on that, Mr. Chairman.

I feel that there are many changes that it would be beneficial to make in our tax system.

Chairman PATMAN. We are confining this just to this across-the-board, or the low-income group.

Mr. SAULNIER. I will come to that point, Mr. Chairman. As I say, I feel there are many changes that should be made in our tax system; to my way of thinking the question is mainly one of priorities we should place on them. In my judgment, the reason why we are not achieving the kind of economic growth we would like to have is that we have an inadequate growth of investment expenditures in the private sector of our economy, and I have suggested two changes in taxes which would help overcome that.

Now, I would like to see a broad, across-the-board reduction in the individual income tax, but, Mr. Chairman, I just don't think we can afford it at this point. Our Government is providing services of increasing scope and variety for the whole American population, for every man in the street, if you will. These services must be paid for and there just isn't anybody to pay for them except the whole American people.

There is no other place to put the burden of paying for those programs. Of course, a person may persuade himself that the programs don't really need to be paid for, and some people have apparently managed to persuade themselves of this, but I don't see how you are going to run the Government safely unless you do pay for these services and to do this you must tax everyone. That is why, while I would like to see broad individual income tax reduction, I honestly cannot say, Mr. Chairman, that I see it as a practical thing to do at this time.

Chairman PATMAN. I would like to ask you a couple of questions, Mr. Saulnier. I wish you would comment on them briefly, if you please.

Mr. SAULNIER. Yes.

Chairman PATMAN. What specific monetary policy do you feel should accompany any tax reduction that takes place?

Mr. SAULNIER. Tax reductions, Mr. Chairman, of the character that I have suggested, accompanied, as I have suggested, by reductions in spending on low-priority spending programs and by some, as I have suggested, asset sales, would require no change in money policy.

Chairman PATMAN. One other question. To what extent in your view would there be an increase in investment as a result of reductions in the corporate tax rate?

Mr. SAULNIER. Would you repeat that question so that I may be sure I understand you correctly?

Chairman PATMAN. To what extent, in your view, would there be an increase in investment as a result of reductions in the corporate tax rate?

Mr. SAULNIER. I must answer that question, Mr. Chairman, by saying this: There is no one thing that will get our economy moving up again, not even a cut in the corporate income tax, though that would be helpful.

What we need is a clear definition of a policy, a policy that goes across the board, affecting expenditures, taxes, money, et cetera, and that policy should be clearly defined and projected to our people. I believe that with an understanding of such a constructive policy we would enjoy a good rate of economic growth, and within that policy I would say that the tax changes I have been talking about would be very stimulative.

Chairman PATMAN. You won't make any change—this is in connection with the next to the last question I asked you—in the present interest rate policy, which, of course, I believe you will admit is a high interest rate policy?

Mr. SAULNIER. Would you mind telling me, Mr. Chairman, what you mean by an interest rate policy? Do you mean by that the whole Federal Reserve policy?

Chairman PATMAN. Yes, sir. Of course I believe you will agree that the Federal Reserve makes the interest rate policy. You and I will agree on that point?

Mr. SAULNIER. I think I know what you mean. I just want to be sure, Mr. Chairman, that we are talking about money policy generally and not the policy with respect to the maximum interest rate that can be paid on deposits.

Chairman PATMAN. I am talking about general interest rates that have been going up and up and up over the years. Would you change that, or would you let it go like it is?

Mr. SAULNIER. I can comment, Mr. Chairman, on the current money and capital market situation and can say whether I think money policy, in that situation is too restrictive, or not restrictive enough.

It is difficult, however, to comment on money policy more generally.

Chairman PATMAN. All right, sir. What do you think about it, Mr. Keyserling? Do you think that monetary policy should be changed?

Mr. KEYSERLING. Yes; I do. I have thought so uniformly, for a long time.

Chairman PATMAN. I believe you stated what the recessions we have had in the past were. After the recessions in 1948 and 1949 we had one in 1953 and 1954; of course, more of it in 1953 than in 1954; 1955-56, more of it in 1956 than 1955; and then in 1957 and 1958, more

of it in 1958 than 1957; and then in 1960-61. Is that correct about the recessions we have had in the past?

Mr. KEYSERLING. Yes, generally speaking.

Chairman PATMAN. You think they could have been avoided by a proper monetary policy?

Mr. KEYSERLING. I agree with Dr. Saulnier, and this is one of the few points that I agree with him on, namely, that you cannot stabilize or maximize the health of the economy with any one set of policies. I think we have a broad and variegated economy, and that we need a complex of reasonably workable monetary policies, price-wage policies, fiscal policies, and others.

I think we need them all, and I think that usually they should be based upon one central approach. In other words, if it appears upon an actual examination of the economy in action that consumption is tending to outrun investment, which is a typical inflationary situation, then all of these policies should move toward exercising restraint upon consumption and do everything possible to induce investment. If the reverse is true, then these policies should move in the opposite direction. I don't see any sense at all in two policies moving in opposite directions. That would be like walking the floor with one crutch to walk part of it, and the other to walk the other part, when you need both crutches. You need all policies working in the same direction.

In more direct answer to your question, subject to above qualification, I do think that the tight money policy over the years has been a very pronounced factor in contributing to a seriously low economic growth rate and the recurrent recessions.

By and large, the rising interest rates, which are at least a consequence of a tight-money policy, if not its intent, tend to ration the national income toward those who lend us back our own money. One of the greatest economic reforms of the last 30 years, in my view, has been the movement in the opposite direction, good for everybody. I remember when I was a boy I would walk by the bank and I would see a sign on the bank, "6 percent interest on deposits."

Senator BUSH. That was a pretty average rate in those days.

Mr. KEYSERLING. Yes, and of course, the real interest rate on home-building was 8 or 10 or even 12 percent before you got through. If we believe in an incentive economy, if we believe in an enterprise economy, we ought to favor the fellow who enterprises and invests and the consumer who buys, as against the person who lends them back their own money, and, after all, they are lending us back our own money.

Now, we started turning the clock the other way in recent years, and I think this has been one of the most damaging factors in the whole picture. I made a study of it where I figured that something like \$23 billion had been taken out of the pockets of the average consumer, and the average homeowner, and the average family, and put into the pockets of those who are lending back our own money, during the period 1953-59. I have nothing against these people, but I think it is unsound policy. This is the first way that tight money and rising interest rates hurt the economy.

The second way they hurt the economy is that they hit the things we need before they hit the things that are booming excessively. Mr. Martin of the Federal Reserve System, a great and sincere protagonist

of having us pay more to those who lend us our own money, and I am sure he honestly believes in this policy, in early 1957 before the Senate Finance Committee, said that we needed to do this because consumption was too high and investment was too low and savings were too low.

Yet in early 1957, we had enormously idle plant capacity. The financial institutions were stuffed with savings, and we had a tremendous deficiency in ultimate demand, just as we have now. So a little while later, in consequence of this policy, we got into the worst recession since World War II from which we have never recovered; and the next year the same gentleman came before the same committee and said that the big trouble we had a year earlier was the great deficiency in consumption and that investment was outrunning consumption.

Those who make policy should be more contemporaneous with events. Their observations should not be matters of hindsight only. I think we are now in the same kind of situation basically. I agree with Dr. Saulnier that investment is too low. There is no question that it is, but why is it too low? When you move from what I might call generalization to a specific examination, industry by industry, company by company, total by total, the break-even point is not too low. The steel industry has a break-even point below 40 percent. This does not mean that costs are too high relative to profits per unit.

If they are not making enough money, it is because they have been operating at low capacity for the last 5 years or longer. I hope the committee will very carefully study these factual examinations I have made, and I am always glad when economists come forth and on the basis of a different set of figures show that there is something wrong with my analysis but there is really no way of matching analyses in terms of the data against an analysis in terms of generalities.

The fact of the matter is, as I see it, that a crucial characteristic of American industry is that it generates, at a given level of operations, a level of profits above what it can enduringly invest as against the markets which are militated against by too low a level of ultimate demand.

This has happened over and over again. It has happened four times since 1949. And it is happening again now. There is nothing wrong with first quarter profits, 1962, in any basic industry, with some rare exceptions, which would disprove the general rule. The only thing wrong is that business is operating at too low a level of capacity, and this is relevant in my view to tax policy, and to money policy, and to other basic policies, and it applies to price-wage policy fundamentally.

Chairman PATMAN. Thank you, sir.

Senator BUSH. Mr. Chairman, I have another question.

Mr. Keyserling, you and Dr. Saulnier agree about the investment factor being too low. I mean you do agree that that is one of our problems; is that right? You just said that?

Mr. KEYSERLING. Yes, sir.

Senator BUSH. Dr. Saulnier has developed a thought in here that hasn't been developed before this afternoon in these hearings this week which has to do with the question of cost. I am very much impressed with his argument here about the need for a better control

of cost and the need for not equating increased costs with productivity gains, but using productivity gains not only for wage increases, but for reduced prices, and possibly increased profits; in other words, for the division of increased gains in productivity rather than using it all up in increased costs and particularly wage costs.

Our competitive position is constantly under discussion nowadays, particularly as the Common Market is becoming more and more of an economic factor in trade, and this administration is greatly concerned about that as I think we all should be.

However, it seems to me that as I talk with business managers and people who control the question of expansion of our plants and the use of investment funds to expand plant and job making opportunities, there is sort of an underlying apprehension. It doesn't come out into the open very much because I think there is a certain fear in expressing themselves that no matter how they may try to control costs, they can't do it because of the very great preponderance of bargaining power that lies within the big labor unions.

We have seen lately this year a very substantial increase in the number of strikes over what we had last year. We have even seen some very bad strikes in defense industries and our missile plants. We had a very bad one recently in my State at the Electric Boat Works, which was not really an argument between management and labor, but an argument between unions there, which shut that plant down for a long period of time.

We have the Eastern Air Lines shutdown still because of a dispute between the unions, and some smaller union of 550 members has been able to bring that thing to a halt and throw 18,000 people directly out of work and greatly interfere with the travel incident to our trade and commerce in the eastern part of the country. We now see that we are threatened with a big railroad strike and so on.

It seems to me that this is one of the underlying causes of uneasiness and apprehension and hesitation, and I should like you, Dr. Keyserling, to give your views on that situation.

MR. KEYSERLING. Let me try to. I think that some of the points that I would make are embodied more fully in my charted statistical analyses, which I ran over very quickly. Let me try to clarify at least what my position is in this way: First, you made the point that increases in productivity should be taken partly in wage increases and partly in price decreases.

Senator BUSH. At increased profits.

MR. KEYSERLING. This I assent to. I think it is desirable. I haven't found many great corporations that are pioneers in this effort, but I agree with you on that.

Second, you come to the even more basic question that, in a free society, which we both believe in, nationally organized business and organized labor will contend with each other for the share that they get of the gross income, and it is only natural that labor unions should want to increase the labor share and that corporations should want to increase the profit share, which is income after costs, including wage costs.

The basic economic question, as you so well stated, is, What is a workable division from the viewpoint of the operations of the economy? I mean there is no such thing as a fair profit or a fair wage in an absolute sense.

I say that a workable division is a good division. Then I look at wages, and I look at profits, and prices are a factor in both, because the price level determines the real buying power of the wage as consumption, and the price factor determines the real buying power of the profit as investment.

First I look at the wage side, and I say wages have two functions. One of the functions of wages is to play its part in consumption. Taking that one first, I find a deficiency in consumption relative to the actual productive capacity in being of the American economy. Therefore, I reach the conclusion that, from the viewpoint of the consumer side, the wage increases have not been too high. In other words, they haven't produced a redundancy of purchasing power.

Then I go over to the profit side. I ask, Have the wages been too high from the viewpoint of leaving over enough profits after wage costs, after payment of dividends, after all other costs, to fulfill the investment function, which gets back to the cost per unit idea? Are the wage costs per unit and other costs per unit leaving the business with too small a margin of profits per unit?

The more I study the figures, and I know I am objective, although I may be wrong, as any economist may, the more I reach the conclusion, which I think is supported by all the data shown on individual industries and on the overall picture, that in each period of upturn the profits after taxes, after wage costs, after all other costs, have been too high per unit and have been too high in the overall to be used fully, and that is the only workable test of profits.

Oh, these profits have been used for a while, when we have gone up in one boom or another, but then we have had a tremendous downturn in investment, which has propitiated the successive recessions. These downturns haven't come because of an inadequacy of profits, because then they could never start. There certainly were plenty of profits during the upturns. They didn't come because of too high a wage cost.

What has happened is that the profits have been so high, after allowing for all costs, including wage costs, that they led by way of investment to tremendous excess capacity, and then downturns came. I think this is the fact of our American economic life. I don't cite it as an indictment of business. I wish that business followed a price policy and a wage policy that kept the economy in better balance. They would make more profits in the long run and they would invest more in the long run. But I can't find, and I have asked various economists—they will talk in a general way. Let me give an illustration.

Senator BUSH. You are not worried about the effect of this upon our competitive position, both at home and abroad?

Mr. KEYSERLING. Well, it is the same problem. If you say that the reason that the prices are so high in America is because the costs are too high, then you say that you have to reduce these costs, including wage costs, to get a lower price. But if you say, as I say, that the existing price is too high, not because the cost is too high, but because the profit margin per unit is too high, then you reach my conclusion. I think this conclusion is supported by the repeated collapse of each successive investment boom and each profit boom. I cannot look at the profits of any of our key industries during the past years, or first quarter of 1962, and reach the conclusion that their costs are militating against an adequate level of profit for all investment purposes.

Now, our competitive position would be improved if we had more investment. I admit that.

Senator BUSH. You do not think this factor I am discussing with you is inhibiting the expansion of investment?

Mr. KEYSERLING. I think what is inhibiting the expansion of investment is unused plant and an inability to sell what they can produce now. Investment is based on a prognosis of markets.

Senator BUSH. That does not bear out some of the testimony we have had here, like that of Mr. Ellis of the Du Pont corporation. I do not know whether you saw his testimony. He was in here a couple of days ago.

Mr. KEYSERLING. If Mr. Ellis puts before this committee, I do not mean the same facts, but the kind of analysis that I have tried to put before the committee, which looks at the factual situation instead of mere generalities, and if his facts and his analyses are as careful as mine and lead to different results, I will be perfectly willing to withdraw from my position and ask your committee to take his point of view. All that I ask is whether Mr. Ellis, in examining this question of prices, wages, and profits, and what the real inhibiting factors are, is presenting to you as relevant data, and as carefully related to the facts, as what I am trying to do. All too frequently, I find, in a lot of these big corporations, as well as in others, and I am not criticizing them, a tendency to say that wages are too high, and costs are too high, and profits are too low, and taxes are too high, all by way of generalities rather than careful factual analyses.

Senator BUSH. But this administration has expressed a strong interest itself in a hold-the-line policy, so to speak, because of our competitive position.

Mr. KEYSERLING. I am not here as an unthinking devotee of the economic policies of this administration. I am trying to be nonpolitical about it. I do not think this administration has thus far satisfactorily met the growth problem nor the unemployment problem, and neither did the previous administration. I cannot, and I do not mean to imply that anyone else is trying to treat this on a basis of the fact that, because I am a Democrat, this administration is right on everything. I think that both administrations have swung in a direction of economic policy which has not worked. If I had said this only in 1953 at the beginning of the Eisenhower administration, or only in 1961 at the beginning of the Kennedy administration, I might have had to await events to test my conclusions. All I am saying now is that what has happened squares with what I have been saying, and, therefore, if policies have not worked, there is something wrong with them.

Senator BUSH. My time is up, Mr. Chairman.

Representative REUSS (presiding). Mr. Saulnier, you have stated that the economic situation is disappointing, and you have suggested an economic program. First, you favor the recent increase in depreciation allowances. Next, you favor the proposed 7-percent investment credit, though you say you would prefer an even larger increase in the depreciation allowance. Then, you favor a cut in the corporation income tax by about 5 percentage points, and a cut in the personal income tax down to the 50-percent level. The proposed personal income tax reduction would assist families with incomes of more than \$32,000 a year, as I understand it.

Mr. SAULNIER. That is right.

Representative REUSS. The proposed tax revision would cut tax revenues, you estimate, by \$2 to \$3 billion.

Mr. SAULNIER. Two and a half billion dollars possibly.

Representative REUSS. You would offset such a reduction in tax revenues mainly by cuts in Federal expenditures. You would hold wages down in order to increase corporate profit margins.

Mr. SAULNIER. No. May I interrupt.

Representative REUSS. Yes.

Mr. SAULNIER. I would say that the increases in wages should be kept within, well within, the limits of productivity improvement.

Representative REUSS. But before you would validate a wage increase, you would make sure that corporate profit margins had expanded. That is my understanding of your testimony.

Mr. SAULNIER. Again I am not sure that I like your word "validate." I do not like to cast the Government in the role of validating or invalidating.

Representative REUSS. Strike "validate," but is it not your contention that wages either should not increase at all, or increase only after the corporate profit margins have been widened?

Mr. SAULNIER. I am afraid I would have to amend that to say concurrently rather than after.

Representative REUSS. Concurrently. All right.

Mr. SAULNIER. Which is very different.

Representative REUSS. And further on wage policy, you suggest that present minimum wage determinations under programs of the Walsh-Healy and Davis-Bacon type are too liberal, and that they should be kept down.

Mr. SAULNIER. It may well be. I think they deserve study.

Representative REUSS. Then having stated what I think to be the ingredients of your program, I must ask how it will improve the economic situation. Is it your belief that such a program would increase business investment?

Mr. SAULNIER. That is correct.

Representative REUSS. My question is, Who is going to buy the products that can be made by existing plant and equipment and manpower in our economy under your program, much less the potential output of additional, more modern facilities?

Mr. SAULNIER. The first thing I would say, Congressman Reuss, about that is that it would be very helpful, as a preliminary step, to have a clarification of what our policy is. If I may say so, I think there is a good deal of uncertainty through the country at the present time as to what our economic policy is.

Representative REUSS. I agree.

Mr. SAULNIER. And if I may say so, I think it is almost more important that we have a clarification of what the policy is than that we take this step or that step or some other step. Let me illustrate what I mean, Congressman Reuss, by the discussion of emergency tax cuts. I read the newspapers pretty regularly, a number of them, and day after day I read accounts that taxes are going to be cut; no, they are not going to be cut; we will think about it next week; we are going to wait until we have the economic figures for July 15 or for August. And the date comes and then it is not quite clear whether they are going to be cut or not.

Representative REUSS. I would agree with you there.

Mr. SAULNIER. Mind you, Congressman Reuss, I want to speak very constructively here. I honestly believe that it would be a good thing for the country if we decided here just what we are going to do. It seems to me that the facts are clear enough now to tell us what we should do.

Representative REUSS. I agree with you.

Mr. SAULNIER. I think that clearing the air, in itself, would have an electric effect through the country.

Representative REUSS. I think it is highly important that we clear the air. You, as well as Mr. Keyserling, have, in a very frank and sincere spirit, offered a concrete program for clearing the air. My specific question is, how will your program, in the cleared air which would undoubtedly accompany its enactment, generate purchasing power to take off the market goods we can produce with our present capacity together with the goods which additional capacity could produce?

Mr. SAULNIER. I would answer that question, Congressman Reuss, by saying that if a program were put forward, the business people of this country, and I say "business people of this country" advisedly, because, after all, we are talking about an enterprise economy which works well if business units work well, and does not work well if they do not work well——

Representative REUSS. My point, of course, is if business units work best when there is a good prospect of selling that which they can produce——

Mr. SAULNIER. Indeed they do.

Representative REUSS. I do not see how your program gives us that market. You would take \$2 or \$3 billion out of the spending stream when you cut expenditures by that much. I do not know how much added capital investment you expect to get. While I would agree with both you and Mr. Keyserling that the level of private investment should be raised, the addition of more capacity will not by itself generate enough consumer purchasing power to absorb the extra output.

Mr. SAULNIER. I think I understand the difficulty you have with the statement I made, and I would like to try to clarify it. I started to say that if a program were put forward which the business people and the American people generally accepted as a constructive program, one that they could understand, one to which they could subscribe, I think this would have the effect of improving the confidence which people feel in their future and of removing the uncertainty that they feel in the present situation. That result alone would have an expansive effect on our economy. And within the context of that program you would be doing things in the tax area that would be stimulative.

Then, Congressman Reuss, I would like to comment, if I may, on your observation that Federal expenditure reductions would take funds out of the stream of expenditures. I am not sure that that needs to be the case, and I suggest that there is one area of the Federal budget to which one might look for possibilities for expenditure reduction, where I think a lowering of expenditures would not necessarily take money out of the income stream, but would in effect shift activity from, shall we say, the public to the private sector. That

is the area of the budget which we call Federal credit programs, and which is a very substantial part of the budget.

Representative REUSS. Thank you.

Mr. SAULNIER. I do not want to make that suggestion, Congressman REUSS, quite sincerely. There are many expenditures where Federal Government is spending the money—it is in the Federal budget—but if the Federal Government were not spending, it very likely would be spent in the private sector of the economy.

Representative REUSS. Thank you very much.

Congressman CURTIS?

Representative CURTIS. In listening to these discussions I am impressed, particularly in relation to tax cutting, which it is assumed without offer of proof would stimulate the economy, with the further unproved assumption that demand may be equated with consumer purchasing power. It seems to me that therein lies some of the misconceptions. To prove my assertion I would relate it to the agriculture sector of our economy. As near as I can see, we could increase consumer purchasing power double, triple, or any amount, and it would have very little bearing on utilizing our agricultural surpluses. It seems to me that we have reached a stage in our economy where at least in some sectors we are dealing with an economy of plenty as opposed to one of scarcity. That is why I relate it to the agricultural sector, because that seems quite clear, and what have we done about that? Because the real consumer demand has not been there, we have artificially put it in there through Federal expenditures, agricultural subsidies, and that is where the purchasing goes on of our agricultural produce. In that instance we can continue to improve our efficiencies of wheat farming, cotton farming, or whatever, and lower our unit cost in that fashion, but still the difference is made up with tax dollars where the Federal Government just buys the surplus and stockpiles it. I wonder if you would comment on that, Dr. Saulnier, as it relates to this question that we are now talking about, of whether it is the consumer demand area or rather consumer purchasing power that is the inadequacy.

Mr. SAULNIER. Congressman Curtis, I do not diagnose the problem in that way.

Representative CURTIS. As consumer demand?

Mr. SAULNIER. I do not say that the American economy is generally an affluent economy.

Representative CURTIS. Do you agree with my analysis in the agricultural sector?

Mr. SAULNIER. In the agricultural sector, I would say we have a distinct problem of overproduction.

Representative CURTIS. That is right, which is affluence, and even if our distribution system were better, and even though we may have some of these low consumer purchasing power groups that Dr. Keyserling talks about, even if we project hypothetically the amount that they could buy in the field of agricultural produce, I think using that model we find that it would not make much of a dent in the agricultural surplus production. I think it is important that we break down these economic aggregates into components, because I suspect that in other areas what we are really seeing to a large degree is consumer choice having a great play, and not only consumer choice as between what

the consumer spends the dollar for, but whether the consumer is going to save the dollar, instead of spend it whether he is going to invest it or whether he is going to hoard it, if he saves it. I think there is a difference between investing and hoarding, whether he is going to invest it, spend it, or hoard it, becomes very important.

Mr. SAULNIER. If I may comment just for a minute on that—

Representative CURTIS. Yes.

Mr. SAULNIER. There is common route by which we get to wrong conclusions on these matters. I think it is not unfair to say that theories on these things divide into two major categories. One of these is that there is an inadequacy of demand, and that somehow or other it is this inadequacy of demand that keeps our economy from working at its optimum level. Those who hold that theory typically argue that the way to correct the situation is to increase consumer demand or overall demand. Sometimes the proposal is for higher wages. Sometimes, and frequently nowadays, it is not that, but to cut taxes. There has been quite a shift, I would say, in the last 10 or 15 years in the formulation of this theory, but it comes in the end to pretty much the same thing.

Representative CURTIS. It is based on that volume.

Mr. SAULNIER. It is based on the general premise that there is an inadequacy of demand and that if you somehow increase purchasing power, whether by wage increases or tax cuts, you will get yourself moving again.

Representative CURTIS. I wanted to ask one question.

Mr. SAULNIER. May I conclude and just add one point.

Representative CURTIS. Yes. I am sorry.

Mr. SAULNIER. I don't deny the possibility of there being an inadequacy of demand in a specific economic situation, but in many economic situations, and I think in the present economic situation, our problem is to be found in the relationships within our economy and in our capacity to make the kind of economic adjustments that must be made if our economy is to work well.

More specifically, I have mentioned the relationship between costs and prices. This is a key to a large part of our problem. I would also like to say to this committee, and I have not mentioned it in my testimony, that I think we need to do a great deal more in the area of education, in vocational training, in the area of guidance, to fit our people better to the employment opportunities which do in fact exist. I think we can make considerable improvements in our economic performance by these methods. I do not believe that you can substitute a program of expanding demand for such programs. Failing a solution of these problems of internal relationships and capability to perform adjustments, failing a solution of those problems, I think the demand-type formula will produce largely an inflationary result.

Representative CURTIS. I want to comment on that in this other way, too, because there are areas where there is a real demand. I was very interested in our Federal budget for the National Institutes of Health, and I was interested in two growth figures. One was the growth rate of technicians and people that are needed, research people, by the NIH, and the other was the growth rate of money available to be spent by NIH. The money available to be spent has a very high

rate of increase. The increase of technicians available, the manpower situation, people available who were trained, was a much lower rate of increase. It was just nonsense to be talking in terms of putting more money in there. We did not have the skills available to fill the jobs going begging here. It takes time to train people in these skills. So even in the areas where there is demand, and I submit there are real areas, treating demand as an aggregate in my judgment is a gross error.

I want to ask one question if I may on this growth thing. The President stated—I do not know whether you saw this, in his press conference—that the economy had expanded by 10 percent since he took office, and he seemed to imply that this was a better record than under the Eisenhower administration. I do not want to get it into the political aspects, but I mention this because we are comparing periods and we are trying to relate what is our economic situation. Inasmuch as you followed it closely under the previous administration I wonder if you would comment on that.

Mr. SAULNIER. I will comment on it. I did notice that statement by the President. As I recall, his statement was that gross national product had increased by 10 percent since he took office. Now, it is true that gross national product in current prices has gone up by about 10 percent since the first quarter of 1961, which was the trough quarter of the 1960–61 recession. However, if you look at GNP in constant prices, in order to get a measure of the increase in the actual output of physical goods and services, you will find that the increase is only a little better than 7 percent. I was a little surprised that the President used the current price figures rather than the constant price figures, but I was even more surprised that he found it remarkable that there had been an increase of even 10 percent during a period of business cycle recovery. There is nothing remarkable about that. In fact, I would say the thing that is most noteworthy about GNP in the 1961–62 recovery is that the increase in it was less than what it has been in earlier recoveries. Indeed, it is the tendency of this recovery to lag that accounts for our having hearings here today, I would assume.

Representative CURTIS. My time has run out.

Mr. SAULNIER. You can judge this recovery by almost any measure, and find that the increases are less percentagewise than they have been in previous recoveries.

Representative CURTIS. Thank you.

My time is up.

Representative REUSS. Senator Proxmire?

Senator PROXMIRE. I want to ask both Dr. Saulnier and Dr. Keyserling questions. I want to say, Dr. Keyserling, that I thought your statement that our monetary policy now represents an open declaration of war upon the programs the Nation needs was a very accurate understatement of the situation. I could not agree with you more. Dr. Saulnier, you seem to agree to some extent on at least the restraining nature of monetary policy and I was most heartened to see that you say on the bottom of page 10 and the top of page 11:

I would hope that in considering the position of the economy at this time and the extent of the more direct measures being taken to help correct our balance of payments, it will not be necessary to tighten credit conditions over their present

position. Actually, some easing would be helpful to the economy, especially in the long-term section of the market.

I welcome that.

Dr. Saulnier, you discuss your proposal to lower corporation income tax rates, and I am chairman of the Subcommittee on Small Business in the Senate Banking Committee and am interested in your assertion that, quite apart from other effects, these tax changes would be tremendously helpful to our 4 million small- and medium-sized business concerns.

I presume that you are proposing a 5 point cut in the basic tax, not in the surtax, the 30 percent.

Mr. SAULNIER. I would reduce the tax from 52 percent to 47 percent.

Senator PROXMIRE. Right; but this is made up of two parts, the 30-percent basic tax and the 22-percent surtax.

Mr. SAULNIER. Yes.

Senator PROXMIRE. I presume you are proposing a cut in the 30-percent basic tax by 5 points.

Mr. SAULNIER. Yes.

Senator PROXMIRE. Even this would give very little help as I see it to small business. In the first place, some 75 percent or more of our businesses are not incorporated, and these unincorporated firms are virtually all small. No. 2, of those that are incorporated, about 40 percent, 339,000, have no taxable income. These are overwhelmingly small firms. Of those corporations that do have a taxable income, most have a taxable income of less than \$5,000, and therefore their maximum benefit from your tax cut would be \$250 per firm, so that on this basis I cannot see that 90 percent or 95 percent of small business would get very much benefit from the corporation income tax, although I think it may have merit on other scores.

Mr. SAULNIER. I could not cite a figure for you now, Senator Proxmire, but there are many hundreds of thousands of small businesses in this country, small- and medium-sized businesses, organized as corporations, paying a corporation income tax.

Senator PROXMIRE. The figure I have for 1958—I presume there are more now—was 611,000, of whom 507,000 had an income of under \$25,000, and their income represented only 7 percent of the total corporate income. There are 85 percent of the corporations with 7 percent of the income that is taxable.

Mr. SAULNIER. Yes. I was speaking here with special concern for the fact that small- and medium-size companies by and large finance themselves. They grow out of the money they make themselves, whether they are organized, Senator Proxmire, as a corporation and are retaining corporate income, or whether they are organized as a partnership or a proprietorship—

Senator PROXMIRE. On this I agree with you 100 percent.

Mr. SAULNIER. And are taking their income as individual income.

Senator PROXMIRE. The Butters and Lintner study at the Harvard Business School, for example, showed that if firms 40 or 50 years ago had the kind of corporate income tax rates we have now, none of the big firms could possibly have grown to the size they have. You would have no chance to grow through investment, through what has been the traditional way. I would agree with you on individual firm growth, but I cannot see that the individual small businessmen,

or that 95 percent of them, are going to get any real relief from a reduction in the corporation income tax. I think from the standpoint of growth perhaps you would justify it, not from the standpoint of helping most of our small businesses.

Mr. SAULNIER. I am afraid I cannot agree with you, but for the moment I would like to pursue the point of agreement that I have with you, which is that the growth of small- and medium-size businesses is financed mainly out of the income which they make themselves and retain, and the amount of income which they can retain out of what they make, whether they are corporations or whether they are partnerships and taxed as individuals, depends in large part on the tax rate. A lowering of that rate, including the high rates on individual income, would assist small- and medium-sized concerns in retaining income which for the most part would be reinvested in the business.

Now, a large company, a very large company, also depends on retained income, but at least they always have the option of capital market financing, which the small company normally does not have.

Senator PROXMIRE. You could not be more correct on that, but the figures do show that 70 percent of the net income of corporations are those very few firms with incomes over a million dollars a year. They are going to get the main benefit of this particular tax cut, but you are absolutely right, there is no other way that a small business firm can grow by and large except by reinvestment of earnings.

Mr. SAULNIER. Precisely.

Senator PROXMIRE. I would like to pursue the question a little bit that Congressman Reuss asked because I am puzzled by it, and I think there is an interesting contradiction and conflict between you and Dr. Keyserling on this, and that is that you say that business investment seems to be the principal weakness of our economy and we must stimulate private business investment to really move ahead. At the same time your prescription for a tax cut would be a tax cut that would primarily increase business cash flow, and you say that you would reduce Government spending so that there would at least be no aggregate increase in the deficit.

Mr. SAULNIER. Low priority Government spending.

Senator PROXMIRE. Low priority Government spending, and you would follow a policy of keeping wages in some restraint. At least you would make sure that they do not exert any upward pressures on prices. I think it is a very pregnant question, in view of the full documentation that Dr. Keyserling has given us this afternoon, in which he has given us data that I think is very hard to refute without contrary data. How is this going to enable the economy to move? How can you do it? The fact is, as a number of witnesses have testified here, there has been ample cash flow, plenty of money available, and many of the biggest firms have so much cash available that it is almost embarrassing. General Motors is an example of this. Why should more of the same be the answer under these circumstances?

Mr. SAULNIER. For the reason that I think a tax policy that would have a greater effect in promoting investment expenditures, and which would permit the funds to be retained out of which that expenditure could be financed, would result in a higher level of investment spend-

ing and would, as I think we all will agree, have, in agreeable circumstances, a multiplied effect through the economy. I would say, Senator Proxmire, that I am concerned also about measures being taken to promote a higher rate of investment expenditure because I have the distinct feeling that we have been tending to fall behind in recent years in these matters relative to countries elsewhere in the world.

Senator PROXMIRE. My time is up, but I had a printing company in Wisconsin, and we expanded our plant. We did it for one reason. We thought we had a good market. We thought we could see an opportunity for us to increase our production by selling more. No matter how much had been available for us in depreciation reserves, or even in profits or how good our profit margin was, if we did not feel we had the market, I think it would have been a very stupid decision for us to make.

Mr. SAULNIER. I think I understand your thinking on this. Just let me say that in our country, organized as it is on an enterprise system basis, on a profit system basis, we have managed somehow, not really by design, but more or less inadvertently, to develop a tax system which, if we sat down to work one out that would discourage risk taking, could not be more artfully designed. But, all the same, we have it. What I am saying is: Let us strive for a tax system which is better designed to encourage investment, risk taking, and business activity generally.

In this connection, while I do not make the point in my statement, I think we would be well advised to give very careful consideration to the substitution of some other form of taxation for the profits taxation we currently have. And for that other type of taxation I would suggest a producers value-added tax. Our present tax system, which puts the accent mainly on profits, not only has the effect of discouraging risk taking, but it tends to have a braking effect on the economy when we move toward higher levels of activity. It is excessively unstable in its revenue-gathering effects, and I would like to see us develop a tax system with greater stability in it in this respect.

Representative REUSS. Thank you, Dr. Saulnier.

Representative CURTIS. I had one thing I would like to ask Dr. Keyserling.

Representative REUSS. Mr. Curtis?

Representative CURTIS. Mainly because it was in Dr. Saulnier's statement, and I did not see it in yours. I had this excerpt from the New York Times, an article you wrote which appeared there on August 5, and one of the things you said in there was this:

An unequivocal Presidential assurance against repetition of the recent degree of intervention in price decisions, wage making, and industrial disputes, this would remove a main barrier to confident business investment in new plant and equipment. More investment would create more jobs.

Do you still adhere to that? You did not mention it in your statement. That is the reason I was bringing it up.

Mr. KEYSERLING. I adhere to it. I have the same position today that I had on August 5. I am for more investment, and I am at all times for appropriate risk taking. But when we have 15 or 17 percent of our plant capacity idle, and have had an average of so much idleness for a number of years, then there has been too much risk

taking, and I am not flippant about it. The risks have been very ill advised, when they result in building plants that are not being used. All I want is to encourage risk taking by getting the plants used, and to get the plants used you have to have more sales, and then there will be risk taking on a sound basis. Otherwise, if the other very simple formula is correct, why not reduce the corporate tax rate from 52 percent to 22 percent? You would get so much risk taking, and you would have so many plants built, that pretty soon idle plant and manpower would get entirely out of hand. I am for risk taking in proper proportions.

Representative CURTIS. May I comment on that?

Senator Proxmire is chairman of the subcommittee of this Committee on Economic Statistics, and we held some recent hearings, and have a very good report on industrial capacity. One of the things that has always intrigued me, is the so-called unused capacity. I think discussion about it needs to be always in context with the limitations of those statistics. What I want to relate it to is this: A great deal of the so-called unused capacity that is constantly referred to is obsolete capacity, and the more rapidly innovation comes, the more obsolete plant and equipment we have. How do you relate that?

Mr. KEYSERLING. Congressman, are the 9 percent of the human beings available for work, who have not got a chance to work, obsolete?

Representative CURTIS. Yes; their skills are.

Mr. KEYSERLING. Their skills are obsolete?

Representative CURTIS. Yes, and they need retraining.

Mr. KEYSERLING. Just a minute. First of all, let me divide this into two parts. The 9 percent unused labor force that you say is obsolete—

Representative CURTIS. I said their skills were, Doctor.

Mr. KEYSERLING. All right; that their skills are obsolete. But these unemployed correlate fairly well with my estimates of idle plant capacity, and, therefore, the plant capacity is not truly obsolete, because to have the labor force fully employed you would be using a major part of that plant.

Representative CURTIS. Could we stop there? I do not follow the logic there.

Mr. KEYSERLING. I am saying that if you had full employment of manpower—

Representative CURTIS. What would you have them do?

Mr. KEYSERLING. I will come to that. I want to answer that question about what you would have them do, but let us take it one at a time.

Representative CURTIS. I could not follow the logic as you were relating the 9 percent.

Mr. KEYSERLING. I will try to answer your three questions, because you have asked me three questions. First, I say that, if you had full employment of manpower, and still had 15 to 17 percent of your plants not running, then you could say that the part of the plants that were not running were obsolete, but when you have 9 percent unemployed manpower, you cannot say this, because you cannot say that you do not want people to be working.

Representative CURTIS. But obsolescence relates to demand. There is not the demand for buggy whips any more.

Mr. KEYSERLING. I am coming to the demand question second.

Representative CURTIS. You have this thing all wrapped up so we can't follow it.

Mr. KEYSERLING. You can follow it if you let me answer.

Representative CURTIS. All right. I will try.

Mr. KEYSERLING. If you let me answer it you will follow it very well, because you have a tremendous capacity for following it.

Representative CURTIS. You are very kind.

Mr. KEYSERLING. It is true. Let me answer it, and you will follow it.

Representative CURTIS. All right.

Mr. KEYSERLING. I am saying that the argument is made, with respect to the 15 or 17 percent idle plant capacity, that this is not really idleness because we should have a reserve supply of plant. Obsolescence is a relative term. You call that part of idle plant obsolescent in the context of the part of the plant that you now think represents optimum efficiency to have idle.

I say that, if the United States wants to have 15 percent or more of its plant idle, as reserve supply at full employment, then you can make some argument for it, because there wouldn't be people to operate the unused part anyway. But if you have 15 or more percent of your plant idle and 9 percent of your manpower unemployed, then something is wrong, because you can't apply the argument to the 9 percent manpower that you apply to the plants. You can't say people are obsolete. Now, I will come to the matter of training. That is your second question.

Mr. CURTIS. Could I stop on this one first?

Mr. KEYSERLING. Surely.

Representative CURTIS. You say you like to refer to specifics. Let's take this statement, and I think I am about right. Monsanto Chemical Co. says that about 90 percent of their dollar sales today are products they had nothing to do with 10 years ago.

Mr. KEYSERLING. That is the second question. That I was just ready to answer.

Representative CURTIS. You talked about 17 percent of the obsolescence being reserve. It isn't reserve. There is no demand for this.

Mr. KEYSERLING. I am coming to the demand factor. Let us take them one at a time. My first point is that, if you had a large amount of unused plant and full utilization of manpower, you would say that the unused plant was a desirable reserve; for example, if we got into a war and had to call more people into the labor force on a super-labor-force basis, and so forth and so on. But when we have 15 percent or more idle plant and 9 percent idle manpower, which pretty well correlates with it for a variety of reasons, then you can't say that the situation is sound, because you can't treat human beings like plants and you can't say it is perfectly all right if they are idle. You can't say that human beings should be a reserve supply.

Now, to the second question. The second question you asked is, How can you get this idle manpower and this idle plant used if there isn't demand? Let me answer that part of the question.

Representative CURTIS. For the specific products.

Mr. KEYSERLING. For the specific product.

Representative CURTIS. Which that plant manufactures.

Mr. KEYSERLING. Yes. You gave the agricultural example. It seems to me that there has been a confusion in the discussion among actual demand, purchasing power, and real needs. I define actual demand to mean what people are actually spending out of resources that they have to spend. I don't think that anybody can contest that actual demand, whether it comes from income, whether it comes from credit, whatever it comes from, is far below our current productive capacity of manpower and plant.

This is incontestable in my view. It is far below it, and because it is far below it, actual demand has to be lifted.

Now, I come to the next question. Your next question is, would actual demand be lifted if the people had more purchasing power, or would they just save it, or, to put it in another way, have they got enough purchasing power now but are they just not making the actual demand because they have everything they need or want.

Here is where I think your agricultural example is absolutely fallacious, because it is always true in our economy that as to some specific products there is a saturation point, and this may now be true in agriculture. This simply means that you have to shift your resources to some other kind of production, but it is still true that, in the overall economy, you can't say that the potential demand isn't there, in the sense of needs being satisfied, when there are such tremendous unmet wants.

If you think that \$4,000 a year or less for one-fifth of our families, and \$6,000 a year or below for two-fifths, is the optimum of what the American economy can use and consume, assuming the purchasing power is there, then I would disagree with you.

Representative CURTIS. Let's get back now. You have registered one point; in the agriculture sector if it is saturated, then you have obsolescence or unused capacity.

Mr. KEYSERLING. The only way you can translate those productive resources into other sectors of the economy, because you can't plow people under, you can't plow families under—you could plow crops under—is to create enough demand in other parts of the economy to absorb those underutilized resources.

Representative CURTIS. The point I am going to suggest to you is that they are there. That is why I referred to the NIH. I will give you an area where there is tremendous demand, for private nursing homes or any nursing homes.

Mr. KEYSERLING. Then if the demand is there, and this is the root question, why do we have 9 percent idle manpower?

Representative CURTIS. Because it takes time to train and retrain. It takes time to retool, to build plants. It takes time to do these things. It takes time for research and development, and that is why all these dealings in aggregates that you are doing, in my judgment, ignore these components wherein lie the differences and difficulties.

Mr. KEYSERLING. But the problem of retraining and retooling is a constant problem over the years in the American economy, so you are saying in another way that a level of 9 percent unemployment is the

fractional or proper level of unemployment that we should have, in view of the time that it takes to retrain and retool.

Representative CURTIS. No, I am not. What I am saying is that we have been ignoring this problem and by not treating it we have created a situation where it is entirely too high and it should not be that high. We are losing ourselves in aggregates; we are not paying attention to these components.

Mr. KEYSERLING. Roughly speaking; namely, let's say that unemployment was 5 percent in 1953 and 9 percent in 1962, do you think that this almost doubling of the unemployment rate throughout the United States is due basically to a deterioration in retraining programs?

Representative CURTIS. Yes; or turn it around and put it this way. The more rapid your innovation in your society, and that is my real test of economic growth, the more you are going to create obsolescence, both in skills and in plant. Going into these figures of innovation I was very interested in these figures, that 25 percent of the goods and services on the market today were unknown 5 years ago.

Mr. KEYSERLING. Let's assume for the moment that most, or a large part, of the 9 percent of your unemployed are unemployed because they are inadequately trained. What is the galvanizing force to train them, and what are you going to train them for, if the jobs aren't there?

Representative CURTIS. The jobs are there.

Mr. KEYSERLING. They are there?

Representative CURTIS. Yes. You have to identify them, 900,000 jobs going begging in the one field alone, the health field, hospital technicians, practical nurses, doctors.

Mr. KEYSERLING. You are not defining jobs there in the sense of the jobs being available. You are defining an unmet need.

Representative CURTIS. I am talking about jobs where people are trying to hire people and there aren't people with the training available, like in the National Institutes of Health.

Mr. KEYSERLING. Do you think, on a nationwide basis, that the jobs available for which people are untrained equate in any practical way with the total volume of unemployment?

Representative CURTIS. Yes; not trained now, but could be trained.

Mr. KEYSERLING. I disagree with you.

Representative CURTIS. I think we need to study this problem together, but I think this: that just as our Nation throughout its history has had a shortage of labor, it is true that there is a shortage today. What we need to do is get the dictionary of skills in the Department of Labor brought up to date. We need to study what are the unfulfilled demands for labor, and then we can talk about it, work up some statistics. We haven't even touched this area, we have so concentrated our minds on failure, the unemployed, that we have neglected success, the jobs going begging.

Mr. KEYSERLING. Then what you are really saying, if I understand it, and it is rather an important innovation in economic thinking is, that, after all, the business cycle in its virulent forms, in other words, quick shifts from high employment to low employment, from full capacity use to low capacity use, from prosperity to recession to de-

pression to recovery, is explained mostly by variations in the adequacy of training as we go along and isn't due to basic economic forces outside of the particular problem of training.

Representative CURTIS. No; you misunderstand me. I say that this is becoming the dominant factor in our dynamic economy. It has always been a factor.

Representative REUSS. Your time has expired.

Senator Proxmire?

Senator PROXMIRE. I would just like to say, before I ask Dr. Saulnier one more question and a couple of questions for Dr. Keyserling, that as I remember the Tobin study which was made by the Council of Economic Advisers a couple of years ago, and the Knowles-Kalacheck study that was made for this committee, both stated that structural unemployment, that is, the fact that people who are unskilled are heavily unemployed and we don't have adequately trained people for many jobs, could not really account for a substantial proportion of the unemployment, and I have seen no contrary studies, although I have heard some contrary assertions from Chairman Martin and others who contend that our main problem is structural unemployment.

It is hard to find any documentation to confirm that assertion.

Representative CURTIS. If the Senator would yield just on that, if you had allowed me to bring in witnesses at the time we held the hearings I think we would have documented our theory, but unfortunately the list of witnesses was compiled without my having an opportunity to contribute. I would have been glad to have brought in witnesses to try to establish this point.

Mr. KEYSERLING. May I just make one very brief comment?

Senator PROXMIRE. Yes.

Mr. KEYSERLING. If the problem is due largely to the falling behind of skills, the falling of skills behind technology, if that were the main problem, then assuredly speeding up technological progress by swinging more of the economy to investment in plant, which would speed up the rate of technological progress, would accentuate this problem, if it is the right explanation.

In any event, you couldn't fit together the proposition that unemployment was mainly structural and the proposition that you should try to spark investment at the expense of consumption.

Representative CURTIS. It would simply be an extension of the problem. Because we can cope with the problem if we will identify it.

Senator PROXMIRE. We can get on that shortly. I would like to say to Dr. Saulnier I went to Harvard Business School and enjoyed it very much. I recognize that it is, I think, a very responsible school and I think quite conservative school, although it is associated with Harvard. The attitude on the basis of political polls and so forth indicate it is about 95 percent Republican or at least it was when I was there and I think still is.

The National Association of Manufacturers, which is not an outstanding liberal association, although I think it is a fine group of people, financed a study at Harvard Business School of the impact of taxes on risk taking, a whole series of studies, and I wonder how you

would explain the fact that these studies showed no adverse effect on risk taking as a result of our tax system.

Mr. SAULNIER. I am not acquainted with the study. I must say the result astonishes me.

Senator PROXMIRE. As you see it, it works both ways.

Mr. SAULNIER. Perhaps you would be good enough to give me a reference on that and I would be glad to comment on it.

Senator PROXMIRE. Fine. The studies were criticized by the National Association of Manufacturers, as I understand, after they were made.

Mr. SAULNIER. I may find myself in a critical mood, too, after I check it. It stands to reason that a high profits tax will tend to suppress risk taking.

Senator PROXMIRE. You recognize how it works both ways. If you have a high profit tax, and (1) a carryback and carryforward loss provision on your taxes; (2) you have capital gains provisions where there is every incentive for risk-taking in that sense as compared with other types of investment; (3) you have the kind of law we passed recently for the small business investment companies, where your losses are treated as ordinary losses and your gains as capital gains; (4) there are all kinds of other provisions in our tax laws to encourage risk-taking, including oil depletion provisions and mineral depletion provisions which would encourage people to risk their funds in mineral investment. So that there are all kinds of ways in which there are at least counterbalancing forces against the obvious discouragement that would come from people having their income reduced through a profits tax. Most profound of all perhaps is the marginal utility factor which I think may be very significant. That is, if people had no income tax on, say, \$100,000 worth of earnings, the incentive for working hard to earn another \$10,000 might be quite different and far less than if they had an income tax and their net income would be \$45,000 or \$50,000 after taxes whatever it works out to, because by almost any standard they would be satisfied with \$100,000 and many would not be satisfied with the lesser after-tax figure.

Your friend, Dan Throop Smith, I understand, was the editor of this—a fine man. He was my finance professor at Harvard.

Mr. SAULNIER. Was he the author?

Senator PROXMIRE. He was the author. I know you have respect for him.

Mr. SAULNIER. I have great respect for him and this increases my interest in having this citation.

Senator PROXMIRE. You may have a different interpretation. Dr. Keyserling, you are not asking for a quickie compensatory fiscal tax cut in the sense of balancing fiscal policy to get us out of recession. You are asking for a fundamental, substantial, permanent tax cut. Isn't that correct?

Mr. KEYSERLING. Yes. The essence of my whole position is that we should not be engaging in an antirecessionary program now. We should be engaging in a fundamental correction of the imbalances which have made themselves more and more manifest in the whole economy for 9½ years.

Incidentally, I think that this is the safest, and surest, and soundest way to prevent a recession, as a sound, long-range policy. The

whole essence of my concern is that we are predicating whether or not we should have a tax cut now on the imperfections of prophesy as to whether a recession threatens in 3 weeks, 5 weeks, or next year, which nobody can really answer, whereas we should be predicating action now—and we confuse the situation by calling it emergency—upon the fact that we have had a problem for $9\frac{1}{2}$ years, and it is emergency only in the sense that we are 2 or 3 or 5 years too late already.

I regard an appropriate tax cut now as a permanent, durable, sound improvement in the American economic process.

Senator PROXMIRE. Is this your economic advice? If the politicians decide that the best way they can achieve that, given the attitudes in Congress, is to wait until next year, you may deplore the wait, but you might recognize the political realities that there would be more chance of getting it then?

Let me ask you then, in your statement on page 4, you engage in something that even baffles me from the standpoint of arithmetic. Frankly, it seems to be bootstrap hoisting.

Take your program of a \$10 billion cut. Well, let's say a \$7 billion tax cut and a \$3 billion increase in expenses. You might call it an initial \$10 billion increase in the deficit. You say that this would result in about the same deficit ultimately as the deficit we are going to have without it.

In saying that I am baffled because you use a multiplier of $2\frac{1}{2}$ to 3, and taking your extreme multiplier of 3, this would mean that if you have a \$10 billion drop in revenue and increase in expenditures, net, then your multiplier would give you a \$30 billion increase in gross national product. If you apply the one-sixth rule, of revenue increasing about one-sixth, with an increase in the gross national product, you would get back about \$5 billion and the result would be that the deficit would be increased by \$5 billion and you would have a \$9 to \$12 billion deficit, not a \$4 to \$7 billion deficit, and a deficit that would match the biggest we have ever had in peacetime.

Mr. KEYSERLING. There are several ways in which I think you don't correctly understand what I am saying. In the first place, the one-sixth figure is not correct for the purposes that I have in mind. In other words, you derive the one-sixth figure presumably by looking at the average tax take related to the size of the economy, but this has nothing to do with the progressive rate at which an increase in gross national product during an upturn rather than a downturn increases the tax take under a progressive tax structure.

Senator PROXMIRE. You are giving the benefits to the lower income end of the economic scale. The prime benefits would not flow, at least directly, to corporation income?

Mr. KEYSERLING. Indeed they would, because the fact that I am giving the benefits to the lower end of the income scale doesn't affect the fact that this is my formula for an overall upward movement of the whole economy by correcting the imbalances.

In other words, I am not saying, because I give the tax reductions to the lower end of the income scale, that this wouldn't improve the investment picture and the profit picture. My position is precisely that it would, because this is what is wrong with the investment and the profit picture.

My computation works out as follows:

The President's proposal for an approximately balanced Federal budget in fiscal 1963 seems to be based upon an estimated GNP of about \$585 billion in fiscal 1963. But my estimate now, in line with that of many other economists, is that the program proposed by the President would result in a fiscal 1963 GNP of not better than \$565 billion, and perhaps as low as \$555 billion or even lower. These figures, respectively, would be about \$20 to \$30 billion lower than the \$585 billion figure estimated to produce a balanced budget. The \$20 billion lower figure would result in an estimated deficit of about \$4 billion, and the \$30 billion lower figure would result in an estimated deficit of about \$7 billion. These estimated deficits are based upon the fact that, under a progressive tax system, and allowing for the relatively greater impact upon profits of unfavorable economic developments, the reduction in Federal tax receipts would be much more than one-sixth of the amount by which GNP is lower than \$585 billion, and also the deficit would increase proportionally as the GNP deficiency grew. Coming over to my proposal, I estimate that it would result in a fiscal 1963 GNP of close to \$600 billion, allowing for the multiplier effect and the timing factor, contrasted with the \$565 or \$555 billion figure. This \$600 billion figure would be about \$15 billion higher than the \$585 billion figure which would yield a balanced budget under the spending and tax proposals of the President. This \$15 billion increment would, because of its composition and because of the progressive tax system, recoup \$3 billion or more of the \$10 billion planned deficit which I propose, thus resulting in my estimated deficit of \$6½ to \$7 billion. This \$3 billion or more recoupment is based upon the fact that profit and other income trends, combined with the progressive tax system, would yield incremental tax revenues coming to more than one-fifth of the \$15 billion increment in GNP (\$600 billion minus \$585 billion).

Senator PROXMIRE. My time is up. I would like to see this arithmetically. I think you would make many converts if you could show this because this really bothers me. It bothers many, many Senators, because if you can show that you can reduce taxes and not increase the deficit, it would be miraculous. In fact it would be an accomplishment like that of the fabled Baron Munchausen who found himself sinking in quicksand and only saved his life by pulling himself out by his bootstraps.

Mr. KEYSERLING. Further let us just take as a test case, or take two test cases—take the \$12 billion deficit that we ran in fiscal 1959, and take the \$6.3 billion deficit that we ran in fiscal 1962 just ended. Take those two deficits. One of the charts that I have shown here illustrates this matter for the period 1953-62 as a whole.

Then take the size of the GNP during these years with those deficits, and apply as to the beginning of each of those 2 years, on a judgmental basis, what the size tax cut and increased spending might have lifted the actual economic performance during those 2 years to given levels.

Now, economists would have some differences of opinion, but I think you would find that we wouldn't have run a bigger deficit in either of those 2 years if we had adopted the alternative policy. In any event, I would like to suggest finally that, even if I am wrong, even if the deficit under my policy were \$2 billion higher than under the alternative, I

don't think a \$2 billion higher deficit is much to spend for a \$30 to \$45 billion higher level of national product which gives you the prospect, in terms of real wealth, of achieving a budget balance at full employment in later years.

Senator PROXMIRE. I just say it might be \$6 or \$7 billion higher. Furthermore as the debt is reduced through increasing Federal revenues the multiplier is reversed and far below balance.

Representative REUSS. The Senator's time has expired. We are very grateful to both of you gentlemen for being with us for almost 3½ hours this afternoon. If there are no further questions, we will stand adjourned until 10 o'clock tomorrow morning in this chamber. We stand adjourned.

(Whereupon, at 5:25 p.m. the hearing in the above-entitled matter was recessed until 10 a.m. of the following day.)

STATE OF THE ECONOMY AND POLICIES FOR FULL EMPLOYMENT

FRIDAY, AUGUST 10, 1962

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

The committee met at 10 a.m., pursuant to recess, in room AE-1, the Capitol, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, Griffiths, and Thomas B. Curtis; Senators Douglas and Proxmire.

Also present: William Summers Johnson, executive director; John R. Stark, clerk; Hamilton D. Gewehr, research assistant.

Chairman PATMAN. The committee will be in order, please.

We continue hearings on the state of the economy and on the policies for full employment, production, and purchasing power.

This morning we have a panel of economists on fiscal policy recommendations. George C. Hagedorn, director of the Research Department, National Association of Manufacturers; John K. Langum, consulting economist and president of Business Economics, Inc., Chicago; Joseph A. Livingston, financial editor, Philadelphia Bulletin; Stanley H. Ruttenberg, director, Department of Research, AFL-CIO.

Gentlemen, we thank you for coming. We are very glad to have you. Our procedure is to have each witness make an opening statement. Then the members of the committee put questions to the panel under a 10-minute rule for questioning by each committee member.

Mr. Hagedorn, you may proceed in your own way, sir. I believe you have a prepared statement.

STATEMENT OF GEORGE G. HAGEDORN, DIRECTOR, RESEARCH DEPARTMENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. HAGEDORN. I would like to read my prepared statement, Mr. Chairman.

Chairman PATMAN. You may do so, sir.

Mr. HAGEDORN. Differences of opinion as to the proper fiscal program to be followed at any given time are usually the product of differences in basic conceptions of the function of fiscal policy generally. For that reason it is well to start with a statement of the principles on which the approach advocated in this paper is based.

They are relatively simple and not at all original. First, spending should be kept to the minimum needed for performing the necessary functions of the Federal Government. In that way the Government does not use up economic resources which would otherwise be avail-

able for supporting the growth of the private economy. Second, the tax system should be designed to raise revenues necessary to meet these expenditures, but with a minimum of interference with private economic activity and expansion.

This sounds like a very old-fashioned way of viewing the function of fiscal policy in our economy, and maybe it is. But I also think it is the most realistic and appropriate guide for facing the complex set of economic difficulties in which the Nation presently finds itself. The bulk of this paper will be devoted to explaining the reasons for that conclusion.

Since the principles just stated may seem rather general and abstract, it had better be explained at the start that there is a practical way of implementing them. It is through the earmarking, in advance and by legislation, of the revenue increase which comes from economic growth to income tax rate reform rather than to increased Federal spending. Such a program, spread over a series of years, offers the best hope for a gradual reduction of the burden which excessive tax rates now place on economic activity and economic expansion. It is attainable within the framework of a balanced budget.

The approach advocated here may be contrasted with the view that the Federal budget should be regarded as a positive instrument of national economic policy. According to this latter view, the budget should be designed to supplement private demand to whatever degree is necessary at the given moment. Some of the adherents of this view state that they prefer tax reduction to expenditure increase as a means of increasing total demand.

However, the basic logic of this approach would lead to the conclusion that one way of increasing demand is as good as the other. The net effect of the budget on the economy is to be assessed by the size of the deficit or surplus. According to the jargon of this philosophy, the greater the deficit, or the smaller the surplus, the more expansionary the budget is in its economic effects.

The case between the two alternative views of the proper objective of fiscal policy could be argued on general principles. However, for the present occasion the discussion will be limited to a comparison of the two approaches in the light of the specific economic situation in which we now find ourselves.

You have been holding extensive hearings both at this time and earlier this year, on the state of the economy. So I am not going to try to give you a comprehensive review of that subject. I just want to make a few points that I think are relevant to the current issue of fiscal policy.

No. 1, the problem before us is one of chronic suboptimum economic performance, rather than of a short-term cyclical downturn which may or may not be in the offing.

For almost 5 years, ever since the latter part of 1957, unemployment has remained at or above 5 percent of the labor force.

There is one exception, I think February 1960, it got down to 4.8 percent. That is the only month in the period where it got below 5 percent.

The real cause for concern has not been the two recessions which occurred during that period, neither of which was severe, but the

tendency of the subsequent recovery to lose momentum before reasonably satisfactory levels of economic activity had been reached.

We are not in a situation calling for radical emergency action. But we should be concerned with discovering and removing the barriers which prevent us from attaining fuller realization of our economic potential.

Two, although total economic activity showed a substantial growth over this period, two important elements did not participate fully in that growth—corporate profits and business investment expenditures. By contrast, consumer incomes and consumer expenditures have kept pace with the general growth.

The facts are summarized in the following table:

Percent increase, 1957 to 1st half of 1962

	<i>Percent</i>
Gross national product.....	+24.0
Corporate profits after tax.....	+15.0
Business expenditures for plant and equipment.....	— .2
Disposable personal income.....	+23.0
Consumer expenditures.....	+24.0
Compensation of employees.....	+25.0
Government expenditures.....	+38.0

I might say corporate profits have gone up much less. Business expenditures for plant and equipment have not gone up since 1957. Actually that figure shown for corporate profits after tax perhaps doesn't really adequately describe the degree to which profits have been stagnant in the postwar period generally. In the last decade, ever since 1950, corporate profits have fluctuated between \$20 and \$25 billion, and really have gotten no place in that period. They have gone up and down in cycles, but there has been no growth in corporate profits. While the gross national product, the dollar value of economic activity in the country has doubled.

These data certainly do not suggest that present economic difficulties are due to inability or unwillingness to spend on the part of the public generally. The problem centers rather on the inadequacy of profits and of business investment.

Three, costs of production have increased because wages have gone up faster than productivity. In recent years it has been impossible to recover such increased costs in higher prices. This is an important cause of the squeeze on profits already noted.

The relationship between the cost of an hour's work, and the output achieved by it, is summarized as follows:

Period	Percent change per year	
	Average hourly compensation	Output per man-hour
1947-53.....	6.2	2.7
1953-57.....	4.6	2.3
1957-61.....	4.0	2.5

NOTE.—The data apply to all employees of nonagricultural industries.

There has been a gap between those two figures. The cost of an hour's work has gone up faster than the physical yield from each hour's

work. The gap has somewhat narrowed in recent years in the period since 1957, but there is still a sizable gap between those two figures. The discrepancy between average hourly pay and output per man-hour is a measure of the increase in cost per unit of production. This discrepancy has been somewhat less since 1957 than in earlier years.

The trouble has been that, since 1957, market conditions have been such that it is no longer possible to get back the increased cost in higher prices. Since 1957 the wholesale price index for industrial products has increased by only 0.3 percent per year on the average. There has actually been a slight decline in such prices since 1959.

The net result of rising costs and practically steady prices has been a squeeze on profits. The incentive for business expansion, or even for the maintenance of current operations, has been curtailed. Marginal operations which would otherwise be profitable, and provide jobs, are not worth undertaking.

Four, as a result of past deficits in our international balance of payments, foreign short-term claims against this country now exceed our gold stock. This necessitates that measures used for promoting economic expansion at home shall not depend on low interest rates and shall not encourage increases in costs of production.

The gold stock has declined to a level only slightly above \$16 billion. Foreign short-term balances—which are potential claims against gold—have risen to \$19 billion.

A situation of this type is not necessarily dangerous or inherently disastrous. Foreigners are not likely to convert their balances into gold as long as they can earn reasonably competitive interest on them, and as long as they are confident that such balances are ultimately convertible into American goods at internationally competitive prices. But if they come to believe that we will pursue economic policies which will make it impossible to preserve such conditions, they might begin to withdraw gold at a rate which could eventually force us to abandon the convertibility of the dollar at its present rate.

Fiscal policy to increase demand—the wrong approach. With this background it seems clear that a fiscal policy designed to raise the level of demand by increasing the Federal deficit is entirely inappropriate—for a number of reasons.

First, the economic problem which confronts us is chronic, rather than intermittent or temporary. An occasional deficit to meet a temporary situation might be tolerable. But an indefinite series of deficits to offset persistent underlying maladjustments is not to be contemplated.

Second, adoption of such an allegedly expansionary fiscal policy would encourage and intensify the very forces which have brought about the present economic difficulty. Uneconomic wage increases have a restricting effect on economic activity and on employment. If we pursue a national policy of using Federal deficits to “bail out” those who are responsible for such uneconomic cost increases, we are in effect encouraging them to go ahead and promising to guarantee them against the consequences of their own actions.

Finally, adoption of this course would diminish foreign confidence that we have any real noninflationary solution to our economic problems. They are watching to see whether we intend to underwrite cost increases by Government deficits, or adopt the alternative policy

of promoting growth through the control of costs and the improvement of efficiency. The former course could only lead to inflation and ultimately the devaluation of the American dollar. The consequences for our own economy and for the free world generally would be very serious.

The conditions for prosperity and economic growth: A program for promoting high levels of employment and economic growth with generally stable prices, of course, involves many elements. As long as we are to remain predominantly a private enterprise market economy, such a program must center on the incentives for, and the resources available to, private economic activity.

As already noted, the two poor performers in our recent economic history have been profits and business investment. A program for growth and prosperity must certainly provide for a reversal of these trends.

The growth of labor costs at the expense of profits is a problem that must be dealt with. The constant upward pressure on labor costs is due partly to the power of labor organizations to raise wage rates and fringe benefits regardless of market conditions, and partly to a failure on the part of the public to understand that such cost increases curtail employment opportunities and economic expansion.

Since I have been asked to speak here primarily on fiscal policy, I will concentrate on that aspect of the problem. There is an important contribution that Federal fiscal policy can make to prosperity and growth. It is through enactment of a systematic program of rate reduction applied both to the corporate income tax and to the personal income tax. Such a program would increase the flow of capital for modernization and expansion and improve the profitability of business operations.

Such a program should be carried out within the general framework of a balanced budget. Otherwise, it would be merely another form of the deficits-to-increase-demand approach which should be rejected for the reasons given earlier.

The tax rate reform should be permanent and it should be substantial in amount. It should apply to both corporate and personal income taxes since both affect incentives and both affect the supply of capital for private investment. The objective should be, not an expansion in demand, but an improvement in profitability and an increase in the flow of savings for investment. Hence, while such a program should involve reduction of individual rates all along the line, it should also provide for a substantial compression of the steep progressivity of the rate structure.

This is, of course, too big a package to be achieved all at once. But it is not impossible of achievement if we have enough determination to adhere to a program of gradual rate reduction spread out over a series of years, meanwhile preventing any further increase in Federal spending.

The program just described is designed to meet the longer term problem of chronic economic sluggishness, rather than the immediate short-term danger of a cyclical downturn. But the lift that early adoption of such a program would give to the confidence of business and the public would have a prompt and salutary effect on the economic trends of the immediate future. Progress toward a solution of

the long-term problem contributes substantially to improving the short-term outlook. Unfortunately, the converse is not equally true.

I recommend this approach to your consideration. It is a practical resolution of the dilemma posed by the barriers to growth involved in the present tax system, and the inflationary effects of tax-reduction involving substantial and persistent government deficits.

(Tables accompanying Mr. Hagedorn's statement follow:)

TABLE A.—*Gross national product and related totals*

[In billions of dollars]

Year	Gross national product	Disposable income	Consumption expenditures	Compensation of employees	Corporation profits after tax	Business expenditures for plant and equipment	Government expenditures ¹
1947	\$234.3	\$170.1	\$165.4	\$128.8	\$18.2	\$20.6	\$43.8
1948	259.4	189.3	178.3	141.0	20.5	22.1	51.0
1949	258.1	189.6	181.2	140.8	16.0	19.3	59.5
1950	284.6	207.7	195.0	154.2	22.8	20.6	61.1
1951	329.0	227.4	209.8	180.3	19.7	25.6	79.4
1952	347.0	238.7	219.8	195.0	17.2	26.5	94.7
1953	365.4	252.5	232.6	208.8	18.1	28.3	102.0
1954	363.1	256.9	238.0	207.6	16.8	26.8	96.7
1955	397.5	274.4	256.9	223.9	23.0	28.7	98.6
1956	419.2	292.9	269.9	242.5	23.5	35.0	104.3
1957	442.8	308.8	285.2	255.5	22.3	37.0	115.3
1958	444.5	317.9	293.2	257.1	18.8	30.5	126.6
1959	482.8	337.1	313.5	278.4	23.7	32.5	131.6
1960	503.4	349.4	328.5	293.7	22.7	35.7	136.8
1961	518.7	363.6	338.1	302.2	23.3	34.4	149.3
1962	² 548.5	² 378.6	² 352.6	² 318.4	² 25.6	² 36.3	² 158.7

¹ Purchases of goods and services, transfers, interest, and subsidies.

² 1st half estimate.

³ 1st quarter estimate.

Source: U.S. Department of Commerce; Council of Economic Advisers.

TABLE A-1.—*Various economic magnitudes as a percent of gross national product*

Year	Disposable income	Consumption expenditures	Compensation of employees	Corporation profits after tax	Business expenditures for plant and equipment	Government expenditures ¹
1947	72.6	70.6	55.0	7.8	8.8	18.7
1948	73.0	68.7	54.3	7.9	8.5	19.7
1949	73.5	70.2	54.6	6.2	7.5	23.1
1950	73.0	68.5	54.2	8.0	7.2	21.5
1951	69.1	63.8	54.8	6.0	7.8	24.1
1952	68.8	63.4	56.2	5.0	7.6	27.2
1953	69.1	63.7	57.1	5.0	7.7	27.9
1954	70.8	65.5	57.2	4.6	7.4	26.6
1955	69.0	64.6	56.3	5.8	7.2	24.8
1956	69.9	64.3	57.8	5.6	8.3	24.9
1957	69.7	64.4	57.7	5.0	8.4	26.0
1958	71.5	66.0	57.8	4.2	6.9	28.5
1959	69.8	64.9	57.7	4.9	6.7	27.3
1960	69.4	65.3	58.3	4.5	7.1	27.2
1961	70.1	65.2	58.3	4.5	6.6	28.8
1962	² 69.0	² 64.3	² 58.0	² 4.7	² 6.6	² 28.9

¹ Purchases of goods and services, transfers, interest, and subsidies.

² 1st half estimate.

³ 1st quarter estimate.

Source: U.S. Department of Commerce; Council of Economic Advisers.

Chairman PATMAN. Thank you, sir. Our next witness is Mr. John K. Langum. Mr. Langum, you have a prepared statement, I believe. You may proceed in your own way.

**STATEMENT OF JOHN H. LANGUM, PRESIDENT, BUSINESS
ECONOMICS, INC., CHICAGO, ILL.**

Mr. LANGUM. I would like to go over my prepared statement, and with that I have prepared a document of 10 pages of tables which I should like to use along with my prepared statement.

Chairman PATMAN. Without objection they will be inserted in the record.

(Document referred to above follows:)

CORPORATE PROFITS AND CASH FLOW

John K. Langum, president, Business Economics, Inc., Chicago, Ill.

*Corporate profits in relation to depreciation accruals and capital outlays,
1946-61*

[In billions of dollars]

Year	Corporate profits after taxes	Depreciation and amortization allowances	Cash earnings	Plant and equipment outlays	Net cash earnings	Corporate dividends
1946.....	\$13.4	\$4.2	\$17.6	\$12.5	\$5.1	\$5.8
1947.....	18.2	5.2	23.4	17.0	6.4	6.5
1948.....	20.5	6.2	26.7	18.8	7.9	7.2
1949.....	16.0	7.1	23.1	16.3	6.8	7.5
1950.....	22.8	7.8	30.6	16.9	13.7	9.2
1951.....	19.7	9.0	28.7	21.6	7.1	9.0
1952.....	17.2	10.4	27.6	22.4	5.2	9.0
1953.....	18.1	11.8	29.9	23.9	6.0	9.2
1954.....	16.8	13.5	30.3	22.4	7.9	9.8
1955.....	23.0	15.7	38.7	24.2	14.5	11.2
1956.....	23.5	17.3	40.8	29.9	10.9	12.1
1957.....	22.3	19.1	41.4	32.7	8.7	12.6
1958.....	18.8	20.3	39.1	26.4	12.7	12.4
1959.....	24.5	21.6	46.1	27.7	18.4	13.7
1960.....	23.0	23.1	46.1	30.8	15.3	14.4
1961.....	23.3	24.8	48.1	29.6	18.5	15.0

*Profit margins and rate of return on equity, all manufacturing corporations,
1947-61*

Year	Profit after taxes per dollar of sales	Annual rate of profit after taxes on stockholders' equity
	<i>Cents</i>	<i>Percent</i>
1947.....	6.7	15.6
1948.....	7.0	16.0
1949.....	5.8	11.6
1950.....	7.1	15.4
1951.....	4.8	11.8
Average for period.....	6.3	14.1
1952.....	4.3	10.2
1953.....	4.3	10.4
1954.....	4.5	9.8
1955.....	5.4	12.3
1956.....	5.3	12.0
Average period for.....	4.8	10.9
1957.....	4.8	10.7
1958.....	4.2	8.4
1959.....	4.8	10.2
1960.....	4.4	9.1
1961.....	4.3	8.7
Average for period.....	4.5	9.4

*Inventory valuation adjustment in relation to corporate profits before taxes,
selected years*

Year	Inventory valuation adjustment	Corporate profits be- fore taxes	Inventory valuation adjustment as ratio of corporate profits be- fore taxes
	<i>Billions</i>	<i>Billions</i>	<i>Percent</i>
1947.....	-\$5.9	\$29.5	-20.0
1948.....	-2.2	33.0	-6.7
1950.....	-5.0	40.6	-12.3
1956.....	-2.7	44.7	-6.0
1957.....	-1.5	43.2	-3.5
1961.....	0	45.6	0

*Rate of return on net worth, leading manufacturing corporations (First
National City Bank data)*

[In percent]			
Year		Year	
1925.....	10.7	1952.....	12.3
1926.....	10.8	1953.....	12.5
1927.....	9.0	1954.....	12.4
1928.....	11.6	1955.....	15.0
1929.....	12.8	1956.....	13.7
Average for period.....	11.0	Average for period.....	13.2
1947.....	17.0	1957.....	12.8
1948.....	18.9	1958.....	9.8
1949.....	13.8	1959.....	11.6
1950.....	17.1	1960.....	10.5
1951.....	14.4	1961.....	10.1
Average for period.....	16.2	Average for period.....	11.0

Corporate profits and cash earnings in relation to corporate sales, 1946-61

[In percent]

Year	Corporate profits after taxes/ corporate sales	Deprecia- tion and amortization allowances/ corporate sales	Cash earnings/ corporate sales	Net cash earnings/ corporate sales
1946.....	4.96	1.55	6.50	1.88
1947.....	5.24	1.60	6.73	1.84
1948.....	5.28	1.60	6.87	2.03
1949.....	4.32	1.92	6.24	1.84
1950.....	5.27	1.81	7.08	3.17
1951.....	4.03	2.01	6.40	1.58
Average per period.....	4.83	1.77	6.66	2.09
1952.....	3.45	2.08	5.53	1.04
1953.....	3.46	2.25	5.71	1.15
1954.....	3.26	2.61	5.87	1.53
1955.....	3.84	2.62	6.46	2.42
1956.....	3.71	2.74	6.45	1.72
Average per period.....	3.54	2.46	6.00	1.57
1957.....	3.32	2.84	6.16	1.30
1958.....	2.85	3.08	5.94	1.93
1959.....	3.31	2.92	6.23	2.49
1960.....	3.02	3.03	6.06	2.01
1961.....	2.98	3.17	6.14	2.36
Average per period.....	3.10	3.01	6.11	2.02

Capital outlays and corporate dividends in relation to cash earnings, 1946-61

[In percent]

Year	Plant and equipment outlays/cash earnings	Corporate dividends/corporate profits after taxes	Corporate dividends/cash earnings
1946.....	71.02	43.28	32.95
1947.....	72.65	35.71	27.78
1948.....	70.41	35.12	26.97
1949.....	70.56	46.88	32.47
1950.....	55.23	40.35	30.07
1951.....	75.26	45.69	31.36
1952.....	81.16	52.33	32.61
1953.....	79.93	50.83	30.77
1954.....	73.93	58.33	32.34
1955.....	62.53	48.70	28.94
1956.....	73.28	51.49	29.66
1957.....	78.99	56.50	30.43
1958.....	67.52	65.96	31.71
1959.....	60.09	55.92	29.72
1960.....	63.81	62.61	31.24
1961.....	61.54	64.38	31.18

Cash flow in relation to sales, all manufacturing corporations, 1961

BY INDUSTRY

	Percent of sales		
	Net profit after taxes	Depreciation and depletion ¹	Total
All manufacturing corporations.....	4.3	3.3	7.6
Durable goods.....	3.8	3.2	7.1
Transportation equipment.....	4.0	2.7	6.6
Motor vehicles and equipment.....	5.3	3.3	8.6
Aircraft and parts.....	1.8	1.7	3.5
Electrical machinery, equipment, and supplies.....	3.4	2.3	5.8
Other machinery.....	4.1	3.5	7.6
Metalworking machinery and equipment.....	3.2	3.1	6.4
Other fabricated metal products.....	2.4	2.6	5.0
Primary metal industries.....	4.8	4.8	9.6
Primary iron and steel.....	4.5	5.0	9.4
Primary nonferrous metals.....	5.3	4.4	9.7
Stone, clay, and glass products.....	5.6	5.2	10.8
Furniture and fixtures.....	1.5	1.6	2.8
Lumber and wood products, except furniture.....	1.8	4.7	6.5
Instruments and related products.....	5.4	2.9	8.3
Miscellaneous manufacturing and ordnance.....	3.6	2.0	5.6
Nondurable goods.....	4.6	3.4	8.0
Food and kindred products.....	2.3	1.8	4.0
Alcoholic beverages.....	3.2	2.0	5.2
Tobacco manufactures.....	5.7	.8	6.5
Textile mill products.....	2.0	2.4	4.6
Apparel and other finished products.....	1.2	.6	1.8
Paper and allied products.....	4.6	4.2	8.8
Printing and publishing, except newspapers.....	2.8	2.1	4.9
Chemicals and allied products.....	7.3	4.6	11.9
Basic chemicals.....	8.1	7.0	15.2
Drugs.....	9.8	2.2	12.0
Petroleum refining and related industries.....	10.1	7.5	17.6
Petroleum refining.....	10.3	7.6	18.0
Rubber and miscellaneous plastics products.....	3.8	3.1	6.8
Leather and leather products.....	1.1	1.1	2.2

BY SIZE

All asset sizes.....	4.3	3.3	7.6
Under \$1,000,000.....	1.2	2.1	3.3
\$1,000,000 to \$5,000,000.....	1.8	1.9	3.8
\$5,000,000 to \$10,000,000.....	2.8	2.2	5.0
\$10,000,000 to \$25,000,000.....	3.1	2.4	5.5
\$25,000,000 to \$50,000,000.....	3.8	2.8	6.6
\$50,000,000 to \$100,000,000.....	4.0	2.9	6.8
\$100,000,000 to \$250,000,000.....	4.1	3.2	7.2
\$250,000,000 to \$1,000,000,000.....	4.8	3.3	8.1
\$1,000,000,000 and over.....	8.4	5.7	14.0

¹ Including accelerated amortization of emergency facilities.

Annual rate of profit after taxes on stockholders' equity at end of period, all manufacturing corporations, 1961

BY INDUSTRY		Percent
All manufacturing corporations.....		8.7
Durable goods.....		8.1
Transportation equipment.....		10.6
Motor vehicles and equipment.....		11.4
Aircraft and parts.....		9.8
Electrical machinery, equipment, and supplies.....		8.9
Other machinery.....		7.8
Metalworking machinery and equipment.....		6.0
Other fabricated metal products.....		5.9
Primary metal industries.....		6.4
Primary iron and steel.....		6.2
Primary nonferrous metals.....		7.1
Stone, clay, and glass products.....		8.8
Furniture and fixtures.....		4.9
Lumber and wood products, except furniture.....		10.5
Miscellaneous manufacturing and ordnance.....		9.8
Nondurable goods.....		9.6
Food and kindred products.....		8.9
Alcoholic beverages.....		7.3
Tobacco manufactures.....		13.6
Textile mill products.....		5.0
Apparel and other finished products.....		7.0
Paper and allied products.....		7.8
Printing and publishing, except newspapers.....		8.5
Chemicals and allied products.....		11.8
Basic chemicals.....		10.6
Drugs.....		16.7
Petroleum refining and related industries.....		10.3
Petroleum refining.....		10.3
Rubber and miscellaneous plastics products.....		9.3
Leather and leather products.....		4.4
BY SIZE		Percent
All asset sizes.....		8.7
Under \$1,000,000.....		5.6
\$1,000,000 to \$5,000,000.....		6.0
\$5,000,000 to \$10,000,000.....		6.8
\$10,000,000 to \$25,000,000.....		7.0
\$25,000,000 to \$50,000,000.....		7.6
\$50,000,000 to \$1,000,000,000.....		8.3
\$100,000,000 to \$250,000,000.....		8.4
\$250,000,000 to \$1,000,000,000.....		9.3
\$1,000,000,000 and over.....		10.8

Mr. LANGUM. The record since World War II for total profits after taxes of all corporations is shown in the first column in the table on page 1 entitled "Corporate Profits in Relation to Depreciation Accruals and Capital Outlays." This record reflects the varied developments which have occurred in the American economy. A marked pattern of cyclical fluctuations is evident, even in terms of the more moderate swings in the business cycle which have been experienced in the last decade and a half.

On the downside, in recessions from 1948 to 1949, from 1953 to 1954, and from 1957 to 1958, the sharp declines are manifest. As is the case in most measurements of the level of economic activity, the effects on corporate profits of the recession of late 1960 and early 1961 are buried in the annual figures.

In that recent recession, however, corporate profits after taxes dropped from a seasonally adjusted annual rate of \$24.9 billion in the

first quarter of 1960 to \$2.3 billion in the first quarter of 1961. Similarly, in terms of recovery and expansion, there should be noted the sharp rises from 1946 to 1948, from 1949 to 1950, from 1954 to 1955, and from 1958 to 1959. The current recovery has carried total corporate profits after taxes from the \$20.3 billion annual rate seasonally adjusted in the first quarter of 1961, to \$26.3 billion in the fourth quarter of 1961, \$25.6 billion in the first quarter of 1962, and about \$26 billion in the second and third quarters of this year.

The problem of adequate profitability for business enterprise under present-day circumstances, however, is pointed up by the unsatisfactory performance in the second and third year of good times following recession. Thus, profits declined from 1951 to 1953, from 1955 to 1957, and from 1959 to 1960. Given this pattern, the decline in corporate profits from the fourth quarter of 1961 to the first quarter of 1962 was a most disheartening development.

Beyond the cyclical swings, however, something more fundamental has been occurring in the level of corporate profits. Over the last decade or so, the total dollar amount of reported earnings in peak years has moved sideways—\$22.8 billion in 1950, \$23 billion in 1955, \$23.5 billion in 1956, \$22.3 billion in 1957, \$23 billion in 1960, \$23.3 billion in 1961, with a temporary breakout to \$24.5 billion in 1959, on the basis of revised figures, and the \$26 billion figure in recent quarters. Meanwhile, gross national product rose from \$285 billion in 1950 to almost \$519 billion in 1961, corporate sales went up from \$432 billion in 1950 to \$783 billion in 1961, and invested capital rose in equally substantial measure. This combination of developments has resulted necessarily in continued decline in the ratio of corporate profits to gross national product, marked deterioration in profit margins, sharp drop in rate of return on stockholders' equity, and no return at all in reported earnings to the increment to invested capital during these years.

Herein lies the profit squeeze—in terms of reported figures without interpretation—which has been so widely discussed. Measures of the profit squeeze are shown on page 2 in terms of profit margins and rate of return on equity from 1947 through 1961 for all manufacturing corporations. Profit after taxes per dollar of sales dropped from 6.3 cents an average in 1947–51 to 4.8 cents in 1952–56, and to 4.5 cents in 1957–61. Annual rate of profit after taxes on stockholders' equity dropped from 14.1 percent on average in the first 5 years of the post-war period to 10.9 percent in 1952–56, and to 9.4 percent in the last 5 years.

Another measure of the profit squeeze is shown on page 332 in terms of the relationship of corporate profits after taxes to the corporate sales. This ratio dropped from 4.83 percent in 1947–51 to 3.54 percent in 1952–56, and to 3.10 percent in 1956–61.

These developments have been stated in terms of overall data as reported and without analysis of their underlying causes. They are the basis of deep concern in business circles. They mean to many a grinding down of profits to such low levels as to threaten the successful operation of our private enterprise economy and to impede attainment of adequate performance of the economy.

Close examination of the underlying data and analysis of the casual factors involved, however, point to a different conclusion. In my

judgment we do have a profit squeeze. We do need to give consideration to an adequate level of profits. We do need to encourage business investment through increasing cash flow. But, the historical record in terms of the overall data as reported greatly exaggerate the real decline in corporate profitability which has occurred. More than that, undue concern about the profits situation has in itself caused weakening of business confidence and hurt the cause of adequate recovery. Furthermore, erroneous interpretations of the situation regarding corporate profitability direct attention away from the more basic matters making for the good health of the economy and with that the well being of corporate profitability as well.

As I see it, there have been three fundamental factors causing the decline from the high levels of profit margins and rate of return as reported which prevailed in the early postwar years. These are: First, the unusual circumstances of the early postwar years which led to record levels of profits never reached before or after. Second, the tremendous stepup in depreciation charges during the last decade which has lowered reported earnings but has increased cash flow. Third, the inadequate growth in the economy generally from 1957 on and particularly the sideways movement of real output in the private durable sector.

Unusual circumstances of high demand and short supply made the early postwar years the most profitable period corporate enterprise has ever experienced. Beyond this, costs, including the cost of plant consumed, were seriously understated and reported profits were greatly overstated. In particular, the tremendous burst of demand in the early postwar years brought about a rapid increase in prices which gave rise to major inventory profits included in reported corporate profits. The effect on profits of inventory valuation from changing prices has been specifically recognized and measured by the Department of Commerce. Some aspects of this are shown in the table on page 332 entitled "Inventory Valuation Adjustment in Relation to Corporate Profits Before Taxes."

The degree to which inventory valuation raised reported profits is indicated for selected early postwar years—1947, 1948, 1950—in contrast to certain recent years. When prices are rising, as they were sharply in the early postwar years, higher profits emerge from inventory valuations at lower levels of costs. The Department of Commerce includes corporate profits before taxes in national income only after adjustment for inventory valuation. Thus the high profit margin ratios and rate of return figures in the early postwar period were substantially boosted by inventory profits occurring as a result of rapid inflation and other understatements of costs and overstatements of reported profits. Such years hardly offer a reasonable base of comparison.

As a matter of fact, much of the decline in corporate profitability as indicated by reported data is simply a return to more usual circumstances from extremely abnormal situations prevailing after World War II. This is indicated to some degree by the authoritative data shown on page 4 concerning rate of return on net worth of leading manufacturing corporations prepared and published over the years by the First National City Bank of New York.

Rate of return on equity declined from an average 16.2 percent in 1947-51, to 13.2 percent in 1952-56, and to 11 percent in 1957-61. But that 11 percent during the last 5 years of profit squeeze is exactly the same as the average of 11 percent in the 5 years from 1925 through 1929, the previous high point of corporate profitability.

Basic emphasis must be given to rising depreciation charges. Data on this matter are shown on page 331. The dollar amount of depreciation and amortization charges, as measured in the Department of Commerce series on sources and uses of corporate funds, is shown in the second column. Depreciation charges have risen from \$7.8 billion in 1950 to \$19.1 billion in 1957, and \$24.8 billion in 1961.

The sideways movement in total corporation profits during much of the last decade or so has resulted partly from this tremendous rise in depreciation allowances. This situation in terms of individual companies as well as the economy, has caused many financial analysts to devote a great deal of emphasis to the concept of "cash earnings," that is, the sum of reported earnings plus depreciation charges. It will be noted in the table on page 1 that cash earnings of all U.S. corporations have risen from \$30.6 billion in 1950 to \$48.1 billion in 1961.

The rise in depreciation charges and in so-called cash earnings has been due to two major factors. First, business enterprises have made substantial and continuing expenditures on plant and equipment.

I might interpolate that while some of those expenditures have been for increasing capacity, they have also been for modernization and cost cutting, and have been the effective medium by which many business enterprises have been able to achieve a substantial offset to higher employment costs, and thus hold down and restrain the increase in cost per unit of output, which otherwise would have occurred on a much bigger scale.

As the amount of depreciable property has risen, the depreciation charges related to that property have risen.

Second, accelerated amortization of defense facilities in connection with the Korean war and liberalized depreciation enacted in the Revenue Act of 1954 have increased depreciation charges. Ahead of us, of course, is the effect of a potential \$4.7 billion increase in depreciation, of which \$3.6 billion is for corporate businesses, under the new guidelines set forth by the Treasury Department in its recently announced basic reform in the standards and procedures used for the determination of depreciation for tax purposes.

The tremendous rise in depreciation charges during the postwar period is an essential element in appraisal of recent profit developments. Certainly the nature of depreciation accruals as noncash charges against sales is valid, as is the resultant concept of cash flow available for dividends on investment in business assets. A cash earnings concept may be necessary for comparability, given changes in the rate of depreciation and amortization allowances.

While depreciation accruals represent noncash costs, they are nevertheless true costs. Total costs, as Leonard Spacek has recently emphasized, are made up of (a) costs spent in prior years but used up today, (b) costs spent today, and (c) costs accrued today to be settled in future years, and reality prevents any one of these cost elements from disappearing. There are no real profits to a business enterprise

until all costs are recovered, including full recovery of investment in assets in terms of book value, to say nothing of current value after inflation. Earnings computed after all costs are covered are still the only true earnings.

Nevertheless, the rise of depreciation accruals and cash earnings in absolute and relative amount has clearly changed the financial position of corporate enterprise. The rules of the game for recording costs have certainly been altered by changed depreciation standards and procedures of the Internal Revenue Service. The quality of reported earnings has been substantially strengthened and improved, as has been the stability and protection of dividend payments, by the rising levels of depreciation accruals and cash flows. Furthermore, the financing of new plant and equipment outlays is materially eased by rising cash earnings.

These developments may be observed from consideration of the data on page 331 concerning cash earnings and plant and equipment outlays. From some standpoints, a concept of "net cash earnings" might be meaningful as an alternative approach. "Net cash earnings" are defined as cash earnings less plant and equipment outlays. The table indicates that the level of "net cash earnings" in 1961 and in 1959 was far higher than in previous years. Year-to-year changes in net cash earnings are caused, of course, by short-run fluctuations in plant and equipment outlays as well as in reported earnings.

The data on page 332 relate corporate profits and cash earnings to corporate sales. The reported figures on corporate profits after taxes in relation to total corporate sales have declined substantially during the postwar period as a whole, as previously noted. But attention must also be given to the matter of rising depreciation and amortization charges. The ratio of these charges to total corporate sales rose from 1.77 percent in 1947-51 to 2.46 percent in 1952-56, and to 3.01 percent in 1957-61. The rise in this ratio is equivalent to all of the decline in the ratio of total corporate profits after taxes to total corporate sales during the last 10 years. Cash earnings averaged somewhat higher in relation to corporate sales in the last 5 years, 6.11 percent, than in the previous 5 years, 6 percent. The same is true of net cash earnings in relation to corporate sales.

Information as to cash flow in relation to sales in 1961 for manufacturing corporations by industry and by size is presented on page 333. Similarly, data on rate of return for manufacturing corporations by industry and size are presented on page 334.

Another set of basic relationships concerning cash earnings is shown on page 6. A reasonably close correspondence historically has existed between business capital outlays and cash earnings. This is shown in the column at the left on page 6.

Likewise, as shown in the two columns at the right, corporate dividends have been maintained in reasonably close relationship to cash earnings, although the payout ratio in terms of reported corporate profits after taxes has risen during the postwar period.

A third key factor accounting for the behavior of corporate profitability during recent years has been the inadequate growth in the economy generally from 1957 on. Particularly important in this respect has been the sideways movement of real output in the private durable sector. As an example, the steel industry needs more busi-

ness, much more than it needs higher prices. Here is where the matter of achieving a level of corporate profitability which is necessary and desirable merges with the general public interest in achievement of the fullest potential of the economy. What is good for the economy will be good for corporate profits. Adequate expansion and growth in the American economy is the most important ingredient of high and rising corporate profits.

My judgment is that much of the historical decline during the post-war period in corporate profitability as reported is not as significant as is commonly thought in business circles.

But, the hard and bitter struggle that every business is engaged in—no matter how big or how small—must receive adequate attention as a key factor in the current economic scene. Every business firm must make vigorous efforts to keep pace with competition, to develop new products, to introduce the newest technological improvements, and to try to keep at least even in the hard and relentless race against higher costs. These actions by businessmen in response to the profit motive, in turn, are a most important ingredient of adequate expansion and growth in the American economy.

Chairman PATMAN. Thank you, sir. Our next witness is Mr. Joseph A. Livingston. Mr. Livingston, we are very delighted to have you and glad to hear from you. You have a prepared statement, I believe.

**STATEMENT OF JOSEPH A. LIVINGSTON, FINANCIAL EDITOR OF
THE PHILADELPHIA BULLETIN AND NATIONALLY SYNDICATED
COLUMNIST**

Mr. LIVINGSTON. Yes, sir. I am honored and complimented to have been invited to appear before this committee. As a newspaperman, I am accustomed to have Senators and Congressmen talk to me and not listen to me. I hate to think of myself as a worm, but it is pleasant to have the worm turn.

If economics were an exact science, this committee wouldn't be holding hearings. And if I or anyone else knew the correct answers to this Nation's economic problems, again there would be no need for hearings. We'd simply accept the judgment and policies of this economic giant.

An economist is a bundle of biases, who isn't always able to see history and trends in the making because of his biases and theories. I offer that generality, because I may be completely wrong in what I am about to say.

It seems to me that too many economists believe in deficit spending as a panacea for everything. If business slacks off a bit, let the Government cut its income, either by spending more or taxing less.

If we have chronic unemployment, let the Government jab some deficit adrenalin into the system.

If we don't grow as rapidly as the Soviet Union or Western Germany or Italy or France, well, obviously, it's the Government's fault. It is not doing enough.

We are trying to treat prosperity in the same way we dealt with depression.

I fear we have been misled by comparisons. We note how rapidly European nations and Japan have expanded production and employment, and we say: "We're laggards. We're not doing as well." We forget that the war destroyed the farms, factories, and commercial organizations of these countries. We also forget that these countries had lagged far behind the United States even before the war—in industrial techniques.

After the war, as the Good Samaritan, we made available funds to build plants, technicians to explain our technology to them, and economic aid of all sorts. It was only natural these countries would grow more rapidly than the United States. So much more had to be done.

These countries have one other big advantage in the growth race. They can imitate and emulate. We have to innovate. Thus, after the war, the French, Italian, West German, Belgian and to a lesser extent British manufacturers had a whole line of proven consumer products which they could offer housewives—washing machines, dryers, mixers of all sorts, freezers—household conveniences which had sold well here and presumably would excite European housewives too. The manufacturers and distributors didn't have to engage in extensive market research; they didn't have to invent. All they had to do was copy. And they're still doing it—manufacturing and distributing products which were first widely marketed in this country. Most industrial countries of the world are just finishing the first lap in post-war development, whereas we are in our second or third. Hence, the slower pace.

I fear that we, the emulated, are in danger of becoming the emulators. We have looked at the rapid development of European nations in recent years, and said, almost childishly, "Gee, how fast they are growing. What are they doing that we ought to do?" Instead of recognizing that in most of these countries they are doing what we already have done. We note that some of their plants are more modern than ours; that their steel mills, having been built from the ground up, are in excellent competitive shape, and that their governments have offered special incentives to encourage plant development.

Should we not ask ourselves: Are their policies and tax structures useful here, or were they devised to meet specific and indigenous postwar conditions?

Let me cite an example. This administration has favored an investment tax credit. This amounts to a 7 or 8 percent subsidy to manufacturers of equipment. Undoubtedly lower prices will induce some firms to buy equipment.

But it seems to me, this can be accomplished more easily and less deviously by tax reform.

The investment tax credit has been used in Europe, I have been told by Treasury officials, effectively. But Europe has a scarcity of labor. Laborsaving devices are especially needed at the present time.

We don't have a shortage of workers.

Furthermore, Europe has been short of capital and the investment credit was the European way of encouraging investment. We are not short of capital in the United States. Rather, we are long on both labor and capital.

Why should the Government encourage investment to modernize plant and equipment, or to save labor? Might it not be better for the

unemployed and for the economy in general if the Government encouraged expansionary activity.

The Nation would be far better off if businessmen weighed alternatives: Is it more profitable and useful to modernize plant and save labor, or is it more efficient to maintain and improve or retrain the present labor force to particular productive purposes?

But the Government offers a tax carrot to businessmen to do what most of them would do anyway. It introduces one more gimmick into an overgimmicked tax structure. And it does not by so doing, in my opinion, create an atmosphere of expansion, innovation, and experimentation. And that is what, in my opinion, the economy needs.

Perhaps our problem is that the postwar appetites are jaded. We want more products coming off the industrial dreaming boards. We want more risk-taking and less worry about tax avoidance. This can be achieved only by restructuring our tax system.

It is significant that even though the gross national product has risen nearly 40 percent in the last half dozen years, expenditures by industry on plant and equipment have bumped up against a \$35 to \$36 billion ceiling. It is also significant that the gross national product has doubled in the last dozen years and that corporate profits after taxes have bumped up against a \$23 billion ceiling; maybe this year they might break through, if estimates for the first half are correct.

It could be more than a coincidence that plant and equipment ceilinged out at about the same time as corporate profits and that both in relation to the gross national product are well below their peaks, as the following table shows:

Percent of gross national product

Year	Corporate profits	Plant and equipment	Year	Corporate profits	Plant and equipment
1929-----	8.0	(1)	1953-----	5.0	7.7
1939-----	5.5	6.0	1954-----	4.6	7.4
1945-----	3.9	4.1	1955-----	5.8	7.2
1946-----	6.4	7.1	1956-----	5.6	8.4
1947-----	7.8	8.8	1957-----	5.0	8.4
1948-----	7.9	8.5	1958-----	4.2	6.9
1949-----	6.2	7.5	1959-----	5.1	6.7
1950-----	8.0	7.2	1960-----	4.6	7.1
1951-----	6.0	7.8	1961-----	4.5	6.6
1952-----	5.0	7.6	1962 (estimated)-----	4.7	6.7

¹ Not available.

A very popular theory among economists today is that taxes have become an economic drag. Every time we approach full capacity, taxes drain off too much purchasing power. Therefore, recoveries are aborted, and the growth rate is kept low relative to the growth rate in other countries. However, considering the frequent deficits and their size, it hardly seems as if the Government is taking too much out. It seems to be putting in. Mr. Saulnier said this yesterday.

However, I do think and agree that the way the tax system is structured, not the size of the take, impedes growth. I think we need lower corporate and personal taxes. I would reduce individual taxes across the board—in the lowest bracket from 20 percent to 18 percent or even 16 percent, and lop off the top rate at 60 percent and possibly

50 percent. I would try to get the corporate rate down to 45 percent or even 40 percent. As an offset to the loss in revenue, many exemptions and loopholes will have to be eliminated. This last is the big job.

Taxes have become so high that they enlist the best minds in corporations, in law firms, in accounting firms, in tax avoidance. It becomes more profitable to save on taxes than to make money—to produce goods and services—on which you have to pay taxes. The more successful a person is the lower is the incentive to become more successful. Our tax system is a disincentive system, and, a temptation to immorality.

It is quite possible that we are on the threshold of a recession. Evidence can be assembled to make a case either way. My own feeling—and the word “feeling” can be translated into hope—is that any decline, if there is one, will be shallow, something we can weather.

We have talked persistently in the postwar period of cutting costs, becoming competitive, yet every time we have faced a readjustment, we have been inclined to inflate, and thus prevent the modest readjustment in costs, in prices, that industrial cycles, adjustments, are supposed to bring about.

We talk about a government of checks and balances. Periods of industrial lull are, in a sense, a check to keep the economy in balance. I would rather save a tax cut for the overhaul of the tax structure next year. Privileged taxpayers will cite “strong” reasons why their various vested loopholes should not be closed. Congressmen favoring tax reform will have to offer substantial cuts in personal and corporate taxes to generate enough general enthusiasm to overcome the intense and specific objections of the privileged and the lobbyists.

I think if we restore profits to the profit system, we will stimulate the incentive to innovate, experiment, and expand, both for the corporation and the individual. The Government won’t need to offer special inducements to put up new plants, because businessmen will want to expand. There will be more money—profit—in it.

During the period of the great depression, it was right and proper for the Government to undertake stimulation of purchasing power. We still want rising standards of living at all levels, and especially at the lower levels. In this context let us be thankful that, though we have unemployment in the United States, few families go hungry. In the Soviet Union, which so often is served up as an economic example of rapid growth, supposedly, there is no unemployment, but plenty of hunger.

Economics does not abhor slack. Only certain economists!

Slack is part of the process of growth and change. We have slack on the railroads because of trucks, passenger cars, turnpikes, and airlines; slack in steel because of aluminum, concrete, and plastics; slack among writers because of the decline in the number of newspapers and magazines; and slack among politicians because for every senatorial and congressional seat there are usually three or four candidates.

The wave of the past won’t perpetually suit the present. At this juncture in our economic development, it seems to me we will achieve future economic growth and higher employment by regenerating faith and confidence in profits as profits and not in trying to breast-feed the economy every time it whimpers.

Thank you for listening to me.

Chairman PATMAN. Thank you, sir. Our next witness is Stanley H. Ruttenberg, director of the Department of Research, AFL-CIO. You have a prepared statement, I believe.

STATEMENT OF STANLEY H. RUTTENBERG, DIRECTOR, DEPARTMENT OF RESEARCH, AFL-CIO

Mr. RUTTENBERG. Yes, I do, Mr. Chairman. I would like to engage in debate with each of the three gentlemen that preceded me, but I shall refrain from doing that at the moment, and go to the text of my prepared statement. I would like to discuss in further detail the reason we view the flexible use of fiscal policy to counter a downward cyclical trend to be of the utmost importance. This kind of limited fiscal objective is entirely apart from the longrun structural reform of the tax system which I hope will be undertaken next year. While overall reform is vitally needed, it is also important to recognize, as President Kennedy and the Commission on Money and Credit already have done, the vital role that flexible use of the power to levy taxes can play to help meet the problem of recurring short-run economic downturns.

Since World War II we have already suffered severely from four business recessions, and in my judgment the economy is already on the threshold of the fifth.

The losses due to these business downturns, if measured in goods and services we could have produced but did not and the tax receipts the Federal Government could have collected but did not, total scores of billions of dollars. Moreover, they have imposed incalculable misfortune upon the families of the unemployed.

It is true that none of the postwar recessions reached the depth and duration that would characterize them as "depressions." This is largely due to the wholesome effect of a series of stabilizers, most of which have been built into the economy since 1929, often despite strenuous opposition. Taken together, they have helped to sustain economic demand and the stability of our economic institutions and have checked the downward business spiral that in the past has too often overwhelmed us.

Unlike the deflationary chain reactions that set in after the 1929 stock-market crash and on other occasions, family income and demand have been helpfully sustained during the postwar downturns by social security payments, farm-income supports, minimum wages, and the stabilizing impact of long-term management-labor wage agreements. Banks have not crashed during the postwar recessions and hundreds of thousands of homes have not been foreclosed, as a consequence of foresighted legislation enacted in the 1930's. Economic stability has been further aided by those corporations that have not reduced investment levels during business downturns but have held to long-term plans. Furthermore, during each recession, unemployment compensation has been helpful—although inadequately so—in countering the wage and salary losses of the jobless and the underemployed. Moreover, important countercyclical levers to make credit more easily available at a lower cost have continued to be available to the Federal Reserve System as a significant antirecessionary tool.

All of these factors have helped apply brakes to the postwar recessions and, as business inventories were worked down, have helped speed recovery. Nevertheless, the cost to the Nation of any recession is tremendous. What is more, the downward phase of the economic cycle is now reoccurring with increasing and alarming rapidity.

For example, the economy enjoyed 45 full months of recovery from the low point of the 1949 recession until the next downturn began. After the slump of 1954, on the other hand, the recovery phase of the cycle lasted only 35 months and, after the recession of 1958, it ended after 25 months. And now, only 17 months since the low point of our most recent recession, the recovery is already faltering. Unless we act, another downturn may be on the way.

The sole issue to which I wish to address myself is the timeliness of a prompt temporary countercyclical tax cut to prevent this downturn from occurring.

It is not my intention to debate the effort of the chamber of commerce or NAM to stampede the Congress into permanent corporation and top-bracket income tax reduction. I am confident that this poorly timed effort to impose a permanent and inequitable long-term cut—completely unrelated to the short-term cyclical needs of the economy and clearly intended to make tax reform impossible next year—will be rejected.

Furthermore, I will not discuss now, but set aside for another hearing, the relevant long-term question of the appropriate level of aggregate Federal tax receipts and budget outlays in relation to the effort to sustain long-term economic growth.

My point of emphasis is very clear. A basic distinction must be made between a tax cut designed to stimulate economic activity, and one designed to produce permanent and structural tax reform.

The U.S. Chamber of Commerce in making its proposal to cut corporation and upper individual income taxes did so, I am convinced, as a means of stopping tax reform of the kind that Mr. Livingston referred to in his remarks.

Countercyclical tax cuts designed to stimulate economic activity should not be used as a means of accomplishing tax reform. A tax cut at this point in time should produce the maximum impact in stimulating the economy.

The economic situation is today sufficiently serious, as I shall indicate later in my statement, to justify an immediate, emergency short-run tax cut. If such a tax cut were enacted now, and terminated on December 31, 1962, it would in no way interfere with either permanent tax reform or efforts to bring the budget into balance at a higher level of economic activity. The Congress would be free next year to approach these two problems unencumbered by the action which it should take this year.

I would strongly recommend that the Congress enact a tax cut of approximately \$5 billion, to become effective as soon as possible and terminate December 31, 1962. The impact of such a tax cut upon the economy would be much greater than just the \$5 billion because it would be concentrated in a 3- to 4-month period. The impact on the budget would be a loss of \$5 billion, while the impact on the economy on an annual basis would be the equivalent of almost \$20 billion.

Such a tax cut could have immediate impact upon the spending stream by reducing the withholding taxes on personal individual income taxes by \$10 per week for 10 weeks for each taxpayer. Those taxpayers whose total withholding tax is less than \$10 per week could apply immediately for a tax refund that would permit them to have a total tax cut of \$100. Individuals not subject to withholding could apply for a tax refund of \$100.

This kind of tax cut would put income into the hands of the American consumers, whose tendency has always been to spend the greatest proportion of their income on maintaining adequate and decent living standards for themselves and their families.

This is in direct contrast to a \$100 tax-cut spread over a 52-week period. Such a cut would add less than \$2 per week to each taxpayer's take-home pay. The impact would be considerably less upon the economy than one which gives the same \$100 tax cut to individuals in a 10-week period.

A good case can be made for differentiating between this type of immediate, emergency, short-run tax cut and tax changes which are designed at permanent and structural tax reform.

The Commission on Money and Credit in its report last year made a very clear distinction between temporary and permanent tax changes. I was privileged to be a member of this Commission during its 3 years of intensive study, in the good company of 17 leading bankers and business executives and 7 other distinguished citizens.

The investigations of the Commission, which was financed by the Ford Foundation, in the main, encompassed the whole field of monetary and credit policies and their influence upon employment, prices, and economic growth. One of its most significant recommendations is its endorsements of a flexible fiscal policy as a means of helping to stave off excessive cyclical swings.

In the report of the Commission a year ago, much attention was given to ways that our existing built-in economic stabilizers can be improved. But, in addition, the report declared:

Even if the automatic stabilizers can be improved discretionary fiscal measures will remain an important instrument of stabilization policy.

The Commission then carefully weighed how a flexible tax policy should be applied as a countercyclical tool. Its most important conclusions follow:

One, with regard to a clear distinction between temporary and permanent tax changes, the Commission states:

Discretionary fiscal policy requires speed of decision and effect and can only be successful if temporary and reversible fiscal changes for stabilization purposes are dissociated from permanent and structural changes. Techniques should be developed by which taxation and expenditure policy can be applied more flexibly, and the first step in this direction lies in a sharp demarcation between short-run cyclical changes and long-run structural changes.

Two, with regard to how the temporary tax should apply, the Commission states:

Clearly, as a stabilization instrument, the first-bracket rate adjustment is superior to proportional adjustments in the entire rate structure in stimulating consumption, since for each dollar of income tax reduction the lower income groups would receive a proportionately larger share of the reductions.

A change of this sort is also flexible and reversible. Withholding changes can be made promptly, regardless of their size. Congress and the administration have

had experience with intrayear changes in withholding rates, for example in 1948, 1950, and 1951. The technique is readily and easily applicable. Declarations of estimated tax can also be promptly modified in line with the new tax liabilities.

The Commission, therefore, concludes that when discretionary tax adjustments are used to promote short-run economic stabilization, they should consist of variations in the first-bracket rate of the personal income tax.

Such variations should be regarded strictly as temporary departures from a permanent tax structure.

The Commission proposal should not be and cannot be viewed as a business-oriented or as a non-business-oriented tax. It is the kind of fiscal proposal which is deemed to be in the interests of the entire Nation. I would call to your attention once again that the Commission was made up of 25 people, 17 of whom were business executives, corporation officials, or insurance company presidents.

Last January, in his Economic Report to the Congress, the President cited three major measures which he views to be essential to help sustain prosperity. Noting that—

recurrent recessions have thrown the postwar American economy off stride at a time when major industrial countries have moved steadily ahead.

President Kennedy urged strengthening of the unemployment compensation system, standby authority to increase public works construction, and, finally—

Presidential standby authority for prompt temporary income tax reductions.

The costs of a temporary tax cut, the President pointed out, should be measured against the costs they are designed to forestall:

The tens of billions of potential output that run to waste in recession; the pain and frustration of the millions whom recessions throw out of work; the budget deficits of \$12.5 billion in fiscal 1959 or \$7 billion this year.

And the President concluded:

The proposed partial tax suspension would launch a prompt counterattack on the cumulative forces of recession. It would be reflected immediately in lower withholding deductions and higher take-home pay for millions of Americans. Markets for consumer goods and services would promptly feel the stimulative influence of the tax suspension.

It would offer strong support to the economy for a timely interval, while preserving the revenue-raising powers of our tax system in prosperity and the wise traditional procedures of the Congress for making permanent revisions and reforms in the system. * * *

Essentially, the President's proposal, in the main, conforms to that of the Commission on Money and Credit, but differs in one very important respect. The President proposes that the temporary 5-percentage-point cut be in all individual income tax rates as contrasted to the Commission on Money and Credit's recommendation that the 5-percentage-point reduction be in the "first bracket of the personal income tax." Such a change, as proposed by the President would considerably reduce the economic benefit resulting from the cut.

Events since the President submitted his Economic Report to the Congress prove the timeliness of his legislative proposals of 6 months ago.

The promising recovery of last winter has faltered; at best we are now moving sideways. Total demand generated by consumers and the other segments of the economy just has not been sufficient to utilize an everrising capacity to produce. The latest figures suggest, as a

matter of fact, that total demand may now be headed down. Meanwhile, a large part of our production plant is idle and this considerably dampens hope for an immediate investment boom. Moreover, despite small fluctuations up and down, unemployment has remained intolerably high and by winter is likely to again reach 6 percent or more.

It may be a fact that the Nation is still statistically poised at an all-time GNP high; nonetheless, we clearly have failed to achieve a full recovery in terms of today's needs and potentialities. What is more, the "mixed bag" of available economic indications already points to the likelihood of an impending descent—if not in a month or two, then a little later.

Clearly the economy needs an antirecessionary temporary tax cut now of the kind the Commission on Money and Credit has proposed. Surely it is far wiser to take steps to prevent the Nation's fifth post-war recession from occurring, than to do nothing now and seek to regenerate the economy next year when the cost will be far higher.

Finally, I must express concern over rumors, and I guess it is more than rumor, that the Federal Reserve Board will seek to offset a tax cut, if one comes, by a tighter money policy. Action of this kind would simply destroy the beneficial effects of the tax reductions.

While it is important to take monetary measures to help ease the balance-of-payments problem, they must be selective and constructive in nature. A general effort to tighten the availability of funds and thus raise interest rates across the board now to meet the payments problem just cannot be tolerated at a time when the American economy needs credit ease and lower borrowing costs in order to overcome stagnation.

Policies to meet the international monetary problem can and must be shaped that do not undermine the achievement of what must be our number one objective—the restoration of recovery.

Chairman PATMAN. Thank you, sir. Mr. Rutenberg, to what extent do you believe that the tight money and high interest policy of the Federal Reserve has contributed to our present plight?

Mr. RUTTENBERG. Mr. Chairman, I believe very strongly that the Federal Reserve System, which has been maintaining a level of free reserves in the banking structure, of somewhere around \$500 million during the early parts of 1962, and then moved down to somewhere in the neighborhood of \$400 million, and more recently, although it has fluctuated up and down, it has been between \$320 million and up to \$450 million, but it looks like the tendency is to come down on the level of free reserves. Simultaneously with this happening, we have seen over the course of the last 6, if not 8, weeks a rise in the long-term interest rates by 20 basic points, at least.

I think this move on the part of the Federal Reserve Board at this point in time, when the economy still has 5½ percent, 5.5 percent of its labor force, totally unemployed; when it has something like 600,000 additional workers who are not in the labor force, who should be there; that has something like 2½ million workers who are working part time for economic reasons, who would be working full time if full-time jobs were available; an economy which has about 15 percent of its total plant and equipment lying idle is wrong. I think a policy which holds down the level of free reserves, which tends to force up the

long-term interest rates is absolutely and unequivocally, in my judgment, the wrong policy for the Federal Reserve to be following at the moment.

Chairman PATMAN. Mr. Martin did say that he would give this tax cut what you might call a Russian veto. He is going to stop it. He said that in testimony before our Committee on Banking and Currency on July 17, 1962. I will place in the record the exact statement that he made in reply to a question that I asked him, and in reply to a question Mr. Reuss asked him.

(Testimony referred to follows:)

EXCERPTS FROM TESTIMONY OF MR. WILLIAM MCCHESENEY MARTIN, JR., CHAIRMAN
OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

(Hearings of the Committee on Banking and Currency, House of Representatives,
July 17, 1962)

Mr. PATMAN. What is your view of the other part of the recommendation to get the economy going that we ought to stimulate the economy with a large Federal deficit?

Mr. MARTIN. That gets into the field of fiscal policy that I don't believe is my province or prerogative to deal with.

I will return to the simple statement I made earlier. In the event a decision is made which widens or further deepens the deficit we are already running, I want to put the Federal Reserve specifically on record this morning, if I haven't done it already, that I think that we must not finance a deficit by bank-created funds, that how the deficit is financed is of vital importance and that it should be financed out of bona fide savings and not by writing up assets on one side or the other of the bank ledger (pp. 90, 91).

Mr. REUSS. * * * Now, you made a statement a moment ago which I think is quite historic. You said—and I want to be sure that I heard you right—that if the administration and the Congress go ahead and cut taxes by \$7½ billion as advocated by the U.S. Chamber of Commerce or by \$10 billion as advocated by Walter Reuther or whatever—you said that nobody should rely on the Fed for financing any of that deficit and that all of the deficit would have to be financed from so-called real savings.

Did I hear you right?

Mr. MARTIN. I think you heard me substantially correctly, but I didn't say "all" of it. I don't think you can completely measure this operation, but I am sure that the role of the central bank is to see that the debt is financed when deficits develop in a way which will bring into play the savings of people and not just create money out of thin air, which is what is done when the banking system does it by writing up assets on one side and liabilities in the other" (pp. 106, 107).

* * * I think that easy money has done about all it can do at the present time for the employment and growth of the economy * * *" (p. 108).

Representative CURTIS. Did he use the words "Russian veto"?

Chairman PATMAN. No; I did that. I used the term "Russian veto."

Mr. RUTTENBERG. Whether it is Russian or not, it is a veto.

Chairman PATMAN. It is a Russian veto. That is what I called it. Mr. Martin didn't call it that. Mr. Ruttenberg, you served on that Commission on Money and Credit. Weren't you really shocked to find out how little power the Congress of the United States has left the Executive to use in carrying out his duties insofar as it applies to monetary affairs?

Mr. RUTTENBERG. As far as the Executive is concerned, he is left with relatively little authority at all in the monetary field because the Congress has delegated this authority to the Federal Reserve.

Chairman PATMAN. That is right. Dr. Weston testified the other day, sitting right there where you are, and he told us, a committee of Congress, that he was not going to talk about monetary affairs because

we didn't have anything to do with it. He was going to talk about fiscal affairs. I congratulated him on reprimanding the Congress for not carrying out their constitutional duties. I think he is exactly right.

During the depression when Congress was preoccupied with trying to improve conditions and willing to do anything in the way of cooperating, they passed a law in 1935 to change our banking laws. They changed it substantially, as you know, primarily for the depression period, but it has lasted until now.

During that time they created the most powerful group on earth, the Open Market Committee. It functions through 7 public members of the Federal Reserve Board and 12 presidents of Federal Reserve banks, who represent the private banking interests of the Nation. They determine our policy. They determine the volume of money, and what the interest rate will be. It seems to me that is a lot of power.

In 1935 this Open Market Committee was set up with 7 members, with 14-year terms. The law says not to exceed 14 years, I believe. It will be another year before—2 more years before Mr. Robertson's term will expire, in 1964; 4 years before Mr. Balderson's term expires, 1966; 6 years before Mr. Shephardson's term expires, 1968; 8 years before Mr. Martin's term expires in 1970 as a member of the Board; 12 years before Mr. King's term expires; and 14 before Mr. Mitchell's term expires. It occurs to me that Congress, in trying to get the country out of the depression and eager to pass any measure that might help, took away from the Executive the principal weapons we can use for the purpose of aiding this country in time of distress.

Do you agree to that, or not

Mr. RUTTENBERG. You mean by the long terms of the Federal Reserve Board members?

Chairman PATMAN. By putting such great power into the hands of a few people. In other words, the Federal Reserve has seceded from the Government. They were looking for an occasion to try it, and during the last year or two of Mr. Truman's administration, when Mr. Truman's popularity line was down a little low, they took advantage of it and seceded from the Government.

Senator DOUGLAS. Don't start that.

Mr. LIVINGSTON. So did the vice chairman.

Chairman PATMAN. Now they are operating as a fourth branch of government. They are not elected by the people, in any way, shape, or form.

They are off by themselves for a 14-year term, and they claim that each member is responsible to his own conscience and God, and nobody else—not to the Congress, not to the people—his own conscience and God.

That is to whom they are responsible. Don't you think we better take another look at what we did back in 1935?

Mr. RUTTENBERG. Mr. Chairman, I was a member, as you said, of the Commission on Money and Credit, which functioned for 3 years and made a report. I had some 8,000 words of dissent in that Commission report, but the one part of the report with which I fully agreed and dissented not at all, was the issue of the reorganization of the Federal Reserve System. The reorganization included, among other

things, the abolition of the Open Market Committee, as such, and the turning over the function of the Open Market Committee to members of the Federal Reserve.

Chairman PATMAN. I have advocated that a long time, and I agree with you.

Mr. RUTTENBERG. Secondly, that the Chairman should be appointed, and his term should expire coterminous with the expiration of the Presidency.

Chairman PATMAN. To make him more responsive to the President.

Mr. RUTTENBERG. In a sense, a President can come in as President Kennedy did, in 1961, and he could not change the Chairman of the Federal, March 1963, when his term expires.

Chairman PATMAN. If he does make a change, he has to select somebody on the Board at the time. He could not go outside.

Mr. RUTTENBERG. He would not necessarily have to, Mr. Chairman. If, for example, you had also the termination of a member of the Board's term coinciding with the odd year in which the President takes over.

Chairman PATMAN. It would be a coincidence.

Mr. RUTTENBERG. It so happened that there was a term expiring and there was a vacancy. Governor Vardeman resigned at the end of his term, and Mr. Mitchell, of Chicago, was appointed. At that point in time, had the President authority to change the Chairman, he could, if he wanted to have done it. One of the recommendations of the Commission on Money and Credit is that you reduce the number of members of the Federal from 7 to 5. You run their terms 10 years. You have them expire in the odd years so that the odd year when the President takes office, he will not only have a vacancy, but he would also have the right to designate his own Chairman without changing as a member of the Board, the man who might have been previously Chairman.

Chairman PATMAN. My time has expired. I am glad you went that far. I hope the Congress can do something about it because it is not treating the President of the United States right to make him depend upon the Open Market Committee, to do what he should have the power to do himself. Certainly the Committee should be more responsive to the President. I yield to Mr. Curtis of Missouri.

Representative CURTIS. Thank you, Mr. Chairman. I presume from that that you are glad that they didn't make these life-term appointments, as we do our Federal judges.

Chairman PATMAN. I certainly am. We didn't do that. I think the Constitution did it.

Representative CURTIS. Yes. I am pleased about one thing particularly in Mr. Ruttenberg's paper, of drawing the issue, and I think you do it fairly, you point out a basic distinction must be made between a tax cut designed to stimulate economic activity, and one designed to produce permanent and structural tax reform.

I believe our hearings in the Ways and Means Committee, which were in secret session, as well as these hearings here, have demonstrated a muddled approach to this. Many of the people who were here urging a tax cut were thinking in terms of tax reform. I know the theory, I feel, the theory that is being advanced in our public discussions along the lines of that which was recommended by this Com-

mission on Money and Credit, the recommendation in the President's message to the Congress to give him standby authority. The urgings now are, instead of the President having this standby authority, the Congress should move in here.

This is the matter with which I take issue. I am expressing my own view. Those who have advanced this theory, in my judgment, have not come forward to examine into what its effect would be. They have been begging the question. This has never been tried before, has it, Mr. RUTTENBERG?

MR. RUTTENBERG. What has not been tried?

Representative CURTIS. The use of fiscal policy, tax cutting, to stimulate economic activity, this temporary tax cut. We have examined into our history with other witnesses and I can't find a period when this was ever done. We have tax reform which amounted to tax cutting, but this kind of approach has never been followed.

MR. RUTTENBERG. I think, Congressman Curtis, it is fair to say that the approach which has not been followed is one which involves a temporary reversible tax cut.

Representative CURTIS. That is right.

MR. RUTTENBERG. We have had tax cuts that have been justified one way or another for economic reasons, and for stabilization reasons.

Representative CURTIS. I disagree. I think in all our tax cuts, thank goodness, we have been concerned whether the tax laws are good, and talking about revenue. There are people, and I am one of them, who believe that our taxes should be for the purpose of revenue, and we should try to make them as neutral as possible in their economic impact.

MR. RUTTENBERG. Congressman Curtis, I don't want to have to disagree with you, but I would like you to refer back in your own mind, as a member of the Ways and Means Committee, to the testimony of the Secretary of the Treasury, Mr. George Humphrey, in 1953 and 1954, and unless I am mistaken, the great emphasis which he placed upon the basic tax changes of the Revenue Act of 1954, was to stimulate economic activity.

Representative CURTIS. No.

MR. RUTTENBERG. You check back on the record.

Representative CURTIS. That may be something we can both check, because I am going on memory, too. I can certainly say this, as one who sat through those long sessions, that we were thinking in terms of tax laws and what specifically was equity and what specifically we needed in order to get revenue, and what the economic impact of a particular tax was, whether it was a good tax from the standpoint of collecting revenue efficiently, and what its impact might be. I don't think we ever were going on the theory—and I have never in all my years on the Ways and Means Committee—ever heard anyone discuss this economic innovation that has been an idea floating around for years—that if you do cut taxes that you would stimulate the economy, per se.

I frankly think it is a theory that is untested. Let us go in and test it, though. I wish that our witnesses would do so, those who follow this theory. Here is the question I have asked. Here we are in a period of deficit financing. Take your example of a \$5 billion quickie tax cut. We have just gone through some rather lengthy

hearings on debt limitation in the Ways and Means Committee, where we increased the amount of bonds that we could issue to a \$308 billion ceiling. This \$5 billion tax cut you propose would immediately mean that we would have to increase the amount of bonds that we could market to \$313 billion, but that is not the basic point.

The real point to consider is this: What is the economic impact of having to market \$5 billion worth of bonds on top of the amount that we already have to market in the private economy? If you are going to try to market the \$5 billion in E bonds, for example, you take away the very money, if you are successful in marketing them, that you have given to the consumer. Dealing in economic aggregates, why is there a stimulus from taking \$5 billion from the tax revenues and turning it over to the people or the private sector, and then withdrawing \$5 billion from the private sector in the bonds you sell them? Where is the economic stimulus in that kind of a process?

Mr. RUTTENBERG. You see, Congressman Curtis, I don't quite approach the problem of Treasury debt financing from the same point of view you do.

Representative CURTIS. I do it as a legislator who has to try to figure out how we are going to sell the bonds.

Mr. RUTTENBERG. Let us just look at the situation. It is true, as you point out, that if a \$5 billion deficit ensues, and this has to be financed by the issuance of Government bonds, if it is done: (1) by selling more E-bonds, this in effect takes up the tax cut and the people who had the tax cut, in a sense, may be the ones who buy the E-bonds. Therefore, I don't think E-bonds would be bought because it is my judgment that people who get this kind of tax cut in the low- and middle-income brackets, would spend the overwhelming proportions. The Treasury financing would fail. You would have to find another way. Let us assume they issue long-term bonds, and these long-term bonds are then bought by the banks. This, in a sense, then reduces the level of free reserves in the American economy, reduces the level of available funds for lending purposes, and in a sense, does the kind of thing on the tightening of money policy that I was criticizing at the end of my own statement.

Let us assume that they do do this, though, and that they do have to float the \$5 billion deficit in terms of long-term bonds, or even intermediary term bonds. I don't care. It has the purpose of going to the banking structure as against going to individuals in buying the bonds. If it goes to the banking structure and the free reserves are reduced by the selling of the new Treasury bonds, and if the economy needs to have a higher level of loanable funds in the banking system, then the thing to do is for the Open Market Committee of the Federal Reserve, at that point, to step in and see to it that the money supply of the country as reflected by the lendable funds, is at adequate levels. I am not saying we go back to the problem that preceded the accord of 1951.

I am not saying that the Federal Reserve should buy the Treasury bonds that are put on the market at the point and time they are put on the market. It is highly conceivable that the Treasury can float \$5 billion of bonds, and at that point in time and a future point when the Federal Reserve feels the level of money supply should be increased, should buy other bonds through the Open Market Committee.

Representative CURTIS. My time has about run out. Now, we are beginning to discuss the real problem. Up to date those who have been proposing this quickie, have been perfectly content to say we will pass this whole problem over to those who have the problem of debt management and let them figure out what they are going to do with the \$5 billion of additional bonds that have to be sold without any examination into the economic impact that marketing this additional debt might have on the economy.

I want to emphasize all of this is in light of a very serious balance-of-payments situation which has produced a strained situation where we are trying to keep short-term interest rates high and long-term interest rates low.

As one witness said yesterday, he said it was an impossibility. It almost seems like it is.

Mr. RUTTENBERG. I don't think it is.

Representative CURTIS. It is a very difficult thing, at any rate. This quickie proposal poses great problems in the area of debt management and monetary policy. All discussion of these problems, Mr. Ruttenberg, by the witnesses who have been talking about this quickie, has been absent in their prepared papers. None have been prepared to discuss this key issue.

They have begged the question. The only time the issue is discussed, is when I raise the question. They have not given it previous thought. In my judgment, the Commission on Money and Credit didn't relate its suggestion to an actual situation such as we have today, of deficit financing, coupled with a serious balance-of-payments problem.

I doubt if they would recommend a "quickie" in that kind of economic climate.

Mr. RUTTENBERG. My response to you this morning, Congressman Curtis, is not an improperly advised one of how the Treasury debt financing should be taking place with the deficit financing of the Government.

Representative CURTIS. Why is it not in your prepared paper?

Mr. RUTTENBERG. I was prepared on this because we had a go round on this in the secret session of the Ways and Means Committee.

Representative CURTIS. That is right. Why is it not in the prepared statement so that the people who question it can read it? I think you are passing on a debt management problem to those of us in the legislature who have to be concerned about it, or in the executive, the Treasury Department, and you do not discuss the problems of debt management and the economic impact it might have.

You simply pass it over and say the "quickie" will stimulate the economy, without dealing with the problems that are created by doing it.

Chairman PATMAN. Thank you, Mr. Curtis. Senator Douglas?

Senator DOUGLAS. I would like to pass.

Chairman PATMAN. Mr. Reuss?

Representative REUSS. I would like to comment, Mr. Langum, on your paper, and particularly on the very revealing chart you have in your supplemental materials, entitled "Corporate Profits and Cash Flow." The chart relates to cash flow, that is, net profit after taxes and depreciation and depletion allowances, in relation to sales of all

manufacturing corporations in 1961, by size. There I am struck by the fact that as you progress from corporations with under \$1 million—is that in assets or sales?

Mr. LANGUM. Total assets.

Representative REUSS. And move in the direction of corporations with \$1 billion in total assets, the percentage of net profits after taxes moves quite progressively from a fairly miserable 1.2 percent to a fairly lush 8.4 percent. When you add in the depreciation allowances, it moves in exactly the same progression from 3.3 to 14 percent.

In the case of the \$1 billion corporation, the rate of net profit after taxes is about eight times the rate for the \$1 million corporation. Total cash flow for the largest class of corporations is at a rate five times the rate for the smallest size class. In computing your depreciation allowances, I take it you used the allowances in effect in 1961?

Mr. LANGUM. Yes, sir.

Representative REUSS. The discrepancy between the rich and the poorer corporations would be even larger if you took into account the increased depreciation allowances made by the Treasury last month and the 7-percent investment credit, once enacted, would it not?

Mr. LANGUM. I think it would increase to a moderate degree the differences shown on page 8. I believe the Secretary of the Treasury noted, in commenting on the new depreciation guidelines, about the differing degree of usage of increased depreciation accruals and possibly a tax credit by the larger corporations with excellent accountants and technical staff to do so.

I think that it would probably be a moderate proportion. But it certainly, in my judgment, would be along the lines of the differences shown in these tables.

Representative REUSS. The general point I got from your paper is that, if you take into account cash flow, including depreciation and depletion allowances, corporations generally have never had it so good.

On this table, I take it that the bigger the corporation, the larger the cash flow in percentage terms.

Mr. LANGUM. I think that is true in terms of cash flow, because unquestionably there has been a major step-up in cash flow with the rise in depreciation accruals. I think, however, that we should look upon that as a matter of greatly strengthened and improved quality of reported earnings.

In terms of reported earnings, the rate of return on equity, which I think is the ultimate measure, in the last 5 years has been about the same for leading manufacturing corporations as in the years of the late twenties.

Representative REUSS. I have a question for Mr. Hagedorn. You referred to the foreign short-term financial claims against this country and said that, therefore, measures used for promoting economic expansion at home should not depend on low interest rates.

I would ask you this question: Now that the Western World has laboriously attained the goal of currency convertibility among the major free world nations, isn't it really quite drastic to conclude that whenever any country, Ruritania, decides for good or bad reasons that it is going to raise its interest rates, we have to raise ours correspondingly, lest foreign or domestic capital leave this country?

Mr. HAGEDORN. No, of course not, Congressman. Holding balances in this country has attractions that may be entirely aside from the competitive interest rate.

Representative REUSS. Those attractions would include the avoidance of currencies that may have speculative dangers, even though the countries of those currencies pay a high interest rate.

Mr. HAGEDORN. Certainly. The quality of the loans must be considered.

Representative REUSS. Another reason for holding balances is one quite apart from interest rates. It involves lubricating the wheels of international trade.

Mr. HAGEDORN. The ability to get goods for those balances. Certainly that is an important consideration in their willingness to keep balances here.

Representative REUSS. I am glad to hear you recognize both of those things, because it seems to me they militate against a too great obsession with differential interest rates.

I would hate to see this country adopt the policy that whenever some country somewhere, by reason of its central banking policy at the moment, raises its interest rates, we raise ours competitively. If the free world starts doing that, the sky is the limit.

Mr. HAGEDORN. Yes. I realized, as I wrote this, that the comparison of the \$16 billion we have in gold and \$19 billion of short-term balances might sound like a scare statement to somebody. I didn't mean it as such. We are in the same position as a commercial bank. There is no reason to expect them to have cash in the vaults to pay off all their depositors at once. But they certainly have to maintain their assets in a condition that recognizes the fact that they have a certain amount of demand claims against them.

We, as a nation, are in that same position. The interest rates we maintain is one of the many factors we have to take into account.

Representative REUSS. I am wondering if this country should become so alarmed because other countries have temporarily higher interest rates than ours. For example, if Ruritania's central bank wants to raise its interest rate structure to 8 percent, why should we become alarmed if holders of claims against this country then take off after that 8 percent?

Mr. HAGEDORN. I doubt that the Ruritanian economy could pay 8 percent on any very large volume of balances, Congressman. I have not seen recent figures on the national income of Ruritania. I would guess they simply cannot. After all, the income on investments or the interest on balances has to come out of the product of the economy.

Representative REUSS. Yes, except non-Ruritanian countries such as Germany and France. I hoped you would not goad me into mentioning them. They have had rather high interest rates in recent years. I am wondering whether it is a cause for alarm in a free world of convertible currencies, if holders of claims choose to put down their money where they get the highest interest rates. I don't see why this should bother us.

Mr. HAGEDORN. I would be very much alarmed if our gold started flowing out of the country at a rate which would make it impossible for us to maintain the convertibility of our own currency.

Representative REUSS. Gold doesn't flow until the central banks of these countries demand it. Are they likely to demand it because temporary short-term money has come their way because of the higher interest rates? I shouldn't think this is necessarily the case.

Mr. HAGEDORN. The foreign central banks are in the same position as a depositor is in the domestic bank, when they look at each other and wonder which one is going to start a run on the bank. This would have been true before the changes in our own banking system in the past 30 years.

If, 50 years ago you had a town where the people were all doubtful about the solvency of the local bank, each one of them would recognize, it is a bad thing for me as well as all the others if I start a run on the bank. We don't want to see that happen to our bank. But on the other hand, if it is going to happen, I better get there first.

The foreign central banks might reason in much that way.

Representative REUSS. Just as Federal deposit insurance to a degree has stopped the depositors of domestic banks from ganging up and starting a run on the bank, so some of us hope the recent \$6 billion standby agreement of the International Monetary Fund will, in a modest way, constitute a step toward an international depositors insurance fund, and thus remove us from the mercy of foreign central bankers.

Mr. HAGEDORN. I don't agree that it would remove us.

Representative REUSS. Lessen the exposure.

Mr. HAGEDORN. It will protect us to a degree. Yes, Congressman, I would agree that you can't compute in any mechanical way the interest rates we must maintain in the light of all foreign interest rates.

Foreign interest rates are a complex of rates in different places and for different qualities of loans. I would certainly not be willing to agree that we could ignore that foreign complex of interest rates. That is what makes the Federal Reserve Board decision so difficult. It can't be done in any mechanical way. As Mr. Livingston said, if economics were an exact science we wouldn't have much to argue about here.

Representative REUSS. Thank you very much, Mr. Chairman.

Chairman PATMAN. Mrs. Griffiths?

Representative GRIFFITHS. Thank you very much, Mr. Chairman. I don't particularly have a question, and I don't want to testify, but I would like to address some remarks to Mr. Livingston and Mr. Ruttenberg.

I read a column of yours last week, I believe, Mr. Livingston, in which you questioned the matter of where a tax cut would be spent if you gave everybody \$100. Just before I read it I had sent out a newsletter to my own constituents, about 30,000 of them, asking them where they would spend it. The answers that I have received are quite interesting.

One of the Detroit papers picked up the question and asked what each one would do if he got the \$100 at one time. One woman had replied in what I thought was the most interesting of all the answers, "I would buy a cashmere coat, and I know where there is a sale on right now." She was then asked, do you have any preferences in the way you get the tax cut? She said, no, she didn't. Just as long as she got the \$100 and the cashmere coat. One of the more knowledge-

able answers that I have personally received, because I spread the \$100 tax cut over 12 months in equal installments, came from a man who said this would be a tremendous tax cut for 50 million people. That personally he would fritter it away but that he would feel he was spending his grandchildren's candy money. At any rate, I had the feeling, as I sat in Ways and Means and listened to the economists, that they were multiplying \$100 by 50 million people by a multiplier of $2\frac{1}{2}$ and dividing the grand total by 300 for refrigerators or 3,000 for cars, to determine what the effect of a tax cut would be.

I hope when I have conducted my amateurish and nonscientific poll, at least I will have a better idea of where this money is going to go.

I expect the chairman will let me spread it on the record of this committee hearing.

Chairman PATMAN. Senator Proxmire.

Senator PROXMIRE. Yes, I would like to say first to Mr. Livingston that I agree with a great deal you said.

No. 1, too many economists feel deficit spending is a panacea for everything. I think that is true. I do not think it can help a great deal.

Regarding your statement that the investment tax credit amounts to a 7- or 8-percent subsidy to manufacturers of equipment, there is no question about it. This is the first time this Government would permit anybody to depreciate more than 100 percent, which is in effect what we would be doing.

Over on page 4 of your statement, you say that:

I think the way the system is structured impedes growth. I think we need lower corporate and personal taxes and to reduce individual taxes across the board—

and so forth. You have a reduction in the personal income tax first bracket from 20 percent down to 16 percent; a cut in the corporate rate down to 40 percent ultimately, 45 percent as an interim goal.

Everybody would like to see it. But in view of the very great likelihood of increased expenditures, which increased \$6 billion last year and \$6 billion the year before, the fact that so many of these expenditures have become sacred cows whether they should or not in defense and space, are you not going to run a perfectly enormous deficit if we even come close to approaching this tax reduction you propose unless we have some alternative revenue source?

Mr. LIVINGSTON. I think you are quite right, Senator. I don't presume to be a tax expert and I don't presume to say how these revenues can be made up. But it seems to me that we have a condition of pernicious anemia in this country. The pernicious anemia is the result of our tax structure.

I would rather see a deficit, and a large deficit incurred—I am not afraid of deficits per se—if we can get this country moving again, as the President has so well said.

But I don't think we are going to get it moving again if we don't stop business organizations and businessmen in general from working to find out ways how to avoid taxes.

Whenever you get a rate of above 50 percent, you make it more profitable to find ways to save taxes than to actually do the job. I don't have to tell you the numerous devices that are schemed up to do it.

You buy a piece of property from somebody because your income is very large. You set up a mortgage by which you can pay the thing off progressively. It is all covered. And then you take depreciation on the property against your other income.

There are all kinds of schemes like that. You could cut down the business expense allowance that Senator Douglas has talked about. I think there would be no trouble at all of putting a limitation on businessmen's expenses if you at least gave the businessman an incentive to save on expenses.

A law partner or an accountant is in the 60- or 70-percent bracket; he does not want to save on his expenses. He wants them to go up because this is the way to increase his standard of living. But if you said you can have half of what you don't spend, at least you have a chance to say, "Look, \$25 a day is enough." We came down here and we were told the limit we had was \$15 a day. That might be a little too little for a businessman.

The tax structure is tilted to prevent people from going out and doing things. I think you can get some of this money back by changes of various sorts.

Senator PROXMIRE. I would agree that we have to plug lots of loopholes. We would lose less than \$400 million by reducing the top bracket from 91 to 65 percent. There is a lot of sentiment in Congress for it. I think there is a real possibility we might achieve it.

But even still as I look at your arithmetic, there is a \$6 billion corporate tax cut and a \$12 billion individual tax cut if you go from 20 to 16 percent and everybody else the same way. Most of that loss is in the lowest bracket.

As I say, it sounds very unlikely we can really cut expenditures. I have introduced amendments to do so, too. I think there may be an inconsistency here if you indicate that we cannot solve this problem by deficits and we have to be concerned about them. If we can have an \$18 billion tax cut, even given a good multiplier and better tax collection, I do not see how we can avoid an immense deficit.

Mr. LIVINGSTON. There is a difference in concepts there, Senator. What I said is we cannot solve this problem by deficits. That is right; I still think so. Because every time you have a deficit you do tend to inflate the economic structure. You push up costs. When you push up costs with an inflexible price ceiling and a low rate of profit, you deter the incentive to innovate and experiment on the part of businessmen.

I am not trying to defend the businessman's rate of profit per se. As a matter of fact, just before the meeting started, Mr. Ruttenberg said, "Are you trying to agree with the NAM?" and I said, "Just as a stopped clock is right twice a day, so the cycle has swung around so that the NAM is finally right."

Mr. HAGEDORN. I think our record is a little better than that.

Mr. RUTTENBERG. I don't think it is even that good, George.

Mr. LIVINGSTON. I am not sure whether going down from 20 to 16 is right or going down from 20 to 18 is right. Obviously there has to be some measure of wisdom and common sense in doing this and working out the figures.

These were put down as goals, as something to strive for, and if the theory of the present mystique among economists is correct that

our problem is growth and if I am right that this is what is lacking and you get the economy really chortling at \$600 or \$650 billion GNP, then your taxes will roll in at these low rates.

We have quantified the economy in terms of the gross national product in terms of what might be accomplished if everybody were working. Then we said, "My gosh, everybody is not working; this is our lag; this is our failure."

Now, the quantification does not tell us anything about the economy at all. It is merely a description—a certain set of statistics based upon certain sets of assumptions made by our economists at Harvard, Michigan, or elsewhere.

What we all want to find out is why the dickens do we have this anemic performance. I think our anemic performance is in part because we are the leading nation in the world. I said that in my paper. We cannot expect to grow more rapidly until we get some new industry, something entirely new that revitalizes our economy and makes us want to spend.

Senator PROXMIRE. Let me ask this: Why is this such an anemic performance? I think we can do better and there are all kinds of things to stimulate our economy in education and research. But actually 3.5 percent is substantial growth. We are by far the world's most developed nation. As you point out in your paper, you cannot compare us with Germany and Italy and France and it is ridiculous to do so.

They are going to grow faster in the next 10 years. They are bound to. They will also have worse inflation and so on.

But if you take the fact that we have grown at 3.5 percent and not try to compare it with this very high level, and then recognize that we are now moving into a very exciting period when we are emphasizing research so heavily—the amount of Government and private money going into research has been terrific, especially in the space effort—the consequences of this are likely to be a more dynamic economy than we have had in the past.

It seems to me the feeling of pessimism that persuades us in a time of relative prosperity that we need a substantial tax cut, varying from \$6 to \$18 billion, depending on the witness, it seems to me is committing our reserves when the situation does not justify it.

Mr. LIVINGSTON. I don't think our performance has been anemic. As a matter of fact, we have had an 8 percent increase in our total output of goods and services in the last year.

Our performance is only anemic in relation to what economists say we ought to do, in relation to the quantification of the full use of our resources.

I happen to believe, and I know this is hardhearted to say, that there are times when you have to have slack and when some people have to be unemployed. When you reduce carloadings on the railroads, the result is unemployment. When you use plastics instead of steel, it means that the steel companies do not sell as much steel.

This process is going on at a very rapid rate in this country. It may be this is the best possible performance we can get, except in my dealings and talking with business men I do know that the tax structure itself, because of the progressivity of the rates, and because of the gimmicks—gimmicks such as stock options for business executives

and capital gains rates. As long as it is more profitable to find out ways to save on taxes, I think you are taking away some of the best moneymaking minds from the actual production of goods and services.

This is all I am trying to say.

Senator PROXMIRE. Thank you very much. My time is up.

Representative CURTIS. I do want to say this, Mr. Livingston: I read your paper with great interest and what you have just said I could not agree with more. It is a theme I have been trying to preach for years, unsuccessfully, I might say, apparently.

Mr. LIVINGSTON. We are common spirits in that.

Representative CURTIS. We certainly are.

I have described our tax structure as like these pinball machines. There is more time spent getting into the 25 slot or zero slot than in ringing the bell in solving economic problems. That is why I want tax reform.

Mr. Langum, I was really interested in some of your charts and figures and this approach. I am going to do a lot of thinking about what you have here.

One of the points on chart 4, rate of return on net worth, this is something I have been after for some time.

Let me ask you this: This is First National City Bank data. How did they go about getting their net worth, because it is a difficult thing to get? Do you know how they computed this?

Mr. LANGUM. Yes; I believe so. They are using, of course, the balance sheet figures in the annual reports to shareholders of the companies.

In net worth or what they call sometimes net book assets, they have common stock equity.

Representative CURTIS. At what value?

Mr. LANGUM. At book value.

In addition, preferred stock. So it is total equity including both the common equity and the preferred stock equity and then they take the ratio of net income as reported to that total net worth.

Representative CURTIS. Would this net worth, do you think, be realistic? Suppose one of these corporations were sold and the net worth on the book was \$10 million, would it be apt to get a price of \$15?

Mr. LANGUM. I think for many successful corporations in recent years that in such a transaction the market price would be above the book figures. One way of looking at that is that the market prices of common stock typically for successful firms are far, far above book value per share.

Another way of looking at this and understanding it is that given the inflation that we have had, the book figures are recorded in dollars of different value. In other words, the basic unit of measurement has changed. So that if we sort of repriced net worth and expressed it in current dollars, that statement of net worth would be higher than the book figures and the rate of return would be lower.

Representative CURTIS. The reason I am so glad to get this much is that I have always looked at the figures of corporate profits, and I have been disturbed about the fact that they seemed to have leveled off.

I was even more disturbed because I felt that the profits as a percentage, the rate of return to the amount of money that had been plowed into that enterprise would be even lower.

Your chart here seems to indicate that it is not quite as bad as I had thought.

Mr. LANGUM. That is right. And not as bad as is frequently thought to be the case in many business circles. I do believe, as I said in my testimony, there is a profit squeeze. Businessmen are in a real hard race between cost and sales and in turn, between income and capital invested. But the historical figures, this decline from 1947 to 1961, just simply do not indicate the real profit situation.

Representative CURTIS. The other thing that relates to this is this business of turnover of capital assets and replacement. I had felt that post-World War II inflation, because of the impact of inflation on the corporate tax, had amounted to a capital levy.

I am not sure that it caused as much damage as I thought that it would. But if you follow what I mean, take the telephone company, they have a telephone pole that they put in the ground for a hundred dollars or whatever it is, then they replace it 10 years later and it costs \$200 for the same identical thing. They don't care about the dollar. They want the telephone pole in order to stay in business.

Let us take it another way, they would only be allowed to set aside \$100 on their depreciable asset and then they have to spend \$200. This means they would have to dig up another hundred somewhere else.

I have never seen a study in depth made of the impact of inflation on capital investment as it was affected through our tax structure.

I have felt that it has been a real one. I have seen it come out in this way. Where businessmen have come before the Ways and Means Committee and asked for the LIFO formula instead of FIFO on inventory.

I have never seen any studies made on the inflationary effect on depreciable capital assets comparable to inventory.

Mr. LANGUM. That is a very important point. Some studies have been made on that. I have made those myself in the case of numerous utilities and the American Accounting Association has formally prepared studies on this.

The problem has two aspects. First of all, without any doubt in my judgment after inflation, particularly in the earlier postwar years, that depreciation charges per books understated the cost of plant consumed, and hence overstated the reported profit figures.

That was widely noted at the time in business discussions of profits, and the point was quite right. Parenthetically now we should not use those overstated profits as a measure of where we ought to be.

The other part is this, however. Many corporations have had substantial retained earnings, and beyond that this major rise in depreciation accruals and hence cash flow. So that many corporations have been in this situation; I believe, that the reported earnings and the reported rate of return figures also were really overstated, particularly earlier in the postwar period. But they were not really hurt because the money was coming in, although stated in other forms, to cover the full cost of plant consumed and replaced, except for the point that the reported income was first taxed as income even though the costs were understated.

So it is a complex problem. There is no doubt that many firms, many utilities are in this situation, with heavy plant investment and low retained earnings.

There has been a real capital levy in effect.

Representative CURTIS. I appreciate that. There is one other point I wanted to make. I just want to throw it out. It seems to me there is an economic phenomenon occurring today and it has been gradually moving in, resulting from what I regard as very rapid technological advancement in our society which it seems to me is real growth.

There is where I differ with Mr. Livingston; this is not an economic situation. I refer to statistics which show that 25 percent of the goods and services on the market today available to the consumer were unknown 5 years ago, and things like that.

In this business of depreciation we set up our tax laws to relate to new machinery and equipment worn out. But the economic phenomena today is obsolescence rather than wearing out. This has been the underlying reason for these new schedules. We always used the term "useful life" in the tax law, but only a big company like the telephone company had the accountants and engineers who could come in to establish useful life that related to obsolescence.

The bulk of our industries never could get by the Bureau of Internal Revenue in getting their capital assets depreciated before they wore out.

The question I am coming to is this. I suspect that our capital assets turn over a lot more rapidly today than ever before.

Back in the 1920's or 1930's I suspect that when they built plants they could count on their being useful and available and not obsolete as compared to today—I was talking to Monsanto Chemical and I think my figures are right; they said that 90 percent of their sales today are of products that were not even in existence in 1950.

Knowing the kind of capital equipment necessary to produce chemicals the 1950 capital assets are largely junk. It is obsolete. Would you comment on that and also the general idea.

Are there studies being made into capital plant turnover today?

Mr. LANGUM. Yes; again that is an important point. We might look at it this way.

First of all, in terms of the key concepts. As I see it, the ultimate measurement of corporate profitability that encompasses all the factors is rate of return on total capital, total income available for capital in ratio to total debt and total preferred and total common equity.

That rate of return on total capital is determined in the first step by two other things. First, the overall profit margin. The ratio of that income available for capital to total corporate sales.

Second, by the turnover of that capital, by the ratio of sales to capital. In other words, a company could have and companies have had this, a lower profit margin but a higher turnover of capital in relation to sales with the two offsetting or more than offsetting so that the actual rate of return on invested capital is not impaired.

This matter of obsolescence, and more generally modernization and cost cutting in expenditures on plant and equipment by business is extremely important.

That is one of the reasons why I put in this little concept of net cash earnings and for other reasons as well, to point up the sheer financing of plant and equipment expenditures.

Many businesses are in this situation. They have to make new plant and equipment spending, not particularly for expansion of capacity but to keep alive, to keep in business. They have to keep spending on new plant and new techniques and new equipment to try to offset rising employment costs and hold unit costs down and yet these expenditures that are in a sense almost current costs are capitalized and not charged off on the income account.

We are up against some new situations here where old concepts are not quite the right ones. Certainly we need to know what we are saying when we talk about these concepts. So that the more rapid obsolescence of plant and equipment, the stepped-up pace of technological progress and also, I think, in a technical sense a greater rate of capital turnover are important factors.

Representative CURTIS. Thank you.

Senator PROXMIRE. I would like to ask Mr. Rutenberg: You discuss the position of the Commission on Money and Credit and your own position.

Do I understand correctly that there were two or three basic proposals. One, to improve automatic stabilizers. Two, to provide for a greater discretionary fiscal opportunity for the administration.

Was there a third, a permanent tax reform?

Mr. RUTTENBERG. In the Commission report.

Senator PROXMIRE. Or would that be included in the automatic stabilizer?

Mr. RUTTENBERG. The Commission on Money and Credit carefully avoided going into the issue of the specifics of tax reform. But it does say, there is a very small part of its report which talks in general terms about the need for reform, the need for basic change.

They said that this was an area that went beyond the original assignment of the Commission and therefore, they would not go into it in detail.

Senator PROXMIRE. Is it your position that we need improvement in the automatic stabilizers such as unemployment compensation and social security as No. 1.

No. 2, I am sure that you advocate the provisions for stepped-up discretion for the President to provide public works and tax cuts at his discretion.

Mr. RUTTENBERG. Yes.

Senator PROXMIRE. And three, a basic permanent reduction in taxes; is that right?

Mr. RUTTENBERG. A basic permanent reform of the tax structure. I would not necessarily put it in terms of a net reduction in revenue.

Senator PROXMIRE. You are also calling for a quick, immediate reduction of \$5 or \$6 billion.

Mr. RUTTENBERG. Five billion dollars concentrated in one quarter which has an annual impact of substantially greater than that. For the short run.

Senator PROXMIRE. If you get into that, supposing Congress passed that to take effect September 1 for 3 months? Then business is good but it could be better. There are still 4½ or 5 percent of the work force unemployed. Congress is just going to have to stick with that, are they not?

Mr. RUTTENBERG. Stick with what?

Senator PROXMIRE. With the \$5 billion quarterly of \$20 billion annual tax reduction.

Mr. RUTTENBERG. Of course, as the proposal is, as I have made it and suggested, when Congress would reconvene on January 3, 4, or 5 of 1963, the tax rates that exist as of today would be back in existence then and the Congress would then take a fresh look at the problem. At that point in time I would hope that an emergency stabilizing type of tax cut would no longer be needed.

But at that point the Congress could take then a fresh longterm look at the problems which you have been interested in for many years, namely, the closing of tax loopholes, and the whole host of areas where through tax evasion and tax avoidance so that the income tax base against which these very high rates that everybody now professes to be against never apply.

People don't pay these rates. Anybody that pays these rates above 60 or 65 percent just has bad legal advice.

Senator PROXMIRE. Would this be a \$10 a week cut for every taxpayer in effect? Wasn't this the basic AFL-CIO proposal?

Mr. RUTTENBERG. This was the proposal.

Senator PROXMIRE. For 10 weeks?

Mr. RUTTENBERG. That is right. For a total of \$100.

Senator PROXMIRE. Have you made a Katona-type study or Gallup poll study to determine how much of this particular kind of tax cut, which is quite different, would be spent?

If somebody expects \$10 a week for 10 weeks they would be pretty foolish to buy a home or a car or to make any substantial purchase. There might be a tendency for many people to feel they better save it.

Mr. RUTTENBERG. It depends on what you are relating this type of a \$10 a week for 10 weeks tax cut to. If it is related to the kind of tax cut that Congresswoman Griffiths was talking about, namely, \$100 tax cut spent over 52 weeks, I dare say the impact upon the economy of a \$10 a week tax cut as I recommended as against an impact of \$2 a week tax cut would be considerably different.

I dare say that one of the important considerations in terms of a tax cut for stabilizing reasons, one of the important factors is that it ought to hit very hard and very quick at stimulating economic activity.

You don't do this by spreading \$1.50 or \$1.75 over 52 weeks.

Senator PROXMIRE. What happened with the veterans bonus that was paid after World War I?

Mr. RUTTENBERG. What happened to it? I was one of the participants in this in a State bonus in the State of Pennsylvania, my home, and I daresay I, like a lot of other GI's, spent it very quickly.

This was something that came to us in a one lump check.

Senator PROXMIRE. Was a study made so that we know what the overall effect was?

Mr. LIVINGSTON. There was a bump in spending.

Senator PROXMIRE. Was 75 percent spent within half a year?

Mr. RUTTENBERG. I don't think anybody can estimate this. It is very difficult. We can look at it this way. People with incomes generally in the neighborhood of \$5,000 to \$6,000 a year or less, gross income, tend, according to the survey of consumer finances, to spend more than they earn.

This is the sheer facts of life. As you get up to the people with incomes of \$50,000 or more, obviously they are saving substantially more.

Senator PROXMIRE. When you get into that a little, you find one of the reasons they do require steady income to buy is that every durable good they buy they buy on time.

Mr. RUTTENBERG. Certainly.

Senator PROXMIRE. Two-thirds or three-quarters of automobiles are bought on time. Every house is bought on time. When you are analyzing a hundred dollar tax cut, maybe they spend it but again, it is the kind of spending that would not have the same stimulation as some other kind of a tax cut.

Mr. RUTTENBERG. I am not so sure about that, Senator. If you had a \$10 a week tax cut for 10 weeks, it is conceivable to me that they would use it to pay off some indebtedness.

Senator PROXMIRE. Sure, that's exactly the point but then what happens?

Mr. RUTTENBERG. At which point they are then back into the same position that they have normally been in where they tend to spend more than they earn and they will now be able to commit themselves to expenditure for items that are substantially greater in amounts than the \$10 a week tax cut.

But because they have been able to pay off some of their indebtedness they are able to put themselves further into debt in terms of what the American system, it seems to me, has always done.

This is the sheer facts of life whether we like it or not. I think this is the way people live. They live from hand to mouth. They live to buy the things they want.

Senator PROXMIRE. Don't you think you would build up a tremendous popular insistence on continuing this benefit?

Mr. RUTTENBERG. In continuing the benefit?

Senator PROXMIRE. In continuing the lower tax rate. People who had their incomes increased this much, their take-home pay increased, temporarily.

Mr. RUTTENBERG. Obviously, if you cut their taxes to zero they would love to stay there continually.

Senator PROXMIRE. I am thinking of it in terms of politics. We have responsibility, practically all Members of Congress feel they have to eventually balance the budget and have some sense of responsibility toward meeting the expenditures and the rapidly rising expenditures we have.

If we are going to put ourselves in a position to have a \$5 billion tax cut in 3 months and confront the political reality of constituents who want it and need it then you better have it now. Today the tax cut is not popular on the basis of the surveys. But once you give it, try to take it away. That's likely to be something else.

Dr. Katona's survey conceded that taxpayers didn't want an income tax cut but a property tax cut. The Gallup poll indicated the same thing.

Mr. RUTTENBERG. It is not the province of the Congress of the United States to do anything about property taxes but it is in the income tax.

Senator PROXMIRE. Every single income group which received over \$3,000 a year in the Katona Poll opposed a tax cut. Those who had incomes of less than \$3,000 wanted a tax cut. I sent out and got documentation to show that two-thirds of those incomes under \$3,000 a year paid no income taxes.

What they do pay are property taxes or sales taxes or both and they want a property tax cut, or a sales tax cut. These are the kind of taxes they are talking about. The question was, would it be a good idea to have a tax cut or reduce taxes without specifying?

Mr. RUTTENBERG. Aren't we really begging the question, though. Maybe you disagree with the fundamental underlying concepts.

The underlying concept is that here is the American economy that started out early in 1962 with the expectation of having an annual rate of GNP of \$570 billion, having an annual GNP in the second quarter of 1962 of \$565 and \$570 billion.

Senator PROXMIRE. We failed to live up to our super expectations. But we had the biggest increase in the peacetime history of the Nation.

Mr. RUTTENBERG. But instead of getting to \$565 or \$570 billion we are at \$552. Instead of being on the way toward a 5-percent-or-less rate of unemployment by the end of 1962 we are on our way to a 6 percent or greater level of unemployment.

I say the issue is what does the Congress of the United States, what does the Executive do, faced with a situation in which at least 5.3 percent of the labor force in unemployed, where more than likely the rate of unemployment now is much closer, if you take the part-time job and turn it into the equivalent full-time employment, and take the failure of the labor force to grow, a rate of 4 percent, with plant lying idle, most industries are not booming. Faced with that problem we will either have a worse decline in economic activity or we might be able to inject discretionary fiscal policy, emergency tax cutting as a means of stimulating this activity.

I think this has to be separate and distinct from the longrun problem of the meeting the Government needs for expenditures which you and I and everybody else is for, I hope.

Better educational facilities: I think our economy can't adequately grow unless we do something about the shortage above high school level in education. We need to do many things in these areas.

This is no reason why we should use that as an excuse to let the economy drift further down into the doldrums in 1962.

Senator PROXMIRE. It is very interesting and entirely appropriate and proper that you are concerned with unemployment and I am deeply concerned with it. This has distorted our whole picture.

We have 5½ percent unemployed for 7 months. It is a very depressing statistic. But because of this, I would say this is the overwhelming reason we are talking about a tax cut today and have in recent weeks. I think what we have to recognize is that this is not the only approach. I think there are other approaches, including the supply side of the labor force.

I have said this before but I would say it again. A very large proportion of those unemployed are young people who can't get jobs because they don't have skills. One of the reasons is because they drop out of school, they leave school too early, and admittedly this is outside of the jurisdiction of the Federal Government.

I think we should persuade the States to lift the age of leaving schools, to provide education programs, to do what they can to prepare these young people for the jobs that are not filled now.

That is one aspect. This involves well over a million people who are unemployed and under 20. The second aspect as Chairman Heller told us, is that one of the reasons the work force had not grown, and it was the only specific reason he gave, was because of the earlier retirement period on social security.

They can now retire at 62 instead of 65. He didn't quantify this but I think there may be a substantial number involved. I can tell you from having gone to hundreds of plant gates in my State that this is something our working people want very much, an opportunity to retire at 60 but to do so they would have to accept a lower benefit.

You can't increase social security tax very much, I agree. It is very high now. There is no reason why they can't have the opportunity to retire earlier if they wish to do so.

These two things, I think, are one kind of approach to this situation. While recognizing that we have a terrific challenge from the Soviet Union we have to do all we can to build up our economy, we have not grown enough, that we have a long way to go, still I think we could constructively look at limiting our labor force.

I am not one of those who is ready to die when the labor unions say they are interested in a 35-hour week. I am against a 35-hour week. I think there is not much excuse for people working less than 40 hours. But there is nothing sacred about 40 hours.

We had a 60-hour week and a 48-hour week. If labor unions want to talk about it and negotiate down to 38 hours or 37 hours and gradually work toward a 35-hour week, if people choose leisure instead of higher income, I think this is a perfectly legitimate consideration.

The thing is that we have gotten frozen on the notion that we have to have virtually full employment of a labor force of people between the ages of 14 and 62 or 68, and we have not recognized that in the kind of mature and developed economy that we have with a terrifically strong surge of research and automation that it is perfectly possible for us to achieve wonderful growth and to continue to lead the world without being frozen in this labor force concept we have now.

Mr. RUTTENBERG. I can comment on this if time permits. I agree with you fully that we have a very serious problem of training our youth as they come up. We have a very serious problem of what to do about earlier retirement.

Obviously, I think people want to retire earlier. People are living longer than they used to. This creates the problem who assumes the responsibility for the leisure time of the individuals who retire at 60 or 62.

But aside from these problems, I would like to call your attention to the fact that if one looks at the labor force problems of the last 7 or 8 years, it is true that the number of individuals 14 to 19, their participation rate in the labor force has declined.

It is also true that the participation rate, the number of individuals 62 years of age and over has also declined in the labor force.

This is a partial explanation for the failure of the labor force to grow, but only a partial explanation. It has been my good fortune to be a member of the President's Committee to appraise employment

and unemployment statistics of which Dr. Gordon of the University of California is Chairman, in looking at this problem, the participation of the labor force between 20 and 62 has gone down.

Senator PROXMIRE. Including women?

Mr. RUTTENBERG. Including married women.

Senator PROXMIRE. Maybe from a value standpoint it is better that they stay in the home with their children in some cases.

Mr. RUTTENBERG. But the participation rates of males 20 to 62 has as well gone down over this period. If you take 1955 and come up to date. All I am saying is that the answer to the problem of the failure of the labor force to grow does not rest exclusively in the issue of the youth staying in school longer or the older folks retiring earlier.

Senator PROXMIRE. That is right. We have 3 percent of our married males out of work.

Mr. RUTTENBERG. 4.4 percent adult males.

Senator PROXMIRE. The figure I had was different. But it is too high whatever it is. I think it is something we should be concerned about. But it is far less than the overall unemployment number. I have just a couple of more questions to ask of the other gentleman.

I was delighted to see your statement, Mr. Ruttenberg, on page 7 that action to tighten money would simply destroy the beneficial effects of tax reductions.

I agree with you 100 percent. I think this is very useful. I think one definite thrust of at least part of us on this panel and these hearings has been to try to counteract the otherwise overwhelming tendency on the part of many economists, commentators, and leaders that what we need are lower taxes and higher interest rates.

You are putting on the brakes and stepping on the gas at the same time. Dr. Langum, your chart on page 6 shows that plant and equipment outlays in relationship to cash earnings have been dropping and dropping fairly steadily.

They are now the lowest in any year that you have listed here and perhaps the lowest in many, many years. This represents, in my judgment, a perfectly devastating case against the investment credit.

That proposal would open up a new loophole. Business doesn't seem to want it. Your figures show they don't need it. Your figures don't reflect the new depreciation revision which will increase the cash flow and decrease the ratio of plant and equipment outlays to cash earnings.

So it would seem to me on the basis of the statistics you have, the case for the investment credit is pretty hard to sustain.

Mr. LANGUM. I think we have to consider several things on this. It is true that the ratio of plant and equipment outlays to cash earnings has declined for some years and in the current recovery, plant and equipment has not kept pace with the rising cash flow.

Senator PROXMIRE. Do you have any very recent figure?

Mr. LANGUM. Not a recent figure in terms of this measurement. But when we consider what has happened to corporate profits, the total corporate profits after taxes in the first quarter of 1961 with 20.3 billion and with 25.6 billion in the first quarter of 1961, up a bit to about 26 in the second and third quarters.

Corresponding to that plant and equipment outlays have moved up but are lagging. In the first quarter of 1961, the SEC Commerce

series on plant equipment, was 33.9 billion and the estimated figure for the second quarter of 1962 was about 37 billion.

I think we have to look at these figures by years.

Senator PROXMIRE. McGraw-Hill estimated that they expected it to go up to 39 billion.

Mr. LIVINGSTON. Thirty-eight.

Senator PROXMIRE. Anyway, a relatively modest increase. In view of the billion and a half that is going to be an increment to the profit situation next year, it would seem that this ratio is going to drop further next year.

This investment credit proposal is very controversial. I think there is some chance we can beat it in the Senate. It seems to me you are giving us ammunition for it.

Mr. LANGUM. I think several things affect plant and equipment outlay decisions. One factor that does influence it is the amount of cash earnings. There is something else, too. That is the needs and views of business for additional capacity and equipment and the recent timing of corporate plant and equipment expenditures.

Senator PROXMIRE. McGraw-Hill after a survey found that this would only increase it \$300 million a year. The cost in lost revenues would be a billion dollars. The Wall Street Journal in a survey queried 68 of the biggest firms in the country and found only one that would change its investment policies because of this advantage.

Mr. LANGUM. I would give weight to those surveys. They are well done. However, there are other factors involved that tie into the particular point I was about to make.

In 1955 the American economy moved up sharply over the recession year of 1954 largely because of the automobiles and housing.

In 1956 and 1957 American business went on a major plant and equipment outlay spree. The fact is that was an era when some corporate executives got so enamored about growth in the economy that they were making speeches about GNP in 1975 and the year 2000 but forgot about the extremely important years they had to live in 1958, 1959, and 1960.

Business overdid it on plant and equipment spending in 1956-57. That was one of the reasons for the emergencies of overcapacity. So that having overdone it, these ratios are somewhat lower in more recent years, in my judgment, for that reason.

We are at this stage in time, it seems to me. We have had several years where the whole private durable sector in real terms has moved sideways. Plant and equipment, residential construction, consumer spending on automobiles and other durables.

This is without precedent in the history of our economy. I think that is partly because we overdid it in 1955 and 1956 and 1957. But now I think time is starting to be on our side. Things wear out and become obsolete.

I think we are in a situation on plant and equipment where businessmen, with some renewed confidence, with less worry about things they should not be worried about so much, with looking ahead to future markets and expansion of markets, I think we have the ingredients here for a spark for real expansion and growth.

In these circumstances, even though there is not the immediate comparative problem as you rightly point out from these figures, I

think both the depreciation reform and a tax cut are useful in adding to that spark and interesting businessmen.

I would venture the opinion, even though I highly respect those surveys and would give real weight to them, that surveys of businessmen, economists, and everybody else at times have been very wrong.

The surveys of businessmen about future plans in 1957 in terms of the general outlook of the economy were very wrong. I think at this stage many businessmen are a little too much concerned and too much worried and I think a spark, something that will light things up and get things moving in this area is desirable.

Senator PROXMIRE. They say this is not what they want. It is a giveaway. It means we have made another loophole in the law.

You can extend this to other persons. If you let corporations do this, why not let individuals do it, and so forth. The bill as it passed the Senate committee, as I understand it, even included furniture in motels as plant and equipment.

Mr. LIVINGSTON. Are newspapermen allowed to take credit for their typewriters?

Senator PROXMIRE. Maybe they ought to take credit for what ability they have. You know that wears out; they buy education and so forth.

Mr. LANGUM. It seems to me that the tax credit is desirable. I think that or any other proposal must be put in terms of proper perspective in a group of things or package of proposals.

I think certainly that basic tax reforms along the lines Mr. Livingston was talking about are very much more important than just a tax cut alone and certainly any hurry to cut taxes now because of an alleged recession.

Senator PROXMIRE. That was a Senate rollday, so I have to go. Before I yield to Congressman Curtis, I did want to ask Dr. Hagedorn about his statement, if he could present a statement for the record of any studies on the exodus of capital because of a change in interest rates.

We have asked others who advocate this policy to prove it and they have not been able to do it. Statements by Chairman Martin and other economists indicate quite the contrary, that we are not and are unlikely to lose either gold or much capital as a result of a differential in interest rates.

Furthermore, and you can put this in the record later, isn't it a fool's errand to raise this country's interest rates, not only because of the facts adduced by Congressman Reuss but other countries have a reason to hike theirs and maintain the differential.

They have a shortage of labor. They have a serious inflationary problem. We have neither of those things. Their interest rates are bound to be higher. They also have less political stability than we have.

Finally, there is the argument that these countries have no incentive for bankrupting this country or creating a big drain of gold.

It is within the power of our Government to correct this adverse balance, because the basic cause for the adverse balance of payments is our foreign and military aid programs which help pull these other countries' chestnuts out of the fire.

It would be insane for any of these other countries that have these holdings to precipitate a run on this country under these circumstances, when we have our troops over there protecting them and giving them assistance including military assistance.

I can't see any expectation that there is a real threat that we are going to suffer seriously because of the balance of payments situation. I hate to ask and run but you can put your answer into the record.

I would appreciate it very, very much. You have made many able representations to this committee and others and I am sure if there is a good answer to this you may have it.

Mr. HAGEDORN. Before you do run, Senator, may I say I simply didn't want to say that this was an ominous threat hanging over our heads at this moment. I tried to choose language which would not create that impression.

I said, a situation of this type is not necessarily dangerous or inherently disastrous. I was simply pointing out that when you are in the situation of being a banker for other parts of the world that you don't have the degree of freedom that you have when you are not in that situation.

As I said in answer to Congressman Reuss, certainly I won't expect that we should look at all types of interest rates for all kinds of loans in all parts of the world and then take the largest of those figures and match that as the short-term interest rate.

Senator PROXMIRE. England, Holland, and Switzerland are all lower than ours.

Mr. HAGEDORN. Certainly you can't do it that mechanically. It is equally true that we can't forget about the necessity for maintaining some relationship between our interest rates and those abroad.

Perhaps I can clarify my position this way. I don't really think it is disastrous or ominous for us to have one deficit or even a series of deficits in our fiscal accounts. I don't think it is necessarily disastrous for us to have much easier money conditions for a short period.

What I think is dangerous is for us, in discussions of just this type, to come to the conclusion that the way to keep the country prosperous is always to turn to fiscal and monetary policy because that means we are going to turn to deficits to pull us out of whatever difficulties we have.

If we create that impression around the world and at home, that is the real danger. The real danger is that in meetings of this type we would come to that conclusion. That is what I have been trying to protest.

Senator PROXMIRE. I wish I could carry on. I have a 100 percent rolloff record so far and I am afraid I may lose it. Congressman Curtis will take over.

Representative CURTIS. Thank you very much, Senator, all I wanted to do was to pick up on the question of the civilian labor force which I think is one of the unique economic phenomena of today.

I have the tables back to 1929; 1962 will be the first time that the labor force in peacetime—the civilian labor force—has not increased.

As a matter of fact, since 1955 it has been increasing at the rate of a little less than a million a year. Before that period it had been increasing about 700,000. Even in the depression in the 1930's it continued to increase, although I want to put a caveat. One of the

staff tells me that before 1940 those figures are interpolations. But the figures that are put out by the Labor Department show a continued increase each year. This deserves real attention, I think.

In light of Senator Proxmire's speculation and also the speculation of Mr. Heller, I want to call attention to what is the cause of it. I regret to say that the figures do not indicate that it is in any particular age or sex group.

In the July 13, 1962, U.S. Department of Labor news in this table D, "Labor force participation rates, by age and sex, showing comparisons of second quarter averages from 1957 to 1962," shows the breakdown by age groups and by sex.

The very interesting thing is that there are two areas where there have been increases. One is "Female, 14 to 19." This is a real poser. Females from 55 to 64. That has been the biggest increase.

In every other bracket there has been a decrease. Every single one including the 25 to 54 male, which is the bulk of our work force declined from 97.2 to 97.1.

I had requested the chairman of the committee to have Dr. Ewan Clague as a witness next week, and he will be with us to go into some of this problem. He has reassured us that he has rechecked the methods of computing the employment and unemployment data and they have not changed and it is not in the compilation of these figures.

I raised the question, had someone been jockeying with the figures or had they changed their techniques. But apparently we have a new phenomenon that needs interpretation.

It has fallen on my shoulders to announce that we will adjourn and reconvene Monday morning at 10 o'clock and will hear the Central Director of the Banca del Lavoro of Rome and others and continue on Monday afternoon.

Thank you, gentlemen, for a very valuable contribution to our hearings.

(Whereupon, the committee recessed at 1 p.m., to reconvene Monday, August 13, 1962, at 10 a.m.)

STATE OF THE ECONOMY AND POLICIES FOR FULL EMPLOYMENT

MONDAY, AUGUST 13, 1962

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

The committee met at 10 a.m., pursuant to recess, in room AE-1, the Capitol, Hon. Wright Patman (chairman) presiding.

Present: Representatives Patman, Reuss, Griffiths, and Thomas B. Curtis; Senators Sparkman, Proxmire, and Bush.

Also present: Wm. Summers Johnson, executive director; John R. Stark, clerk; Hamilton D. Gewehr, research assistant.

PROCEEDINGS

Chairman PATMAN. The committee will please come to order. The committee has been engaged in a series of hearings on the state of the U.S. economy and on possible changes in policies of the U.S. Government, which would help us to achieve a higher rate of utilization of our labor force and our productive capacity, and also achieve a more rapid rate of economic growth.

Such improvements are desirable for obvious reasons. First, to raise the level of living of American families, many of whom have many unsatisfied needs and wants; and second, to be better able to help the underdeveloped nations of the free world, and to meet our other commitments to the defense and advancement of free and open societies.

Accordingly we would hope that any changes in policy or technique we might recommend, will be compatible with the economic policies of the other free world nations.

This morning we are honored to have with us a panel of distinguished experts from three European nations. Prof. Alan Day, professor of economics, London School of Economics, London, England; Dr. Ettore Lolli, executive vice president, Banca Nazionale del Lavoro, Rome, Italy; Prof. Jurg Niehans, professor of economics, University of Zurich, Switzerland.

We are happy to have you with us. Our usual procedure is to have each member of the panel make an opening statement. Then the members of the committee put questions to the panel. Each member is limited to a 10-minute questioning period, in rotation. The committee always invites free expression on the part of the witnesses and we do so now.

A panelist may reserve comment on any question asked. Our usual procedure, also, is to have the panelists begin in alphabetical order of

their names. Prof. Day, if you are ready, you may proceed in your own way.

**STATEMENT OF PROF. ALAN DAY, PROFESSOR OF ECONOMICS,
LONDON SCHOOL OF ECONOMICS**

Mr. DAY. Mr. Chairman and gentlemen, I am very happy and honored to have this opportunity to appear before the Joint Economic Committee. In this statement, I propose to discuss the economic situation of the United States and, in particular, the implications of the present situation where economic activity appears to be slowing down at less than full employment levels, but with a continuing balance-of-payments problem.

Despite the immense wealth and prosperity of the United States, there have been, in the past decade, increasing signs of certain weaknesses in her economic position. None of these appears to be insoluble, and since some of them are somewhat similar to weaknesses that have existed in the British economy for an even longer period of time, it does seem that British experience can be helpful in the determination of the strategy of American economic policy.

It cannot, of course, be claimed that Britain has herself solved these problems, largely deriving from her early industrialization and from the widespread international use of her own national currency. But it is sensible to try to prevent the United States from making mistakes which have long caused difficulties for Britain.

In particular, I would like to mention two: The first is that of the complacency of a country which has led the world in industrial techniques and productivity—as Britain did in much of the 19th century and as the United States does now. This complacency tolerates a slow growth of productivity in comparison with other countries, such as Britain has tolerated through the 20th century and the United States is in danger of tolerating now. The second mistake is that of giving undue importance in the determination of economic policies to the maintenance of the international status of one's national currency. Repeatedly since the First World War, Britain has restrained domestic expansion in order to maintain international confidence in sterling. Until recently, the strength of the dollar has been such that no such problem has arisen for the United States. But now, the same problem has arisen here. The maintenance of the international use of one's national currency as a reserve and trading currency, in the way that sterling and dollars are used today, can impose significant restraints on a country's domestic freedom of action.

In the past decade, the U.S. economy has experienced a slower growth of industrial production and of industrial productivity per man-hour than any other major country, in either the Western World or the Soviet bloc—with a single exception, namely the United Kingdom. The growth which has taken place has been marked by a series of minor trade cycles.

It has been accompanied by a modest degree of inflation of consumer prices; the rise has been rather under 14 percent in 10 years, which is considerably slower than most European countries and indeed is probably not excessive in view of the failure of the index to take adequate account of quality improvements and in view of the almost inevitable

rise in the price of services as rising prosperity leads to rising wages. The American economy has, through most of the last decade, experienced relatively high levels of unemployment, which showed a trend increase through the decade. It is an unnecessary waste of national resources and probably an unnecessary cause of personal suffering, that even in the recent recovery, unemployment was still well over 5 percent of the labor force.

All of these domestic difficulties would almost certainly be relieved by a more expansionary domestic economic policy, designed to run the economy with an average level of unemployment somewhat nearer to those which are regarded as satisfactory in Western Europe. Perhaps an average of 3 to 3½ percent over the swing of the trade cycle might be regarded as a satisfactory target.

Such a policy would make considerably fuller use of the Nation's present productive resources. It would also make possible an increase in investment to increase future productive capacity at a higher rate—and by increasing present capacity utilization, it would make such an increase in investment attractive to businessmen.

If a faster growth of capacity can be achieved, the problem of the swing of the trade cycle would also be reduced. No country has solved the problem of achieving perfectly steady growth and it is probably inevitable that there should be some fluctuations from year to year, connected with things such as changes of inventories and the inability of economic forecasters to provide perfect forecasts to the policy-makers.

But European experience suggests that these fluctuations are much less disturbing if they take place around a rapidly rising trend than around a slow upward trend of production and incomes. If they are around a rapid trend, as has happened in most of the continental European countries, the periods of setback are merely periods of relatively slowly rising output; if they are around a slow trend, the setbacks involve longish periods of stagnation of output, as in Britain, or actual declines, as in the United States.

At the same time, there is little evidence to suggest that a reduction of the average level of unemployment of the magnitude recommended here would have a significant effect on the rate of inflation in the United States. There can, indeed, be no doubt that the rate of increase of money incomes does tend to be the greater, the nearer an economy such as ours is working to full capacity. But this effect is probably relatively weak until an economy is quite close to full capacity operation, as Britain's is, but that of the United States is not.

In its effect on price inflation, it would almost certainly be offset by the fact that a faster rate of growth of output would permit faster rises in money incomes without causing any increase in the rate of inflation.

In the immediate situation facing the United States, it is clear that the above analysis implies that deliberate policies designed to encourage an expansion of demand are justified now. There is no doubt that the economic expansion which started early last year has been disappointing, as is indicated by the July unemployment figure of 5.3 percent of the labor force. Still more disturbing are the numerous indicators which suggest that little further expansion of demand or output is likely during the rest of this year. At best, output seems

likely to level out again in the latter part of this year; quite conceivably, there may be another minor setback in late 1962 or early 1963.

In these circumstances, with output currently perhaps \$30 to \$40 billion below what could be produced with an unemployment rate of 3 to 4 percent, and with the clear prospect of a widening gap between actual output and potential full capacity output as potential output increases as a result of rising productivity and a rising labor force, the need is for a sharp expansionary stimulus.

The question remains of the form which this stimulus should take. It could either be introduced by monetary measures or by fiscal measures; the latter could take the form either of tax reductions or of increases in Government expenditures.

In the present situation where a substantial and quickly operating stimulus is needed, the choice should be for tax cuts. The effect of increases in Government spending would be slow to operate, because of the lengthy legislative and administrative procedures. It is doubtful whether monetary measures, such as interest rate reductions, could have as large an effect as seems to be necessary. The important need is to act in time. If action is delayed until a downturn has started, the necessary measures will have to be all the stronger.

And it is clear from British experience, where fiscal measures have been used on many occasions since the war to influence the domestic situation, that tax changes do have a marked and relatively rapid effect in altering expenditures particularly by consumers.

It, therefore, seems to me most unfortunate if no decision is taken to reduce taxes substantially and immediately. It would be unfortunate in terms of the American domestic situation. It would also be unfortunate for the rest of the world, whose economic growth and prosperity is closely dependent on that of the United States. There is evidence to suggest that, in present circumstances, the prices received by the underdeveloped countries for their own material exports show a tendency to fall, unless production in the advanced countries as a whole is rising at around 5 percent a year.

If American production, which accounts for about two-fifths of the total, stagnates or declines, it is most unlikely that this average of 5 percent can be achieved, since it would imply phenomenally rapid expansion in the other industrial countries. Rather, the effect of a slowdown in the United States would be to slow down growth of production in the other industrial countries.

Certainly, I should expect that a new setback to American expansion would greatly reduce the chances of expansionary policies in the United Kingdom, because of our heavy dependence on import earnings from the North American market. It seems clear, then, that if nothing is done domestically in the United States, the effect will be further declines in primary product prices and a new upset to the precarious payments position of the underdeveloped countries, together with a slowing down of industrial expansion in Western Europe.

None of this would be in the interests of the free world. We have learned to run our economic system well enough to disprove the Marxian thesis of the inevitable capitalist crisis; we must now learn to demonstrate that it is also wrong to suppose that our economic system suffers from chronic anemia.

There appear to be two main arguments against a decision to take this expansionary domestic measure in the United States. One of them is wholly illogical and unjustified; the other does possess a certain logic, but it is still bad. The first argument is that a budget deficit must be avoided at practically any cost. The second argument is that domestic expansion would further weaken the international position of the dollar.

The budget deficit argument is wholly unjustified. It is difficult to understand why it still has such a stronghold, except on those people for whom all Government expenditure is wholly bad. Other transactors, such as industrial firms, are perfectly willing to run budget deficits and to increase their debt if the purpose is worthwhile.

Equally, there is no reason why the whole of Government spending should come out of current Government income; after all, much of it is devoted to strengthening the future of the country's economy, by building roads, providing education, and acquiring technical knowledge on matters of defense. And when the effect of an increased budget deficit would be to increase total spending in the country and so to use the whole of the Nation's productive resources instead of leaving many of them underutilized, the effects of the outworn and irrelevant dogma of balanced budgets is wholly to the bad.

The correct rule is to insure that the budget deficit is not so large as to increase demand to the point where there is overstrain on the Nation's capacity to produce. Of that, there is no current danger.

The second argument against increasing domestic expenditure, income, and output is that of the danger to the balance of payments. This argument has a certain logic, but is still not defensible. It can be developed in four possible ways. One is that expansion would reduce international confidence in the dollar. The second is that one of the ways of inducing expansion, namely reduction of interest rates, would increase the net capital outflow from the United States. The third is that expansion would increase American exports prices, and reduce the competitiveness of American exports. The fourth is that expansion would increase American demand for imports.

The first line of argument—that about confidence—is of relevance in a world where many people are not as sophisticated as one might hope. There are, indeed, many people who would believe that a budget deficit in the United States automatically implies that the dollar is suspect. As has been argued, the question of whether or not to have a deficit depends not on dogma, but on circumstances. But while many people are not so enlightened as to see this, the right policy is to carry out the correct domestic policies and at the same time to take other steps, which I shall consider later, in order to restore confidence.

Let us turn to the second question, that of the effect of interest rate reductions on capital movements. It is, in fact, true that a cut in American interest rates would almost certainly increase the net capital outflow, and this is strong reinforcement to the argument that domestic expansion should be encouraged by tax cuts rather than interest rate cuts. Already, the general level of interest rates, particularly on short-term paper, can be seen to be low in the United States compared with Europe, if account is taken of the choices effectively open to commercial operators.

Admittedly, official discount and Treasury bill rates in several continental countries, for example, Germany, Switzerland, Netherlands, are lower than in the United States, although in Britain they are higher. But the official rates in these continental countries are not as accurate as a guide to market rates open to commercial operators as in the United States, or Britain. In some cases, for example, Germany, the official rates cover a very narrow and rather unrepresentative market, and rates on prime commercial paper are significantly higher than in the United States.

In another case, Switzerland, access to the domestic market is partly restricted for foreigners. A better guide to the relationship of American and European rates is provided by the active market in Eurodollars, which are a means by which North American funds can be loaned to Europe at higher rates than are available domestically in North America, and without exchange risk.

A large volume of funds has been attracted to Europe by the higher rates available there; it appears that the major American source has been from banks in centers, notably New York, with extensive international connections and that banks and firms in other centers have made little use of other facilities.

If they were more widely used, the strain on the U.S. payments position from an outflow of short-term capital might greatly increase, precisely because of the interest rate differential in favor of Europe. At least it seems that it would therefore be unwise to cut rates sharply in the United States, unless European rates fell sharply.

The international capital market is now so unified that no country can, while allowing effective freedom of capital movements, safely allow its interest rates to be far out of line with those in other major centers. Moreover, it seems likely that for some time ahead, shortage of capital will keep European rates relatively high. Indeed, purely on balance-of-payments grounds, there is a case for arguing that American rates should be raised.

I must hasten to add that I would not begin to recommend this as a policy. But this is one way of highlighting one of the major dilemmas of policy in our present international currency system. This system, which finally became established with the restoration of convertibility at the end of 1958, is a restoration of the gold standard as we knew it in the 1920's and before the First World War.

The rules of this system are simple. Each country maintains fixed exchange rates with all other members; except in extreme circumstances, exchange rate charges, beyond very narrow margins, are ruled out.

In order to maintain balance-of-payments equilibrium, those countries find themselves in payments deficit which deficit improves contractionary domestic policies, including high interest rates which also serve as a palliative to the payments deficit by attracting foreign funds. Countries in payments surplus should introduce expansionary domestic policies, even to the point of inducing a degree of price inflation, although this prescription is rarely emphasized by proponents of the gold standard.

The virtues of this system include the maintenance of stable exchange rates and the simplicity of the basic rules. Its major disadvantage, which is well exemplified by the present U.S. situation and

by repeated British experience, is that it may tend to a conflict between the requirements of domestic and international equilibrium. At the moment, domestic considerations suggest that American policy should be expansionary.

But the deficit in the balance of payments suggests that the right policy, under gold standard rules, is one of domestic contraction. The dilemma is emphasized if one considers what would happen if expansionary policies were taken, as suggested above, and demand were increased by, say \$30 billion a year. Some of this demand would take the form of a rise of imports; the net effect would be less than this direct effect because the extra demand for foreigners' goods would raise their prosperity and so increase their demand for American goods; but on balance there can be little doubt that the net effect would be a sharp deterioration of the U.S. balance of payments. And if it should happen, though this seems unlikely, that the domestic expansion led to a faster rate of price rises, then the situation would be made all the worse by the reduction in the competitiveness of American exports.

Here, then, lies the source of the present dilemma about policy. Ultimately, there may be a way out, if the competitors of the United States, and Britain, inflate faster than we do so that their exports become less competitive and our balances of payments improve. But, at best, this is likely to prove a fairly lengthy process.

It is the logical basis of current British policy and would be the only logical basis for an American decision to accept a new period of domestic stagnation or a renewed minor recession. The immediate effect of such a policy is a waste of unemployed resources. The longrun effect may also be that the deflation may inhibit investment and innovation and so reduce the potentialities for future growth and for future competitiveness in world markets.

Short of changing the rules of the game and developing an international financial system with greater exchange rate flexibility, which I would consider the most desirable policy, there are still a few things that can be done. Some are already being done with considerable effect, such as the steps taken to reduce Government expenditures overseas.

In addition, action might be taken more forcibly to restrain speculative pressures on the dollar during the period of payments weakness. For example, that part of the gold reserves which is now tied as currency backing might be released; the U.S. reserves are still very large by world standards, in relation to deficits, and it would be worthwhile to take measures such as this to emphasize the fact. Again, the present system of swap agreements, whereby the United States and other countries have agreed to hold stipulated amounts of one another's currencies, might usefully be expanded.

Beyond this, it is desirable to take steps to deal with two interrelated problems which greatly exacerbate the difficulties of working the present gold-standard system. One is the system's dependence on the two key currencies—dollars and sterling—which serve to act as a substitute for gold, of which the amounts available for use as intercontinental reserves is now quite inadequate, taken alone. The other difficulty is that of the overall shortage of international liquidity.

The main disadvantages of the key currency system are that it provides a particular inhibition to the policies of the countries whose currencies are so used, because the risks of speculative withdrawals of funds are so great, that the system is weakest precisely at the times when it needs most strength, namely when one of these major countries is in payments difficulties.

This happens because, at such time, confidence in one or other key currency is reduced, and there is a flight either into the other or into gold. A good deal could be done to reduce these difficulties, if the United States and the United Kingdom were, preferably jointly, to offer a gold guarantee on foreign balances held with them, to reduce the risk of speculative movements of funds.

Beyond this, there is a pressing need for a further creation of international currency. The strongest evidence in favor of this need is the fact that very few countries ever act in a way that suggests that they regard their reserves as excessive, so following the rules for surplus countries under the gold standard, while many countries act in a way which is dictated by what they regard as the inadequacy of their reserves.

Most of the burden of the deficit is thereby thrown on the deficit countries. In simple terms, there is just not enough internationally acceptable money to go around. As a result, a deflationary bias is introduced into the world economy, as by the restrictive domestic policies in Britain and the danger that expansionary policies will not be followed in the United States.

This is happening now, at a time when the world payments system is in a sense nearer to equilibrium than at any time since the war—there are now almost no large-scale surplus or deficit countries. The danger is that the equilibrium will be at an unnecessarily low level. All of which is reinforced by the tendency for an increasing amount of gold to disappear into private hoards, so reducing the available supply of international currency at a time when the need is for an increase.

The right answer is then to create an international reserve currency in adequate quantities. Many proposals have been made along these lines. In an attenuated form, they were to be found in the revision of the IMF in September 1961, but the improvements then made are already proving quite inadequate.

In the absence of an adequate and effective plan along such lines, in place of the present tendency for policies to drift toward a more rigid gold standard orthodoxy, the dilemma for American policy will in time become even more acute.

On the other hand, the United States may find itself sliding farther down the path which has been followed by Britain—that of repeatedly following policies of deflation in order to maintain the strength and prestige of sterling at a fixed exchange rate, with the long-run effect of holding back our economic progress and allowing ourselves to be overtaken industrially by rivals with no better natural resources than we possess.

On the other hand, the United States might find itself with no sensible alternative to causing unnecessary restraint on the growth of the economics of the Western World, than raising the price of gold and thereby increasing the supply of international currency.

If this painful choice is to be avoided, action must be taken very soon to create adequate supplies of a new reserve currency, to use that currency to replace the international use of sterling and dollars for reserves, and, preferably, to introduce a greater degree of exchange rate flexibility.

Chairman PATMAN. Thank you, sir.

Our next witness will be Dr. Lolli. Dr. Lolli, we are glad to have you, sir.

**STATEMENT OF ETTORE LOLLI, EXECUTIVE VICE PRESIDENT,
BANCA NAZIONALE DEL LAVORO OF ITALY**

Mr. LOLLI. Mr. Chairman, members of the committee, it is a proof of the existing international cooperation that the United States, the outstanding teacher and example of economic growth and full employment, should now be asking some of its pupils and followers in Europe, to tell the United States what was so recently learned from it.

It is with humility, and as an act of appreciation for all that you did so generously to help us effectively, that I will try briefly to return a little of what we learned:

1. The difference in basic resources, stages of development, industrial organization, and other key factors between the United States and Europe are so great as to make their problems of economic growth fundamentally different.

A higher rate of growth can be achieved more easily if the starting level is lower; and so in the European countries, either destroyed by war or not so highly developed, industrially and economically, as the United States, it was relatively easier to achieve a higher rate of growth in the postwar years. But to the extent that there are some basic common factors I will try to mention them.

2. First, it must be clearly understood that after a certain stage of economic development in a so-called affluent society the problem is not of output, but of disposal of output.

The action of the Government, therefore, should aim not at increasing output but at disposing of a naturally increasing output.

As far as personal consumption goods are concerned, the Government cannot do much. Food consumption and durable and non-durable consumer-goods consumption has reached in the United States such levels that they practically cannot be increased further (except of course, inasmuch as population increases).

The Government might buy surplus production and distribute it abroad (as is done in a certain measure for food) but this is only a negligible palliative.

The Government's action, then, should be directed toward the disposal of the output of investment goods. This can be done by financing better housing, better roads, better schools, better public transport, better health services, and so forth.

This means, physically, a shift of employment patterns from output producing employment to output consuming employment.

3. The picture seems clear from a physical point of view. But what is to be done practically, in terms of monetary and fiscal policy?

I do not think that one should be afraid of a budget deficit within certain limits and provided that it is financed from savings with little resort to bank credit.

In the conditions described above, which are the U.S. conditions at present, the danger is not inflation, but deflation, in spite of any contrary appearance.

The immense productive capacity of U.S. industry lies, at the moment, for a large part idle because it is geared to produce goods whose supply is already abundant. The Government should help to deblock this situation by starting a large program of output consuming activities, even at the cost of a budget deficit, at the beginning. Later this deficit will be reduced or disappear automatically, as increased economic activity will bring in large revenues.

4. However, by so doing, the international position of the dollar, already weak, might be weakened even more. So one must turn now to this other aspect of the problem and if possible find a way of separating the effects of domestic fiscal policy from the international position of the dollar.

5. The dollar at present is weak on the international markets. This is a fact. But why is the dollar weak? Is its weakness justified?

In my opinion the weakness of the dollar is entirely artificial and stems exclusively from the fact that, in spite of any denials, many people believe that the dollar price for gold can and may be raised.

In this country I know that every President and administration since 1934 has said that without an act of Congress your price of gold cannot be changed and that they were all against a change in the price of gold.

In the minds of people who deal in your dollars the risk does exist. They feel that if you do not change the price of gold you may refuse to exchange gold for dollars. Many of those who hold your dollars feel that history teaches that all devaluations have been officially denied up to the last moment.

So denials are useless and perhaps even have a contrary effect. Since, on the other hand, there is no risk that the price of gold will be reduced by you below \$35 an ounce, it is natural that people should tend continuously to change some of their dollars into gold.

If this is true, the only way to strengthen the dollar is to dispel as definitely as possible, by some deeds, rather than mere denials, the fear that there will be an increase in the price of gold.

Until this fear about the increase of gold is definitely dispelled, any other attempt to correct the balance-of-payments situation will probably remain unsuccessful.

What could be done then? We must distinguish at this point the possibility of a devaluation of the dollar against all other currencies from the possibility of a general increase in the price of gold, leaving the exchange rates between currencies unchanged.

The first case, the devaluation of the dollar against all other currencies, is very unlikely to happen as a devaluation of the dollar would be followed almost automatically by similar devaluations of all other currencies.

However, even if we assume that it could happen and the United States were prepared to guarantee the present exchange rate to the foreign holders of dollars, this would not solve the problem. For it

would not eliminate the relative disadvantage of holding dollars in the (more likely) case of a general increase in the price of gold.

To dispel entirely and definitely the pressure on the dollar of the fears of a general increase in the price of gold, the United States should, in some practical way, guarantee the gold price of the foreign holdings of dollars.

There are several ways in which this could be done, and I submit, as an example, for your consideration the following way:

(a) The U.S. declares itself prepared to exchange foreign dollars, official and private, into special gold certificates for any amount, practically as it does now;

(b) The release of these special gold certificates, however, would not mean, as at present, a legal transfer of gold from the United States to the foreign buyer and therefore a decrease in the gold stock of the United States, but merely a legal promise by the U.S. Treasury, to buy them back for dollars at any moment, at the price of gold at the time of the purchase back by your Treasury.

Thus, for instance, if the price of gold were doubled, those certificates which could not in any case be changed into gold, would be, however, worth twice as much in dollars; and

(c) These gold certificates would, of course, not carry any interest.

6. What would be the cost of such a guarantee for the United States? None at all, and perhaps it could result in a net gain.

At present, official dollar holdings outside the United States amount to about \$11 billion; probably a little more. These figures are 1 or 2 months old. And another \$5 billion are held by private foreign banks.

In total, the dollar holdings outside the United States amount to about \$16 or \$18 billion. If all these dollars were converted into special gold certificates and then the price of gold were raised by 50 percent, the maximum cost of the guarantee for the United States would be \$8 billion, or less than 1.5 percent of the GNP.

But, of course, apart from the fact that the value of the gold held by the United States would be higher, foreign dollar holdings would never be entirely converted into special gold certificates, and anyway, if the United States really means to keep unchanged the price of gold, the guarantees would cost absolutely nothing.

It would, on the contrary, yield a profit, as dollar balances bear interest, whereas the special gold certificates would not carry any interest.

This proposed solution is not, of course, a panacea, but something for you to consider in dealing with the problem of confidence; and that is primarily the psychological and practical problem of the international position of the dollar.

In many ways gold is a symbol, and if that symbol can be effectively used more correctly to mirror the mighty strength of the United States and to restore confidence in that strength, I think it should be done not only for the good of your people, but for your close and loyal friends as well.

(Mr. Lolli submitted on August 22 a supplementary statement, which appears in the appendix at p. 982.)

Chairman PATMAN. Thank you, sir.

Prof. Jurg Niehans, professor of economics, University of Zurich, Switzerland. We are glad to have you, sir. You may proceed in your own way.

**STATEMENT OF JURG NIEHANS, PROFESSOR OF ECONOMICS,
UNIVERSITY OF ZURICH, SWITZERLAND**

Mr. NIEHANS. Mr. Chairman, it was with some hesitation that I accepted the invitation to comment on the state of the U.S. economy for my great respect for my American fellow economists makes it difficult for me to believe that I have to offer anything which they could not offer as well and perhaps better.

In any case, I shall concentrate on one or two aspects of the problem in which I can hope to have perhaps a fair chance to have some comparative advantage.

The American economy today has two overriding problems; one is the unsatisfactory rate of economic growth, the other is the deficit in the balance of payments, and the shaken confidence in the dollar.

None of these problems can be really solved without regard to the other. Whatever is done to balance international payments, there will be no confidence in the dollar if the domestic economy is stagnant.

If, on the other hand, domestic economic policy is at the expense of confidence in the dollar, the present international economic system would eventually collapse with dire consequences, for all Western economies, including the American one.

Unfortunately, the two ills have opposite cures. The classical prescriptions for stimulating the domestic economy would be easy money and easy taxes, implying possibly a budget deficit. The classical balance-of-payments policy, however, would be tight money and a stiff budget.

In such a dilemma there is obviously no perfect solution. The task of the policymaker is to devise an optimal compromise.

THE DIMINISHING AVAILABILITY OF MONETARY POLICY FOR DOMESTIC PURPOSES

The early 1950's witnessed a remarkable revival of monetary policy for domestic purposes, be it to combat inflation or to stimulate business. However, when most European currencies became convertible at the end of 1958, things began to change.

Capital was now moving freely from one country to another. Any tightening or easing of credit conditions for domestic purposes thus called forth large capital flows. When in 1960 Germany tried to restrict internal demand by tight money and high interest, she was at once faced with such an influx of foreign money that the hoped-for effects were largely nullified and she had to abandon the policy.

European countries were thus forced to recognize that under present conditions the scope of monetary and credit policy for internal purposes is very limited. A system of free international exchange and capital movements seems to be incompatible with primary reliance on monetary instruments to combat inflation or stagnation. I believe this experience is relevant for the American economy, too.

THE CHOICE OF AN OPTIMAL STRATEGY

Under these circumstances the most promising strategy seems to be as follows:

Concentrate your monetary weapons on the balance-of-payments problem and take care of domestic problems, if necessary, by fiscal and possibly other measures. If monetary policy is, so to say, mortgaged to the international problems, the logical answer would be a revival of fiscal policy for domestic purposes.

This seems to be recognized by a growing number of international observers. There is a problem of timing, too.

The balance-of-payments deficit is an immediate, and, in view of the surplus on current account, I hope a short-term problem. Stimulating the rate of economic growth, on the other hand, is a long-term proposition and the threat of real depression still seems to be potential rather than actual.

A promising strategy would thus consist, I feel, in fighting, first, a rather short but decisive battle on the external front by restoring international confidence in the dollar. Success on this front will then free forces for the domestic front where the struggle might take much longer.

INTEREST RATES

Such a policy would require somewhat higher interest rates, both on long and on short term, perhaps not for very long but for a certain time. The effects of higher interest rates seem to come in two stages.

The immediate effect is mainly on the balance of payments; European experience seems to show that this effect is quite prompt and strong. This is partly because in a free market money, particularly bank money, goes where it earns the most.

At least as important, however, is the psychological effect, for a tightening of money is taken as a sign that one means business and thus helps to restore confidence. At the moment I am under the impression that it will be very difficult to say the least, to stop the international drain on the dollar without a certain, if perhaps modest, rise in interest rates.

There is, it is true, a second stage where credit restrictions begin to affect domestic demand for commodities, particular housing. In Switzerland this effect of credit conditions on construction activity could be observed quite clearly and I do not want to minimize it. But this effect takes several months, perhaps a year, to be felt, and it could, in principle, be neutralized by appropriate fiscal measures, if necessary.

An effective restoration of confidence in the dollar by a temporary tightening of money may even make it easier to maintain moderate interest rates in the long run.

THE QUESTION OF ALTERNATIVES TO HIGHER INTEREST RATES

Isn't it possible, it may be asked, to solve the present problems without resorting to dearer money, even in the short run? Theoretically there is, of course, the possibility of a devaluation of the dollar. It seems to be generally agreed, however, that this is not a practical solution. In fact, it would be the ultimate expression of the failure to find a solution.

Since in all probability most other currencies would follow suit, there will be no net gain for the dollar. While in some limited sense devaluation would increase international liquidity by making gold do

double duty, so to say, it would at the same time reduce liquidity by robbing foreign exchange, including the dollar, of its quality as currency reserves.

Going for a moment beyond strict economics, it could probably be said that it would considerably weaken U.S. international leadership, in general.

Fortunately, there are other ways to reduce the required increase of interest rates. In general, it must be recognized that international capital flows do not depend just on interest rates, but on interest rates plus the state of confidence in the currency concerned.

If this confidence is high, a country may be able to sustain very low rates, thus Switzerland probably has about the lowest interest rates anywhere.

If, on the other hand, this confidence is shaken, even rather high interest rates may be insufficient to stabilize capital flows. In fact, some of the money the United States has been losing in recent months was going to a country with even lower rates, that is, Switzerland. Conversely, Germany found in 1960-61 that low rates did not stop the influx of foreign money.

The most effective alternative to undesirably high interest rates, thus, is restoring confidence in the dollar. I cannot go into all aspects of this problem here. In particular, I do not want to comment on the possibilities of further reducing military and other assistance or of making it conditional on purchases in the United States.

While in a state of confidence in the dollar, it may even be desirable for the United States to maintain a moderate deficit in her balance of payments in order to supply dollar reserves to the rest of the world, for the time being the deficit should be eliminated as far as possible. My following remarks will focus on two specific points.

EXCHANGE GUARANTEES BETWEEN CENTRAL BANKS

In past months central banks have been very active, bold and imaginative in devising new ways and means of assisting each other. Among these arrangements the recent dollar-franc swap between the Federal Reserve Bank of New York and the Swiss National Bank is of particular significance in this context.

On the surface it looks highly complicated and technical indeed. But the basic idea is quite simple and as far as I can see, it has not found the attention it deserves. It consists, in fact, in creating a new type of dollar, that is, dollars free from exchange risk. This means that 50 millions of "normal dollars" in the hands of the Swiss National Bank are replaced by the same amount of dollars carrying no exchange risk.

The Swiss commercial banks, in turn, have shown by their action that they are quite willing to take over these risk-free dollars at interest rates at which they could not be induced to hold the "normal dollars."

This operation killed two birds at one stroke: On the American side it prevented a further loss of gold because Switzerland is now willing to hold more dollars. On the other hand, liquidity in the Swiss market could be reduced because the Swiss banks are now holding U.S. Treasury bills instead of central bank deposits.

The present operation is limited in scope, though. It cannot be easily enlarged indefinitely. It shows, however, that the idea of exchange rate guarantees between central banks should be given very serious thought.

Central banks, in general, are loath to expose their reserves to exchange risks except perhaps in common emergencies. This is true for the Federal Reserve as well as for European central banks. As soon as confidence in a currency becomes doubtful they will withdraw from it. If central banks under the gold exchange standard are expected to hold each other's currencies, ways and means must be found to eliminate the exchange risk.

If central banks go on in their present imaginative spirit, I do not doubt that suitable techniques could be developed.

I personally feel, with respect to the gold certificates which were mentioned before, that such techniques may be an essential prerequisite for the continued functioning of the gold exchange standard. At the same time they will permit United States to balance her accounts at somewhat lower rates of interest than would otherwise be required.

POSSIBLE LIMITATIONS OF ACCESS TO U.S. CREDIT MARKETS

The second point has to do with possible limitations of access of foreign borrowers to the U.S. credit markets. One of the bigger drains on American reserves, amounting to hundreds of millions of dollars in the first half of 1962, is from foreign bonds issued in the United States.

At present, access to this market is perfectly free. Foreign borrowers were repeatedly urged to develop their own facilities instead of having recourse to New York, but gentle admonition does not always seem to be effective enough.

Now it is true that any form of exchange control or any lapse from convertibility would do much more harm than good to international confidence in the dollar. There are, however, certain ways of restricting access of foreign borrowers to credit markets which are usually considered to be entirely compatible with free exchanges and full convertibility.

I am sure nobody would accuse Switzerland of practicing exchange control. Still under present banking legislation all foreign bond issues and similar transactions of more than 10 million Swiss francs have to be submitted to the central bank.

The central bank may refuse approval depending on the state of the credit market, of international payments, and of the economic situation as a whole. In general, the national bank exercises this control in a rather gentle way in close cooperation with commercial banks.

Restrictions take the form of a stretching out or spacing of planned issues over a longer period rather than of an absolute veto. On the whole, this arrangement is now working to the satisfaction of all parties concerned for almost three decades, even if there may be occasional differences of opinion in individual cases.

It is agreed to be one of the most useful instruments of Swiss credit policy. It might be worth while thinking about the possibility of

applying something of this sort to the American credit market, too. Some people's confidence, it is true, may be further disturbed by such a measure. Against this risk, however, must be held the great gain in confidence which can be expected from some temporary restriction of long-term capital outflows in times of strain.

In a widely publicized statement one of the directors of the Swiss National Bank recently remarked that if this kind of an arrangement had been in operation in the United States, we would today have a worldwide dollar shortage. It may well turn out that in the long run it would not only be compatible with free exchange but even its prerequisite.

At the moment the prospect of a forceful policy to restore confidence in the dollar seems to be good. The current balance of payment continues to show a considerable surplus. Prices and wages in Europe have risen fast and thus the American economy has gained in competitive strength.

Though I would refuse to predict it, I would not be surprised if in the months to come the tide could be turned in favor of the dollar. It may well be that the American troubles of today are the European problems of tomorrow.

Confidence in the dollar cannot be restored by words only. Certainly strong statements on the maintenance of the present dollar parity are more effective than weak statements. But the effect of even the strongest statement will fade away within a couple of weeks unless it is supported by forceful action.

If such action is taken, perhaps by combining the required credit restraint with certain fiscal concessions, there seems to be a fair chance that within a matter of months, thanks to restored confidence in the dollar, the United States can afford to give much more potent stimulus to domestic economic growth than if the present situation is permitted to drag.

Chairman PATMAN. Thank you, gentlemen. Your statements have been most constructive. It is interesting that Mr. Lolli and Professor Niehans, have both suggested a way of assuring confidence in the dollar and have both made the same suggestion; and Professor Day, I believe you also made essentially the same suggestion.

Mr. Lolli, your suggestion is that we issue a certificate to foreign central banks which would guarantee the gold content of the dollars they hold. In other words, as I understand it, you feel that notwithstanding the fact that the U.S. Government has no intention of devaluing the dollar, a lot of people in Europe feel that the dollar may be devalued anyway, and that is the source of the trouble.

Your suggestion is, I believe, that our Government issue to foreign central banks a certificate which would guarantee that if we do raise the price of gold the certificate would be redeemed at any time in new dollars, equivalent in value to the old dollars.

Then you feel that such certificates should be issued without interest. Professor Niehans' suggestion is the same but you feel, I believe, that such certificates might be issued to bear a small rate of interest. You mention also that this has already been done in one case where we made a contract with the Central Bank of Switzerland.

When was that?

Mr. NIEHANS. About 3 weeks ago.

Chairman PATMAN. Professor Niehans, do you know if that contract contains a two-way guarantee?

Mr. NIEHANS. Yes.

Chairman PATMAN. It does?

Mr. NIEHANS. Yes.

Chairman PATMAN. That is, should the Swiss franc be devalued those francs which we hold would be convertible at the old rates?

Mr. NIEHANS. That is right.

Chairman PATMAN. The suggestion you have made appeals to me very much. Later this week we will have Secretary Dillon here before our committee and also Mr. Martin, the Chairman of the Federal Reserve Board of Governors, and Mr. Hayes, president of the New York Federal Reserve Bank.

We will ask them about this suggestion of yours and if they agree to it, it would be my prediction that they would have no difficulty obtaining whatever legislation might be needed to put the suggestion into effect.

The problem of the trading nations, as I see it, is to create enough acceptable money to permit us to carry on the volume of business which our increased productivity makes possible. I am not even sure that it is correct to say that the United States has a deficit in the balance of payments.

Historically, a nation was considered to have a deficit in its balance of payments, only if it was going into debt to other countries on the basis of its trade balance, and that is not our problem. Our assets abroad are a great deal more than our liabilities to foreigners, and our assets are still growing more rapidly than our liabilities, but we are like a commercial bank that has to maintain sufficient liquidity, Mr. Lolli, don't you agree?

Mr. LOLLI. Yes, sir.

Chairman PATMAN. The problem is that, whereas our assets are long term, our liabilities are short term, like demand deposits. If we devalued the dollar we would not gain anything. We would be canceling a debt owed to us which is payable in dollars. Since the dollar is so widely used as reserve currency, if we did devalue the dollar then the other countries would devalue the currency.

So there would be nothing to gain for anybody except possibly the Russians who hold a lot of gold. Mr. Lolli, let me ask you a question or two about another subject. The Central Bank in Italy, is that publicly owned and is it recognized to be publicly owned?

Mr. LOLLI. Yes.

Chairman PATMAN. In other words, the private commercial bankers do not operate it?

Mr. LOLLI. No.

Chairman PATMAN. And do not fix policy?

Mr. LOLLI. No.

Chairman PATMAN. How about Switzerland?

Mr. NIEHANS. It is a mixed corporation in which the Government has a dominant influence but it is not influenced by private bankers.

Chairman PATMAN. It is not influenced by private bankers?

Mr. LOLLI. You asked me about the Bank of Italy. The Bank of Italy is the Central Bank and I said yes. You are not referring to the commercial banks?

Chairman PATMAN. I am talking about the central bank like our Federal Reserve. Compare the Bank of England.

Mr. DAY. The Bank of England is nationally owned.

Chairman PATMAN. Do you know any country in the world where the central bank authorities have as much power as they have in the United States?

Mr. DAY. I doubt whether we have in England. I don't know of any other that is comparable with the Federal Reserve.

Chairman PATMAN. What about you, Dr. Niehans?

Mr. NIEHANS. I wouldn't have a specific comment.

Mr. LOLLI. I would say the Central Bank of Italy has similar powers to the powers of the Federal Reserve Bank.

Chairman PATMAN. Does any other central bank in the world have as much power as the central banks of England and the United States?

Mr. LOLLI. I would not be able to answer. In Italy the Central Bank has, I think, almost the same powers.

Chairman PATMAN. What about the independence of the banks from the government? Your bank is publicly owned. It is directly connected with the government.

Mr. LOLLI. It is in the sense that the government, take the crisis that happened in 1929 or 1930, has the majority of the capital of all major Italian banks. But as a matter of policy the government does not interfere in any way with the operation of the commercial banks. We are only under the control of the central bank the same way as the commercial banks in the United States are under the control of the Federal Reserve.

Chairman PATMAN. I would like to ask each one of you to briefly answer this question, if you please.

We have a bill pending. It has been reported by the House Banking and Currency Committee, to provide higher interest rates for foreign accounts.

Do you believe that will be of substantial help in our difficulty?

Mr. LOLLI. Personally, no.

Mr. NIEHANS. I don't believe in interference in the interest rate structure. It might help on the short-term, but it is not a fundamental remedy.

Mr. DAY. I believe it might have some effect, but I think it would be extremely difficult in practice to separate foreign-held accounts from domestically held accounts.

Chairman PATMAN. This would only apply to the central bank accounts?

Mr. DAY. For central bank accounts I can see this working quite successfully, although I would prefer the idea of the gold exchange guarantee.

Mr. LOLLI. May I comment? My answer "No" was based specifically on the fact that all major New York banks and all major American banks, I would say, have branches in Europe and in London, particularly, where they are free to pay any interest that they want. So they are in a competitive position, if they want to be, with any other European bank.

They don't need any specific legislation to pay a higher rate if they want. As far as I know, they are not paying now, for long-term