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**THE 1967 ECONOMIC REPORT
OF THE PRESIDENT**

HEARINGS
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
NINETIETH CONGRESS
FIRST SESSION

FEBRUARY 2, 3, AND 6, 1967

PART 1

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THE 1967 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 2, 1967

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

The joint committee met at 10:10 a.m., pursuant to call, in room S-228, the Capitol, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Talmadge, Ribicoff, Javits, Jordan of Idaho, and Percy; and Representatives Reuss, Moorhead, Widnall, Rumsfeld, and Brock.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The meeting will come to order.

This is the first meeting of the Joint Economic Committee of the 90th Congress and I would like first to welcome our new members. I think we are fortunate in getting the quality and caliber as well as the number of new members. The Joint Economic Committee has been expanded from 16 to 20 and we have some of the outstanding Members of the Congress, in many cases recognized as such throughout the country, as new members of this committee. Some of them are not here. I am going to mention their names even though they are not here. Senator Symington had to be in Armed Services Committee this morning. They are holding hearings on the Air Force and, of course, he is the outstanding expert in the Senate in this area.

Senator Percy, I believe, will be here later. He has been momentarily delayed. Other new members of the Joint Economic Committee are here: Senator Ribicoff, Congressman Moorhead, Congressman Rumsfeld, and Congressman Brock.

I would like to note that the staff of the Joint Economic Committee has prepared under Wright Patman, our eminent vice chairman, a 10-year projection of our economy which tries to explore its potential and some of the problems that can be expected over the next decade. It will be officially released tomorrow morning, Friday, February 3. I will not attempt to prerelease it here other than to say the problems set forth in the study do not offer any promise that the Joint Economic Committee's load will be lightened over the course of the future.

One other item I would like to call attention to, a "Fact Book" which appears on the desk of each member of the committee. It was compiled and prepared by our Joint Economic Committee staff to provide factual information on the economy and the subject of our current inquiry. It also contains at the end of each section questions which were suggested to the staff in reading the Economic Report of

the President and the Annual Report of the Council of Economic Advisers, and in considering the present state of the economy.

I believe it would be advisable to insert at this point in the record the press releases announcing these hearings including the witnesses who will appear.

CONGRESS OF THE UNITED STATES JOINT ECONOMIC COMMITTEE

SENATOR WILLIAM PROXMIRE ANNOUNCES HEARINGS ON THE 1967 ECONOMIC REPORT OF THE PRESIDENT

Senator William Proxmire (D., Wis.), Chairman of the Joint Economic Committee, today announced that early in February seven Government officials would testify before the Joint Economic Committee on the President's 1967 Economic Report. The committee is charged by law with the responsibility for reviewing the President's Economic Report and submitting to the Congress its own evaluation of that Report, along with recommendations for maintaining maximum employment and economic growth.

The hearings will be held in Room S-228 (Old Supreme Court Chamber) of the Capitol. The witnesses are as follows:

Thursday, February 2—10:00 a.m.

Council of Economic Advisers:

Gardner Ackley, Chairman.

James S. Duesenberry, Member.

Arthur M. Okun, Member.

Friday, February 3—10:00 a.m.

The 1968 Budget.

Charles L. Schultze, Director, Bureau of the Budget.

Monday, February 6—10:00 a.m.

Henry H. Fowler, Secretary of the Treasury.

Tuesday, February 7—10:00 a.m.

Alexander B. Trowbridge, Acting Secretary of Commerce.

Tuesday, February 7—2:00 p.m.

W. Willard Wirtz, Secretary of Labor.

Wednesday, February 8—10:00 a.m.

John W. Gardner, Secretary of Health, Education, and Welfare.

Thursday, February 9—10:00 a.m.

William McChesney Martin, Chairman of the Board of Governors of the Federal Reserve System.

Senator Proxmire indicated that several additional days of hearings would be held after the Lincoln Birthday recess to hear the views of other invited witnesses on the subject of the economy and the President's recommendations. These will be announced later.

I am also happy not only to welcome our new members but to welcome the extremely competent and able Chairman of the Council of Economic Advisers, recognized not only in economic circles but throughout the country as a man of great ability, and a man who has contributed immeasurably to our economy.

We are very grateful to you, Chairman Ackley, for your brief statement. This is the most concise and to the point statement that has been delivered to this committee not only by the Council, but by any other group or single witness in my knowledge. We welcome you.

We will have a number of questions to ask and even though all the members of the committee are not here at this time, I know others will be coming in later.

I would like now to yield to the senior Republican, Senator Javits, who I understand has a statement.

OPENING STATEMENT OF HON. JACOB K. JAVITS, A U.S. SENATOR FROM THE STATE OF NEW YORK, ON BEHALF OF THE MINORITY

Senator JAVITS. Thank you very much, Mr. Chairman. I make this statement on behalf of the minority members of the Joint Economic Committee in place of Congressman Curtis, who under our practice is this time the ranking minority member, and who today must necessarily be at the Ways and Means Committee meeting.

In the coming year the economy must walk a tightrope to avoid falling into a recession, on the one side, or more serious inflation on the other. This precarious balancing act has been precipitated by the administration's day-to-day policymaking by expediency in 1966.

Through fancy fiscal and budgetary footwork, the administration last year made it appear that it was working to slow down the steep climb in consumer prices and restrain the excessive growth in aggregate demand. It speeded up tax collections, rescinded excise tax cuts, sold \$3.9 billion of participation certificates, made unusually large profits on seigniorage, suspended the investment tax credit and accelerated depreciation on buildings and promised substantial cuts in spending which have never been documented. All these devices were employed to obscure the Government's inflationary impact on the economy. As if this were not enough, the administration's military spending estimates were based on the untenable assumption that the Vietnam war would end this summer. The result was a \$10 billion underestimate in defense spending.

With restraint lacking on the fiscal side, either from genuine spending cuts or a modest tax increase early in the year, monetary policy necessarily was drawn in to fill the vacuum. The tight money policy followed by the Federal Reserve was accentuated by the administration's own policy of accelerating tax payments and selling participation certificates.

The results of the administration's overall economic policy were predictable. The boom rolled on, prices increased sharply, the economy suffered from the highest interest rates in 40 years, a near financial panic occurred in the late summer, the residential construction industry fell into recession and the trade surplus shrank dramatically.

The imbalances that the administration's unbalanced policies built into the economy last year are likely to be more damaging and more general this year. The outlook now is for inflationary pressures from the cost side, a rash of serious labor disputes, a marked slowing, or possibly a downturn, in business activity, the danger of an increase in unemployment, some worsening in the balance of payments, and aggravation of the cost-price squeeze on agriculture.

Neither in its budget nor its economic message does the administration demonstrate that it is prepared to meet the challenges arising from its mismanagement of policy last year. Can the administration demonstrate that it has improved its forecasting techniques, or the reliability of its budgetary estimates or the coordination of policy between the Pentagon and the economic policymakers? We are asked to believe that the administration's policy prescriptions for the coming year are designed with precision to save the economy from the Scylla of inflation and the Charybdis of recession. As a matter of fact, it looks as though we may be heading for both at the same time.

Yet, the administration's approach to our economic dilemmas is unpromising from the start. Its request for a 6-percent tax surcharge is based on the assumption that economic activity will slow in the first half of the year but resume a strong rise in the second half, with 4 percent real growth for the year as a whole.

The opinion of many private economists is that real growth will total much less than 4 percent and that the pattern of the advance will be just the opposite to that predicted by the administration. Many private economists believe that activity will continue its rise in the first half of the year, and then level off in the second half as suspension of the investment tax credit discourages business spending and as defense outlays, hopefully, taper off.

Even more to the point, the tax increase seems solely designed to offset the inflationary impact of the large increase in social security benefits requested by the administration. Since some increase in social security benefits is likely to be passed by the Congress, while the fate of the tax surcharge is in doubt, the budget could well be more expansionary than already planned.

If fiscal policy is expansionary—even with a tax increase—how does the administration hope to stop inflation? It accepts the likelihood that wage settlements will exceed the guideposts this year, as they did in 1966. In fact, settlements could well exceed the 5 percent pattern of advance recorded last year, in spite of the administration's plea that labor not try to compensate for all of the increase in prices.

Business is supposed to provide the first line of defense against inflation by absorbing cost increases and shaving profit margins. But consider the current and prospective pressures on profit margins. With the growth of sales slowing down, there will be little or no increase in pretax profits this year, and profits in the fourth quarter of 1966 already appear somewhat disappointing. Business also has lost the investment tax credit and accelerated depreciation in buildings; it is paying higher payroll taxes for social security this year, and major boosts are in store next year; the President has asked for further accelerated taxpayments on top of a corporate tax increase; and finally there is an 11-percent increase in the minimum wage this year.

Is it realistic to hope that business can absorb further cost increases? With business spending for plant and equipment already weakening, too great a squeeze on profits could lead to a capital goods recession that could spread throughout the entire economy.

The following other contradictions in the administration's policies should be noted:

First, the administration believes that interest rates should be lowered in order to correct the distortions and imbalances which arose from its high interest rate policy of last year. Yet based on conservative estimates, it proposes \$9.4 billion in regular Treasury borrowing, net agency borrowing, and participation sales. The result of these Federal activities in the financial markets will make it difficult, if not impossible, to lower interest rates by any meaningful amount.

Second, if the administration is successful in reducing interest rates, it is likely to create a further deterioration in our balance of payments this year in the absence of a sounder fiscal policy. The administration's goal to lower interest rates, while desirable on domestic grounds,

poses the risk of a massive outflow of funds that could create a balance-of-payments deficit of crisis proportions.

I conclude as follows:

A complete turnabout in the design and execution of economic policy is mandatory for the coming year to avoid the near-crisis conditions the administration imposed on the economy in 1966. Last year Government policy was the chief source of uncertainty and instability in the economy.

Policy should be designed to meet current problems while encouraging a balanced economic future, instead of designed to weather today's problems with no thought of tomorrow's. Policy should be based upon economic, not political, considerations. Finally, policy should be planned with the explicit recognition that we cannot know all the answers. Present forecasting techniques do not allow us to make the decisions having their impact many months in the future. Flexibility is required, not increased "uncontrollable" expenditure commitments or heavyhanded revenue measures with uncertain effects.

During the hearing on the President's Economic Report, we in the minority hope to obtain the answers to many questions which have created an undeniable sense of uneasiness in the Congress and among the public. After considering the testimony to be presented at these hearings, we will present in more detail our views on the appropriate course of economic policy in 1967 in the minority section of the Joint Economic Committee's annual report.

Mr. Chairman, I agree with the sentiments contained in the statement of the minority members of the Joint Economic Committee, but would like to make the following supplementary points:

It is clearly evident from the President's Economic Report that all the administration's incantations and all its economic sleight-of-hand were unable to keep some old-fashioned chickens from coming home to roost.

The administration has failed to take the fiscal measures needed to bring inflation under control in 1966 and now it is forced to admit that the economy may slow down this year while inflation will remain a serious problem. I am very disturbed by one evidence of this slow-down, the cutback announced in the automobile industry.

In my judgment—and this is the critical point we all noted—at the moment the administration has failed to present a convincing case for the 6-percent tax surcharge. I will withhold my support until I have the opportunity to consider the testimony of the administration witnesses and other experts during these hearings and also, and very importantly, to gage the state of the economy in the next 60 to 90 days. I urge my colleagues to do the same. I feel, Mr. Chairman, that we should consider the evidence we receive in the next 60 or 90 days before we decide whether a tax surcharge is called for to prevent a recession or whether it is really essential to deal with the deficit and inflation.

Just one or two other points. First, I note that last year the President's report made specific reference to the wage-price guideposts of the Council of Economic Advisers, and the President specifically endorsed them, stating that "it is vitally important that labor and industry follow these guideposts."

This year, the President's Report makes no mention at all of the guideposts, but instead confines itself to vague generalities, such as:

Restoring price stability is one of our major tasks. But even as to these, no specific program is endorsed by the President—and, in fact, he acknowledges that the price stability will *not* be restored in 1967.

The Council of Economic Advisers' report, on the other hand, devotes *15 pages* to the subject of wage-price policies, and the entire discussion is built upon the concept of the guideposts. The Council recommends no changes in the guideposts based upon our recent experiences, even while the Council acknowledges that wages and prices in 1967 will inevitably reflect, and make some allowance for, the cost inflation we have been experiencing. In short, the Council adheres to its guideposts but gives us no reason to expect that labor or management will adhere to the guideposts this year any more than they did last year.

So it is no wonder that the President himself ignored the guideposts altogether: labor and management are already ignoring them—indeed everyone is ignoring them but the Council of Economic Advisers.

Perhaps it is time to acknowledge frankly that the guideposts are not—and never were—anti-inflationary weapons, but rather only storm signals indicating that we should use them.

Second, I note that last year's Economic Report of the President contained a broad section on labor and management, including recommendations for changes in our labor laws. This year's Report is completely devoid of any such recommendations. Yet there is strong sentiment in the Senate and in the Congress for some means to deal with national emergency strikes. The Senate three times passed a request to the administration to deal with that.

Finally, as I have strongly supported the 30-year-old U.S. policy of liberalizing world trade—I have emphasized the negative so far in any personal views—I express my gratification for the President's call for maximum use of the authority granted under the Trade Expansion Act during the Kennedy round, by his call for a continuing liberal trade policy, and by his courage in respect of dealing with watch movements and plate glass in order to show that he is trying to practice what he preaches.

We have gained a lot from liberal trade in the last three decades and I feel deeply we must continue.

Thank you.

Chairman PROXMIRE. Thank you, Senator Javits. Before you begin, Mr Ackley, I would like to commend you on your Economic Report. It is, I think, a very competent job and one that provides understanding to me and I might say that for all members of the committee, especially new members, as I understand it, this is your principal statement and one of the reasons why you make such a concise statement to us this morning is that you have gone on record—it has been available to members of this committee for more than a week now with the fundamental statement which appears in the Economic Report.

Mr. Ackley, you may proceed.

STATEMENT OF GARDNER ACKLEY, CHAIRMAN, COUNCIL OF ECONOMIC ADVISERS; ACCOMPANIED BY ARTHUR M. OKUN AND JAMES S. DUESENBERY, MEMBERS OF THE COUNCIL OF ECONOMIC ADVISERS

MR. ACKLEY. Mr. Chairman, it is always a pleasure for members of the Council of Economic Advisers to appear before this distinguished committee. As we have noted many times, we feel a family relationship since both your committee and our Council were created by the same act of Congress.

Therefore, I feel I can take the liberty of joining you in welcoming the new members of the committee. I am sure it will be a pleasure to participate with them in this hearing.

May I also say, Mr. Chairman, that we are greatly pleased to appear under your chairmanship here today.

As you have noted, Mr. Chairman, we have a rather brief statement this morning and the reasons for it are as you suggested; namely, that we do feel we have presented our views rather fully in our own Report which you have had for a week or 10 days. But, I will take just a few minutes to summarize the major threads of this year's Report of the President and of the Council. First, the economy, it seems to us, is in a basically sound and healthy condition and we expect it to stay that way throughout 1967. We see an advance of gross national product this year by about \$47 billion to the neighborhood of \$787 billion.

This would be a smaller gain than last year's, and appropriately so. The real growth would be about in line with the increase in the economy's potential. We expect the advance to be somewhat slower in the first part of the year, speeding up later on.

Second, it is clear that we face significant economic problems. The principal ones are clearly presented in the President's Report. Prices have risen more than we would like, and will rise again in 1967, although by less. Our balance of payments still shows a troublesome deficit at least on the liquidity basis. Our housing industry is depressed as the result of last year's tight money and high interest rates. And despite the general prosperity, too many of our citizens are left behind by economic progress. None of these problems will be easily resolved, but we expect to make progress on all of them in 1967.

Third, because we already enjoy a high rate of utilization of our productive resources, the economy cannot be expected to expand at as rapid a pace this year as it has expanded over the past 6 years. During that period we have been absorbing idle or underutilized resources into productive use. Last year, for example, an extra \$10 billion of output came from reducing unemployment, converting part-time into full-time jobs, and attracting previously discouraged workers into the labor force. We expect no such bonus this year. But this is not bad news; on the contrary, it is welcome evidence of how far we have come in recent years. Further reduction of unemployment is feasible in the longer run. But the rate of progress will depend on the success.

of our manpower training programs and on an improvement in the operation of our labor markets.

Fourth, designing economic policy is more challenging in today's high-level economy than in an economy with an abundance of underutilized resources. In a slack economy, the appropriate policy is to stimulate an expansion of total demand at a faster rate than total productive capacity is growing. A high-level economy has to track a narrower path—not, however, a tightrope, Mr. Chairman. Nor can I quite understand a tightrope off which one can fall in both directions at the same time.

There are stabilizing forces in our economy which help to keep it on an even keel. But timely adjustments of policy are also necessary to promote a steady rate of growth. Too slow an expansion of demand would result in economic waste and human suffering. Too fast an expansion would build up inflationary pressures. To keep the economy moving steadily ahead, a close watch on economic developments and a maximum degree of flexibility in policy are required. The normal requirement for flexibility is intensified by the need for prompt action if, unexpectedly, peace should return in southeast Asia. And the President has directed that preparations should be made for that event, and kept up to date.

Fifth, the economic policy which the President has outlined for 1967 involves a mixture of monetary and fiscal measures. The record of the Federal Reserve System in responding to the changing economic climate of recent months as well as our consultations with the Federal Reserve make us confident that fiscal and monetary policies will be working toward the same objectives in the months ahead. Monetary policy is expected to continue the shift—already in process—away from the extreme tightness of last year. As a result, we expect substantial recovery in construction. During the first half of 1967, fiscal policy will be mildly stimulating. This will give time for easier credit conditions to be translated into improved liquidity of financial institutions, increased lending activity, and then increased spending. And it will cushion the effect of the reduction in inventory investment expected in the first half of the year. In the second half of the year, the expansion in construction, increased social security payments, and a leveling off in inventory investment will tend to accelerate the growth of total demand. That tendency will be partially offset by the income tax surcharge. The year as a whole should produce continued growth in total output and a better balance among residential construction, business fixed investment, and inventory investment.

Sixth, we expect an improved price record in 1967, primarily as a result of the more moderate pace of economic advance. Some of this improvement is already apparent. Wholesale prices are lower today than they were last August. In the last 2 months the increase in consumer prices has been one-tenth of 1 percent a month, about a third of the rate prior to then.

Unit labor costs will continue to rise during 1967 as a result of bigger wage settlements in a larger number of industries. But demand pressures on labor markets should abate somewhat, particularly in the unorganized sectors where pressures were greatest last year. Nevertheless, the need for restraint and responsibility in private wage and price decisions has not disappeared; if anything, it has become the

more urgent. The Council has not specified a single numerical standard to be applied to wage increases in 1967. Such a numerical standard does not seem useful this year.

In any case, such a precise numerical standard has had in the past the unfortunate effect of making restraint appear to be a "yes" or "no" question. A 3.2 percent wage settlement was taken as evidence of restraint, a 3.4-percent settlement as no restraint, and a defeat for the policy. In fact, restraint and responsibility—or their opposites—constitute a continuous spectrum; and the more restraint and responsibility the better. A 4 percent wage settlement does involve more restraint than a 6-percent settlement, even though both of them may exceed the growth in productivity. In a given situation, a price reduction may be a more responsible action than a 1 percent price increase, yet the latter is to be preferred to a 3-percent increase.

Seventh, we will be working to narrow the liquidity deficit in our balance of payments in 1967, and to retain a major share of the 1966 improvement in our official settlements balance. In particular, our trade balance should strengthen significantly through a slower rise in imports, reflecting the more moderate pace of domestic economic expansion and the lessening of specific pressures on productive capacity. To guard against a renewed excessive outflow of capital, the voluntary balance-of-payments programs have recently been strengthened; the President has asked for discretionary authority to vary, within limits, the rate of the interest equalization tax; and initiatives have been taken to achieve better worldwide cooperation in lowering interest rates. These seem to be bearing some fruit already. The President has also suggested new steps to promote foreign travel in the United States.

Eighth, the problem of poverty will continue to be attacked through the many weapons already at our disposal. In addition, the President has singled out for special attention in 1967 an expansion and improvement of training activities for the disadvantaged, and some steps to modernize our system of public assistance. The social security changes which he has recommended will, among other things, contribute to a reduction of poverty among the aged. And he has indicated his intention to ask a commission of prominent Americans to study the possible merits of entirely new ways of attacking the problem of poverty.

Ninth, and finally, the President's Report, and our own, look back on an amazing record of economic performance during the past year and the past 6. These accomplishments should give us confidence in our ability to find solutions to the economic problems remaining to be solved. In the last year alone, these are some of the achievements:

The largest increase in nonfarm payroll employment of any year in our history, except 1941 and 1942;

A nearly 5½-percent growth in real output;

A 3½-percent increase in the real per capita standard of living of the American people, led by a 7-percent increase in the real income of our farm operators, and including a 3-percent increase in the average real hourly compensation of employees.

Over the whole 6 years of unmatched expansion, our economy has—

Created nearly 9 million additional jobs;

Achieved more than a 50-percent expansion of industrial production, twice that of the preceding 6 years;

Accomplished a 50-percent increase in average real farm incomes, in contrast with a 9-percent gain in the preceding 6 years; and

Achieved almost a 25-percent increase in the real per capita standard of living of the American people, a gain equivalent to that of the entire 13 years preceding.

Six years ago, Mr. Chairman, when the current expansion began, the American people faced many and serious economic problems. Some of them still remain, and new ones have arisen. Finding solutions for these problems will be the continuing concern of the administration, this committee, and the American people. And when one strikes the balance between our progress and our problems, the record provides basis for confidence that these problems can and will be solved.

Mr. Chairman, we will be happy to attempt to respond to your questions.

Chairman PROXMIRE. Thank you, Mr. Ackley. I would like to suggest that Mr. Duesenberry and Mr. Okun might participate freely in responding to our questions. I anticipate that many of the questions will be directed to you, Mr. Ackley, because you are the Chairman, but I am sure you agree you have two very competent assistants with you and that we would miss a lot if we did not invite them to take part. I hope they will take part as aggressively as they desire to do so.

We are going to follow a 10-minute rule which means that each member will have 10 minutes the first time around. However, I understand that you can come back this afternoon, if necessary. If the members want to question two or three times, that is perfectly acceptable. In fact, it might well be desirable, because we want everybody to ask as many questions in as much depth as they wish.

Before I begin my questioning I would like to say, Mr. Ackley, that you have presented a fine statement. I particularly appreciate the good emphasis that you put at the end of your statement on economic progress, on growth, and on employment. These are gains that resulted in no small part from the policies which you and your predecessors have advocated and you deserve a lot of credit for it.

Now, having said that, let me say that in 1966 our Government made a serious economic policy blunder. Our fiscal policy was established early in 1966 and altered during the year on the assumption that—I should say, altered not at all during the year on the assumption that the Vietnam war would cost \$10 billion. As late as March 23, when we knew we would have 400,000 troops in Vietnam, the Secretary of the Treasury insisted—and as I understand it, this was the position that you took, too—that the estimates were accurate and they could rely on them. Instead of \$10 billion, the cost of the Vietnam war was \$20 billion and because we did not know accurately what our spending would be, having anticipated that it would be only \$10 billion, we followed the policies that I think would have been quite different if we had had accurate information.

It is clear to me that we would have reduced spending and/or increased taxes—possibly both—if we had better and more accurate information.

When you take this \$10 billion of spending which we did not know about, or were not informed about, and apply a 2.2 multiplier which I think is fairly logical because this has a multiplier effect as you know, it would have an effect on the economy of \$22 billion in increasing GNP. The results of this, it seems to me, are, to begin with, a tight monetary policy which seems to many people to be essential under these circumstances to restrain inflation, monetary policy that in your own terms, in your own report, resulted in a reduction of spending in credit-financed expenditures—homes, particularly—of \$8 billion. It also resulted, of course, in a painful burden on part of our economy, a 3.3 rise in the cost of living which was the greatest rise we have had in a number of years; and altogether a year in which, I think, Mr. Dale, of the New York Times, reporting in his column on January 9, was borne out when he said: "History is likely to record 1966 as the year of the big goof in Government economic policy."

Now, under these circumstances, I wonder if you can tell me what was the basis for this error. Was it based on the assumption that the war would be over by July 1, 1967?

Mr. ACKLEY. Mr. Chairman, you are undoubtedly correct that defense expenditures were underestimated for 1966. I think, however, your measure of that underestimate is perhaps somewhat misleading. So far as calendar 1966 is concerned—which is what we should be talking about—we estimated a rise of \$6 billion in defense expenditures and it turned out to be \$10 billion. Our estimate was not \$10 billion low but \$4 billion low.

Chairman PROXMIRE. Wait a minute. I am talking about fiscal 1967.

Mr. ACKLEY. Yes.

Chairman PROXMIRE. July 1, 1966 to July 1, 1967.

Mr. ACKLEY. Yes, and I am talking about calendar 1966, which is the period to which your question related. You spoke, I think, about the economic policies that were in effect during 1966.

Chairman PROXMIRE. Well, no. My question was directed to the assumptions which we were given in January of 1966 and corroborated again in March of 1966 that we would have 400,000 men in Vietnam and, therefore, we would have a cost of Vietnam war of \$10 billion during fiscal 1967.

Mr. ACKLEY. Well, it was certainly recognized fairly early in the year, Mr. Chairman, that defense expenditures could run higher than had been estimated. It was made clear early in the year at the time the Federal budget was submitted. The budget was submitted on the basis of the assumption that the war would be over by June 30, 1967. It was made clear that if that assumption turned out to be incorrect that other plans would have to be made.

It seems to me we have to recognize the fact that when defense expenditures were first estimated, it was at a time when military activity in Vietnam was increasing at an incredibly rapid pace. Under those circumstances, it was impossible to have a precise estimate. This was made clear, I believe, by the Secretary of Defense.

Our own report, in January 1966, spoke at some length of the difficulties of estimating defense expenditures and of the uncertainties this created for economic policy.

Chairman PROXMIRE. On March 23, the Secretary of the Treasury said flatly he stood by the \$10 billion estimate. He knew at that time we had 400,000 men at Vietnam. He was off \$10 billion. Instead of a \$10 billion cost it was \$20 billion.

What I am trying to get at—and I do not mean to be too critical of you because, after all, you are in a position where, presumably, you have to accept the estimates made by the Secretary of Defense on defense expenditures—what I want to know is whether or not you accepted that assumption, whether there was any alternative assumption that was available, and whether with this in mind you did at any time warn the Congress that we might conceivably have a cost of not \$10 billion, but possibly \$15 billion or \$20 billion, as it turned out to be?

The reason this is so impressive to me is because Senator Stennis stood up on the floor of the Senate and said clearly that we were going to have a big supplemental this year, that it was going to cost in his judgment, and he hit it right on the nose—\$20 billion—and this was flatly denied by people in the administration.

Mr. ACKLEY. Mr. Chairman, I think the record shows that the President and the Council of Economic Advisers, and the Secretary of Defense, at all times emphasized the uncertainty and the difficulty of projecting defense expenditures.

Chairman PROXMIRE. When did they change the figures? When did they give us the corrected figure?

Mr. ACKLEY. I do not believe any corrected figures were given to the Congress or to anyone else. Figures were uncertain. It was recognized that there would be an increased cost, particularly if the war should continue beyond June 30. No precise estimate was given. The President spoke several times of the probable need for supplemental appropriations, for increases in expenditures in the range of \$5 to \$15 billion. Indeed, the supplemental that was called for was not far from the middle of that range.

Chairman PROXMIRE. Well, certainly, Mr. Ackley, in the year in which we knew our economy was strained, in the year when we had a shortage of labor, shortage of material, rising prices, tight money, almost a financial crisis, under these circumstances if we had been told that the war in Vietnam was going to cost as much as it did, would it not be clear to you that you would certainly have recommended that the Congress very likely would have followed a different fiscal policy, that we would have looked much harder than we did at cutting other expenditures or spending, much more seriously would have considered raising taxes?

Mr. ACKLEY. Mr. Chairman, I think it is not quite correct to say that the fiscal policy failed to take account of these changing facts. Indeed, in September the President did present some additional fiscal proposals. He did take some steps to curtail Federal expenditures. As far as trying to get Congress to reduce the budget, I think the President's record on that is fairly clear.

Chairman PROXMIRE. You would have had a lot of muscle behind it if you pointed out the deficit, however.

Let me just ask, going into a different area quickly—

Mr. ACKLEY. Could I just make another couple of points on defense expenditures?

Chairman PROXMIRE. Yes, indeed.

Mr. ACKLEY. The difference between the original estimate and what now appears to be the total of such expenditures in fiscal 1967 has two parts. It has one part which reflects the fact that the budget was based on the assumption that the war would terminate by June 30. This accounts for something like half of the difference between the original estimate and the current estimate. The other half reflects the fact that there was a more rapid and efficient buildup of forces in Vietnam than had been initially considered possible, and second, increased requirements resulting from more intensive hostilities than had been initially assumed.

Chairman PROXMIRE. Now, let me—

Mr. ACKLEY. Let me point out that in a period of hostilities it has always been difficult to estimate the volume of defense expenditures. Even in a period without hostilities, it is difficult to do so.

Chairman PROXMIRE. It is difficult, but let me just say that to miss it by 50 or a hundred percent—to say 10 when it is 20—is not just being off by a billion or two. It is being off by a fantastic amount, and it seems to me we should know why the error was made to be in a position to correct it in the future. We have had very able Members of the Congress saying the very same mistake is being made this year. We want to find out what the assumptions are in the present estimate, and we also want to find out what we can do to prevent the kind of error made before so that we are fully informed as the situation changes. You told us that we got no revision, no figure other than the initial figure, on what the war was going to cost.

Mr. ACKLEY. Mr. Chairman, I have been trying to—

Chairman PROXMIRE. I know, and you have been doing a good job of explaining. I think the reason why you make mistakes is because it is in wartime. I am trying to find out how we can correct that. We still have the Vietnam war. We have the serious problem. We want to have economic policies that can prevent inflation if that is going to develop but we cannot have the right kind of policies unless we get the right kind of intelligence.

We want to know what the Defense Department has done to prevent this kind of a major economic policy blunder in the future.

Mr. ACKLEY. Let me say that defense estimates for fiscal 1968, even indeed the defense expenditures currently estimated for fiscal 1967, undoubtedly will be wrong. I do not know in which direction they will be wrong. It is in the nature of war that it is difficult to forecast such expenditures. As I recall, there were seven supplemental appropriations during the Korean war, which suggests again the difficulties of estimating such expenditures. But I do think the possibility of making a reasonable estimate of defense expenditures in the year ahead is substantially better than the possibility a year ago.

At that time the war was rapidly escalating. Our forces were being moved there at a very rapid rate. Today the situation is far more stable.

Obviously we cannot forecast precisely what may happen but the plans of the Defense Department for deployment of forces, the nature of the conflict, are now settled plans on the basis of the current situa-

tion, the current strategy. A year ago that was not the case. It could not be the case.

Chairman PROXMIER. My time is up. Let me just say I do not see anything that you have described in this situation that was substantially different, nothing that would begin to explain this kind of an error. If the Red Chinese had come in, if we had an entirely different kind of escalation, bigger than we had anticipated, there would have been some reason for it, but there is nothing that was unforeseen on a big basis that would justify this kind of a serious error. Senator Javits?

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

Mr. ACKLEY, what is the administration's current assumption on the conclusion of the Vietnam war in the Economic Report of the President and on what considerations is it based?

Mr. ACKLEY. Senator Javits, the defense budget for fiscal 1968 does not rest on the assumption of any given termination date of the war. In fact, it rests on the assumption that the war would continue indefinitely so far as budgetary planning is concerned.

Senator JAVITS. Would you allow me to ask you specifically, just to interrupt you, because I think we have to get it crystal clear, does this budget in your report assume continuance the war in Vietnam until June 30, 1968?

Mr. ACKLEY. It assumes its continuance beyond that date and provides for procurement for delivery beyond that date.

Senator JAVITS. And what is that assumption based on?

Mr. ACKLEY. I think, Senator Javits, any question regarding the assumptions with respect to the military situation should not be directed at this Council. We take those as given.

Senator JAVITS. Now, I notice from page 5 in your statement a clear implication with respect to the so-called tax surcharge. I would like to ask how you look at it. You say that in the second half of the year the expansion of construction, increased social security payments, and leveling off of inventory investments would tend to accelerate the growth of total demand and that this tendency would be partially offset by the income-tax surcharge.

Now, do you expect the income-tax surcharge to be effective for the second half of the year or is there any assumption on that in your report and forecast?

Mr. ACKLEY. In the budget and in our planning the assumption is that the proposed income-tax surcharge would be effective during the second half of this calendar year.

Senator JAVITS. Not before?

Mr. ACKLEY. Not before.

Senator JAVITS. So that even in this assumption you will allow time for the Congress to make up its mind, is that correct?

Mr. ACKLEY. Senator, I welcome your comments to the effect that Members of the Congress ought to keep open minds on this question, not reach decisions—certainly contrary decisions—at a date as early as this.

Obviously there will be more information about the state of the economy available at the time that decision has to be approached, when the Ways and Means Committee gets around to its hearings and when the Congress gets around to its consideration. Of course,

there is time. The recommendation was made on the basis of the best information, the best forecast, the best projections that we were able to make at the time when the budget had to be prepared. Those could change and if they changed, then some other course of action might be appropriate. But as of now, it is our view that in the second half of the year, the advance in the economy, in the absence of tax increases, would be sufficiently rapid to threaten the possible resumption of the kind of situation that we had last year. I think all of us want to avoid that situation, in which demand was growing too rapidly, inflationary pressures were intensifying, and the resulting response of the monetary system and of the Federal Reserve System was to create credit conditions which none of us liked.

Senator JAVITS. Now, can we summarize what you say by the statement that from what you can see now, we have certainly the 90 days' time that I was talking about?

Mr. ACKLEY. I would certainly think so, Senator.

Senator JAVITS. I noticed on another subject that the President's Economic Report never mentioned the wage-price guidelines but that your report gives a lot of attention to it. The press has unanimously headlined the proposition that "the President has abandoned the guidelines."

Has he abandoned the guidelines? Have you abandoned the guidelines in the Council, and what is the difference between your positions?

Mr. ACKLEY. Guidelines have not been abandoned. As I suggested and as the report makes clear, we did not feel it appropriate this year to suggest a specific numerical standard for wage increases. But the guideposts—the guidepost policy—has always been a great deal more than the single number.

The guidepost policy recognizes that private wage and price decisions—where the decisionmakers have discretion—can be an important force either for instability or stability, and that the national interest requires that private decisionmakers take account of the impact of their decisions on the entire economy.

The President states in his Economic Report, as clearly and as emphatically as I believe it would be possible for him to do, the urgent necessity for continued restraint and responsibility in private wage and price decisions.

We also stated it about as clearly, I think, as it would be possible for us to do. We intended to make clear our view that restraint and responsibility are called for.

We do not suggest a single number for the guideposts. It may have been a mistake to have suggested it last year. Indeed, it was criticized rather forcibly by members of this committee and others.

In any case, we certainly have not abandoned the policy and do not intend to.

Senator JAVITS. Then, this is the policy of the Federal Government now, in wage-price negotiations, restraint, not 3.2 percent?

Mr. ACKLEY. I think that is correct.

Senator JAVITS. A fair statement. And does that represent a change in policy?

Mr. ACKLEY. It is a change perhaps in tactics. It is a change in interpretation of the policy under the current circumstances. It is not a change in the basic proposition which is as sound as ever, I think.

It would be difficult to dispute it because it is primarily a matter of arithmetic.

If wage increases exceed the advance in productivity in the economy, unit labor costs will rise and there will be inflationary pressure on prices.

Senator JAVITS. But you are not setting a figure on the advance in productivity any more. You are just saying you want restraint?

Mr. ACKLEY. No. We have not changed our view that the trend of advance in productivity in the economy is slightly over 3 percent a year. What we are recognizing is that it is unrealistic this year, in view of the price increases that have occurred, to ask labor and to expect labor to agree to wage increases which do not exceed the productivity trend.

Senator JAVITS. And is it going to continue to be the policy of the Federal Government and all its agencies to use its influence to implement the policy as you have now described it?

Mr. ACKLEY. I believe it is.

Senator JAVITS. Just one other question, Mr. Chairman. I am much intrigued by your seventh point on how you are going to deal with the balance of payments. I would like to ask you this. Do you assume that the behavior of France, which has been drawing down our gold as if there was no tomorrow, and that of other countries will remain exactly the same as it has in 1966 in your assumptions on the international payments situation?

Mr. ACKLEY. I wonder if I could ask my colleague, Mr. Okun, to respond to that question?

Mr. OKUN. We are counting on a measure of cooperation in international discussions. I think we have a basis for doing so. Countries will differ in their policies and attitudes toward the way they want to hold their reserves.

The French have chosen to take their surpluses and convert them into gold. I see no reason to be optimistic about any change in their policy and we have not assumed any change in that.

Senator JAVITS. Will you next year or this year ask for a further reduction of the gold cover or a repeal of the gold cover on currency?

Mr. OKUN. This is obviously an area that will have to be kept under consideration. At the present time, we feel that there is no need for a request for amending the legislation.

Senator JAVITS. But that assumes a continuance of the French and other positions as they are. If there is a worsening, then you reserve the right to seek some remedy on gold coverage, is that right?

Mr. OKUN. Obviously what happens depends not only on the policies of the individual nations but also on their surpluses or deficits. The fact that the British balance-of-payments situation has improved is a favorable factor. The French domestic recovery should mean that they will have a smaller surplus this year than they have had in the past.

That would be a favorable factor as far as holdings of international reserves are concerned.

Senator JAVITS. Thank you, Mr. Chairman.

Chairman PROXMIRE. Senator Talmadge?

Senator TALMADGE. Mr. Ackley, I regret I came in a little late and did not get to hear your presentation but I have read it very hurriedly. I want to take up where Senator Javits left off.

I consider the balance-of-payments problem and the gold deficit as one of the most serious problems that faces our Nation. Do you share that view?

Mr. ACKLEY. It certainly is a serious problem and I listed it as one of the four principal problems with which we must be concerned.

Senator TALMADGE. What are we doing to correct it?

Mr. ACKLEY. Senator, I believe we are doing a great deal to correct it. The Federal Government has a number of programs. I am not sure on first recital that I will list them all but there is certainly a large number of them.

First, with respect to the Government's own international transactions, very stringent measures have been taken to reduce the dollar drain associated both with our defense expenditures and with our foreign aid program. Our foreign aid programs have been tied almost entirely to procurement in the United States. The Defense Department has tried to procure domestically wherever possible. It has succeeded in getting agreement with other countries to offset some of the offshore costs of our Defense Establishment. Every Government agency which has international expenditures is scrutinized with great care by the Budget Bureau with respect to its spending abroad.

So every effort has been made, is being made, will continue to be made to reduce the dollar cost of the Government's foreign expenditures.

Indeed, the record of the Defense Department has been quite remarkable. In the light of the greatly expanded and high level of their operations abroad, the dollar drain has increased very moderately.

With respect to private investment expenditures abroad, as you know, there are programs, one administered by the Federal Reserve System, affecting banks and financial institutions, the other, administered by the Department of Commerce, affecting corporations, in which rather successful effort has been made to obtain the voluntary cooperation of businesses and banks to hold down the dollar impact of their investment expenditures abroad.

One of the principal results has been a very large rise in foreign financing of American investment abroad. The volume of American security issues in Europe to finance investment expenditures there has risen dramatically.

With respect to travel, we have not felt it appropriate to interfere with the freedom of Americans to travel abroad but a strong effort has been made and strong and new initiatives have been suggested with respect to encouraging foreign travel in the United States.

I failed to refer, in connection with American private investment, to the interest equalization tax. The President now proposes to make it a more flexible instrument to counter any new surge of foreign borrowing in our markets.

I think it would be fair to say that every aspect of the balance of payments is under continual scrutiny by the Federal Government, by every agency of the Government. Every effort is being made to limit foreign expenditures, and to maximize foreign receipts. Indeed, despite the very large costs of the Vietnam hostilities, I think the record has been really a remarkable one in maintaining as small a deficit as has been achieved.

Senator TALMADGE. With the standard steps that you have outlined is it not true that we have lost gold during 16 of the past 17 years?

Mr. ACKLEY. I think that is probably correct.

(Insert later supplied by the CEA:)

Actually, the U.S. gold stock increased in 4 of the last 17 years.

Senator TALMADGE. And that continued last year?

Mr. ACKLEY. Yes, it did.

Senator TALMADGE. What was the gold drain last year?

Mr. OKUN. \$570 million.

Senator TALMADGE. What was the deficit on the balance of payments?

Mr. ACKLEY. We do not have final figures for 1966. On the liquidity accounting basis it was somewhere around the previous year, about \$1.3 billion. We do not know for sure. It appears that on an official settlements basis we probably had a small surplus last year.

Senator TALMADGE. Wasn't that figure helped greatly by prepayment of debts that foreign countries owed us?

Mr. ACKLEY. Yes, indeed.

Senator TALMADGE. What was the amount prepaid by the foreign nations?

Mr. ACKLEY. I am not sure I have that figure readily available.

Senator TALMADGE. \$400 or \$500 million?

Mr. ACKLEY. Of prepayments?

Senator TALMADGE. My recollection is it was approximately that figure. Also, did we not borrow a good deal of money from the International Monetary Fund?

Mr. ACKLEY. We did make some drawings on the Fund last year. We have for the last several years.

Senator TALMADGE. What gimmicks were used to make our balance of payments show up better than it did outside of the prepayment and also borrowings from the International Monetary Fund?

Mr. ACKLEY. Borrowing from the IMF is a means of financing the deficit, not reducing its size. I am not sure—

Senator TALMADGE. I understand that we had the advance prepayments of debt by foreign countries. We also got some money from the International Monetary Fund and we exchanged that. As I understand it, we used every device the Government had available to make the balance of payments and gold drain look better; is that true?

Mr. ACKLEY. We certainly used every device—every legitimate device—to minimize our balance-of-payments deficit.

Senator TALMADGE. Notwithstanding all that, it continues, and has for 16 or 17 years.

Mr. ACKLEY. I think reference to a 16- or 17-year period is somewhat misleading, Senator. During most of that period we were quite happy to have a deficit. The world's economic health and the post-war recovery of the world was greatly—

Senator TALMADGE. That time has long since passed, has it not?

Mr. ACKLEY. Yes, but it is not 16 or 17 years.

Senator TALMADGE. Is it not time we used stronger medicine? Is it not true the dollar is being forced to carry a bigger burden every year, to blanket the world, to be Santa Claus for the world? Is it not time we took serious steps to stop this hemorrhage of dollars in gold that goes on year after year?

Mr. ACKLEY. As the Secretary of the Treasury has declared several times, it would be possible for the United States to end its deficit at any time. The measures which we might take to do that, however, have to be considered in terms of their impact on our own economy, and on the economy of the world. We believe we have responsibilities to our own people, and responsibilities to the economy of the whole world which limit the kinds of actions that are appropriate for us to take. The kinds of measures that we could take to end our balance-of-payments deficits, for example, to deflate our domestic economy, have a recession, might end our balance-of-payments deficit, but at a cost we are not prepared to pay.

We could drastically restrict our imports. In short run, at least, this would perhaps—

Senator TALMADGE. Will you yield for a question at that point? That is another problem that seriously concerns me. As I understand it, our imports last year increased something in excess of 14 percent, while our exports increased only 4 percent, is that about correct?

Mr. ACKLEY. No. I think the figures are both somewhat higher. Our imports increased about 20 percent, our exports 10 percent.

Senator TALMADGE. The gap is getting worse instead of better, is it not?

Mr. ACKLEY. For the past 2 years our balance on trade has deteriorated, starting from a very high level. The fourth quarter of last year was the first time in several years in which our balance of trade improved. We expect that improvement to continue in 1967.

The surge of imports that we had last year is largely explained by the state of our economy last year, by the overrapid expansion of our gross national product, by the pressures on productive capacity in a large number of industries.

You may recall, in connection with the discussion of the suspension of the investment credit, that it was pointed out that the great pressure on American industries producing capital goods was drawing in a large volume of the imports of capital goods—not because foreign capital goods were better or cheaper but simply because the order backlogs of our own makers of machinery had gotten so long that domestic purchasers sought supplies abroad. We do not expect that kind of condition this year.

The action that was taken to suspend the investment credit, and the much more moderate pace in the advance of the economy that we expect, both suggest that the rise of imports this year should be substantially smaller than the rise last year.

Senator TALMADGE. I am informed that my 10 minutes have expired. I had hoped to ask you about our troop commitments in Europe because I think it is high time we reconsidered and reappraised that.

Also I desperately feel that reduction in interest rates is going to worsen our balance-of-payments record because I look for some of the so-called “hot money” to go for high interest rates. So I would hope you would look carefully into those problems and comment in the course of this inquiry on that.

Thank you very much.

Chairman PROXMIRE. Mr. Widnall?

Representative WIDNALL. Thank you, Mr. Chairman. Following up Senator Talmadge's question, I would like to ask this one. Last

year the balance-of-payments problem really benefited by high domestic interest rates. Do we not run a serious balance-of-payments risk if rates are lowered too sharply this year?

Mr. OKUN. We do have to remember that the situation in the domestic economy last year had two large and opposing effects on the balance of payments. As Mr. Ackley pointed out, because of the pressures on demands in many areas, we had a huge surge in imports which was unfavorable. On the other hand, as you point out, the tight money and high interest rate conditions in the United States certainly did have favorable effects on the capital account.

This year we look for a significant improvement in the import situation, with much more moderate growth. We do not expect our purchases from abroad to outstrip the growth of GNP as they did by a very wide margin last year. That is going to make a big difference.

On the other hand, we do have to be concerned about the capital account. This will make a difference in the kind of monetary easing we get. We will have to consider the structure of interest rates, in full recognition that short-term interest rates are the ones that are likely to be most important to our international capital flows.

Our capital account depends not only on what happens to interest rates in the United States but also on how they behave abroad. That is why we have placed great emphasis on international discussions among the Finance Ministers. Secretary Fowler's recent conference in Chequers with the Finance Ministers of other major industrial countries helped to emphasize that the overall level of interest rates in the Western World may well have gotten too high. It can be safely brought down if it is brought down cooperatively by all countries so that there is not a competitive aspect of trying to pull in capital. And we are optimistic.

There are indications that interest rates in Europe can behave better and these should make it more feasible for us to have the monetary easing we want here.

At the same time, concern about the capital account imposes a real need to keep our voluntary programs at the highest effectiveness this year. The Federal Reserve program relating to bank lending does call for a very high degree of restraint and asks for a great deal of cooperation from our banks to hold down their volume of lending to developed countries. The Department of Commerce program also has new guidelines for the cooperating firms which should make it possible to bring down our direct investment outflows this year. I think this gives us a balanced program and the basis for optimism that, despite the lower interest rates, we can still have improvement in our liquidity deficit and still retain part of the very substantial improvement we scored last year in our official settlements.

Representative WIDNALL. Thank you, Mr. Okun.

Mr. Ackley, in your statement you said something that I think is very important. It is a fairly short sentence: "The record of the Federal Reserve responding to the changing economic climate in recent months as well as our consultations with the Federal Reserve make us confident that fiscal and monetary policies will be working toward the same objective in the months ahead." This would seem to me to be a change in direction. In the past few years the fiscal policies and monetary policies have been merrily wending their own separate ways

without the necessary coordination which was needed to hold the economy in check.

Does this mean that the administration recognizes the very extreme importance of tying the two together?

Mr. ACKLEY. I think we do fully recognize the great importance of coordinating monetary and fiscal policy. I think it would not be fully correct to say they have not worked together in the past. Indeed, during the whole period from 1961 through 1965 both were working together to promote expansion, to promote a restoration of our economy to reasonably full employment of its resources.

Last year they both worked in the same direction of restraint. The President proposed several fiscal measures which the Congress accepted. The Federal Reserve was working in the direction of restraint last year. I think your reference may be to the unfortunate dispute that took place a year ago in December about the timing and the nature of the particular action which the Federal Reserve System took at that time.

I think we still feel it would have been possible to have had better coordination at that time between monetary and fiscal measures. But I think it is correct to say that both the Federal Reserve System and the administration share the same objectives of a sound and healthy and noninflationary economy, and that our coordination is close and, I think, effective.

Representative WIDNALL. Are you consulting more frequently than you used to?

Mr. ACKLEY. Perhaps more frequently this year, though certainly there had been frequent consultations in the prior period as well.

Representative WIDNALL. So that you indicate a better rapport between the Federal Reserve and the administration than you have had in the past?

Mr. ACKLEY. I certainly hope that that rapport will continue to be as good as it has been in the past year.

Representative WIDNALL. Many newspapers have read the Council's report and concluded that the guideposts are dead. Are they really dead or merely in the "deep freeze" ready to be revived when the economy cools down?

Mr. ACKLEY. Senator Javits was interested in the same question. I think they are not dead and they are not in the deep freeze. The one thing that is in the deep freeze is the expectation that, for this year at least, wage increases can in general hold to the trend of productivity in the economy. I think it is impossible to expect that. We do not expect it. But it is very clear that if we are to have stability of costs and prices, in the longer run wage increases cannot on the average exceed the trend of productivity.

That principle we have stated as firmly and clearly as we know how and we expect to have the cooperation of labor and business in returning as rapidly as is feasible to a condition of price stability.

Representative WIDNALL. Are you not really saying that when consumer prices go up, an effort to hold wage increases to the guideposts is futile? In other words, when the guideposts are most needed they are ineffective.

Mr. ACKLEY. The fact that consumer prices rose in 1966—and undoubtedly will rise further in 1967, although by less—is certainly one

of the reasons why it is difficult to expect that labor will restrain its wage settlements to the trend in productivity.

I would point out that the increase in the cost of living last year was primarily concentrated in a couple of areas that are largely unrelated to guidepost activity; namely, prices of food and prices of services. Our report attempts at some length to explain what happened in both of these areas.

In part they reflected the unfortunate timing of the hog production cycle, and some bad weather in farming areas. Some of it reflected the fact that, as we returned to full employment, it was necessary and unavoidable that there should be certain adjustments in the relative wages of lower paid unorganized workers in services as compared with the higher wages in manufacturing, mining, and transportation. This gave us a bulge in service prices which was unfortunate in terms of its impact on the cost of living.

Perhaps in terms of what it has done to the wage structure it was a good thing, an appropriate thing; but it is not something that has to be repeated every year.

Representative WIDNALL. Well, how will the 11-percent increase in minimum wage that goes into effect this year affect other wage increases? What industries will be principally affected by that?

Mr. ACKLEY. The effect of minimum wage increase this year will undoubtedly be to raise labor costs and prices in a few lower paid manufacturing industries, in services, hotels, restaurants, and laundries. It undoubtedly will have some impact on both labor costs and prices. The impact of the minimum wage is not entirely limited to those wages which have to be raised to meet the new minimum. There is also a "bumping" effect upon wages above the minimum. This is one of the factors which must be recognized as part of the cost and price picture in 1967.

Representative WIDNALL. I have a series of questions I am going to ask Secretary Wirtz when he appears before this committee dealing with teenage unemployment, and that is supposed to be the greatest factor in unemployment today. One of those questions I would like to ask you.

Has the increase in minimum wage limited teenage employment?

Mr. ACKLEY. Let me ask Mr. Duesenberry to take a crack at that one.

Mr. DUSENBERRY. We have very little direct evidence of an adverse effect of the minimum wage on employment. And we do have evidence, I think, that the relatively high level of teenage unemployment is mainly due to demographic factors.

If you compare teenage unemployment rates now with teenage unemployment rates in earlier periods of generally high employment, you do find that teenage unemployment rates are much higher compared to the unemployment rates for, say, married men and men over 25 than they were in the midfifties, even more in the early fifties.

If you look at the age distributions, you find that during the Korean period when teenage unemployment was much lower than it is now, that the teenage labor force was actually declining, and that a very high proportion of those in that age group were in the armed services. If you go to the midfifties you find that the teenage labor force was increasing but at quite a slow rate, whereas in the last couple of

years as a result of the fact that the postwar baby boom is now 15 years and past, we have had a very large number of new entrants.

The following table was later supplied for the record:

Adult and teenage unemployment rates and teenage civilian labor force, 1951-66

Period	Adult unemployment rate (20 years and over; percent)	Teenagers (14 to 19 years)		Percentage change per year in teenage civilian labor force
		Unemployment rate (percent)	Civilian labor force ¹ (thousands)	
Annual average:				
1951-53	2.7	7.6	4,886	-1.5
1955-57	3.8	10.5	5,161	3.8
1961-63	5.2	14.7	6,172	1.6
1964-66	3.6	13.4	7,150	9.5
1964	4.3	14.7	6,531	4.0
1965	3.6	13.6	7,091	8.6
1966	2.9	12.0	7,828	10.3

¹ The civilian teenage labor force increased rapidly despite the fall in teenage labor force participation rates in the 1960's. Major factor was large demographic increase in teenage population.

Sources: Department of Labor and Council of Economic Advisers.

It is quite clear that a very large part of the unemployment in the total labor force and particularly among teenagers arises from the fact that you get a substantial amount of unemployment if it only takes a month for a new worker to find a job when he leaves school. And this is a group which enters the labor force when it leaves school, also enters the labor force in the summer and leaves it again. It is also a group which does a good deal of moving around, tries out one job, finds it unsatisfactory, moves to another job, and a good deal of unemployment is associated with that kind of movement.

So we think most of the difference between unemployment rates in the last couple of years and the unemployment rates in earlier years of generally high employment is attributable to the large number of teenagers entering the labor force rather than to the effect of the minimum wage.

As I say, there is very little evidence to show reductions in the kind of employment that teenagers get as a result of the minimum wage, although I would not deny that that could be a factor to some extent, but I think the other factors are much more important in accounting for this differential.

Representative WIDNALL. Thank you very much. My time is up.

Chairman PROXMIRE. Thank you.

Mr. Reuss?

Representative REUSS. Mr. Chairman, gentlemen, the President in his Economic Report ¹ quotes from President Eisenhower's ill-fated 1956 Economic Report and points out that very shortly thereafter this country was visited with a severe recession and a very sharp inflation.

I am concerned that we profit by the mistakes of the past, and I am somewhat worried that we may have both a recession and some inflation ahead of us.

Specifically right now, as we know, automobile production is lagging, consumer durable production is lagging, housing starts are way off. Faced with that, the President has nevertheless firmly requested a 6-percent across-the-board tax increase to take effect next July 1.

¹ Economic Report of the President, January 1967, pp. 24-25.

It seems to me that inevitably this is going to have in the months to come before July 1 a chilling effect on both consumers and on investors in new plants and equipment, because they are going to feel that come July 1, they are not going to have as much money in their pockets and they had better plan their private budgets accordingly.

Would it not have been better, in view of the possibility of increased unemployment, for the President to have requested whatever tax plan he wanted—a 6-percent surcharge, if you like—and asked the Congress to act on it, iron out the details, have the lengthy hearings, and if approved, enact it, but provide that it not go into effect until and unless the President requested that it go into effect, and Congress by a speedily passed joint resolution could have acted on it? Would not that method have kept our anti-inflationary powder dry and avoided what I fear may be a short fall in demand in the next few months?

Mr. ACKLEY. Certainly there is much to be said for improving the flexibility of fiscal policy. There are even many economists who feel that it would be highly useful for some experimenting to be done with discretionary tax authority in the hands of the President, subject, as you suggest, to prompt congressional approval or veto.

But with respect to the particular situation of the next few months, I am not sure that your suggestion would have created the additional certainty that might prevent the expectation of a possible tax increase depressing expenditures in the meantime.

Representative REUSS. I hope you are right.

Mr. ACKLEY. If the tax increase had been passed but put in suspension, I think it would have the same effect—to the extent there is any such effect in depressing expectations.

Representative REUSS. Let me turn now to the inflationary side, and I want to join in a theological discussion on “are the guideposts dead?” I gather from what you have said that we certainly do not have any clear wage guideposts.

Let me ask: Was the President’s Labor-Management Committee—headed, I believe, by the Vice President—consulted on that portion of the Economic Report which relates to the guideposts and did they give the Council the benefit and give the President the benefit of their views, and what were their views, and were they written, oral, or what?

Mr. ACKLEY. The Labor-Management Advisory Committee has met several times this year and the Council has participated in those meetings. You may recall that last August the Labor-Management Advisory Committee declared itself with respect to guideposts, suggesting the abandonment of a fixed numerical standard but endorsing thoroughly the productivity principle. That statement of the Labor-Management Advisory Committee was, of course, very much in our minds as we thought about guidepost policy for 1967. At a subsequent meeting of the Labor-Management Advisory Committee in the late fall, we specifically suggested to them the kind of approach we were considering. I believe, without any formal action or adopted resolution, that they did agree that the general character of the approach that we were proposing was one which they approved.

Representative REUSS. Has that resolution been made public?

Mr. ACKLEY. The one of last August was.

Representative REUSS. Yes, I know that.

Mr. ACKLEY. There was no resolution, no vote. There was a discussion with the committee of different possible ways of handling the guideposts. Some indication was given that we proposed to go along the route we have followed and that—

Representative REUSS. Were minutes of that meeting held?

Mr. ACKLEY. I am not sure.

Representative REUSS. Would you undertake to supply for the committee any minutes of that meeting or impressions of what was said so that we can have the benefit of what the Labor-Management Committee had to say on this subject?

Mr. ACKLEY. May I suggest, Mr. Reuss, that the cochairmen of that committee are Secretaries Connor and Wirtz and both of them—or rather, Acting Secretary Trowbridge—will be appearing before your committee. It might be more appropriate to ask them whether they wish to supply any minutes.

Representative REUSS. Well, you were in on the discussions, were you not?

Mr. ACKLEY. Yes.

Representative REUSS. I would appreciate it if you could file for the record, your impression of those discussions and particularly on what they had to say on the nonexistence of guideposts, which I regret very much.

(The material which follows was supplied by CEA at a later date in response to the request of Representative Reuss:)

PRESIDENT'S ADVISORY COMMITTEE ON LABOR-MANAGEMENT POLICY

REPORT SETTING FORTH THE COMMITTEE'S VIEWS ON THE GUIDEPOSTS FOR NON-INFLATIONARY WAGE AND PRICE BEHAVIOR, AUGUST 18, 1966

I. Introduction

A. The purpose of this memorandum is to provide the President with the Committee's views on what are referred to in the 1962 Annual Report of the Council of Economic Advisers and subsequent reports of the Council as "guideposts for non-inflationary wage and price behavior."

B. In our judgment the 1962 report of the Council relative to the guideposts is of particular significance. A copy of the relevant portions of the 1962 report is attached. We desire to emphasize the following portions of the report:

1. "Productivity is a guide rather than a rule for appraising wage and price behavior for several reasons. First, there are a number of problems involved in measuring productivity changes, and a number of alternative measures are available. Second, there is nothing immutable in fact or in justice about the distribution of the total product between labor and nonlabor incomes. Third, the pattern of wages and prices among industries is and should be responsive to forces other than changes in productivity."

2. "These are not arbitrary guides. These described—briefly and no doubt incompletely—how price and wage rates would behave in a smoothly functioning competitive economy operating near full employment. Nor do they constitute a mechanical formula for determining whether a particular price or wage decision is inflationary. They will serve their purposes if they suggest to the interested public a useful way of approaching the appraisal of such a decision."

3. "These are advanced as general guideposts. To reconcile them with objectives of equity and efficiency, specific modifications must be made to adapt them to the circumstances of particular industries. If all of these modifications are made, each in the specific circumstances to which it applies, they are consistent with stability of the general price level. Public judgments about the effects on the price level of particular wage or price decisions should take into account the modifications as well as the general guides."

C. Consistent with this approach we have agreed on the recommendations that follow:

II. Recommendations

A. That in the near future and at least once a quarter thereafter an objective evaluation should be made of the economy by the Council of Economic Advisers to determine the extent to which the economy as a whole is achieving the goals reflected in the guideposts.

B. That if the evaluation indicates that the overall economy is falling short of the goals reflected in the guideposts, the following steps be taken:

1. The Council of Economic Advisers should identify the nature and apparent chief causes of the major problems or shortcomings.

2. To the extent that the causes may relate to matters within the purview of the President's Advisory Committee on Labor-Management Policy, representatives of that Committee and the Council of Economic Advisers should discuss those problems to determine whether any appropriate corrective action can be recommended.

3. The President's Advisory Committee on Labor-Management Policy should submit to the President a report identifying the problems or shortcomings and including recommendations for corrective action.

III. Conclusion

A. We believe that it is essential to the continued economic growth and health of the country that the present inflationary trends be stopped, and that maximum efforts should therefore be made to restrain, through voluntary procedures, unjustified wage or price behavior.

B. We believe that the goals reflected in the guideposts as set forth in the 1962 report of the Council of Economic Advisers providing for the alignment of wages and prices with productivity in the economy as a whole need and deserve support.

C. We believe that the procedures set forth in the section headed "Recommendations" will assist in providing such support in that they will help to develop a more general understanding of why voluntary restraints serve both the national and private interests.

D. We also believe that it is impractical, if not impossible, to translate the goals reflected in the guideposts into formulas for application to every particular price or wage decision.

E. We believe that in a free society any policy to achieve price stability will be acceptable and effective only if it bears equitably on all forms of incomes.

Representative REUSS. On the price side, a year ago when we had our colloquy, I pointed out that while the price guidelines had for some years had in them a clause saying that where the productivity increase in a particular industry exceeds the average, there should be price reductions there. I noted with disappointment that nothing seemed to have been done about this, and I asked you to file with the committee, which you did, a list of industries where productivity exceeded the national average, so that I might inquire whether they had increased prices. You did file such a list, which is found on page 31 of our last year's hearings, pointing out that oil, mining, copper, gas and electric utilities, iron, cement, malt liquors, manmade fibers, paper, petroleum, aluminum, tires, tobacco products, plastic materials, motor vehicles, dairy products and railroads, had all achieved productivity increases greatly in excess of the national average, and hence were eligible to do the noble act of reducing prices, but as your record showed, most of them had actually increased their prices.

(The table referred to by Mr. Reuss was included in pt. 1 of hear-

ings before the Joint Economic Committee on the January 1966 Economic Report of the President and is reprinted below:)

TABLE 3.—*Industries with above-average rates of productivity growth*

[In percent]

Industry	Average productivity growth rate ¹	Average price change ²		
		1957-65	1960-65	1964-65
GROUP A				
Nonmanufacturing:				
Coal mining.....	3 7.5	-0.5	-0.5	-0.4
Copper mining.....	3 4.1	2.0	1.7	9.6
Gas utilities.....	} 6.9	2.8	1.2	1.8
Electric utilities.....		0	-2	-3
Iron mining.....		-1.6	-1.4	-1
Manufacturing:	3 9.2			
Cement, hydraulic.....	5.3	.4	-.5	.2
Malt liquors.....	5.5	.2	.1	.2
Manmade fibers.....	4.2	-.8	-.5	-.8
Paper, paperboard, and pulp mills.....	4.9	.1	-.4	.9
Petroleum refining.....	6.6	-1.3	-.4	3.5
Primary aluminum.....	7.8	-.5	-1.2	3.3
Tires and inner tubes.....	6.4	-1.5	-.7	1.1
Tobacco products.....	5.5	1.1	.9	.3
GROUP B				
Plastic materials.....	11.6	-1.9	-1.7	-7
Motor vehicles.....	5.0	.4	-.1	.2
Dairy products.....	4.0	1.2	.7	.6
Railroads.....	5.9	-1.2	-2.0	(4)

¹ Average productivity growth rate relates to changes from 1957 to 1963 for all industries in group A and railroads in group B. They are based on BLS indexes of output per man-hour. (See Indexes of Output per Man-hour, Selected Industries: 1939 and 1947-63.) Growth rates for other industries in group B relate to changes from 1959 to 1964 and are based on Federal Reserve indexes of industrial production and BLS man-hour data.

² Based on BLS wholesale price indexes for all industries except railroads; in the latter, average freight rates, computed by Interstate Commerce Commission, were used.

³ Based on output per production man-hour.

⁴ Not available.

Sources: Department of Labor, Board of Governors of the Federal Reserve System, Interstate Commerce Commission, and Council of Economic Advisers.

Representative REUSS. What has the administration done with those 17 industries, or any other above-average productivity industries, which may have joined the list, to get them to reduce prices?

Mr. ACKLEY. I think the table you cite shows that in a number of the industries in which the productivity increase exceeded the average, the trend of prices has been downward—to be sure, not universally, I note; and between 1964 and 1965 there were a number that showed increases.

Representative REUSS. Well, on that, taking your 1964-65, one column shows a tremendous increase in the productivity of most of those industries, but many of them actually increased their prices, copper by 9.6 percent, petroleum by 3.5, aluminum by 3.3 percent, and nobody decreased their prices by as much as 1 percent. The highest decrease was in plastic materials with seven-tenths of 1 percent. And the overall average is a very considerable average of increases.

So my question is, What have you been doing about that?

Mr. ACKLEY. Let me suggest first, that the productivity growth rates that are shown in the first column of that table are averages for the period 1957 to 1963. You cannot take it for granted that the

same trend of productivity has been maintained in those industries. Moreover, it is also relevant to point out that the guideposts relate not only—in effect—to changes in unit labor costs but to changes in other costs. In several of these industries, although labor productivity gains have been rapid, there have also been increasing materials costs. So it is not possible to go directly from the trend of productivity to the appropriate trend in prices.

Representative REUSS. What baffles me is, I do not see how you all can expect labor to sit still for taking just the increase in productivity, 3.2 percent and yet do nothing about enforcing your price guideposts with respect to price decreases, and I would commend to you some conversation and action in this coming year on this whole question.

Mr. Chairman, I am disturbed at the failure of the administration to formulate and send to the Congress intelligible wage-price guideposts, and I am going to suggest at the proper time that the Joint Economic Committee, by default, may have to take on the job of hearing labor, management, consumers and other interested parties, and itself suggest guideposts, because these guideposts are just going to cause people to get lost, since they cannot be read.

Chairman PROXMIRE. I agree wholeheartedly. There is no question that this has been the cornerstone of anti-inflationary policy in my judgment. To the extent that the fiscal and monetary policy enters into, as we all know, the coming situation, it is particularly important because fiscal and monetary policy is less likely to work in an area of less expansionary and noninflationary—

Representative REUSS. It seems to me this is just the time we need the guideposts most.

My time is up.

Chairman PROXMIRE. Thank you. Senator Jordan?

Senator JORDAN. Thank you, Mr. Chairman.

Mr. Ackley, at the beginning of your statement you say "that the economy is in a basically sound and healthy condition. We expect it to stay that way through 1967." You go on to say, "We see an advance in the GNP this year of about \$47 billion to the neighborhood of \$787 billion."

Your forecast is for a slowup of the growth in the first half and stepup in the second half which you claim will need to be restrained by a tax increase. Economists believe the growth for the year as a whole will be considerably less than the 4 percent you estimate and that the slowdown will come in the second half.

Would you elaborate on the reasons for your forecast?

Mr. ACKLEY. I will try, Senator. We think there are several factors that account for the within-the-year movement that we suggest.

In the first place, the revival of the housing industry, which we surely expect to occur in 1967, is something that takes a while to accomplish. The easing of monetary conditions began several months ago. But it takes a while for that to be reflected first in improved flows of funds to the thrift institutions—which are primary suppliers of mortgage credit—for them to rebuild their liquidity, for them again to be willing to lend, and for their increased willingness to make lending commitments to be reflected in construction. So we do not anticipate that the recovery in the housing industry will be nearly

as sharp in the first part of the year as in the second half, when it should really begin to roll.

Everything we have seen since the time we wrote our report suggests that this is definitely coming. Interest rates are down. The flows of deposits into mutual savings banks and savings and loan associations has greatly stepped up. It even appears that in some cities mortgage interest rates have passed their peak and are coming down. So that we do believe that the revival of construction is well on its way to consummation. But it will take a while, and we do not expect it to be sharp in the first half.

The second reason for a slower first half is the fact that the rate of inventory accumulation, which has been rather high in the last several months, will undoubtedly decline. Last year we were adding to inventories at a rate of between \$11 and \$12 billion. We think that this year the rate of inventory accumulation will be no more than half of that. Most of that decline should come in the first half. Once the rate of inventory accumulation stops declining and merely levels off, this will mean a faster advance in the second half.

I think those are the primary reasons that would affect the pattern that we expect within the year. Perhaps Mr. Okun and Mr. Duesenberry might have something further to say on that.

MR. OKUN. It does occur to me, Senator Jordan, that as you suggest, there are some private forecasts which have a weaker second half than first. I do not think that is typical. I think the typical view today is in accord with our own, that the return to monetary easing and the leveling off of inventory investment will make the second half of the year stronger than the first.

While our forecast may be a little above the average of most forecasts coming out today, it is our impression that it is not very different. It is not atypical. We have kept score on a great many of the forecasts that have come to us and they range all over the lot. There are some forecasts as low as 770 for the year. There are others that go well into the 790's.

I think the median forecast today is roughly \$785 billion, which is not significantly different from our own views.

SENATOR JORDAN. Thank you. Mr. Chairman, I have before me "Experts' Forecast of Economic Outlook for 1967," in which experts' forecasts are not quite as optimistic as the testimony we have had this morning. It was printed in the Congressional Record, January 25, pages S-830 to S-835. I ask unanimous consent it be included in the record at that point.

CHAIRMAN PROXMIRE. Without objection, so ordered.
(The document referred to follows:)

EXPERTS' FORECASTS OF ECONOMIC OUTLOOK FOR 1967

[Source: Congressional Record, Jan. 25, 1957. Pages S830-S835]

NATIONAL INDUSTRIAL CONFERENCE BOARD—"BUSINESS OUTLOOK 1967": A DISCUSSION BY THE CONFERENCE BOARD ECONOMIC FORUM AND GUESTS HELD AT THE WALDORF ASTORIA, NEW YORK CITY, NOVEMBER 28, 1966

The conclusions of the ten members and three guests of the Conference Board of Economic Forum, meeting for the 21st year, summarized by Martin R. Gainsbrugh, Senior Vice President, National Industrial Conference Board, presented the average consensus of the participants.

For the year 1967, as a whole, the GNP is placed at \$787 billion, or 6 per cent above the corresponding output in 1966. The group's expectation is that the growth will be at a slower rate not only for the year 1967 but significantly slower in the second half than the first—up 3.2 per cent in the first half as against a rise of 2.7 per cent in the closing half. Thus, the GNP is estimated at about \$802 billion for the fourth quarter, 1967.

Changes in the index of industrial production are expected to be far more modest than the anticipated changes in the gross national product since the latter incorporates value as well as volume change.

Virtually every member of the forum indicated a continued increase in consumer prices, but with a slowing rate in the second half. Wholesale prices have stabilized of late, and the forum has them moving up in '67 less than the CPI.

For the last key aggregate, unemployment, the group was almost unanimous that full employment in the lexicon of the form will again prevail in 1967 but with some slippage in the closing half of 1967 to a figure of 4 per cent or slightly higher by year end.

A descriptive word, . . . on the basis of the forum's collective views, is "consolidation," certainly not recession. . . . As the second half of 1967 matures, there will be a regrouping of demand-and-supply forces far more sweeping than in the months immediately ahead. This consolidation process should be facilitated as we move into 1968, if not earlier, by the restoration of the 7 per cent investment incentive and liberalized depreciation.

Accelerated corporate tax payments, too, will have been eliminated, as we move into 1968. Far more attention, too, may very well have been extended to stepping up the rate of home-building activity, through both public and private measures.

The process of consolidation may thus be building this expansion on a sounder basis as the year ends than when it begins.

THE AMERICAN BANKERS ASSOCIATION: CREDIT POLICY COMMITTEE AND THE DEPARTMENT OF ECONOMICS AND RESEARCH

According to the Business and Credit Review and Outlook published by the A.B.A.'s Credit Policy Committee and the Department of Economics and Research, the present business expansion, now almost six years old, will continue to advance in '67 but at a slower rate than last year.

GNP in 1967 is expected to reach \$783.7 billion—an increase of 6.2 per cent over the previous year's estimated \$737.8 billion. Not all of this gain in GNP will be real in the year ahead. An increase in the physical output of goods and services will account for more than one-half of the increase, or about 3.5 per cent of the rise. The remainder—2.7 per cent—will be due to price increases.

In 1967, the thrust of the 6.2 per cent rise in GNP will again come from Government spending. The advance in this economic sector is estimated at 13 per cent. Consumer spending will be a little below that of the previous year, but will support the business advance by rising at an annual rate of 6.2 per cent. The growth in GNP, however, is expected to receive little impetus from business investment, residential construction, or from business inventories.

WILLIAM H. CHARTENER, ECONOMIST, GOLDMAN, SACHS & Co.: ADDRESS BEFORE THE FORECAST FORUM, INVESTMENT ANALYSTS SOCIETY OF CHICAGO, DECEMBER 15, 1966

There are signs that we are heading into a recession, although the recession may not even be detectable except by professional chart-watchers and people in afflicted industries. The leading indicators have had a dreary aspect for several months. We shall probably come out of this recession in a matter of months since the basic forces in the economy are unusually strong.

Defense spending is probably rising about \$3 billion, in annual rate terms, per quarter now. I expect the rise to be about \$2 billion by spring and \$1 billion per quarter later in 1967. But defense spending is still almost certain to remain among the more important expansive forces in the economy.

Inflation, which I would define pragmatically as the prices we pay rising faster than we care to see them rise, will continue through 1967.

The rate of increase in prices, though, is likely to be less in 1967 than it has been in 1966.

With consumer prices rising close to 4% at an annual rate, it would be surprising indeed if unions acceded graciously to a reduction in the real wages of their members—particularly when labor markets are tight. Under these circumstances, I would regard the recent pattern of about 5% for major wage settlements and the moderate rise in strike shutdowns as reassuring.

For 1967 as a whole, our expectation is $8\frac{1}{2}$ million passenger car sales—which should be no occasion for tears.

I believe there is a good chance that housing starts will regain the million-and-a-half level by the end of 1967 and double to 1.7 million within the next two years.

Latest reports of plans for plant and equipment spending in 1967 indicate a rise of less than half of 16% increase occurring this year.

On the National Income basis, we expect profits after taxes to be about \$48 billion in both 1966 and 1967.

THE WHARTON SCHOOL, UNIVERSITY OF PENNSYLVANIA: AS REPORTED IN DECEMBER 3, 1966 ISSUE OF BUSINESS WEEK

The Wharton School operates a computerized model of the U.S. economy constructed along so-called econometric lines to forecast general business conditions. The forecast reported in the December 3, 1966 issue of *Business Week* indicates that the model at that time pointed to contingent growth throughout '67 at roughly a 4% per year rate with an overall annual rate of increase in prices of about $2\frac{1}{2}\%$ against 1966 experience of 3.7%. This would mean an average rise of about \$12 billion per quarter in gross national product in 1967.

The model indicates that the size of 1967 wouldn't be changed much by shifting the mix of fiscal and monetary policy. Consumer spending is expected to rise about \$6.6 billion per quarter, about \$1 billion less than this year.

Non-residential construction, plus producers' durable equipment spending will rise only 5% from this year's anticipated fourth-quarter rate to the third quarter of 1967 with no increase in the fourth quarter.

Inventory accumulation will slow down to about \$7.5 billion per year. Imports will rise faster than exports, which will impair the net foreign trade surplus.

The labor market will not ease. Unemployment will be down to 3.5%, compared with 3.9% at the time the projection was made.

Profits will continue moving up strongly, despite higher costs.

GERHARD COLM, CHIEF ECONOMIST, NATIONAL PLANNING ASSOCIATION,
DECEMBER 1966

A summary of our estimates indicates a further rise in gross national product in current dollars, and likewise in constant dollars, though at a somewhat reduced rate as compared with the recent past. Taking into account the prospect for productivity advance and labor force growth, the projected 4 percent real growth rate implies an over-all unemployment rate rising, by the end of 1967, somewhat above the average recorded in recent months.

The high level of business spending, continued during the last months of 1966, will probably slacken through 1967.

Residential construction starts showed a steady downward trend, significantly decreasing in the third quarter of 1966. The outlook for this sector of the economy is made more dire by stringent credit conditions, saturation of the market, high rate of interest, scarcity of funds for both those building and those purchasing homes, and rising costs of construction. A conservative estimate of this sector is that the rate of decline will taper off as the floor is approached midway in 1967. Congressional action to aid this sector of the economy is quite likely to have some effect by that time, and a modest upturn may occur toward the end of next year (although it may not be of a magnitude sufficient to affect the annual rate of residential construction).

Inventory accumulation is expected to run lower in 1967 than in 1966, partly because of the rise in steel prices in August 1966, the continuing uncertainty of the the annual rate of automobile sales, the fact that some procurement programs will rise in the fourth quarter of 1966 but might taper off through the remainder of the year, and the general uncertainty prevailing the economy.

The road ahead for 1967 may be rougher than it was for previous years. There will be more bottlenecks, more labor disputes, more price rise. Policy will be determined largely by the political developments in Southeast Asia and other parts of the world; by decisions at what level to continue economic and social programs that have been initiated; by the need to combat the threat of inflation and the balance of payments deficit by monetary, fiscal, and price-wage policies, and particularly by the necessity to better balance these component parts of a comprehensive anti-inflation program; and, finally, by psychological factors of importance under conditions of uncertainty. How the partly conflicting goals of policy will be reconciled in the political arena is a question which the economic crystal-ball gazer is even less equipped to answer than the political soothsayer.

DR. OLIVER JONES, DIRECTOR OF RESEARCH, MORTGAGE BANKERS ASSOCIATION OF AMERICA, DECEMBER 29, 1966

The most optimistic projection of business plans for plant and equipment expenditures foretell a lower volume of business demands for credit. After a rapid build-up in inventories, the slowed pace in autos, appliances, retail sales, and steel also suggest that business will require less credit in 1967. Bank loans to business have already slowed, but some of this demand has shifted to the capital markets. The momentum already built up will keep business demands for credit relatively high during the first half of 1967, but a marked reduction can be anticipated in the second half.

Consumers have already slowed down their credit demands. Net additions to consumer installment credit in the second half of this year have been running below 1965, and in October the \$380 million added to consumer installment credit was the smallest in several years. Surveys of consumer buying intentions indicate that those moderating influences will continue in 1967. There is good reason for these changes. Buying power has eroded steadily in 1966 and reduced the consumer's discretionary income. Still consumer expenditures will continue to rise throughout 1967 but the pace will be slower, releasing some credit for other uses and discouraging further expansion of productive capacity.

We have little hard information about the federal budget at this time, but a deficit of \$12 billion is clearly possible. Thus, the Treasury will remain a heavy borrower during much of next year. Even so, government expenditures are not likely to increase enough to offset in full a slower rate of growth in the private economy.

All of this adds up to a gross national product of \$772 billion for 1967. Government expenditures will be increasing throughout the year. Consumer expenditures, particularly on durables, will increase at a slower pace. The drag on the economy during the first half of the year will be in residential nonfarm construction outlays and moderately in inventory adjustments. In the second half, residential construction should increase sharply while additions to inventories and plant and equipment expenditures are reduced.

In this frame, private nonfarm housing starts will continue at a relatively low level during much of the first half of 1967, around the prevailing 1 million unit annual rate, and pick up sharply during the second half to reach a 1.6 million annual rate by December. This delayed turnaround will produce an average volume of private nonfarm starts of 1,188,000 units, only slightly below this year's 1,220,000 units. More important, the trend will be up.

"THE AGRICULTURE SITUATION AND OUTLOOK FOR 1967": REX F. DALY, CHAIRMAN, OUTLOOK AND SITUATION BOARD, NOVEMBER 14, 1966

Another good price and income year is in prospect for farmers in 1967, even if realized net farm income does not quite measure up to the near-record 1966 level. This is the best judgment we can make in the face of the greater-than-usual uncertainties in the agricultural outlook for 1967.

Prospective developments for the next 6 to 9 months seem fairly clear. But the picture becomes a bit more blurred than usual as we project further into the 1967/68 marketing year. Among the uncertainties in the economic outlook for 1967 are possible changes in the Vietnam conflict and their impact on the general economy and agriculture; new grain programs with added acreage and

their influence on 1967 crop output; and foreign crop prospects and their effect on export markets.

Domestic demand for food and fiber is expected to increase in 1967, but not so much as the whopping advance this year. Expanding output, more jobs, and prospects for a more rapid rise in wage rates in 1967 will increase consumer buying power and the demand for farm products.

Farm output will likely increase by a sizable margin over this year, with much of the gain in grains, soybeans, hogs, poultry, and eggs. Producer prices for food and farm products as a whole next year may average close to 1966 levels; but wages, transportation and other costs of processing and marketing are expected to rise. Accordingly, a further increase is indicated for retail food prices. The rise is not expected to be anything like the big increase now indicated from 1965 to 1966. However, it is expected to exceed the average annual increase of $1\frac{1}{2}$ percent from 1960 to 1965.

"FACTORS IN THE 1967 ECONOMY": TALK BY LOUIS J. PARADISO, ASSOCIATE DIRECTOR, OFFICE OF BUSINESS ECONOMICS, U.S. DEPARTMENT OF COMMERCE, 44TH ANNUAL NATIONAL AGRICULTURAL OUTLOOK CONFERENCE, NOVEMBER 14, 1966

To sum up: The foregoing discussion suggests that business activity may be expected to continue upward through 1967, with a high probability that the increases would be at a slower pace than this year, assuming that the Vietnam war goes on at the present tempo. The momentum of the current boom will carry through in the first half of next year so that a slower rate of increase is quite likely in the second half than in the first half.

This year, real GNP is expected to be about $5\frac{1}{2}$ percent above 1965; the increase in the total labor force is 1.7 million or 2.2 percent; the number in the Armed Forces has increased by about 400,000; this year's gain in productivity for the entire economy is estimated at 2.5 percent. These numbers imply a reduction in the rate of unemployment from the average 4.6 percent in 1965, to 3.9 percent this year which, on the basis of the actual rates for the first 9 months, look reasonable.

I am citing these figures to show how we have accomplished the interim objective of reducing the rate of civilian unemployment to around 4 percent. This rate was achieved with an increase in real GNP of $5\frac{1}{2}$ percent, an expansion which was required to reach the low rate of unemployment. However, in the process, imbalances and price pressures have developed. Such a high growth rate of output is not sustainable without causing further severe pressures and imbalances. Now that we have attained a relative low rate of unemployment, we can maintain this rate with a slower growth in real GNP than we had this year.

For purpose of illustration, let us assume that the gain in total labor force in 1967 will be 1.6 million, a little smaller than the 1966 increase, and that the Armed Forces will rise by 300,000 over this year's average of 3.1 million; the assumed increase is not much above the 3,230,000 in the Armed Forces as of this past September. Also, let us assume that total productivity in 1967 will be a little higher than that expected for this year—a gain of 2.7 percent over 1966; and, finally, we shall assume that the rate of unemployment remains at this year's average of a little below 4 percent. Then it follows that to absorb the growth in the labor force a real GNP growth of about $4\frac{1}{2}$ percent would be needed.

This is not a forecast, but it does provide the dimensions of the real growth in output needed to maintain the rate of unemployment at a relatively low level.

If the growth rate of output is reduced to a more sustainable pace, we shall reap two important benefits: The present imbalances in our economy would be corrected and price pressures would ease. If the present rapid pace of economic activity, however, should continue, the penalty eventually will be a painful adjustment. I don't think anyone knows at this time, considering the uncertainties, that tax increases or control measures would or would not be required to moderate the tempo of economic activity in 1967. The President is watching developments closely and when the picture becomes clearer he will make a decision one way or another.

THE PRUDENTIAL INSURANCE CO. OF AMERICA: "PRUDENTIAL'S ECONOMIC FORECAST FOR 1967, THE OUTLOOK IN BRIEF"

What worries some observers, however, is not our ability to expand production but that the boom will peter out and a recession begin in 1967. They point to declining housing starts, weakness in new orders for durable goods, lagging car sales, and depressed stock prices as symptoms of an economy heading for trouble. We do not share this view. Although the rate of economic growth may slow in the second half of 1967, we expect no recession during the coming year. In brief, these are our reasons:

Federal government spending will soar \$12 billion, as both defense and non-defense expenditures continue to rise.

State and local spending will increase \$5 billion. While substantial, this gain is somewhat less than the amount indicated by a simple projection of past trends.

Business capital outlays will rise \$6 billion of 7½ percent in the full year 1967. Although this is only 60 percent as much as the dollar rise in 1966, it is still a considerable advance. The combined effect of tight money and the suspension of the 7 percent investment credit will reduce new orders but will not affect actual outlays until mid-1967. At that time, a minor and short-lived dip in plant and equipment expenditures is likely.

Inventory buying will continue at an above-normal \$7.5 billion, compared with the hectic \$10.5 billion accumulation of 1966.

Housing starts have been in the doldrums for months. As a result of tight money, a more than 300,000 unit backlog of demand has been accumulated. The result will be an upturn in housing expenditures during the second half of 1967, just as plant and equipment expenditures begin to show signs of easing.

Consumer expenditures will rise 7 percent, in line with our projected increase in personal incomes. The average American family will enjoy a boost in income from \$7,250 in 1966 to \$7,600 in 1967.

We conclude, therefore, that overall GNP will rise an impressive \$50 billion, from \$740 to \$790 billion. This equals a 7 percent increase, of which inflation will claim 3 percent, real growth 4 percent. During the second half of 1967, however, some slowing of the expansion is expected. The result will be smaller real growth but also less intense pressures as the year draws to a close.

DR. ARTHUR F. BURNS, PROFESSOR OF ECONOMICS, COLUMBIA UNIVERSITY AND PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH: "THE ECONOMIC AND FINANCIAL OUTLOOK"

Let me now summarize briefly what I have tried to convey. The expansion of these economy has recently abated considerably, and this slackening is likely to continue in the private sector. Indeed, were it not for the federal sector, we might now be gradually moving into a recession, albeit one in which the price level would still be under upward pressure. With federal spending continuing to rise, an early recession is unlikely. Even so, the growth of aggregate demand is likely to abate, economic crosscurrents will multiply, some industrial slack may develop; and while business as a whole should be good, profits will be less satisfactory than the volume of business. In view of the uncertainties of war, if for no other reason, prudence requires effective restraint on nonmilitary expenditures, but the economic case for a tax increase now appears very doubtful. All these surmises and judgments, I need not repeat, are based on relatively optimistic assumptions concerning future financial costs of Vietnam.

I would like, finally, to suggest a few lessons that may usefully be drawn from recent experiences.

1. Expansionist fiscal and monetary policies, if pushed beyond a point, may readily bring on inflation and threaten the continuance of prosperity. Economic forces have momentum and work with lags. Unless inflationary pressures are recognized at an early stage and steps taken to slow down gradually the growth of aggregate demand, blunt measures—such as those used in the credit market this year—may become unavoidable.

2. Although the promotion of a high level of aggregate demand is a vital governmental responsibility under modern conditions, we should not seek through expansionist policies what can be achieved at lower cost, and with more lasting effect, by attending diligently to the structural causes of unemployment.

3. The flow of factual information needs to be improved. We need current and comprehensive statistics on job vacancies as well as on unemployment. And we need information on prospective federal revenues and expenditures, quarter

by quarter, similar to the information that the government now compiles on business sales expectations and investment intentions.

4. Perhaps most important of all, we need better coordination of economic policies. When, in a year of full employment and inflationary pressures, the government runs up expenditures sharply, tightens credit to a point that one day this summer seemed almost to invite panic, does little about taxes, exhorts labor to be modest about wage demands, and simultaneously legislates a substantially higher minimum wage, it appears that the art of managing our national prosperity has not yet reached the excellence that we hope for it.

A. G. EDWARDS & SONS, AN ADDRESS BEFORE THE INDUSTRIAL RELATIONS CLUB OF ST. LOUIS BY OLIVER M. LANGENBERG, NOVEMBER 16, 1966: "PROFIT PROSPECTS—1967"

So, very briefly and putting my conclusions at the beginning, what we look for is a continuation of this present period of slackening growth going through the balance of 1966 and most of next year, 1967, with negative forces gathering momentum in the early and the middle part of the year, hopefully bottoming out late in 1967 or early 1968. It is still too early to determine the extent and depth of a downturn. We just don't know about Vietnam. If the many questions that can only be resolved by the Administration are done so properly, the effects of a downturn can certainly be modified and the stage set for exploiting our bright long-term potential.

So, what does this all add up to? The picture as we see it is that we are closing in on a long period of business expansion. Demand by the consumer and business is leveling off and will decline next year as a result of the imbalances that have developed since 1965. Government spending, however, will rise, hopefully less than earlier expected as a result of the recent elections. We now have to boil off some of our excesses during which corporate profits, which already are flattening out, will be declining. How much you ask? Plus or minus 15 percent by year-end 1967, with some industries with a high labor component experiencing a much greater decline in my guess.

BUSINESS WEEK, DECEMBER 31, 1966: "THE 1967 BALANCING TRICK"

The U.S. economy will be trying to pull off a high wire act in 1967. And business, government, and labor will all have a tough time keeping their balance.

By all the odds, the problems will not cook up into a recession. The best available information points to a 1967 gross national product of around \$790-billion, up \$50-billion, or 7%, above last year.

Plenty of trouble. Demand will continue to press against capacity. Productivity gains will come hard. Profit margins will be difficult to maintain. And the fight will be intense between business and labor over how income should be distributed.

Real output will grow at a 4 percent annual rate.

Prices will continue to rise fast—at a 3 percent annual rate.

Productivity gains—the oil from the wheels of the economy—will come harder. The Labor Department experts who track productivity expect the year-to-year increase to average no more than about 2.5 percent to 2.6 percent in 1967, as against this year's 2.9 percent and the 3.5 percent average of the earlier years of the boom.

Unemployment will rise slightly from the current 3.7 percent.

Profits will stay high, but the trend will be level or perhaps slightly down.

NATIONAL ASSOCIATION OF HOMEBUILDERS, NOVEMBER 1966: "ECONOMIC NEWS NOTES—1967 FORECAST"

In 1967 the economy will likely once again show substantial growth but at a slower pace than during 1966. Gross National Product will increase by \$53 billion or at a rate of 7.2 percent. Due to increased inflationary pressure already being experienced during the latter half of 1966, real growth will be held to about 3.2 percent. The total GNP next year will be double that of 1959. In that 8 year period, however, residential construction will have increased by only 12 percent.

Economic growth during 1967 will take a different shape than that in 1966. Corporations, which in recent years have experienced rapid growth, heavy demand for their products and a resultant growth in corporate profits, will make only modest gains in profits during 1967. This, if coupled with a tax increase and a loss of the major portion of the benefit from the 7 percent tax credit, would result in a slowing in the rate of plant expansion. Any freeing of funds from the sector could eventually have a positive impact on the home building industry.

Slower rates of growth will effect the employment picture in 1967. The seasonally adjusted rate of unemployment is now running at 3.8 percent but will soon begin to edge upward. Any reduction in the commitment of men in Vietnam would also accelerate this rise. 1967 will be a year of major labor contract negotiations which usually put pressure on prices.

High levels of consumer after taxes income, have increased personal consumption expenditures by \$100 billion since 1964. During 1967 the increase is expected to be \$34 billion with the heaviest rise in the service sector. The consumer appears to be spending not only all his additional income but a little more. The savings rate has dropped from 5.5 percent of disposable income in 1965 to 5.1 percent this year and will fall even lower in 1967, to 4.9 percent.

The 11th Quarterly NAHB Metropolitan Housing Forecast covering 94 metropolitan areas indicates a further decline in home building activity during 1967.

After weighing the forecast for geographic representation and for the mixed single and multifamily activity, it was found that the decline during 1967 would be approximately 8 percent or an additional 100,000 units.

NATIONAL CITY BANK OF MINNEAPOLIS: "THE ECONOMIC OUTLOOK FOR 1967," BY
WALTER W. HELLER, JANUARY 3, 1967

In sum, the following overall GNP pattern emerges for 1967 from the foregoing analysis:

A 1967 GNP in the neighborhood of \$780 billion, or about \$42 billion above 1966.

A near-6% advance over 1966 in money GNP, but only 3% in real GNP.

A rather soft economy in the first half of 1967, gaining momentum in the second half and pushing toward a fourth-quarter GNP of \$800 billion or a bit beyond.

In drawing lessons for policy from this GNP forecast, one must bear vividly in mind the earlier warnings about margins of error and the premium on skillful timing and maximum flexibility. Not many months ago, most of us foresaw strength in the first half, with the danger of undue softening delayed until summer or fall—not to mention that the whole year looked stronger than it does now. What does the revised outlook imply for policy?

First, it calls for all deliberate haste in easing monetary restraints, even at some risk on the beleaguered balance-of-payments front (though the probable readiness of Germany, Canada, the United Kingdom, and perhaps even France to follow our lead on lower interest rates tends to reduce this risk).

Second, if there is to be a tax increase (and I, for one, still favor a modest surtax to buy more monetary ease and more budget leeway for the Great Society), its economic risks can be minimized by aiming at a July 1 effective date, thus not adding to the burdens of an already soft first half: giving the stimulative effects of easier money time to be felt before imposing the surtax; permitting a better assessment of whether the *quid pro quo* in (a) easier money and (b) stronger support of essential civilian programs will really be forthcoming; keeping open the option of no tax increase at all in case the economic softness proves to be more than temporary.

Third, several important and flexible fiscal weapons should be pressed into action swiftly if and when needed: restoration of investment tax incentives; restoration of Federal highway funds; adjustment of the size and effective date of the projected Social Security increases.

The year 1967 will be a difficult one, economically. Wrong-headed economic policy could even make it a dangerous one. But with responsive economic policy—which I expect—it will be a year of movement toward better economic balance and a stronger base for future economic growth.

"THE ECONOMY IN 1967": BY IRVING SCHWEIGER—TEXT OF HIS ADDRESS AT THE ANNUAL BUSINESS FORECAST LUNCHEON ON DECEMBER 7, 1966—IRVING SCHWEIGER IS PROFESSOR OF MARKETING IN THE GRADUATE SCHOOL OF BUSINESS AT THE UNIVERSITY OF CHICAGO

In 1967, I expect the current economic boom to end. It will be a year characterized by downward revisions in sales targets and planned capital investment, by rising unemployment and industrial disputes, and by major changes in monetary policy. The boom will end not with a crash but with a materially reduced rate of growth and an economy unbalanced and dangerously sensitive to an unexpected truce in Vietnam, should it come in the early months of 1967.

My estimate is that the Gross National Product will total \$778 billion in 1967, about \$39 billion more than in 1966. However, a little more than half of this increase will be water resulting from substantial price rises, and only \$19 billion of the \$39 billion advance will accrue from growth in real output of goods and services. The number of unemployed persons will rise steeply from very low current levels as one of the more serious consequences of a greatly diminished rate of growth coupled with rapid expansion of the labor force.

Very briefly: I consider that present monetary and fiscal policies have been more effective in shrinking demand in the private sectors than is generally believed and that they will be more than sufficiently potent unless altered. Full effects of these policies have been masked by continuing waves of price and wage increases and by surveys that ascertain business investment plans to be still rising.

Instead of a gain in plant and equipment spending in 1967, I believe the yearly total will just about match the \$79 billion of spending in 1966. From the fourth quarter of 1966 to the fourth quarter of 1967, I anticipate a decline of about 10 percent.

I am therefore allowing for an increase of \$11 billion in defense spending in 1967 compared with a \$9.5 billion rise in 1966. Nondefense Federal spending will be pruned heavily and I anticipate only a very small increase in this category. On the other hand, spending by state and local governments will continue to rise strongly and should total about \$8 billion above the 1966 figure.

In 1967, slackening in consumer demand will contribute significantly to a lessened rate of overall economic growth. Tight credit is undoubtedly one major factor in contraction of the housing and automobile markets.

Disposable personal income will total about \$435.5 billion, a gain of about 6.2 percent. Consumers are expected to increase their total spending for goods and services by only 5.5 percent. The difference is accounted for by higher interest payments and by a small increase in the rate of personal savings attributable to a reduced rate of spending for durable goods, primarily automobiles.

My estimate is that total private residential construction expenditures in 1967 will be about \$24 billion, more than \$2 billion below the total for 1966. Because of anticipated loosening of the credit reins, the fourth quarter 1967 rate is placed at about \$26 billion.

In summary, the economy in 1967 is expected to grow less in real terms than in any year since the recession of 1960-1961. Monetary restraint applied forcefully, with modest assistance from fiscal policy, is completing the task of checking demand in the private sector of the economy—business and household. In the absence of a major expansion of the war, delicate and skillful shifts in governmental policy are now required to smooth transition to a new balance in the economy. It is probable that errors in monetary and fiscal policy will occur. A year ago fiscal and monetary restraints were too slow in coming and too weak to be effective before major damage resulted. In 1967, monetary and fiscal restraints are likely to last too long in too great strength for the needs of the economy. Slow growth, higher prices, major strikes, rapid increase in the number of unemployed, and greatly varying trends in individual markets are anticipated.

In spite of the complexities and strains, GNP in 1967 is expected to grow about 2.6 percent in real terms and by 5.3 percent or \$39 billion in the higher prices that will prevail.

It will go down in the books as a nonvintage year for the economy.

"AN END TO ECONOMIC EUPHORIA": TEXT OF ADDRESS BY BERYL W. SPRINKEL, VICE PRESIDENT AND ECONOMIST AND DIRECTOR OF RESEARCH FOR THE HARRIS TRUST & SAVINGS BANK, CHICAGO, AT ANNUAL BUSINESS FORECAST LUNCHEON, DECEMBER 7, 1966

For the first time since 1960, a convincing although not conclusive case can be made for a recession within the year. If not for the anticipated strength in Federal and state and local spending, the argument would be completely convincing. Leading indicators of economic activity are quite weak, with well over half contracting. The present pattern is typical of developments prior to either a leveling tendency in the economy or a recession. At a minimum, this evidence suggests the rate of rise in the private sector of the economy will slow.

Analysis of individual major sectors of the economy fails to disclose hidden strengths. Consumer surveys suggest the consumer developing restraint after engaging in the longest and largest buying spree in U.S. history. Auto sales appear to be headed downward by at least a half-million units and probably more. Residential construction is severely depressed and money market conditions and building permits show no indication that improving demographic factors will exert a stimulus in near-term months.

Surveys of plant and equipment spending plans for all of 1967 indicate no rise above the current projected rate. Already plant and equipment spending is running 6 percent above the annual rate for 1966 and surveys suggest a 3 percent to 5 percent increase in 1967 over 1966. Although some modest increase may occur early in 1967, the recent suspension of the investment credit is likely to initiate a downtrend in plant and equipment spending in the last half. Inventories have risen over \$10.5 billion in the past year and if sales gains moderate as expected, less inventory accumulation can be expected in 1967.

History is replete with evidence that our economy cannot adjust smoothly to abrupt policy shifts such as occurred in monetary policy in 1965 and 1966. Although the economy is probably not yet beyond the point of no return, historical relations suggest that continued monetary liquidation for a few more months would mean recession in 1967.

Although continued monetary restraint would, in my opinion, mean recession, I must assume that for both political and economic reasons the current policy will shortly be reversed even though there are numerous examples in the past where such reasoning proved erroneous. Even if we avoid a recession, the economy will surely show less steam in 1967. We project a rise in GNP to about \$777 billion, approximately 5.3 percent above 1966. At least half the rise will represent inflation, so that real output will increase well below the long run trend and unemployment is likely to rise.

In such an environment corporate profits will come under pressure as wage rates rise well in excess of productivity gains.

Interest rates have probably already recorded their highs for this cycle, but so long as inflation remains a serious threat and recession is avoided, a sharp reduction in interest rates is unlikely.

There are times when convictions concerning the future trend in economic activity can be formulated with great confidence, i.e., at 3 to 1 or better odds. Unfortunately, the present is not one of those occasions.

"MONETARY AND FISCAL POLICY AND THE COMMERCIAL BANKING SYSTEM": AN ADDRESS BY WALTER E. HOADLEY, SENIOR VICE PRESIDENT AND ECONOMIST, BANK OF AMERICA AT AMERICAN FINANCE ASSOCIATION ANNUAL MEETING PANEL SESSION, DECEMBER 29, 1966

The second factor I mentioned—the course of the general economy—is a highly debatable subject these days. Polls of economists and other forecasters reveal an unusually loud chorus of complaints that 1967 is proving to be one of the toughest years to predict in a long, long time.

The current opinion of many of the nation's most seasoned economic forecasters, however, is that 1967 will see a rise in:

1. Gross national product of about 6 percent,
2. Consumer prices of no more than 3 percent, and
3. Industrial production of slightly more than 2 percent. But they foresee *no rise* in interest rates, no drop in unemployment, and a small additional decline in new housing starts.

In my judgment, this consensus still gives an encouraging picture of prosperity ahead for 1967, but not without some obvious problems. For some months, the coming year has seemed to me to be one of "pock-marked prosperity." The standard forecast just given clearly is less buoyant than just a few weeks ago, and general confidence is waning. Once again, we've had a dramatic shift in sentiment within 60 to 90 days—from widespread fears of overheating to rising concern about impending recession.

Private demands for money seem likely to diminish at an irregular pace over the year ahead, but not until the record high second quarter tax payments have been covered. Contributing to slackened private demands will be the creating of plant and equipment expenditures, reduced inventory and receivable build-ups plus some actual liquidations, and lessened need to acquire added funds for financial reserves as well as operating purposes.

Economic trends in Western Europe suggest some cooling there as well as in the United States. In part, this undoubtedly reflects, as here, the inevitable results of restraining monetary policies. There also seems to be some scattered evidence, however, of supply catching up with some of the formerly urgent phases of durable goods demand. The profit margins of foreign enterprises, including those owned or controlled by U.S. organizations, are showing signs of narrowing, abroad as well as at home. Hence, new direct investment overseas in 1967 should continue to drift lower than in the recent past, taking some pressure from the developed countries off the international money market. The developing nations, however, will continue to ask for huge credit accommodations next year to the full limits of available money supply, so no sharp decline in international interest rates seems likely.

In short, the year 1967 will be another rough one for all who are directly or indirectly involved in making public or private financial policy decisions. Flexibility and liquidity must and should dominate most thinking. Tight money will not disappear as a problem next year, although some of its most acute aspects should be gone, and some of the delayed consequences of tight money are still to be felt. The authorities no doubt will make some progress toward achieving a better balance between fiscal and monetary policies in guiding the economy, but monetary policy will still have to carry much of the load.

BUSINESS ROUNDUP: FORTUNE MAGAZINE'S FORECAST FOR THE NEXT 18 MONTHS—JANUARY 1967

The great industrial boom of the last six years, which has lifted factory output by a half and total output by a third, is now coming to an end. From its extraordinarily high level, the U.S. economy is embarking on a new phase, call it pause, readjustment, or even recession. Roundup expects that the FRB index, about 158 in November for the fourth month in a row, will go off five points in coming months and then level out. Real GNP at a \$758 billion rate last quarter, should level out and then edge up (see chart). In current prices (rising 2.5 percent a year), GNP will go up from \$739 billion in 1966 to \$770 billion in 1967, as Roundup in effect forecast last July.

Defense. The spending rate for arms has risen some \$15 billion since 18 months ago, 3 times as much as Roundup was then considering as a possibility, and this, of course, has had a giant multiplier effect on GNP. On present prospects, the next 18 months, and some of that will again represent higher prices.

Budget. Federal fiscal policy, which notably failed to act as a restraint on the boom, does not promise to supply any stimulus now that the economy is turning. The rate of outlays soared by \$23 billion in the past year, to \$150 billion, on the national-income accounting of the budget, which went into deficit last quarter for the first time in a year. Outlays should be going up at only a \$9-billion annual rate over the next 18 months.

On the revenue side, changes in social-security taxes and the suspension of investment incentives are now putting \$2 billion more a year into the till, and the economy would throw off an additional \$10 billion annually if it kept at full employment. A more realistic appraisal of economic and revenue prospects, however, indicates a moderate deficit.

Capital goods. Fixed investment in new plant and equipment has swelled by almost two-thirds or \$30 billion over the past six years, in real terms. But the gains have been diminishing from \$8 billion in 1965 to half that rate lately. And now demand for new capacity is being cramped by the suspension of the invest-

ment tax credit and the money situation. Next quarter, the volume of investment will be hardly bigger than it was last quarter, and then it will decline. Even when the tax credit is restored and credit gets easier and cheaper, the investment rate will not turn upward, but will continue to decline at a moderate \$2 billion a quarter or less.

Utilization rates will meanwhile fall sharply, for example by nearly 10 percent in manufacturing where capacity will be expanding 7 percent and output dipping 3 percent. A year hence, outlays will still be reflecting large capital appropriations made recently, but new appropriations will be very much smaller, and as time goes on outlays will follow them down.

Inventories. Business accumulation of stocks hit a new peak rate last quarter, about \$14 billion on Census' latest available data and a bit more on Roundup's own preliminary accounting. Cutbacks in industry are bringing the accumulation rate down now, and Roundup projects that it will drop, quarter by quarter, to zero by next summer, then turn into a \$2-billion rate of liquidation in 1968.

Construction. Since spring housing starts have dropped from a rate of 1,500,000 private nonfarm units to below 900,000. Beginning soon, and over the next 18 months, the rate should climb back to its former level. Building activity is \$8 billion down from the spring rate of \$28 billion; by mid-1968 it will still be catching up.

Public-works volume, at \$21 billion for two years, should decline a bit owing to presidential limitations on funds for highways and buildings, as well as to a lag in state and local bond financing. But in 1968 the volume should rise \$1 billion again.

Prices and wages. In the past year consumer prices and the price level in general have risen nearly 3.5 percent which is about 2 percent more than the average of previous years. In the next 18 months prices will go up less than in the past year but again more than the prior average, probably by 2.5 percent per annum, possibly, a bit more.

Wage costs, of course, have been accelerating. New contract settlements have recently been averaging around 5 percent in pay increases. These, and more of the same to come, will speed up the rise in the average factory wage rate, which already has gone up 3.5 percent in the past year.

Consumer spending. Over the next 18 months the volume of consumer purchases will go up only about half as much as the \$32 billion it advanced in the past year and a half.

Credit. The Federal Reserve already began to relax its credit policy last month, as witness the significant fall in money rates, particularly at short term, and the ease with which the market absorbed heavy new corporate flotations. The downtrend of interest rates is not apt to be headlong. And on the experience of the past two decades, they may not get back to where they were.

Exports. The U.S. export surplus hit a low last summer, a rate of \$4.3 billion, down some \$4 billion from its 1964 levels. Most if not all of this loss should be recovered by mid-1968.

Imports are the key now. They have been racing ahead, \$1 billion a quarter, in part to meet demands U.S. suppliers could not fill, but hereafter they should decline, as domestic capacity grows and home demand eases.

Senator JORDAN. Mr. Ackley, I was somewhat concerned by something else in your statement. Among the accomplishments of the past 6 years you list "Accomplished a 50-percent increase in average real farm income in contrast with a 9-percent gain in the preceding 6 years."

Upon what do you base that optimistic conclusion? It does not tie in with the evidence I get from my own agricultural State of Idaho and from the evidence of other experts available to us.

Mr. ACKLEY. Senator, these are the official figures prepared by the Department of Agriculture and, as far as I know, no one has raised serious questions about their accuracy or validity. We do not produce the numbers ourselves. They are official statistics.

Senator JORDAN. One retired official of the Department of Agriculture does not share your optimistic view of agriculture. I do not know whether you are familiar with a book put out by Mr. Frank Le

Roux, retired official of the Department of Agriculture, entitled "1961 through 1965, Farmers' Worst 5 Years." Mr. Le Roux, after working over there for 5 years, made the report at his own expense and I quote from his foreword.

This report attempts no debate on the state of agriculture. It simply lays out the facts in eye opening graphic form so that you can form your own opinions. By almost every possible pertinent economic measurement that I can apply to our national agricultural situation, it all seems to come out about the same. The 1961-1965 period has been the worst five years in our modern agricultural history.

He goes on to say :

No other segment of the economy has accomplished as much in recent years as has agriculture. There is no other sector that has received so little in return.

Mr. Le Roux says all the statistics in this book he has put out are directly from or derived from Government publications. He goes into some great length. I recommend it to you because it might have been written by a Republican. It was not. It was written by a Democrat, a disillusioned Democrat who quit the administration. He says the fact is, from 1961 through 1965, instead of the farmers never having it so good, the farmer never had it so bad. He goes on to say :

By almost every conceivable standard this has been the worse 5 years for the American farmer of any administrative period regardless of party in modern agricultural history.

He said :

The farmers had the lowest share of the gross national product, the lowest return on gross sales, the lowest return on total capital investment, the lowest return on capital investment per farm, the lowest share of the consumer dollar, the lowest share of the food dollar, the lowest level of parity of income, the lowest return for farmers against the Government salaries, lowest return from farming against all other major businesses.

And so on.

And this is, I think, a serious indictment of the farm program of this administration and then you come along with your Economic Report and I cannot think my people out in my State believe that in the past 6 years we have accomplished a 50-percent increase in average real farm income, because they are going downhill pretty rapidly. So are they in many other parts of the agricultural economy of the country.

So I can think there is a great discrepancy in the data and information that comes to us from the same Department of Agriculture and the Federal Government and I wish there was some means of reconciling these differences.

Do you have any suggestions along this line?

Mr. ACKLEY. Senator, we have not studied this particular publication to which you refer. I was aware of its existence from a newspaper story. I would be very happy to undertake an analysis of these views. If the author of this publication does not question Government statistics and uses them, I find it difficult to see how he can reach the conclusion he reaches on the basis of the official statistics of farm income per farm.

I think that many figures which are cited with respect to agriculture, such as its share in the gross national product, are quite misleading. It is an inevitable law of economic development that as a society becomes richer, and incomes rise, agriculture necessarily shrinks

as a share of the total. People's stomachs are limited in their capacity, and whereas in our own early history agriculture probably accounted for 90 percent of our GNP, today it accounts for less than 5 percent. I do not think that bears at all on the average income position of farmers. It merely reflects that as incomes rise we spend the larger part of it not on additional food and fiber but on other products that are available. The most crucial figure, as far as I am concerned, on the farm situation is the average income per farm and that is the figure to which we refer. We will, however, be very happy to undertake an analysis of the document.

Senator JORDAN. I wish you would. I will present you with this book. I wish you would have it analyzed and come back with an official answer perhaps to some of the points I have raised.

Mr. ACKLEY. We will be glad to.

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

(The CEA subsequently supplied the following memorandum for the record:)

MEMORANDUM FOR THE RECORD IN RELATION TO THE STATEMENTS AND STATISTICAL INTERPRETATIONS MADE BY MR. FRANK M. LE ROUX IN HIS PUBLICATION ENTITLED "1961 THROUGH 1965—THE FARMERS' WORST 5 YEARS"

We wish to be very clear in stating the Council's concern for the income levels and the progress of farm people. When we report recent gains in net farm income, we do not mean to imply that no further improvement is possible or desirable. Likewise, some farmers have moved ahead more rapidly than the average, others have fallen behind. All this we recognize fully. But this should not detract from the fact that the average net income per farm has increased substantially, as pointed out in our Annual Report. In his publication, Mr. Le Roux relies heavily on the use of percentages and ratios which in most cases have little relation to the net income position of farm people. His interpretations are not supported by professional analysis. In fact, his interpretations and conclusions are quite misleading.

For example, he uses as evidence that these were "the worst five years" the fact that net farm income represented the lowest share of the gross national product in history. Using this criterion, the same could have been said in 1960 of the preceding five years, or, indeed, at almost any time in our history. With a rapidly expanding gross national product, it is almost certain that this will hold true for future years. This should not be surprising when we know that agricultural employment dropped from 5.7 million in 1960 to 4.2 million in 1966 while nonagricultural employment increased from 61 million to 70 million in this same period. Mr. Le Roux fails to point out the rapid technological improvements and the great increases in efficiency of U.S. agriculture, the growing number of large commercial farms and the declining number of small, marginal units.

Mr. Le Roux says that while "National Income Soars—Farm Income Stagnates." This is simply not in accord with the facts. Realized net farm income was \$11.7 billion in 1960 and rose to \$14.2 billion in 1965. It rose further, to \$16.3 billion in 1966. This is not stagnation. Furthermore, the per capita income of farmers has increased at a faster rate since 1960 than has that of the population generally.

Another measure used by Le Roux is realized net farm income as a percentage of realized gross farm income. Farmers have been using relatively more purchased inputs. The percentage that net is of gross has actually been quite stable since 1957, moving within a range of 30 to 33 percent. However, over the longer run, as the use of purchased inputs has increased, realized net income as a percentage of realized gross has been declining. But a stable or even declining percentage of a rising gross income can lead to marked improvement in the net income position of farmers. Farm 1961 through 1965, realized gross farm income increased by \$5.35 billion, production expenses by \$3.72 billion, and realized net farm income by \$1.63 billion. Net as a percentage of gross was near 32 in both years.

Mr. Le Roux makes much of the point that the percentage return on all farm investment was lower in the years 1961-1965 than in previous periods. But he fails to take into account that much of the capital increase in agriculture has been the result of rising land values. From 1961 through 1965, total value of farm assets increased by \$33.6 billion of which \$28.0 billion or over 83 percent represented increases in the value of real estate. Most of this "investment" increase reflects nothing more than the rise in land values. In fact, these rising values have provided substantial capital gains to farm owners, and land prices continue to increase.

The farmers' share of both the consumer dollar and the food dollar have declined. It is, of course, a well established principle of economics that as consumer incomes rise the proportion spent for food declines. But this has no necessary implications for farm income. A family with a \$5,000 income spending 25 percent for food contributes \$1,250 to total food expenditures of the nation, but one with \$10,000 income spending 15 percent for food contributes \$1,500. The declining percentage of consumer disposable income spent for food tells us nothing of farm prices or farm incomes.

The farmers' share of the retail food dollar has been at or under 40 percent since 1956. This is another measure, like net income as a percent of gross, that is affected by the movement of certain functions from the farm to other specialized firms and industries. Historically, the trend has been toward greater specialization in production on the farm, with input producing functions (chemicals, farm machinery, etc.) as well as processing and marketing functions being taken over by specialized nonfarm firms. The farmers' share of the retail food dollar varies widely by product reflecting variations in the resources used in farm production of a product and those used in processing and distributing after farm sale. A larger share of the consumer food dollar today goes for products that are ready to serve or cook. There are more foods available on a year-round basis than ever before. These additional services add to the costs of transportation, refrigeration, packaging, storage, etc. But again there is no necessary relation between these proportions and the net income position of farmers, as farm net income realized in the past five years clearly demonstrates.

Other measures used by Mr. Le Roux have interpretations equally irrelevant for understanding the present income position of American farmers. The Council is very much interested in seeing that farm incomes keep up with those in other parts of the economy. But we all need to be sure that we are interpreting correctly the present record. The interpretation given by Mr. Le Roux is not useful in this respect.

Chairman PROXMIRE. Congressman Moorhead?

Representative MOORHEAD. Thank you, Mr. Chairman.

Mr. Ackley, I want to indicate I do not agree with this Republican statement which seems to predict we can do the gymnastic feat of falling off both sides of the tightrope at one time, but I do share the concern expressed here by Senator Jordan about our forecasting techniques and the suggestion that seems to be presented to the Congress that we should decide today or in the near future on a tax increase to take effect July 1.

Would it not be wiser to wait nearer to the proposed effective date before making this decision and then presumably as we get closer to the date, our forecasting can be more accurate?

Mr. ACKLEY. Mr. Moorhead, I agree it might be useful if it were possible not to present an annual budget and an annual economic report, but to dribble out the proposals and forecasts a bit at a time. But we do have this institution of the annual budget and legislative program which has to be presented on the basis of the best evidence, the best projections, the best forecasts of which we are all capable at the time.

It was on that basis that these proposals were made. Obviously, we have to keep an open mind and watch events. Certainly none of us claims to be infallible in terms of forecasting, least of all the Council

of Economic Advisers. Our record last year was less than perfect. We have no infallible crystal ball. We do the best we can.

The proposal for a tax increase to take effect in the second half of the year is appropriate on the basis of the best projections we can make to the Congress and the country. We will have time to review that. If the situation appears radically different, then I think the administration itself will be the first to propose a different course of action.

We emphasize repeatedly the need for flexibility in policy. It seems to me that, particularly in a wartime situation, where there is such great uncertainty as to what may develop, it is more than ever important to keep a very close watch on economic conditions and to be ready to change your mind if necessary about policies.

Representative MOORHEAD. Then it is not important for Congress to decide in, let us say, February that there will be a tax increase in July. As an economist you would not be disturbed if we postponed that decision until May or early June, would that be correct?

Mr. ACKLEY. My understanding of the legislative calendar suggests that inevitably that will be the case since the Ways and Means Committee has been first asked to dispose of the debt limit question. They have decided they ought to act promptly on the President's proposal on the interest equalization tax, and then they have the social security program to take up before they get to the tax question.

Representative MOORHEAD. I believe it was Congressman Widnall who, earlier, asked you about the relationships with the Federal Reserve and talked about the consultations you were having and the President in his message expressed a hope that there would be an easing of the monetary situation.

Now, not to be critical of any individual, but I want to know about the institutional relationships. Do you think that the relationship of the Federal Reserve as now constituted is too independent to work with an administration, or is the present situation institutionally just about right?

Mr. ACKLEY. I hesitate to express a very strong opinion on that question. If one were organizing the Government from scratch, I am not sure one would organize it this way. This is the way it has developed.

I think the institutions are such as to make possible the appropriate and necessary coordination. I am certainly not prepared to propose any major institutional change as essential to get a coordinated and sensible economic policy.

Representative MOORHEAD. Thank you. The next question I suppose would go to Mr. Duesenberry. It comes up on this teenage unemployment, and I note particularly in the Economic Report that you point out the difficulty of the nonwhite females in the teenage group. That is just one item, but are there any proposals that we can make—I understand now the increase in population causes the problem, but do we have any proposals to correct this situation? Would it be more education, training, or do you have any proposals?

Mr. DUSENBERRY. Well, as you know, there are a number of programs in existence now which are directed particularly at the teenage group, and more especially at the disadvantaged part of that group. We have the National Youth Corps; the Job Corps. We have the

Elementary and Secondary Education Act which directs more funds toward those areas where poverty is particularly severe. All those measures are directed toward making this group of teenage workers more acceptable to employers, giving them the skills and education that they need.

Now, we expect that this year's MDTA program will have a much larger proportion of positions for disadvantaged workers rather than for workers who already have considerable skills, and we are trying to develop the whole manpower program in directions which will have a maximum impact on those who find it most difficult to get into employment.

We now have a whole spectrum of programs and those are under continuous examination to see that they are as effective as they can be.

Mr. ACKLEY. I might add on that that the MDTA program has specifically been redirected in two ways that help deal with this problem.

First, greater attention to younger people. There have been a series of amendments to the Manpower Development and Training Act which have permitted a greater emphasis (a) on the relatively unskilled and disadvantaged, and (b) on younger workers. This is only one part of the redirection and expansion of training efforts directed particularly at the disadvantaged youngster.

Representative MOORHEAD. Has the Council taken any position on the guaranteed annual income or the negative income tax, or is this premature?

Mr. ACKLEY. I think it is highly premature. We have expressed interest in this as a proposal. It has been made from a number of quarters, as you know—both from those who describe themselves as “liberals” and those who describe themselves as “conservatives.”

We think it is a sufficiently interesting idea that it ought to be studied. We said so in our 1966 report.

This year the President has suggested that a commission of distinguished Americans ought to take a couple of years to look in close detail at the problems that are presented by this kind of proposal and by alternative proposals such as a complete recasting of the public assistance system, or residual public employment for the disadvantaged. These are all new ideas.

I do not think anyone has studied them enough to be ready to say that they are good or bad. They certainly ought not to be rejected, and they certainly ought not to be accepted; but they are sufficiently interesting that they ought to be studied.

Representative MOORHEAD. Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you. Congressman Rumsfeld?

Representative RUMSFELD. Mr. Ackley, last year the defense expenditures were seriously underestimated. Chairman Proxmire euphemistically has called it a major economic policy blunder.

It is my understanding that last year before this committee that you indicated that there is a group that meets once a month to coordinate policy that includes Secretary Fowler, Mr. Martin, yourself, and Director Schultze.

I am curious to know whether Secretary McNamara or a representative of the Defense Department is involved in this coordinating activity, and if not, would not representatives of DOD possibly lead to better information from your standpoint?

Mr. ACKLEY. Certainly we are not isolated from the Defense Department. And the Bureau of the Budget—with which we participate in our forecasting and policy analysis—is about as well informed as anyone can be of the expenditure plans of the Defense Department. We ourselves are frequently directly in touch with Defense on this matter.

The problem last year was not a failure of communication. It was the nature of the situation which prevented the Defense Department itself from making solid estimates, because of the very rapid pace of the buildup and because of the uncertainty of the situation. I really do not think the problem was one of communication but rather of the difficulty of the Defense Department itself a year ago knowing what the nature and cost of the Vietnam war would be.

Representative RUMSFELD. I am curious to know if you think it is conceivable that the administration, not wanting to telegraph an anticipated and intended diplomatic or military move, might base economic policy on stated assumptions that were not actually intended, planned, or anticipated.

Mr. ACKLEY. I suppose that situation could conceivably arise. It has not arisen so far as I know in my tenure at the Council of Economic Advisers.

Representative RUMSFELD. Turning to another subject, would you say from hindsight that the Federal Reserve's decision to increase the discount rate in December of 1965 was as bad as was expressed at the time by the administration?

Mr. ACKLEY. I think one has to distinguish carefully the nature of the administration's complaint about the December 5 move on the discount rates. It was our feeling then, and I think it remains our feeling, that it would have been better if the Federal Reserve could have waited until the end of December or early January. At that time we could have made coordinated fiscal and monetary policy decisions on the basis of then somewhat better information on budget expenditures. There would have been an opportunity for us to consider together what kinds of tax proposals the President might wish to make in his January message.

Certainly there is no quarrel with the fact that developments in late 1965 and prospects for 1966—particularly after we had received, in early December, the forecast of plant and equipment expenditures from Commerce—made clear that additional restraint on the economy was required.

Representative RUMSFELD. You do not disagree so much with the announcement as you do with the timing and absence of opportunity for the administration to take steps?

Mr. ACKLEY. That is correct.

Representative RUMSFELD. Turning to the question of the guidelines briefly, you indicated that the administration would like to see wage increases held to run parallel with increases of productivity, and I certainly concur in that. But then you go on, and I believe I am quoting you accurately, you say we just cannot expect that.

Why is this? Is the country on notice that labor unions are planning to push wage increases this year beyond the levels of productivity?

Mr. ACKLEY. I think we are in effect on notice, yes. We are on notice if nothing else from the fact that a number of important set-

tlements in the latter part of 1966 considerably have exceeded that figure. I am not only referring to the airlines settlement which was way above it, but to the settlement in the electrical machinery industry, which was somewhere between 4½ to 5 percent, and that in the communications industry, which was in the same neighborhood.

I think it would be too much to expect that most other negotiations which will occur in the early months of 1967 and throughout the year can be held to a level consistent with the productivity trend. I think it is understandable in view of the unfortunate, the lamented, increase in consumer prices which has occurred.

Representative RUMSFELD. It is possible that in dropping the 3.2 figure across the board, that you are turning more to a percentage figure relating to productivity within a given industry?

Mr. ACKLEY. No. I do not think that is correct. We tried to make it as clear as we can that we think this is a false principle. An attempt to follow it would be disastrous for the structure of wages and for the health of the economy.

Representative RUMSFELD. One last question. The administration's proposal concerning increases in social security benefits seems to almost be offset by the increase in revenues from the proposed 6-percent surcharge.

If the social security benefits are increased less than the administration request, will the tax increase be necessary?

Mr. ACKLEY. Certainly the two cannot be completely divorced. If there were no increase in social security benefits in the second half of 1966, the economy would be substantially weaker because of the absence of it. But the tax increase is not directly tied to the social security benefit increase. Indeed, after January 1, 1968, we would have a payroll tax increase as well as the proposed 6-percent surcharge.

As I recall, the 6-percent surcharge would yield on a liabilities basis, something like \$5.1 billion as opposed to about \$4 billion for the social security benefits.

Clearly our trust funds are so important and their expenditures and their revenues so important that fiscal policy planning has to take into account not only of general fund expenditures and taxes but also the expenditures and taxes of the trust funds. So, proposals on social security have to be considered not only on their own merits but as part of the total fiscal planning in which we must engage.

Representative RUMSFELD. Mr. Chairman, I will stop at that point.

Chairman PROXMIRE. Under the rules, the staff tells me we should revert to the next Democrat questioning, but since neither Congressman Brock nor Senator Percy have had chance to question, we will waive that rule and Congressman Brock may question.

Representative BROCK. Thank you, Mr. Chairman.

I am fascinated with this logic of yours on the guidelines, Mr. Ackley. I have a feeling that there is a certain dichotomy in the last statement that you made, that we have gone away from 3.2, we are now advocating "restraint" in your words, which nobody seems to want to define. We are not willing to apply industry guidelines on a selective basis within an industry which seems to be, to me, more logical in that some industries obviously exceed the national increase in productivity and others fall well behind it due to the nature of the industry itself.

It seems to me you are saying we have virtually no policy at all. Is this true?

Mr. ACKLEY. I hope it is not true, Mr. Brock. The guidepost policy has several purposes. I suppose the most basic purpose is an educational one. I think in this it has been partly effective. I think it is important that America labor, American business, and the public understand that we can only take out of the economy as much as we produce and that the effort to do more than that is bound to produce inflation; and that in general it is essential for price stability, for wage increases not to exceed the trend of productivity in the economy.

It is essential that labor unions and business managers in making their wage and price decisions consider not only the immediate, direct shortrun interest of the members of the union or the profits of the firm but their impact on the total balance of the economy.

In this educational purpose, as I say, I think we have had a good deal of success. It is obviously nothing that will be accomplished overnight or even in a few years. But I believe there is a much greater realization on the part of labor unions, for example, that if they attempt to achieve larger increases in real income than the growth of productivity by getting large money wage increases, that is in the end self defeating. It is going to raise prices and they will not get any more real income than if they had made more moderate settlements in the first place.

That is one purpose of the guideposts.

The second was to provide a standard which would affect specific behavior by specific people at specific times, and which would provide some kind of a standard on the basis of which the Government could express the public's interest in wage settlements or price decisions, and to call the attention of the parties to their responsibilities.

Now, the specific guidepost formula, as it was laid out in the Economic Reports of 1962 through 1965, really assumed that the guideposts in fact would work and that prices in general would be stable. In a climate of general price stability it certainly was not unreasonable to ask labor unions to keep their settlements close to the trend of productivity.

Well, that basic assumption simply has been violated by the facts. Under those circumstances we think that it is unrealistic, meaningless, probably counterproductive to say that we insist that wage settlements this year not exceed 3.2 percent. To try to do that would not accomplish the purpose.

So, for the present, we have abandoned that specific a standard for wage increases. We have not abandoned, and do not intend to abandon, the effort to get the maximum degree of restraint that is feasible through persuasion, through education. And we would hope that once price stability is restored, we can, in a climate of price stability, again have a more specific standard for wage increases.

Representative Brock. I could not agree more that the great advantage of guideposts is not in fact a holding down so much as it is educational, but I wonder how much you are educating people when you state we want restraint and you do not give them any standard by which to measure that. You have refused to apply standards on a broad basis, and you say it would be disastrous to apply standards on an industry-by-industry basis.

This leads me into the second thought. When you are talking about your projections on your balance-of-payments problem this year, you expect a lessening of the increase in imports and you express some hope at least that there will be a lowering of interest rates internationally, so vis-a-vis our international competition we are in a somewhat better position.

If we abandoned the guideposts I do not know that anybody has projected a reduction in raw material costs. If your wage costs considerably exceed productivity as you apparently predict and expect, is it not pretty obvious that we are going to have either a pretty severe reduction in profits or an increase in prices and thereby a weakening of our competitive position internationally, and do you not think that there is a very great prospect that given the fact that wages will exceed both productivity increases, that perhaps taxes will go up and perhaps raw materials will at least be maintained at the present level, that we will be in a less competitive position and our balance of payments could get even worse?

Mr. ACKLEY. I would certainly not think so, Mr. Brock. Our record on price stability has been so much better than that of any of our principal industrial competitors and I think it promises to be better in the future as well.

We regret the price increase we have had. We wish it had not occurred. We wish it could have been avoided. But even so, our record on unit labor costs, on prices, has been substantially better than that of the average of our leading industrial competitors and better than almost any one of them in almost every year. And we expect continuing improvement in our competitive position next year.

No nation has succeeded completely in achieving the goal that we all seek which is a continuous level of prosperity and high employment and complete price stability. Up to now our record has been as good or better than that of any other nation. We certainly think that it is essential that we continue to pursue the objective of doing a better job than any other country in this respect, for balance-of-payments reasons, if no other. Apart from balance-of-payments reasons we all would prefer a high level prosperous economy with absolute price stability, and I think all our policies ought to be directed toward seeking that dual objective.

Representative BROCK. I think so, too, but I question whether you are not being overly optimistic. I think someone mentioned earlier the prospect that a reduction in our level of interest rates, which does seem to be at least hopefully in prospect, could cause an outflow of currency. We have had a number of factors on our side in the past year that I am not sure that I see operating in our behalf in the coming 12 to 18 months as far as the balance of payments is concerned and I really wonder whether we are giving sufficient concern and thought to this balance-of-payments problem, to the effect that the abandonment of guideposts and the deliberate effort to reduce interest rates may not create another monster of a different type than what we have had in the past 12 months, but one which is equally difficult to handle.

Mr. ACKLEY. Certainly we have to be concerned about our balance-of-payments problem, and I think that we are all extremely concerned about it. As Mr. Okun suggested earlier, a number of steps have been taken that propose to strengthen our arsenal of balance-of-payments weapons.

The voluntary programs which were announced in December involve substantially tighter guidelines for both financial institutions and corporations. The proposals with respect to the interest equalization tax provide another weapon in the arsenal. If it turns out that interest rates around the world do not come down to the same extent as ours do, we will have a problem which may limit our ability to continue to lower interest rates.

I think the developments there have been promising. We have had reductions in the Central Bank rates of four countries in the last few weeks—Germany, England, Canada, Belgium. Belgium just yesterday reduced its discount rate.

I think there is a general recognition in the leading financial centers of the world that we have to some extent engaged, all of us, in a futile race of escalating interest rates which has done nobody any good and probably done us all some harm. And there is some prospect now of international cooperation in moving toward a lower world level of interest rates, and I think all of us would welcome that.

But I agree there are uncertainties and we will have to continue to be alert and our policies will have to be adapted to what develops.

Representative BROCK. My time has expired, but I just conclude by saying I very much hope you are right.

Chairman PROXMIRE. Thank you, Congressman Brock.

Senator PERCY?

Senator PERCY. Mr. Chairman, I would like to commend our guest this morning for the brevity of his opening statement which enables us to ask as many questions as possible. He would not be a good Senator without a filibuster but we appreciate this opportunity.

My questions are brief, and they will deal with just three subjects—taxes, gold loss, and capital spending.

First, on taxes. At any time last year did the Council of Economic Advisers suggest to the administration a tax increase would be a healthy thing for the economy to stem inflation?

Mr. ACKLEY. Senator, as you know, we had two proposals made by the administration with respect to taxes, one in January and the other one in September. The subject of further tax action was under constant discussion within the administration, and indeed the whole country seemed to be hanging on the discussion. The press was always alert each week to find out whether the President had or had not made a decision.

I would have, on general principles, to refuse to answer the question about specific recommendations that the Council may have made to the President. When the Council in 1962 restored the practice of appearing before this committee in open session, it laid down a proposition which I guess we ought to repeat each time we come, Mr. Chairman, that we hope the committee will not ask us to reveal the contents of our specific recommendations to the President.

I am not saying this to suggest either that we did or did not make recommendations last year. Senator, but I think it would hurt our usefulness and that of the Joint Economic Committee if the committee were to inquire into the specific recommendations we may have made.

Senator PERCY. I can appreciate your problem in answering the question, but I think it is exceedingly important that just as the Federal Reserve Board has a degree of independence from politics, that

we try in every way possible to pursue an economic course for our country that is free of politics. If we can only make changes in off-election years, you just cannot make changes because elections come around every 2 years.

I can recall about 9 months ago in St. Louis a newspaper column carried a story when I said I felt a tax increase was necessary. How horrified my campaign managers were, but I did not really receive any adverse comments at all from businessmen, consumers, or bankers. I think there was an acceptance by the country at that time that something had to happen. When we see these tremendous deficits that have been revealed to us for this current fiscal year, and the deficit we are facing in the future, and now in a softer economy, with automotive sales down, concern about capital expenditures at the end of this year, I wonder whether the New York Times was not absolutely right when they stated the other day, on the 29th of January, "In essence the President is now doing most of the things that should have been done a year ago."

What economic forces exist within the administration to see that we do the right things, whether they are politically difficult or not? If someone running for office could suggest a tax increase and not lose an election as a result of it, why cannot the administration do things that seem to be necessary at the time?

Mr. ACKLEY. I think, Senator, I would respond again by saying that the question of a tax increase—in addition to those that were actually proposed and enacted—was one that was under continuous consideration in the administration, and to some extent the administration was in touch with the leadership of the Congress with respect to this, and with the leadership of the business community.

You may recall the famous meeting the President had in late spring with a large group of the principal business leadership of this country in which he explored their views on the question, and they did not coincide with the one you have just expressed.

Indeed, the opposition in the business community, as I understand it, and the Congress, was rather strong to further measures at that time.

The role of the Council in the Government is a difficult one. We are professionals, essentially nonpolitical, I hope. We do not believe that we ought to make the Government's economic policy. We believe our role is to provide the President and his other advisers with the best economic analysis and information that we can. We feel that so long as that information is listened to and understood, and our views are sought, that we have done our job.

I do not think that it would be appropriate for the President to make economic policy on the basis of advice from nonpolitical experts. His decisions must embrace a much larger compass of objectives and considerations. But I would say that we feel that we have had the opportunity to present to the President and his other advisers and to the country the best economic analysis of which we are capable.

I certainly do not pretend we are always right or will be right in the future. Matters such as taxation are broad questions, with many implications, that have to be decided on the basis of a large number and a wide variety of considerations.

I have said several times during 1966, Senator, that I thought the question of the tax increase was a close question. I still think it was a close question all during 1966. I am not prepared to say that I think the decisions that were taken were mistaken ones. The record of the economy last year, after the first quarter, shows a pace of advance which was moderate, which was within the productive capabilities of the economy.

It is far from a perfect record. But I think if one looks at it in the large, in terms of the outcome for the year as a whole, it is a record of which we can be pretty proud.

Senator PERCY. On the question of our gold loss—I have just come back from London, from a meeting with Members of the Parliament over there. I was struck by the fact that they were quite proud of the strengthenings of the sterling and obvious strong franc and now are asking us questions about the strength of the dollar, the size of our deficit, the degree of our commitments abroad, and our commitments here at home.

We lessened the degree of loss I think last year, but we still have lost gold supplies.

Are you satisfied that we have an effective enough program now to deal with this problem, and how concerned are you about the gold loss?

Mr. ACKLEY. Well, as I have said several times here this morning, the balance-of-payments problem is one which concerns us all a great deal, and to which the policy of the Government is continually attentive. The President in his Economic Report suggests our objective with respect to the balance of payments. It is to restore equilibrium in the balance of payments as rapidly as the costs of the Vietnam war will permit.

I think we cannot get away from the fact that we are, on behalf of principles which I think most Americans share, engaged in a very costly enterprise in southeast Asia. We at least feel that we are carrying a free world responsibility in southeast Asia, in Europe, and, with our development efforts, around the world. I believe that most of the leadership of our allies recognizes that we are carrying special responsibilities. Although they are concerned with our balance of payments, they recognize that we are taking measures which are designed to achieve improvement at minimum cost to the economic health of the whole world. We are continually in touch with the economic leadership of other countries. They are aware of what we are doing. We are working with them in the interest of a strong world economy and better adjustment in international payments.

Senator PERCY. Finally, very briefly, if we see a weakening in capital expenditure in the last half of this year, would the administration be prepared to move the restoration date for the investment tax credit back from January 1, 1968, to July 1 as a stimulant to economic spending if it looks as though it might be necessary?

Mr. ACKLEY. The effective date of the termination of the suspension of the investment credit is one of the questions that will remain very much in our minds as the year progresses. It is certainly possible that if it were decided that the economy needed the additional stimulus, the administration might propose that the suspension of the investment credit be terminated.

On the other hand, if developments go the other way, we might simply let it expire; or—conceivably—if inflationary forces continue strong, we might even propose the further extension of the suspension.

But it is one of the instruments of flexibility in our policy that we have very much in mind.

Senator PERCY. Thank you.

Chairman PROXMIRE. Thank you, Senator Percy.

Apropos of the investment credit, I think you recognize the time bomb it represents to many of our industries because if it would expire on the specific date of January 1, it makes it very difficult to invest in plant and equipment in September, October, November, December of next year. People in the machine tool industry say they might as well take a vacation, because after all, if you are buying—say an airline is buying \$500 million worth of jets, they kiss off \$35 million in profits by making that investment in September or October thereby losing \$35 million in tax credit they could pick up by waiting until January 1.

A very ingenious suggestion came to me from a constituent of mine, Mr. Randall, from the Kearney & Trecker Corp., that you should renew the investment credit at the rate of 1 percent a month, beginning say, June 1st or July 1st. In this way you solve your problem. You will retard investment to some extent, but at the same time, because you phase into it, there would not be any big gap that would result in layoffs and serious economic dislocations at the end of the year.

Let me get into a couple of things here before we conclude. I do think that in view of the responses, which were very honest and sincere, that it is clear that there was a very serious blunder made in the estimates on Vietnam; the cost of the Vietnam war. I would think that this committee would have a deep obligation to find out whether or not the reason for that blunder has been corrected.

I know that you cannot tell us, but I think that we should go to the Defense Department and find out, and I hope we do that.

I hope that you also have words with the Secretary of Defense, if you have not had them already, because the Joint Economic Committee staff tells me that while you were too low in your 1967 GNP estimate, and while, as you say, you did not predict the GNP for the current year accurately, if the Vietnam figure had been accurate, you would have hit it right on the nose on the basis of the multiplier which they apply.

So, this would make the Council look very good this year.

I am delighted at the sentiments almost every member here have expressed on wage-price guidelines. And I would like to ask you some questions about that now that have not been raised so far.

The Council of Economic Advisers, Mr. Heller, and yourself, have been eloquent defenders of this principle. You indicated it is very important to maintain price stability, that indeed it is in a sense the cornerstone. It is particularly useful, however—correct me if I am wrong on this—it is particularly useful in a period where you have cost-push inflation where demand is moderate, but where there is a situation where wages are pressing against prices and pushing them up.

I call your attention to the publication of the Department of Labor, Monthly Labor Review, for December, which says 3.1 million workers are subject to renegotiation, substantially more than normal, whose contracts are scheduled for revision during 1966. This includes automobiles, farm equipment, meatpacking, and also the deferred wage increase in steel and in many other industries.

At a period when you have the settlements and you are abandoning the specific figure, would you not feel that we can expect and anticipate that we would have more cost-push inflation in the present year than we had in the last? Just a matter of simple logic?

Mr. ACKLEY. Yes, sir. I think that is right. On the basis of our judgments and forecasts of the economy for the year ahead, there should be very little pressure from the side of excess demand. There will probably be, as we have tried frankly to recognize, an increase on the average in unit labor costs as a result of wage settlements in excess of the productivity trend. The emphasis which has been given here and elsewhere to the so-called abandonment of the 3.2 percent guidepost number has been somewhat exaggerated. You may recall that when the guideposts were first formulated there was no specific numerical standard.

Chairman PROXMIRE. I think the 3.2 wage guideline number was wrong, and I said so last year. You cannot hold labor to a 3.2 percent in the face of a cost-of-living average increase of 3.3. This would mean a reduction in real wages. It is impossible. You cannot have a 3.2 guideline that makes any sense when you have that kind of inflation. But it would seem to me that it would be sensible to try to reconcile the situation by perhaps having a compromise.

Could you not take part of the increase in the cost of living, maybe 50 percent of it, maybe 60 percent of it, and the private productivity increase, and have a benchmark of 5 percent or something like that—3.2 is grossly unfair?

Mr. ACKLEY. Senator, we certainly considered the possibility of having a temporary guidepost number higher than the productivity trend. Our judgment, on the basis of discussions with labor and management and with independent experts, was that this would probably not be a useful thing to do. It would create more problems than it would solve.

Whether that is a correct decision, I do not know. But it certainly was made after full consideration of the possibility of suggesting a compromise figure.

Chairman PROXMIRE. You see, a look at the fine record that you had in wage increases between 1962 and 1965 and the record of very stable unit labor costs during that period as you have on pages 81 and 83 of your report,¹ 2.9 percent in 1962, 3 percent in 1963, 3.2 in 1964, 3.8 in 1965, these are the increases in straight-time hourly earnings. Then you look at unit labor costs and the only new element in this situation that I can see was the wage-price guideline. And whereas between 1947 and 1965, the whole period, you had increased unit labor cost of 1.6 percent, and 1960 to 1964 you had an increase of only four-tenths of 1 percent, this was the period, especially 1963 and 1964, of

¹ Economic Report of the President together with the Annual Report of the Council of Economic Advisers, January 1967. U.S. Government Printing Office.

diminishing unemployment, a period when you would expect wages to rise more rapidly, when in my judgment you might expect an increase in labor cost. But, because of the wonderful fight, I thought it was a great fight, that President Kennedy made with the steel industry based on this whole principle and based on having talked steel labor into standing by its productivity increases, he was able to talk steel into rolling back their price increase. President Johnson and President Kennedy were successful with the automobile industry, and in aluminum, copper, and in all these areas because you have had a specific benchmark; and because labor has performed I think with good discipline, you have been able to hold it down.

Now, without a benchmark the President can talk, but his talk, it seems to me, would have very little more effect than Truman's or Eisenhower's or the kind of conversation we get from Presidents, that everybody should be a good citizen, try to be restrained, that we have had before, and it has been ineffective.

Mr. ACKLEY. I certainly appreciate your good words about the guidepost principle.

Chairman PROXMIRE. Well, I have defended it many, many times. I think this is one of the easiest things for a Democrat to defend in our economic policies.

Mr. ACKLEY. But I do not share your view that it is impossible, without a precise numerical standard, to influence the size of wage settlements or the extent of price increases. We have had a good bit of experience this year which we tried to describe in our report. We talked to the leaders of many industries about prices. And I think we feel that we have had some effect—not because we have said the price of X product should go up no more than 1.7 percent, if that is the difference between your productivity trend and that of the economy as a whole, but rather because we have said, “Look, we have a problem. You have a responsibility. Let us see what is the best way in which you can exercise your responsibility.”

We have had good cooperation, almost universally. We expect that we are going to continue to get it. I think we can effectively ask for restraint and responsibility without asking for adherence to a specific numerical figure.

Chairman PROXMIRE. I hope you give real consideration to the possibility of some kind of a compromise so that we have a specific benchmark. Watch this as time goes on, and see if you might change your mind on the basis of the developments.

One other point. The statistic you say you rely on most in farm income is the “average income per farm.” The reason this statistic is unsound, it seems to me, is because what has happened, you indicate in your report so well that marginal farmers, low-income farmers, have been leaving the farm. This is one of the main reasons for your big increase in private compensation.

Now, as this happens, as those with pitifully low incomes leave the farms, leaving by the millions, the farmer with higher but still too low income is left, so your average income per farm figure is bound to increase, simply because you have a different kind of farm population. But if you look at the parity figure, just disclosed to us 3 days ago, it is now 75 percent, the lowest it has been in many, many years. And while there are weaknesses in that figure, too, this does show a

relationship between prices the farmer is receiving, and the prices he is paying.

So I hope that you will give that careful consideration and reevaluate the income per farm figure which is not a realistic figure in view of what is happening to the farm population.

Mr. ACKLEY. I would not agree that it is completely unrealistic to take account of the fact that the low income unsuccessful farmers have left farming. We do want to evaluate what happens to those who remain. We will have, I think before the year is over, a fairly intensive study made by the Department of Agriculture which attempts to account for the income experience of particular kinds of farmers in various size brackets.

I believe that at our hearings a year ago you and I had some colloquy about that study. We had expected it would appear last year. It was held up, but it should be appearing shortly, I think. And I believe that it will be rather revealing about the income experience of farmers of various sizes and various types; various levels of sales.

I cannot let pass the reference to parity figure. It does seem to me that as you suggest, the parity concept—based on price relationships which existed a long time ago—has very little relevance for evaluating the income position of farmers today.

The Council later supplied the following:

Rising net income per farm could, as Senator Proxmire suggested, be solely the result of marginal and low income farmers leaving agriculture. However, in 1966, total net farm income increased by nearly a billion dollars. Since this was distributed among a smaller number of farmers, there was a substantial real increase per farm.

After adjusting for price changes, average real net income per farm in 1966 was 34.5 percent higher than in 1961, and 7 percent higher than in 1965. Farm size increased from an average of 307 acres per farm in 1961 to 351 acres in 1966, an increase of 14.3 percent or considerably less than the rise in real net income per farm. Likewise the increase in average farm size from 342 acres in 1965 to 351 in 1966 was only 2.6 percent compared to the 7 percent increase in average real net income per farm. The increases in average farm size reflect a reduction in the number of farms of 14.7 percent between 1961 and 1966, and of 3.6 percent between 1965 and 1966.

Chairman PROXMIRE. Well, Mr. Ackley, I want to thank you and Mr. Duesenberry and Mr. Okun for a very competent performance this morning. It is extremely helpful.

We also want to thank you once again for the high quality of your Economic Report.

In the absence of Representative Curtis unanimous consent is granted to have inserted in the record, at his request, an article excerpted from the Wall Street Journal, February 3, 1967, entitled "It's Time for an Honest Accounting" from the column, "Review and Outlook." Also to be included are some tables and charts from the Budget of the United States Government, 1965, 1966, 1967, 1968.

(The material referred to follows:)

REVIEW AND OUTLOOK *—IT'S TIME FOR AN HONEST ACCOUNTING

"At the moment, the most essential requirement of economic policy is a clear and scrupulously honest Federal budget."

So said Columbia University economist Arthur F. Burns, in responding recently to a series of New York Times questions on the economic outlook. The fact that such a requisite should even have to be stated is, in itself, an indictment of the Government's bookkeeping.

Last month's Federal budget reached some sort of a new high in unreality but, for one reason or another, the Government's books have been juggled for years, by Republican and Democratic Administrations alike. The unhappy result is that it has become increasingly difficult, if not impossible, for anyone to know precisely where the Government stands financially at any given time.

Yet the Federal establishment has become so dominant in the economy that every policy-maker, in Government or out, needs a clear view of Washington's books—most especially at a time when mistakes could tumble the nation into a recession or worse.

Over the next few months, Congress must make key decisions on taxes and spending; the Federal Reserve System must, or at least it should, manage the nation's money in ways calculated to enhance economic stability. Businessmen must decide on a host of spending projects, all of them geared in some degree to the direction and size of Federal outlays. In the circumstances, Washington's cloudy accounting is not merely unsound but dangerous.

Even past political "justifications" for juggling have largely lost their significance. For some time officials felt the voters would not swallow spending of more than \$100 billion a year, and every available device was used to keep the administrative budget below that level. Now that the supposed barrier has been broken, and then some, isn't it time to throw out some of the gimmicks?

One way to start would be to jettison the idea that the Government when it sells the public an interest in loans it has previously made to individuals or corporations, is reducing the cost of its operations. What it actually is doing, of course, is borrowing money.

Less simple, but no less necessary, are some more basic budgetary revisions. As Maurice Stans, former Budget Director, suggested in a recent issue of U.S. News and World Report, Washington should settle on a single form of budgeting, instead of stressing the budget that happens to suit its purposes at a particular time.

For years, the Government put the major emphasis on the administrative budget, since it showed a lower spending total. Currently, though, Administration officials are inclined to point to their other budgeting formulas which happen to reflect lower deficits.

Mr. Stans' preference is for something close to the present cash budget, which includes everything in the administrative budget plus the Social Security, highway and other trust funds. He notes that these funds often are trusts in name only, because practically all the money they receive is paid out either in the same or in the following year.

In addition, the former Budget Director urges a thorough overhaul of Federal accounting practices, to make sure that a certain type of transaction will not be treated in varying ways in different sections of the books. At present, for instance, repayment of a Government loan may be handled in one place as a receipt and in another as a credit against expenditures.

With the Government's operations combined in a single budget, and with the document cleansed of obfuscations and inconsistencies, everyone would at least have a clearer basis for decision-making. It's really inexcusable that something so sensible has been so studiously avoided.

An honest accounting would by no means assure elimination of wasteful, excessive spending. But no one is likely to tame the Federal colossus if it's allowed to go on forever hiding behind fiscal clouds.

*Reprinted from the Wall Street Journal, Feb. 3, 1967.

Administrative budget receipts and expenditures

[In billions of dollars]

	1965			1966			1967		1968—Initial estimate, January 1967
	Initial estimate, January 1964	Mid-fiscal-year estimate, January 1965	Actual, January 1966	Initial estimate, January 1965	Mid-fiscal-year estimate, January 1966	Actual, January 1967	Initial estimate, January 1966	Mid-fiscal-year estimate, January 1967	
Receipts:									
Individual income taxes.....	48.5	47.0	48.8	48.2	51.4	55.4	50.2	62.2	73.2
Corporate income taxes.....	23.8	23.9	23.5	27.6	29.7	30.1	34.4	34.4	33.9
Estate taxes.....	11.0	10.9	10.9	9.8	9.2	9.1	8.9	9.3	8.8
Other receipts.....	3.3	8.7	8.8	9.4	10.4	10.7	12.2	11.9	11.7
Interfund transactions.....	-6	-8	-9	-6	-6	-6	-7	-8	-7
Total receipts.....	93.0	91.2	93.1	94.4	100.0	104.7	111.0	117.0	126.9
Expenditures:									
National defense.....	54.0	52.2	50.2	51.6	56.6	57.7	60.5	70.2	75.5
International affairs and finance.....	4.1	4.0	4.3	4.0	3.9	4.2	4.2	4.6	4.8
Space research and technology.....	5.0	4.9	5.1	5.1	5.6	5.9	5.3	5.6	5.3
Agriculture and agricultural resources.....	3.0	4.6	4.9	3.9	4.3	3.3	3.4	3.0	3.2
Natural resources.....	2.6	2.7	2.8	2.7	2.9	2.8	3.1	3.2	3.5
Commerce and transportation.....	3.1	3.4	3.5	2.8	3.2	3.0	2.7	3.5	3.1
Housing and community development.....	-3	-3	-1	(1)	1	3	1	1	1.0
Health, labor, and welfare.....	5.8	6.2	6.9	8.3	8.4	7.6	10.0	10.4	11.3
Education.....	1.7	1.5	1.5	2.7	2.3	2.8	2.8	3.3	2.8
Veterans' benefits and services.....	5.1	5.4	5.5	4.6	5.1	5.0	5.7	6.4	6.1
Interest.....	11.1	11.3	11.4	11.6	12.1	12.1	12.9	13.5	14.2
General government.....	2.2	2.4	2.4	2.5	2.5	2.5	2.6	2.7	2.8
Allowances.....	1.0	1.1	1.1	1.1	1.1	1.1	1.1	1.1	1.1
Interfund transactions.....	-6	-8	-9	-6	-6	-7	-7	-8	-7
Total expenditures.....	97.9	97.5	96.5	99.7	106.4	107.0	112.8	126.7	135.0
Excess of receipts (+) or expenditures (-).....	-4.9	-6.3	-3.4	-5.3	-6.4	-2.3	-1.8	-9.7	-8.1

¹ Less than \$50 million.

Note.—Detail may not add to totals due to rounding.

Source: The Budget of the U.S. Government, 1965, 1966, 1967, 1968.

Federal receipts and expenditures in the national income accounts

[In billions of dollars]

	1965			1966			1967		1968—Initial estimate, January 1967
	Initial estimate, January 1964	Mid-fiscal-year estimate, January 1965	Actual, January 1966	Initial estimate, January 1965	Mid-fiscal-year estimate, January 1966	Actual, January 1967	Initial estimate, January 1966	Mid-fiscal-year estimate, January 1967	
Receipts, national income basis:									
Personal tax and nontax receipts.....	52.3	50.3	51.2	52.2	54.8	57.9	60.5	65.5	76.8
Corporate profits tax accruals.....	24.9	23.9	27.0	24.7	29.3	30.7	31.1	32.3	35.3
Indirect business tax and nontax accruals.....	17.3	16.8	16.8	16.1	15.9	15.9	16.5	16.5	16.9
Contributions for social insurance.....	24.2	25.0	24.6	28.0	28.8	28.1	34.1	35.5	38.1
Total, receipts, national income basis.....	118.8	116.0	119.6	121.0	128.8	132.6	142.2	149.8	167.1
Expenditures, national income basis:									
Purchases of goods and services.....	69.1	65.9	64.5	66.7	70.7	71.7	74.4	83.6	91.9
Transfer payments.....	31.8	31.8	30.3	35.2	34.2	34.3	39.2	39.8	46.6
Grants-in-aid to State and local governments.....	9.7	10.7	10.9	13.0	12.8	12.9	14.7	14.8	16.7
Net interest paid.....	8.5	8.5	8.6	8.6	9.0	9.1	9.7	10.0	10.5
Subsidies less current surplus of government enterprises.....	2.5	4.1	4.1	3.5	4.3	4.5	4.7	5.4	3.5
Total, expenditures, national income basis.....	121.5	121.0	118.3	127.0	131.0	132.3	142.7	153.6	169.2
Surplus (+) or deficit (-), national income basis.....	-2.8	-5.0	+1.2	-6.0	-2.2	+1.3	-1.5	-3.8	-2.1

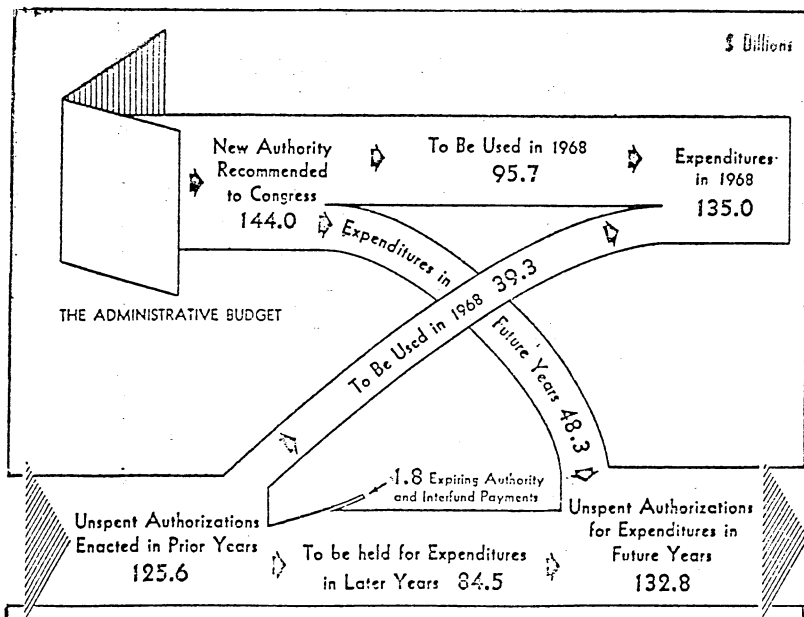
NOTE.—Details in table may not add to totals because of rounding.

Source: The Budget of the U.S. Government, 1965, 1966, 1967, 1968.

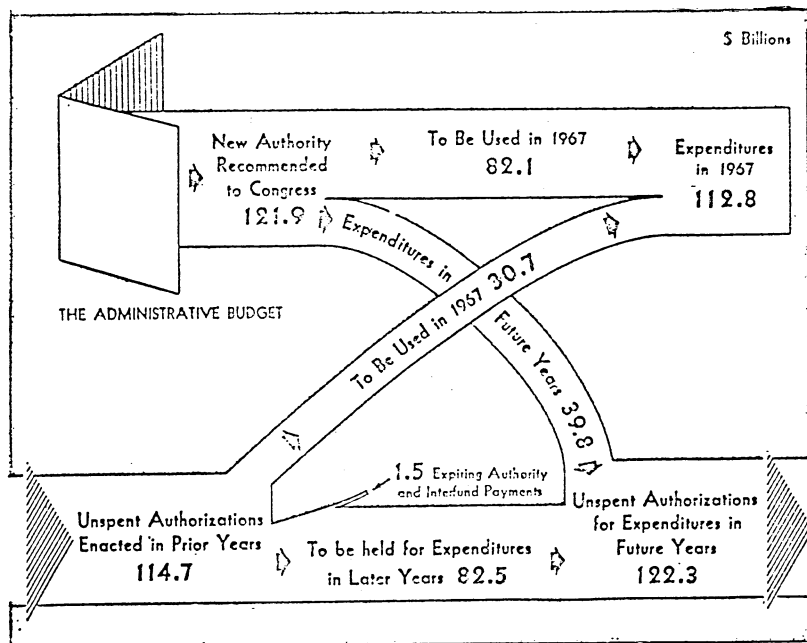
THE ADMINISTRATIVE BUDGETS FOR THREE FISCAL YEARS

Relation of Authorizations to Expenditures

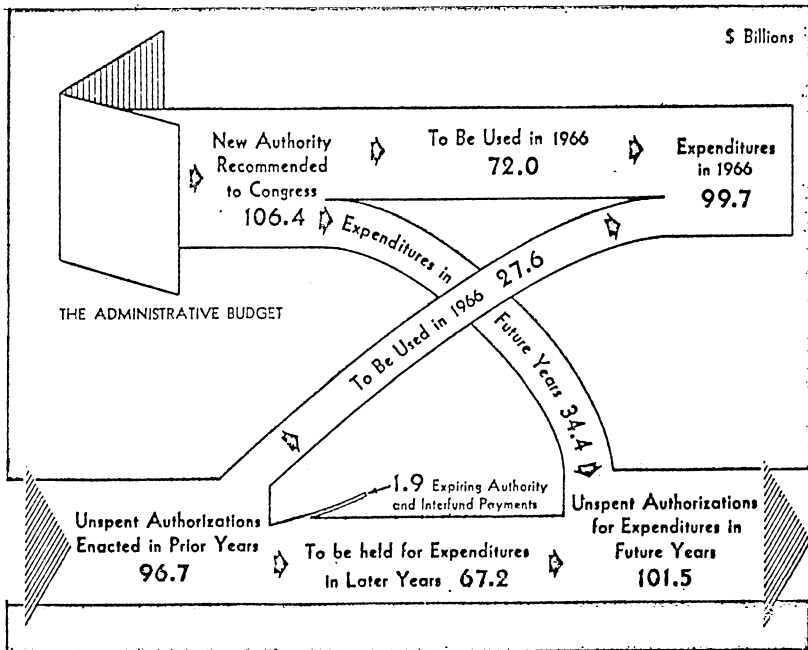
1968 Administrative Budget - Relation of Authorizations to Expenditures



1967 Administrative Budget - Relation of Authorizations to Expenditures



1966 Administrative Budget - Relation of Authorizations to Expenditures



Source: The Budget of the United States Government, 1966, 1967, 1968.

Chairman PROXMIRE. The hearings will resume tomorrow morning at 10 o'clock when the Budget Director, Mr. Charles Schultze, will be our witness.

(Whereupon, at 12:50 p.m., the committee recessed, to reconvene at 10 a.m., on Friday, February 3, 1967.)

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 3, 1967

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

The joint committee met at 10 a.m., pursuant to recess, in room S-228, the Capitol, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Symington, Ribicoff, Jordan of Idaho, and Percy; and Representatives Reuss, Griffiths, Curtis, Rumsfeld, and Brock.

Also present: John R. Stark, executive director; James W. Knowles, director of research; and Donald A. Webster, minority economist.

Chairman PROXMIRE. The Joint Economic Committee will come to order.

I want to announce that, unfortunately, I will not be able to be here all through this. I am going to have to depart and then come back. I will be gone for only 20 or 25 minutes, I hope. We have a potential Federal judge from Wisconsin who is being considered by the Senate Judiciary Committee at 10:30 in the New Senate Office Building, so I will depart and testify for him. Whenever I am through at the Judiciary Committee I will be coming back, meanwhile the hearing will be in the much more capable hands of Congressman Reuss.

Today, we open the second session of our hearing on the President's annual report.

It is most fitting that we hear at this time from the Director of the Bureau of the Budget and his associates.

The Federal expenditures equal about 21 percent of the gross national product on the national income account basis, and the manner in which the public money is spent as well as the place where it is spent has great effect on the allocation of resources on our economy.

Moreover, we know what the income and outgo of Federal funds does. It acts as balance wheel on our economy and can act either as a stabilizing or destabilizing force.

As I stressed yesterday the apparently unanticipated \$10 billion increment in the cost of the Vietnam war contributed strongly to the inflationary pressure that forced up prices during the year. And the fact that it was unanticipated, in my judgment, was the reason why it contributed so greatly to inflation. If it had been anticipated we could have had compensating fiscal policy of a tax increase or other spending cuts that would make a difference.

As we look ahead, it seems very likely that the economy will be poised on a knife edge during the coming year and the budget obviously will play a crucial role in maintaining stability.

Mr. Schultze, we have an expanded committee, and you will find that a number of the members have a number of searching questions to put to you. I know I have a number of questions for you.

I was going to say that I hoped you would confine yourself to 20 minutes, but I have read your statement, and it is a short statement, and, I think, in view of the situation this morning, you can read your full statement, if you would like to do so, or summarize any part of it.

I notice the last seven pages of your statement you have something to put into the record, although I would recommend to the members of the committee that they glance over it, if they have a chance, while you are going ahead, because it is very useful and interesting information.

You may proceed.

Mr. SCHULTZE. Thank you, Mr. Chairman, I thought I might read part of my statement and submit the rest for the record in order to cut the time down and leave more time for dual combat as opposed to unilateral reading.

STATEMENT OF CHARLES L. SCHULTZE, DIRECTOR OF THE BUREAU OF THE BUDGET, ACCOMPANIED BY SAMUEL M. COHN, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. SCHULTZE. Mr. Chairman and members of the committee, it is always a pleasure for me to take part in the deliberations of this committee, which for years has been a prime mover in advancing understanding of economic matters.

I have been, myself, in one capacity or other, associated with the staff or the members of the Joint Economic Committee for upward of 16 years. So I do have some slight background of familiarity with the work the committee has done, and the very good work it has done in the area of greater economic understanding and probing of economic matters.

I appreciate the opportunity to discuss with you today the main elements of the 1968 budget and the economic assumptions on which it is based.

As the President stated in his Budget message, a Federal budget lays out a two-part plan of action:

It proposes *total expenditures and revenues* designed to help maintain stable economic prosperity and growth.

It proposes *particular programs*, military and civilian, designed to promote national security, international cooperation, and domestic progress.

I would like to describe each of these aspects of the budget, touching first on the total *fiscal* strategy and then on the *program* strategy encompassed in the budget.

FISCAL STRATEGY OF THE 1968 BUDGET

The major objective of the fiscal program proposed in the 1968 budget is to provide the proper mix of expenditure and tax proposals which—combined with appropriate monetary policy—is designed to help us achieve a seventh year of economic expansion, along with an easing of inflationary pressures.

As you know, the economy is in a period of unparalleled growth. In the past 6 years, our Nation's gross national product has risen at an average of $5\frac{1}{2}$ percent in constant prices. The rate of unemployment has dropped from 7 percent in the early part of 1961 to under 4 percent. Nearly 9 million new jobs have been created. Plant utilization has risen from 79 to 91 percent and output per man-hour is 19 percent higher than in 1961.

Just in calendar 1966 alone, real GNP rose by almost 5.4 percent, more than 3 million nonagricultural jobs were found, and personal incomes and corporate profits after taxes grew by about 8 percent.

Fiscal policy played a major role in the overall performance of the economy during recent years. Economic expansion received a special stimulus from the major Federal tax revisions and reductions adopted in 1962, 1964, and 1965. These tax measures were a major factor in closing the gap between actual and potential output by fostering a substantial reduction in the excess capacity which was dragging the economy down at the end of the last decade.

As the economy moved toward full capacity operation, however, increased military demands and expanding business investment brought inflationary pressures late in 1965 and in 1966. Our price performance in 1966 was not up to what we had earlier hoped. After a number of years in which large increases in output were accompanied by very slight increases in prices, the last 18 months saw a 4.2-percent rise in consumer prices and a 3-percent rise in wholesale prices. Yet, even here, the price rise was very substantially below the similar period of the Korean war, and, as a matter of fact, below a similar 18-month period during the last time of full employment; namely, 1956-57.

Fiscal policy was brought into action during 1966 to help stem inflationary pressures. In response to the President's recommendations, some excise taxes were restored, taxpayments were accelerated, and last fall tax incentives for investment were suspended. The prompt cooperation of the Congress was an important element in enabling fiscal policy to be used as a tool for economic restraint, as it had earlier been used for economic stimulation.

In addition to last year's revenue measures, the administration undertook an effort to defer, stretch out, or reduce Federal programs wherever possible. As a result, Federal agencies are reducing and deferring program obligations, commitments, and contracts by a total of \$5.2 billion during the current fiscal year. The associated effect on expenditures is estimated at \$3 billion. The action involved in the deferrals and cutbacks ordered to date are under constant review. Should economic conditions require it, some funds now being withheld may be released. At the same time, we are seeking additional areas where postponements or stretchouts can be accomplished.

The tax and expenditure actions taken last year played an important part in the moderation of inflationary pressures we have experienced during the last few months. Now, what of the year ahead?

The 1968 budget proposals are framed to carry out the following objectives:

First: to provide all the resources needed to support our commitments in Vietnam.

Second: to carry forward, at a controlled and reasoned pace, our commitments at home to promote the health and education of our people, to continue the war on poverty, to improve conditions in our urban areas, and to combat the menace of pollution in our environment. A moderate increase in expenditures is provided for these programs, while less urgent activities have been held down to the minimum feasible level.

As a matter of fact, Mr. Chairman, last night I came across an editorial in *Life*, which expressed the nature of the domestic side of the budget better than I could, I think, pointing out that it is a budget that will please neither the pennypinchers nor the spendthrifts but will be defensible against both.

Third: to increase substantially the level of social security benefits as a means of helping to provide a decent income for millions of older Americans.

Fourth: by proposing additional taxes, to provide a fiscal policy which permits a continuation of the recent trend to easier monetary conditions, and the pursuit of balanced economic growth.

The Budget proposes several new revenue measures:

(a) A 6-percent surcharge on tax liabilities of individuals and corporations, exempting individuals with taxable incomes wholly within the first two brackets; the surcharge would be effective July 1, 1967, and automatically expire 2 years later, unless conditions permit an earlier termination.

(b) An increase in the taxable wage base for social security from \$6,600 to \$7,800 on January 1, 1968, as a first step in financing the enlarged social security benefits.

On a national income accounts (NIA) basis, these proposals are estimated to yield \$0.5 billion in the current fiscal year and \$5.3 billion in 1968.

In addition, two changes in the timing of tax collections are proposed which have no effect on the national income accounts budget but do increase revenues in the administrative and cash budgets:

First, an increase from 70 to 80 percent in the relationship that a corporation's estimated tax for any given calendar year must bear to its final tax liability.

Second, elimination, over a 5-year period, of the present exemption on the first \$100,000 of corporate tax liability—elimination, if you will, of that exemption—from the requirement of payment on a current estimated basis.

The combined effect of the expenditure and revenue proposals is to reduce the Federal deficit on a national income accounts basis from \$3.8 billion in fiscal year 1967 to \$2.1 billion in 1968 as a whole. For the last half of the fiscal year, the budget on this basis will be essentially in balance or slight surplus.

We believe this to be a sensible and suitable approach, given the best assessment we can now make of economic trends over the period involved. A substantially larger deficit, on the one hand, might well cause a renewal of inflationary pressures as well as a halt to the easing of monetary conditions. Reaching a substantially smaller deficit or a surplus for the fiscal year 1968 as a whole, on the other hand, might well adversely affect economic activity and, by depressing incomes, be self-defeating insofar as balancing the budget is concerned.

In sum, the overall fiscal program is designed to provide continued economic expansion at a sustainable level. With this program, we are estimating that the GNP will rise by 6½ percent in this calendar year—including a more moderate price increase than last year—around 2½ percent—and a real growth rate approaching 4 percent, which is a reasonable target rate of increase when the economy is already operating at high levels of employment.

Budget totals: Table 1 (below) shows the totals in the 1968 budget in terms of the three major Federal financial measures currently in use: the national income accounts, the consolidated cash budget, and the administrative budget.

TABLE 1.—*Budget totals, fiscal years 1966, 1967, 1968*

[In billions of dollars]

	1966 actual	1967 estimate	1968 estimate
National income accounts budget:			
Receipts.....	132.6	149.8	167.1
Expenditures.....	132.3	153.6	169.2
Surplus (+) or deficit (—).....	+3	—3.8	—2.1
Consolidated cash budget:			
Receipts.....	134.5	154.7	168.1
Expenditures.....	137.8	160.9	172.4
Deficit (—).....	—3.3	—6.2	—4.3
Administrative budget:			
Receipts.....	104.7	117.0	126.9
Expenditures.....	107.0	126.7	135.0
Deficit (—).....	—2.3	—9.7	—8.1

The committee will be particularly interested, I believe, in the emphasis given to the national income accounts budget in this year's budget message. As I noted earlier, it is the best overall measure of the Federal Government's activities for purposes of analyzing the flow of national income and output. When economists forecast the GNP, they have to translate the administrative and cash budgets into the national income accounts framework. Since its first Economic Report, the Council of Economic Advisers has published Government data on an NIA basis. Starting in 1962, the budget message of the President each year has published forward estimates of budget expenditures and receipts on an NIA basis, along with the more conventional administrative and consolidated cash budgets. This year the President took a further step and placed the central emphasis on the NIA budget in that part of his budget message dealing with overall fiscal policy.

As you know, the NIA budget differs from the administrative budget in several ways, the three most important of which are:

First: it *includes* the receipts and expenditures of the trust funds, since these, which now run well over \$40 billion, have a significant effect on the level of economic activity.

Second: it *excludes* payments and receipts from loan transactions since these represent exchanges of financial assets, rather than additions to or subtractions from the stream of income.

Third: it counts revenues when the tax liabilities are *accrued*, rather than when the taxes are actually *collected*, in line with the way in which private income statements are generally kept.

As measured in the *national income accounts*, Federal revenues will rise from \$149.8 billion in fiscal year 1967 to \$167.1 billion in 1968. This increase includes the effect of the President's tax proposals, but stems mainly from prospective continued economic growth. Federal expenditures in the national income accounts are estimated to increase somewhat less, from \$153.6 billion in 1967 to \$169.2 billion in 1968. This 1968 total will represent approximately 21 percent of the gross national product, up only 1½ percent from 1964 despite the added costs of Vietnam, new programs which have been undertaken, and the steady expansion in social security and other trust fund programs.

The increase in expenditures over 1967 consists of: (a) \$5.8 billion for Vietnam and other national defense requirements; (b) \$6.2 billion in trust fund outlays which, you will recall, are included in the NIA, and of this \$6.2 billion about two-thirds represents the proposed increase in social security benefits; (c) \$1 billion to cover the cost of pay increases to be proposed for military and civilian Federal personnel to help Government salaries keep pace with salary increases in private industry; and (d) \$2.6 billion for all other Government programs.

On the *consolidated cash basis*, which combines all administrative and trust fund transactions, *including* loan and credit transactions, total receipts from the public in 1968 are estimated to be \$168.1 billion and payments to the public \$172.4 billion, with a resulting deficit of \$4.3 billion compared with \$6.2 billion in the current year.

In the *administrative budget*, the least comprehensive measure since it excludes \$48.1 billion of trust fund receipts and \$44.5 billion of trust fund expenditures, total revenues are estimated to rise from \$117 to \$126.9 billion from 1967 to 1968. Administrative budget expenditures are expected to total \$126.7 billion in 1967 and \$135 billion in 1968. Thus, the deficit on this basis will decline from \$9.7 to \$8.1 billion in these 2 years.

As I noted earlier, the deficits in the national income accounts budget are estimated at \$3.8 billion in 1967 and \$2.1 billion in 1968.

The time pattern of the balance in the national income accounts budget, by half-year periods, is closely related to our expectations about the course of private spending.

During the first 6 months of calendar 1967, the growth in private economic activity will, we believe, be significantly moderated by a decline in the rate of inventory investment. And during that 6-month period, NIA budget expenditures will be rising slightly faster than revenues. But as the current move toward lower interest rates begins to have a significant impact on the economy, and as the increase in social security benefits provides additional purchasing power to consumers, revenue increases will begin to exceed the growth of expenditures. The NIA budget deficit in the second half of calendar 1967 will, therefore, move sharply downward, reaching a balance or slight surplus in the first half of 1968.

This provides a fiscal policy tailored to the Nation's economic requirements, helping to promote: (a) a healthy growth in economic activity; (b) a moderation of inflationary pressures; and (c) a continued move toward greater availability of credit.

PROGRAM STRATEGY OF THE 1968 BUDGET

This year, for the first time, we have provided in the budget a breakdown of NIA expenditures by major functions. Nevertheless, for purposes of discussing individual programs, and relating those programs to authorization and appropriation actions requested of the Congress, the detailed breakdown currently available in the administrative budget and the trust funds is more suitable.

The program proposals of the President are based on the premise that a healthy and growing nation such as ours can and must continue to move forward in the effort to improve the quality of American life, while at the same time meeting its defense commitments. In view of the substantial resources required for our military operations, however, increases in civilian programs have been proposed only on a selective basis for the high priority needs of our society. In the selection process, particular consideration has been given to those activities designed to help provide equal opportunities for all to share in the Nation's advancement.

CONTROLLABILITY OF EXPENDITURES

To help underscore the difficulties of allocating the limited resources available among many competing demands for funds, it is useful to look at the administrative budget briefly from the point of view of the leeway available in expenditure decisions in any one year. Table 2 sets forth the expenditures in the administrative budget in terms of the controllability of the programs involved.

TABLE 2.—Administrative budget expenditures, fiscal years 1966, 1967, 1968

[In billions of dollars]

Type of controllability	1966 actual	1967 estimate	1968 estimate
National defense.....	\$57.7	\$70.2	\$75.5
Relatively uncontrollable civilian expenditures:			
Major programs.....	24.1	28.3	29.4
Interest.....	12.1	13.5	14.2
Veterans pensions, compensation, and insurance.....	4.2	4.7	4.9
Public assistance grants.....	3.5	3.9	4.2
Farm price supports (Commodity Credit Corporation)	1.3	1.6	1.6
Postal public service costs and revenue deficit (existing law).....	.8	1.1	1.1
Health insurance payments to trust funds.....	.3	1.0	.9
Legislative and judiciary.....	.3	.4	.4
Other.....	1.8	2.2	2.3
Payments on prior contracts and obligations.....	11.5	14.3	15.3
Relatively controllable civilian expenditures.....	13.6	13.9	14.9
Proposed pay increases.....			1.0
Sale of financial assets.....	-3.0	-3.9	-5.3
Other.....	16.6	17.8	19.2
Total administrative budget expenditures.....	107.0	126.7	135.0

As the table shows, \$75.5 billion, or 56 percent, of total administrative budget expenditures is estimated to be required for national defense in 1968, leaving \$59.5 billion for nondefense purposes. Of this nondefense portion, \$29.4 billion—22 percent of the total—is for programs for which payments under existing law are relatively un-

controllable, such as interest on the public debt, public assistance, and veterans compensation and pensions. Another \$15.3 billion, or 11 percent is required to make payments on contracts or other obligations incurred in prior years. Thus, we find that only about 11 percent, or \$14.9 billion, of the budget may be considered "controllable." Or, if one wishes to exclude both the effect of the sale of assets on budget expenditures and the proposed pay increases, the relatively controllable portion equals \$19.2 billion, or 14.2 percent. Even in this category, the margin for decision is limited since it includes programs which must be carried forward and which normally have growing workloads as our country grows; for example, operation of the Nation's airways, maintenance and improvement of our national parks, collection of taxes, and law enforcement.

EXPENDITURE TRENDS

Given the restraints involved, within the area of discretion, the President's policy—as I said earlier—has been to expand selectively what might be termed "major social programs." Economies, savings, and reductions have been provided wherever possible to hold down the total level. The effect of this policy on the budget is shown in table 3.

TABLE 3.—*Civilian administrative budget expenditures, fiscal years 1966–68*

(In billions of dollars)

	1966 actual	1967 estimate	1968 estimate	Change, 1967 to 1968
Total civilian.....	\$49.3	\$56.5	\$59.5	+\$3.0
Major education programs.....	2.8	4.0	4.6	+.6
Major health programs.....	2.5	4.3	4.8	+.5
Other major social programs:				
Welfare, labor, and economic opportunity programs.....	5.1	6.1	6.5	+.4
Housing and community development, regional development, and pollution control.....			2.4	+.4
Interest.....	12.1	13.5	14.2	+.6
Proposed pay increases.....			1.0	+1.0
Sale of financial assets.....	-3.0	-3.9	-5.3	-1.4
All other civilian expenditures.....	28.4	30.5	31.3	+.8

You will note from this table that of the total estimated increase of \$3 billion for civilian expenditures in the administrative budget, \$1.9 billion is provided for major social programs—education, health, welfare, manpower training, the war on poverty, community development, and the like. Fixed interest charges will increase by \$0.6 billion. This leaves an increase of \$0.5 billion for all other expenditures—made up for \$1 billion for the proposed pay increases and \$0.8 billion for all other civilian programs, offset by \$1.4 billion in proceeds anticipated from the sale of participation certificates and direct loans acquired under Government credit programs.

The pattern of expenditure changes I have just described is a continuation of a shift begun a few years ago toward increasing emphasis on investment in human resources and on improvement of the physical environment in which most of our people live. Taking the major social programs in table 3—and for the sake of convenience, I will use figures *net* of asset sales—the expenditures for these programs will comprise 26.4 percent of civilian administrative budget expenditures in 1968 compared with 16.4 percent in 1964.

Moreover, these programs account for almost 54 percent of the total increase in civilian expenditures between these two years. This percentage becomes 75 percent if we exclude the increases in outlays for interest on the debt and for the space program.

The increased emphasis on expenditures for such purposes as education, health, and manpower training represents just as much an investment in the Nation's future productivity as investments in machines and equipment—even though the normal rules of business accounting do not treat them as such. In my testimony before the committee last year I stressed the recent studies by economic analysts which emphasize the economic payoffs from such “intangible” investments. I feel very strongly that a proper evaluation of Federal activity must recognize the hardheaded commonsense of investing in the education, health, and skills of the Nation's present and future work force.

While increases have been provided for major social programs, the expansion is selective. Many of the appropriation requests included in the 1968 budget in these areas are well below the amounts authorized in substantive legislation. Moreover, proposals for starting new Federal construction projects in 1968 are being held well below the average of prior years.

For example, 9 new water resources projects are proposed for the Corps of Engineers, compared with the 58 new projects appropriated in 1967 and 4 for the Bureau of Reclamation, compared to 6 in the current fiscal year. The 1968 budget also provides for 8 starts by the General Services Administration on the construction of public buildings, compared with 33 starts appropriated in 1967.

BUDGET PRESENTATION

As is customary, I will conclude my remarks by mentioning briefly what I consider to be major improvements this year in the presentation of budgetary information.

As I have already pointed out, the 1968 budget message in discussing fiscal policy placed special emphasis on the national income accounts budget. To my mind, this new presentation represents a welcome step forward, since some of our more traditional budget concepts do not adequately portray the Federal Government's activities. But the national income accounts budget by no means solves all the problems of budget treatment and presentation. For example, while it is the best measure of Federal activities as they affect the current flow of income production in the economy—it does not yet have the backup detail needed for analyzing individual Federal programs, although we are moving in this direction. For example, this year for the first time we published a table in the budget showing a breakout of national income accounts expenditures by major program categories both for prior and forward years.

Over the years, spanning administrations of both parties, questions have been raised about the overall budget presentation and about the treatment of particular types of Government financial transactions, by this committee and others as well.

With these questions in mind, the President in his budget message has called for a thorough and objective review of budgetary concepts by a bipartisan group of experts in this field. This group will be asked

to review the budget and make recommendations on budgetary presentation with the objective of assisting both the Congress and the public in better understanding this vital instrument of the public business.

One final point I would like to make is that the planning-programming-budgeting system installed in the executive branch a little over a year ago is making its mark on our methods of establishing objectives and seeking the best means of achieving them. We believe this system, when fully operational, and it will take some time, will improve substantially our entire program decision process. In the 1968 budget, some of the discussion and analysis of the Federal program by function—part 4 of the budget document—shows the effects of the application of this system.

For the first time this year the budget programs of several civilian agencies are presented in that part 4 of the budget document in terms of the major objectives of the agency's activities, along the lines of the presentation in the past few years of the Department of Defense program. In addition, a number of tables are included throughout the discussion which provide data on program accomplishments and trends as well as data on the dollar amounts involved. We have, in other words, presented not only program costs, but also some measures of program outputs in the budget document.

We spend not for the sake of spending, but to produce a specific set of accomplishments. With the aid of these new tables on program outputs, many of the various press reports about specific segments of the budget were for the first time, I believe, able to relate program outputs to the dollar inputs recommended. I think we have made a good beginning in this direction—I think we have got a long way to go—and I look to further progress as the PPB system gains a stronger foothold.

Mr. Chairman, while this concludes my formal statement, I would like to place in the record an "Addendum" which describes, in capsule form, the major "Program Highlights of the 1968 Budget."

(Material referred to follows:)

ADDENDUM

PROGRAM HIGHLIGHTS OF THE 1968 BUDGET

I would like to describe briefly some of the highlights of the budget proposals, particularly for the major social programs and for our national defense.

Education.—I doubt that anyone needs to be convinced of the value and importance of education to the individual and to our society. Education makes a vital contribution to economic growth and technological advance, to the war on poverty, and to personal fulfillment.

Education has received high priority in the 1968 budget. Estimated gross outlays—i.e., excluding the effect of asset sales, mainly in the college housing program—will be 63 percent more than in 1966. These outlays will provide for—

An increase in grants under title I of the Elementary and Secondary Education Act of 1965, reaching 8½ million disadvantaged youngsters from low-income families.

New grants to expand educational opportunities for physically and mentally handicapped children.

An expansion of almost 80 percent in grants for supplementary centers and for other innovative approaches to improving education.

More than \$1.1 billion in aids to undergraduate college students through scholarships, loans, and part-time work.

Improvements in teacher training programs and enlargement of the Teacher Corps.

Increased support for basic research and science training.

Strengthened programs of vocational education, educational television, and planning efforts of State departments of education.

Health.—Cash payments for health services and research, including outlays from trust funds, are estimated at \$8 billion in fiscal year 1968, up \$1.2 billion from 1967. This increase will be used primarily to bring quality medical care to aged and indigent people, enlarge the supply of medical personnel and facilities, support research, and reduce disease and health hazards in our environment.

In recent years, the role of the Federal Government in promoting better health for Americans has grown significantly. It received a special impetus from legislation enacted in the 89th Congress. In carrying out this expanded role, increased emphasis is being given to working in partnership with the States in planning health activities and providing broader and more flexible grants with the aim of improving overall local health services.

The 1968 budget calls for—

Over \$5 billion in cash payments for medicare and medical assistance to the needy.

Extension of medicare to disabled workers.

Expansion of child health services, including dental care.

Addition or modernization of about 21,000 hospital beds and 13,000 beds in long-term care facilities, under the Hill-Burton hospital construction program.

Increased assistance for the construction of medical schools.

Scholarships and loans to an increasing number of medical, dental, and nursing students.

Operation of about 50 regional medical programs aimed at accelerating the attack on heart disease, cancer, stroke, and related diseases.

Increased support for biomedical research and training of researchers.

Nearly doubling our outlays to control air pollution, including a new enlarged 5-year program.

Welfare, labor, and economic opportunity programs.—In addition to the proposed increase in benefits under the social security system, the President is proposing various measures to help others of our society whose incomes fall below the poverty level. For example, the budget includes funds for recommended improvements in the public assistance program—to make cash payments more adequate, to provide incentives for work and training, and to assure assistance to families impoverished because the father is unemployed.

Services to the disadvantaged will continue to be stressed in the manpower activities carried out through the Manpower Development

and Training Act of 1962 and the U.S. Employment Service. An estimated 280,000 trainees will be enrolled in 1968 under the MDTA, about two-thirds of them workers with minimal skills who cannot take advantage of the job opportunities available in an advancing economy. The USES in 1968 will extend to disadvantaged adults the special services it has been providing for disadvantaged youths.

Other significant work and training opportunities are being made available through funds of the economic opportunity programs:

The Neighborhood Youth Corps will provide 355,000 jobs and training opportunities.

Appropriations of \$328 million are being requested to expand other work-training programs, including intensive supporting services, designed to reach hard-core unemployed and underemployed individuals in slum areas.

In addition, an increase of \$312 million is provided in the budget for the Office of Economic Opportunity to—

Expand antipoverty activities and services provided to 6½ million people through 1,100 community action agencies in rural and urban areas.

Provide classes for 737,000 pre-school-age children in the Headstart program.

Work with the Office of Education to improve primary school services as a followup to Headstart.

Offer skill training and useful work experience through the Job Corps to 38,000 disadvantaged young people who are out of school.

Help migrant farmworkers, make loans to rural families, and offer services in poor areas through VISTA volunteers.

Housing and community development, regional development, and pollution control.—Two common themes that run through many of the programs seeking to improve the physical environment in which Americans live are that—

Comprehensive planning and action yield far better results than piecemeal measures, and

The best results are achieved through combined public and private efforts.

Accordingly, the Federal budget proposals dealing with housing, community development, regional development, and water pollution control stress coordinated and concerted efforts at problem solving.

The 1968 budget provides funds for—

The new model cities program, under which cities are given an incentive to plan comprehensive action to transform entire blighted areas into attractive and useful neighborhoods,

The rent supplement program, under which private interests are being enlisted in an effort to help the needy obtain better housing,

Increased efforts to promote urban renewal, preserve open space in the growing suburbs, create parks in developed city areas, and provide needed public facilities,

Assistance to cities in financing mass transportation facilities.

Grants for various types of basic water, sewer, and other public facilities,

An increase in the number of public housing units available for low-income families, and continued support for housing for moderate-income families and elderly individuals.

Expenditures for economically depressed areas and regions assisted by the Department of Commerce will almost double in 1968.

To combat water pollution, the budget includes \$203 million in 1968 for grants to communities to build waste treatment plants.

Research, development, and programs for water pollution control will be expanded significantly, and funds are provided for comprehensive attacks on the problems of pollution in entire river basins.

National defense.—Total expenditures for national defense are estimated at \$75.5 billion in 1968, of which \$21.9 billion will be used to support necessary operations in southeast Asia. This estimate provides for our future requirements as we now foresee events there, including a possible extension of hostilities beyond the end of the fiscal year. It also provides for the requirements of maintaining our superiority in strategic forces, for increases in the capabilities of our conventional forces, and for advances in our military research and development programs.

Other Federal programs.—Apart from fixed interest charges, proposed employee pay increases, and the planned sales of financial assets, the increase for all other civilian expenditures has been held to \$0.8 billion in 1968. This figure represents the net effect of various increases and decreases, two of which are particularly worthy of note.

First, expenditures of the National Aeronautics and Space Administration in 1968 are estimated to decline by \$300 million. We are planning new ventures in space, including an effective follow-on to the manned lunar landing and further unmanned space investigations. However, we are able to reduce overall expenditures because the major systems required for the manned lunar landing are progressing beyond the most costly phases of development. The recent tragic events in the Apollo program are now under intensive review, as you know, so it is too early to assess any possible impact on the manned lunar schedule or budget.

Second, net outlays for postal services will decline with enactment of the postal rate increase being proposed in the budget. This increase is required under the policy set forth in the Postal Policy Act of 1958 to provide improved postal services, to cover proposed pay increases for postal workers and largely offset the remaining postal deficit.

Chairman PROXMIRE. Mr. Schultze, first I want to commend you for the many good things in your statement and the work you have done. Your use of the "national income accounts" budget is a great improvement. This committee, I think, is particularly interested in the impact of the budget on the economy.

It is clear that the national income accounts budget is a much more comprehensive and accurate reflection of the effect of Federal spending and taxes on the economy than the administrative budget for the reasons you have indicated. At the same time, it takes courage for the President to do this, because it is a much bigger budget and it calls attention to the immense impact the Federal Government has on the economy more than the administrative budget does, but I think it is a good thing to do.

I do hope you stick by it. This is an inviting year to do, because you have a smaller deficit of course, but certainly from the standpoint of economic analysis, it is enormously helpful, recognizing, as you properly point out, that there are still defects here.

I also commend you on the results of budgetary policy in recent years, which you have spelled out, in terms of growth, in terms of employment, in terms of real income, after allowing for inflation. After all, this committee is a critical committee and should be, but we tend to overlook the good things about the economic progress, and you properly point them out.

The other commendation I would like to make is in regard to the PPBS. This is one of the most encouraging developments, I think, in Government budgetary policies.

The Defense Department has made wonderful progress in developing systems for comparing costs and benefits, being in a position for the first time, I think, in the history of our Government, really, to determine properly how best our resources can be allocated to meet particular goals with the lowest dollar cost. We have not done this before.

I hope this committee can explore this in detail, to determine how we in Congress can contribute to it, because with a more critical view, I think we can make a much greater contribution than we would if we did not really understand what this PPBS thing is. And I do not think we understand it nearly well enough today, so I hope you can help us on that line.

These are the things I think you are primarily involved in, and, therefore, I think you deserve a lot of commendation.

You can't be held responsible for the position the Congress and the President takes on how much of our resources the Federal Government should spend. You are a champion of that position; you have to be, but I think in these areas of efficiency, you have done well.

There is one other aspect of this efficiency that I would like to mention that I think you might give more attention to, and that this is this measuring productivity in Government departments. Kermit Gordon, when he was your predecessor, published a book in this area which is most encouraging.

Mr. SCHULTZE. That is correct.

Chairman PROXMIRE. We can measure productivity in some Government departments which are doing amazingly well. We make the ridiculous assumption that Government employees do not improve their productivity, as I understand it, in our economic assumption, and yet we find vast improvement in some areas. If we can put a little more stress on this and have this developed in more departments than it has been, I think that this is a very promising avenue.

Now, let me get into an area where I am a little more critical.

Yesterday, we developed an argument that the Vietnam war in this fiscal year had been underestimated by \$10 billion. That the estimates had been a year ago that there would be a \$10 billion cost for the Vietnam war, and it is \$20 billion for this fiscal year.

Of course, this had a devastating effect on our economic policy. We failed to increase taxes as perhaps we might have done; however, I would have been opposed to that.

We failed to cut spending, as I think we should have and would have done if we had these figures before us, if we had an accurate, true reflection of just what the budget was going to be, and I think it would have saved us an awful lot of difficulty with inflation and high interest rates.

I want to ask you, as Director of the Bureau of the Budget, what responsibility do you feel you have to secure accurate estimates for the President and the Congress and Pentagon on the cost of the Vietnam war?

How can you pursue the figure that they give you, to determine whether it is accurate or not?

Mr. SCHULTZE. Let me make several points, in answer to that, if I can, Senator Proxmire.

Let me go first to the substance of your point with respect to the impact of underestimating Defense spending on economic policy and economic consequences, and then to the role of Budget Director.

First, I think you have clearly got to put this in the context of last year's economy. If you will look at last year's economy, you will find that the main inflationary pressures were in being during the first 7, 8, 9 months of the year. Starting in August, the Wholesale Price Index stabilized and began to recede after September. Consumer food prices began to recede after August. The Consumer Price Index itself began to inch up at a much lower rate after October. So, pretty clearly, the main inflationary pressures in the economy were during the first 7 to 9 months.

Chairman PROXMIRE. Beginning in February. In January, prices did not rise. It was in February.

Mr. SCHULTZE. They were rising to some extent in late 1965. And then there was a little tapering down and then they rose again.

Now, let us look at what happened to the Federal budget, as we predicted and as it actually occurred, taking the NIA measure.

Chairman PROXMIRE. I do not want to be rude, but my question was as to what your responsibility is in getting information from Mr. McNamara and the Defense Department, whether you can go behind his figures, or you do go behind them, or not. That is what I want to know. I want to pursue this. You can make any answer you wish, but if you are responsive, what I want to know is whether you have the right and whether you feel you have the responsibility to challenge figures that come from the Pentagon.

Mr. SCHULTZE. Then, let me reverse the order of my answer. I was going to talk first to the substance and then the procedure.

I will switch and talk first to the procedure and then come back to the substance.

Essentially, there is no simple answer to this, Senator.

In the first place, with respect to the Defense Department, the Bureau of the Budget pursues a different procedure than it pursues with respect to other departments. Other departments submit a formal budget request to the Bureau of the Budget which we review and on which we present recommendations of our own to the President. In these cases there is a formal exchange of views back and forth between us and the agency head before we see the President, and then together with the President.

In the case of the Defense Department, the Bureau of the Budget staff and then later I and my top aids work right with the Secretary of Defense and his staff in his overall budget recommendations to the President. In other words, instead of the Secretary formally submitting a budget request to us and the Bureau reviewing it separately, we work together with him in developing his presentation to the President.

Chairman PROXMIRE. So, you work with him in determining that the cost of the Vietnam war will be \$10 billion.

Mr. SCHULTZE. We work with him in determining—

Chairman PROXMIRE. It was a joint error, so to speak.

Mr. SCHULTZE. I accept whatever responsibility comes out of this procedure. Now, let me go ahead on this.

The next point is that the expenditures with respect to Vietnam could not really be determined with any accuracy until the requirements were determined, and those requirements were not determined or pinned down until very late in the year, for two essential reasons, and I think the first one particularly you would be quite interested in.

Chairman PROXMIRE. You knew the requirements involved, 400,000 troops by the end of the year. That was known.

Mr. SCHULTZE. Gradually, that became known; that is correct.

Let me go back a little, if I may.

In October and November of 1965 when the Defense budget for fiscal 1967 was being prepared, our own buildup in Vietnam was literally on a 60° curve. In 120 days we shipped 100,000 men overseas. At the same time, according to actual reports and intelligence estimates, the Vietcong and other strength was rising also at a 60° angle. At that time, we just did not know where this was going to level off.

Rather than present a budget request then or even later in the year, based on unknown requirements, the assumption was made that we would finance the war just through 1967 and come back in later for a supplemental if the war was going to go on longer.

Chairman PROXMIRE. But throughout that period, you must have realized again and again and again that you were going to be off and you did not tell us. There were no figures given.

Mr. SCHULTZE. I disagree.

Chairman PROXMIRE. No opportunity for the Congress to modify its policy. Congressman Laird and Senator Stennis spoke out on this, nailed it down. They turned out to be dead right and all we got from the administration was that they were wrong; they stuck by their figures.

Mr. SCHULTZE. In February of last year, Secretary McNamara, in appearing before a joint session of the Senate Armed Services and Defense Appropriations Subcommittee, pointed out that if the war were going to have to continue beyond the end of 1967, he was going to have to come back in for more money. In August, he told the same committees that it was pretty clear at the time that a supplemental was going to be necessary but he did not know the amount, and I did not know the amount.

In September and October, in appearing before the House Ways and Means Committee and the Senate Finance Committee, to ask for the suspension of the investment credit, Secretary Fowler and I both pointed out unless there was a dramatic breakthrough in the situation in Vietnam, there would be additional need for funds.

Now, the reason that we did not send up, did not want to send up—and I fully agree with Secretary McNamara in not sending up—a supplemental request at the time, hinges on two major points.

First, one of the most important tools that a Secretary of Defense has in trying to provide efficient budgeting in the Pentagon is not to ask for a dime that is not associated with specific requirements. Once you break that rule, which has been painfully built up over the years, I personally believe that the control and the effectiveness of these programs in military budgeting would just go out of the window. I sincerely believe that it would have been a major mistake to come up with a supplemental not based on specific requirements, because in doing so you would be breaking a rule with a lot of psychological impact in terms of effective military budgeting that has taken years to get established and made effective. And for the sake of argument, if we could have come up with an estimate, it would have been a wide-ranging one, and it would not have been based on specific requirements in terms of specific attrition, specific amounts of ammunition required, specific numbers of bombs needed. It would have been a guess.

That money would have been appropriated, as sure as I am sitting here, and would have been available in a lump sum, and the Secretary's ability to limit spending to specific requirements would have been substantially weaker. So I feel it was a correct decision to wait until the specific requirements were known, although it was a politically unpopular one, and has caused us a lot of trouble.

Chairman PROXMIRE. It was just plain wrong. He was off 100 percent. He said \$10 billion and it was \$20 billion. He never corrected it. All this talk about how it is more efficient to make an estimate, based on an assumption which is a ridiculous assumption, is just completely beyond me.

I just cannot understand how in the world you can say it was right, or that it was courageous, or that it was unpopular. It was completely wrong. It destroyed all of our economic policy for that whole year.

Mr. SCHULTZE. May I come back to that? I would like to, very much.

Chairman PROXMIRE. I want to apologize for the fact that I have gone over my time, and also, that I must leave, because I have to attend the meeting of the Senate Judiciary Committee. I will be back. I want to pursue this. You are an excellent witness and you can give us good answers in this area, but I am just going to leave now and yield to Congressman Reuss, who will chair the meeting when I am gone.

Mr. SCHULTZE. Senator, I would like, sometime when you come back, to make a particular point in the record.

Representative REUSS (presiding). I will see to it, if Chairman Proxmire does not come back, that you will be given an opportunity to be heard on that.

Mr. Rumsfeld, you are recognized.

Representative RUMSFELD. Thank you, Mr. Chairman.

Mr. Schultze, I have been very interested in the discussion you have had with Senator Proxmire. I am curious to know, exactly how you, as you suggest, share the responsibility for the decisions that were

made with respect to estimates of the Department of Defense. What has been done since that time to see that your joint capability to accurately forecast or even reasonably accurately forecast will be improved in the coming year?

I sense from your statement that you share my concern about the credibility of the U.S. Government, about the accuracy of your previous budget estimates and about the believability of statements concerning these difficult and technical matters, which I grant are difficult to predict and are subject to change.

I am pleased to see there is going to be a study made to see how the budget can as accurately as possible reflect what is in fact going on in this country, but I would like to hear what steps, specifically with respect to DOD, have been taken.

I asked Mr. Ackley yesterday if DOD was being pulled into this working group, and he indicated not.

Mr. SCHULTZE. May I respond?

Let me make a couple of points. First, I want to make it very clear for the record that I do not and should not share responsibility for the determination of how many men we need in Vietnam, nor how many planes. That is not my responsibility. In translating those determinations into the budgetary impact, of course I do have a role. I want to make it clear that the Budget Director is not deciding what General Westmoreland needs. That is obvious.

On the next point—I do not know whether you are aware of it, but you know you cannot fight a war without supplementals. There were seven of them during the Korean war. Nobody can predict how these things are going to come out and—

Representative RUMSFELD. You say nobody can do it. There were people in Congress doing it over and over again. When the original request came out, three or four Members of the House and Senate took the floor and pointed out that it was outdated then.

The construction activity that was programed to sustain a troop commitment that was considerably in excess of that for which funds were being requested.

I knew that, and I am not on the Armed Services Committee.

Mr. SCHULTZE. As I indicated earlier, Secretary McNamara said time after time that if we were going to finance the long leadtime procurement we would need if the war were to continue past June 1967, "I am going to have to have more money and I am going to come back in for it." He said it time after time. And he also said, "When our commitments are rising at a 60° slope, I can't predict where they are going to level off."

Now, where are we now compared to a year ago? Unlike a year ago, the rate of our planned buildup is moving up much more gradually. It is now possible, with 18 months of combat experience behind us, to assess somewhat better what the requirements are, barring a massive change in the conditions of the war. It is also possible to make a much better set of assumptions with respect to combat attrition, and the like.

As a consequence, the 1968 budget request of the Department of Defense, unlike the 1967 request, provides all of the funds necessary to procure the long leadtime items which will be necessary should the war continue.

Let me give you an example—

Representative RUMSFELD. So, in this case, you are not really violating the principle you are stating in respect to Senator Proxmire's question?

Mr. SCHULTZE. No, sir; not at all.

Representative RUMSFELD. But on the other hand, you are leaving yourself the option—I should not say you, the administration and the Department of Defense—of programming ahead and making specific requests for specific things that they do not know at that point whether or not, according to your statement, they are going to require?

Mr. SCHULTZE. No, sir; that is not the difference. The key difference is that last year, because we were right in the beginning phases of a rapid buildup, we could not know what it was going to be like 18 months ahead. We still do not know exactly what is ahead—obviously, we do not—but we are in a much better position to know. We are on a curve now which is tapering off. We can see the future, barring major changes, much better than we could at that time.

Aircraft is a good case in point. The 1968 budget provides necessary funds, since aircraft have leadtime, to finance the attrition of aircraft to January 1, 1970. In the case of ammunition, which is a shorter leadtime item, about 6 months, the budget provides the amounts necessary to finance it, should the war continue to December 30, 1968. We did not do that, admittedly, at the time of the 1967 budget a year ago, because we were much less able to know what those attrition rates were going to be.

Representative RUMSFELD. Have you detected to any extent a desire to not make accurate prognostications over the near term because of an unwillingness to reveal military activities or a planned buildup?

Mr. SCHULTZE. No, sir.

Representative RUMSFELD. Construction activities?

Mr. SCHULTZE. No, sir.

Representative RUMSFELD. So, in other words, you are stating categorically that you do not know of any situation where tactical considerations, strategic considerations, or diplomatic considerations have dictated the stating of figures or estimates that are not as complete, full, and accurate as they could be?

Mr. SCHULTZE. No. Let's take a look at accuracy, since it has been brought up.

We missed substantially this year on expenditures and a budget deficit. We also missed in 1966, and in 1964 and 1965, but the other way. And if you add those 4 years together, it turns out that our predictions of deficits practically cancel each other out. We overestimated in some years and underestimated in others, but if you look at the record there is no—

Representative RUMSFELD. I am not thinking of how you net out over a period of 6 months. I am talking of the economic impact of poor estimates on a given year's policies.

Mr. SCHULTZE. I am saying again, Mr. Rumsfeld, that (a) we obviously missed, (b) we are in a war, and you miss in a war, and (c) the specific assumptions on which the 1967 budget was based in respect to the June 30 termination of the war were stated by Secretary McNamara time and time again. It was not concealed from anybody. We did not, admittedly, come up until this January with

the specific amount of the supplemental. That is correct. We did not come up with it. I think there were good reasons for not doing that. This is where we obviously disagree.

Representative RUMSFELD. I am pleased with parts of your statement, because of your expressed desire, to see that the budget message and the Budget itself is communicated to the extent possible as an accurate evaluation of where we are going. I think your statements have been encouraging, and I commend you.

You quoted from *Life*, saying that the budget was defensible against pennypinchers and spendthrifts, both. I think we ought to make sure that it is defensible also on the issue of believability, because this is exceedingly important to this country, and I am hopeful that the steps you have outlined here will be taken, and that we can come up with some suggestions for the coming budgets.

I would like to ask you one other question. This question relates to your comment about the Defense Department's procedures in not wanting to make anything other than a specific request for a specific thing.

You, as Budget Director, are familiar with NASA's budget?

Mr. SCHULTZE. Yes, sir.

Representative RUMSFELD. You are also familiar with the categories on advanced missions and Apollo applications?

Mr. SCHULTZE. Yes, sir.

Representative RUMSFELD. To some extent they are specific and to some extent they are catchalls.

Mr. SCHULTZE. Go ahead.

Representative RUMSFELD. I personally am concerned about the fact that we seem to be spending money to keep production lines open in the space program for the apparent reason that post-Apollo decisions have not been made. The reason I am given for the fact that we fail to make post-Apollo decisions is the war in Vietnam.

Now, we can get into a pretty tight and expansive little circle here.

I am curious to know what your role is here. You have, I think, pretty accurately indicated your role with respect to DOD and said it was unique.

I would be curious to know what your relationship to a decision like this might be, simply for my information from a procedural standpoint.

Mr. SCHULTZE. Let's take post-Apollo programs as a good example.

Representative RUMSFELD. I think, in a broader sense, the question is where this country is going post-Apollo.

Mr. SCHULTZE. Exactly, I am trying to complete my thoughts as to how best to present it.

Representative RUMSFELD. Well, my 10 minutes are up.

Mr. SCHULTZE. I will use my time to answer your question, if that is all right.

Starting back in 1965, it was clear that decisions about post-Apollo programs would have to be made in the 1968 budget.

Representative RUMSFELD. Or before.

Mr. SCHULTZE. Well, maybe some small ones.

Representative RUMSFELD. The manpower curve had already started down.

Mr. SCHULTZE. But nevertheless the basic decision would have to be taken in the 1968 budget about what to do with manned space flight capability, and starting with 1965, NASA began to examine a number of alternatives. Those alternatives were discussed with many areas in Government, but let's just stick with what NASA was discussing with the Budget Bureau. NASA made a number of presentations to the Budget Bureau, and discussions were held, beginning in the summer of last year.

NASA came up with a number of alternatives, and those alternatives gradually began to be narrowed down.

As you know, the major problem, of course, is that even though the manned lunar landing, in terms of work to be accomplished, has a long way to go, the leadtimes are such that either you make a decision in 1968 to provide the development to maintain manned space flight capability thereafter, or you let it go.

Representative RUMSFELD. Exactly.

Mr. SCHULTZE. Now, in the 1968 budget, far from being a highly unspecific program, there is a specific program for post-Apollo, as specific as any development program can be, and what that involves is a combination of two things really closely related.

One is, some plans to use Saturn I-B's that might not be needed for the manned lunar landing program, with certain adaptations.

Representative RUMSFELD. I do apologize for interrupting.

I am aware of what is in the budget for 1968.

My question runs to your responsibility with respect to this type of decisionmaking process just as Senator Proxmire's ran to yours with respect to the Department of Defense.

Mr. SCHULTZE. Right.

Representative RUMSFELD. I am interested from a procedural standpoint.

Mr. SCHULTZE. Our main responsibility is to insure that all of the relevant and reasonable options are developed for presentation to the President. Now, when you are getting down to nickels and nuts and bolts, the agency and the Budget Director can very often settle that and make a joint presentation to the President, and there is not much disagreement. But on something as important as this—

Representative RUMSFELD. More like \$100 million in last year's budget.

Mr. SCHULTZE. What I meant to do is contrast simpler problems that with a decision like this where the point is not simply to have one option but to be able to present the President with a number of different options.

Our responsibility is (a) to insure that those options are developed, and that all of the options that are reasonable are presented to him and (b) to make recommendations. But it is up to the President to choose among these. So, I would say here, our role is developing the options and alternatives for the President's decision, in conjunction with the agency head—what the costs are, how they relate to other fiscal problems, et cetera.

Representative RUMSFELD. Thank you.

Representative REUSS. I would like to ask what I think is a very fundamental question, probably the most important I am going to ask in this series of hearings.

The economic philosophy of the administration for some years has been based upon the so-called full-employment fiscal dividend, the full-employment surplus, which postulated, in effect, is "Bear with us, gentlemen, while we run deficits for a few years, because, when we get to full employment so carefully have we calibrated this thing that we will have a nice fiscal dividend available even for sugarplum Heller plans and so on."

We now have, in the words of the first paragraph of the report of the Council of Economic Advisers, essentially full employment. We also have in this half of 1967 a deficit on the national income accounts system in excess of \$5 billion. I stress the national income accounts system.

Mr. SCHULTZE. That is right.

Representative REUSS. Because there is no phony unfair strait-jacket imposed on you, you might question, "What in the world has gone wrong?"

Before you answer and because of the 10-minute limitation, I would like to give you my "two bits worth" on what has gone wrong, for your comment.

I think we have got our income system way out of whack.

I know from an important piece by our friend over here, that after tax, profit margins from manufacturing in 1966 were the highest in history. I know that the real, after tax workers' earnings in manufacturing had gone down in 1966, and this is the first time it has gone down since 1960.

I note that high-interest rates, which we have had, channel money away from poor people to wealthier people. That is the effect of who gets and who receives interest.

I note that our old classic tax loopholes are still with us and new ones are discovered: oil-depletion allowance; the scandalous pirating municipal industrial revenue bonds, which the Economic Report, to its credit, castigates, but nothing, despite my urging, is done about it; or any program, the capital gains, and so on.

So, I suggest to you for your comment, that the reason for this curious paradox is that there is in the Keynesian sense oversaving in a community; that people who can spend the money if it were in their jeans are not getting it in sufficient margin; and those who are getting it neither spend it because they already have several neckties and they do not spend it on investment because we are already investing at a very high rate. So, I think there is a fundamental imbalance there, and that is why I suggest the dream is not coming true.

Now, would you comment on (1) what happened to the great fiscal dividend of full employment and (2) what causes it?

If I am not right, what is your thesis?

Mr. SCHULTZE. I would say one obvious thing that has happened is fairly simply expressed in three words: "Ho Chi Minh." The second point—

Representative REUSS. Just a minute. If you are trying to tell me that our Vietnam budget is causing all the trouble, I wish you would weigh your words very carefully—

Mr. SCHULTZE. I have.

Representative REUSS (continuing). Because if we spend \$22 billion that we are spending in Vietnam, or whatever it is, in building yachts

and then taking them out to the sea and scuttling them, it would have precisely the same economic effect if we were not spending that \$22 billion on Ho Chi Minh. We would have a higher employment rate.

Mr. SCHULTZE. Except for one point, and that is, the rate at which the increases had to occur because of the speed of the buildup in Vietnam. It is not just the level of what you do; it is the rate at which you get to it.

In turn, that has a very important impact on the rate of inventory accumulation, for example. As a consequence, you will find, as you know, from the economic indicators in the report, that in the fourth quarter of 1966, inventory accumulation was up in the \$15 billion neighborhood. That is obviously unsustainable. It almost surely will come down. This means that in the first half of the calendar year 1967, that will obviously have a negative effect on the economy.

If you look beyond that, at our fiscal projections, you will find that the NIA budget at full employment approaches and moves along in balance. Now, as to whether it is actually going to work that way, I can't say that it is going to hit that exactly. It is our best estimate that it will.

But I think that you have got to bring into your equation not just the levels of what is happening but the rate at which it is happening and how this affects temporarily the movements of the economy.

Representative REUSS. May I interrupt again to say that in view of the fact that if we have all been so wildly wrong in the last few years on our projections, wouldn't it be a good idea to give serious consideration to my thesis and to ask us also whether our income-price-profit pattern is not badly out of whack?

This, you know, is what Karl Marx always used to say about capitalism, and I am very anxious to prove him wrong. I think the best way to prove him wrong is to make sure that we do have enough purchasing power and investing power in the economy in each period to take off the market the products that we produce so John say's law does not work. It does not work if you do not automatically get it off the market.

Mr. SCHULTZE. I would make a couple of points on this. I, of course, can't sit here and say that the income distribution as between functional shares, for example, is completely right.

I think, on the other hand, if you put it in the long-term perspective for the last 20 or 25 years, you will find that the large expansion in profits, in profit margins, since 1961, the largest part—not all of it, but the largest part of it—simply returned them to about the normal relationship.

Now, in 1966 they were higher somewhat than what is normal, but as the Council's report points out, there may be a little—

Representative REUSS. You are saying in effect Democratic economics is more sensible than Republican economics, and I agree with you, but the question is: Is it good enough?

Mr. SCHULTZE. I had not thought I said that, but I am willing to accept it.

Representative REUSS. Is it good enough?

Mr. SCHULTZE. I guess, Mr. Reuss, I would have to say that while I can't argue that the income distribution is perfect for long range stable growth, I think I would have to say I see no evidences that it is so badly out of whack that there is a major problem.

Now, let's take a look, for example, at the \$5 billion NIA deficit in the first half of calendar year 1967 and assume for the moment that this is a \$5 billion NIA deficit at the full employment level. We then ask why can't we have zero at a full-employment level?

I indicated earlier the temporary problem, particularly with the inventory accumulation. But more importantly, what we are talking about in terms of a deficit on the one hand and saving on the other is something on the order of magnitude of a saving rate of about two-thirds of 1 percent of GNP.

Now, the extent to which that is related to a change in income distribution gets down to pretty fine judgments, and I am not sure I am prepared to make them. What I am saying is that we are not dealing with very large margins here. We are not dealing with income shares which have moved way off balance with historical levels. There may be a little bit of "out-of-balance" in them but not very seriously, I would say.

Representative REUSS. Were historical levels enough to give us full employment?

The answer is "No."

Mr. SCHULTZE. In some periods, yes; in some periods, no.

Representative REUSS. Therefore, we should not be complacent about the problem.

Mr. SCHULTZE. I agree.

Representative REUSS. And I know you are not complacent.

Mr. SCHULTZE. That is correct.

Representative REUSS. The only thing that worries me is that in the 313 pages of the Economic Report and in the five thousand or so pages of the budget, I do not find any analysis of what I regard as "essential problem" as to whether we can attain employment without inflation, which is what the Employment Act of 1946—which established this Joint Economic Committee—is all about.

Mr. SCHULTZE. I would not have read the Council's section in the whole wage-price area as being indifferent to the problem of full employment without inflation.

Representative REUSS. I did not suggest that. What I did suggest is that I do not find any attempt to grapple with the paradox of the deficit in this amount at this phase of our employment cycle, or with a real searching examination as to whether income shares are such as to put into the pockets of people who will either spend or consume or invest in factory and equipment enough money so that they can in a given period take off the market that which has been produced in the preceding period.

Mr. SCHULTZE. Conversely, Mr. Reuss, in the first half of calendar year 1966 we ran an NIA surplus at an annual rate of about \$3 billion, and I do not think at that time you would have said, nor would I have said, that this implied an income redistribution the wrong way, the other way.

And I do not think—it turns out that over periods of time when you get into stable growth and you get this problem—that you can really point to it as an evidence of income distribution. The fact that this year there will be a NIA deficit of \$5 billion in the first half, and last year it was a surplus of \$3 billion in the first half, that either one of those periods can, per se, be taken to indicate that there is something wrong with the—

Representative REUSS. No, I certainly did not suggest a year ago that there was something wrong during that period, with the income distribution pattern, because I would have expected with full employment that there should be the kind of indicated surplus that we had, but what I am concerned with is that now we do have a deficit at a time when we say that we have full employment, and I can't help but think that the income share situation must have been deteriorating in the last year particularly in order to produce that, and I think this is something we have to take a long hard look at.

My time is up.

Senator JORDAN?

Senator JORDAN. Thank you, Mr. Chairman.

You mentioned, Mr. Schultze, the fact that the administration reduced the expenditures \$3 billion in the 1967 budget. Would you detail that for us?

Mr. SCHULTZE. Yes, sir. I do not know how much detail you want. I have a 20-page list of items.

Senator JORDAN. Give it to us in capsule form.

Mr. SCHULTZE. I will give to you some of the items in capsule form.

What the President has done is request—and we set some targets—each agency to take the budgets they got from the Congress, either through appropriations or back-door spending, and hold back on the contracts and commitments under that authority.

Now, let me give you some major examples.

The one that I am sure you are familiar with is the \$1.1 billion reduction in obligations for the highway program. Our best estimates are that, by reducing those obligations from the budgeted level by \$1.1 billion, there will be about a \$400 million reduction in expenditures in the year from October 31, 1966, to October 31, 1967. That is a case in point.

A second case in point—I am trying to give you examples, which is really the best way to do it—is the Corps of Engineers. We took virtually every new start that was budgeted in 1967, including 25 new starts that we had recommended and 31 more that the Congress had added, for a total of 56 new starts, and postponed by 6 months the dates on which they would start.

We got the Corps of Engineers starting dates and asked them to postpone these for 6 months, except for programs dealing with urban flood protection, where we imposed only a 3-month postponement.

At the same time we told them to go ahead and buy the necessary land because land prices tend to escalate. And we slowed down the rates of construction of Bureau of Reclamation projects, and projects under the Department of Agriculture's small watershed program.

Another case in point would be in the Department of Health, Education, and Welfare, where two kinds of actions were taken. Right across the board on all grant programs for construction, we had them slow down, hold up, and postpone the date of the letting of the contracts and the making of the grants. Second—another kind of illustration applicable to many of the formula grant programs—around the months of February or March the Department normally circularizes the States and finds out which States have not used up their full grant, call back the unused amounts and reallocate them. This year, we are telling the agency not to reallocate the unused grants and this,

in turn, will mean a reduction of almost \$100 million, somewhere in that neighborhood. That is another case in point.

By substantive legislation last year, the President was given \$1 billion in special assistance for housing mortgages. This comes right out of the administrative budget. Instead of releasing all of that, he has held back \$750 million and only released \$250 million.

Now, Senator, I want to point out that in the highway program and some of these others, these represent deferrals or postponements. They are not cancellation of projects, and if the economy should turn out to require it, we may release some of the housing or other funds later, depending on the economic situation.

Senator JORDAN. They are stretchouts.

Mr. SCHULTZE. Yes, sir; they are stretchouts. I would say about half, or maybe a little more, of the total reductions are just stretchouts and the others are actual reductions. But it was never said we were doing anything more than that. We were trying to take some of the heat off the economy last fall, and this is what we are doing, both by deferrals and stretchouts, and by reductions.

But let me be perfectly candid. In many cases, that money eventually will be spent, but it will be stretched out and spent at a slower rate.

Senator JORDAN. On another matter, Mr. Schultze, the administration constantly compares the price performance during the Vietnam war with the performance during the Korean war and concludes that we are doing much better this time. Isn't it true that the national defense expenditures at the height of the Korean war were substantially a greater percent of the gross national product than they are now?

Mr. SCHULTZE. That is correct, sir.

Senator JORDAN. And isn't your comparison therefore false to that extent? You compare percentages now; compare amounts now. Isn't it true that it is a distortion when you say it was much greater during the Korean war?

Mr. SCHULTZE. I would make two points in response to that, Senator. First, the differences were also very largely in price behavior. On consumer prices we have had a 4.2-percent increase versus 11 percent during the comparable Korean war period.

Senator JORDAN. Yes.

Mr. SCHULTZE. But second, let's not take the Korean period, but let's go back to the last prior period before 1963-64, a similar 18-month period of peacetime full-employment. The price increases now, even with Vietnam, are better than that.

Now, one final point. I do not want to appear smug or satisfied about it. You know that we did not do as well as we had hoped for. We did not do as well as we should, in many ways, if you want to look at it in that way. We are trying to do better.

Price increases have tapered off a good bit. I did want to put it in perspective, that it is not what we wanted, but still, compared with other periods when we have had this kind of problem, even in a similar 18-month peacetime period of full employment, it racks up pretty well, even though not as well as we wanted it to.

Senator JORDAN. Will you supply for the record, Mr. Schultze, the relevant figures during both the wartime periods, Korean and Vietnam?

Mr. SCHULTZE. Yes, sir; I will be very glad to.

The Budget Bureau subsequently supplied the following table:

Price index changes during comparable Korea and Vietnam periods

[1957-59=100]

	Consumer Price Index	Wholesale Price Index
Korean period:		
June 1950.....	83.0	84.4
December 1951.....	92.2	95.6
Percent change.....	11.1	13.3
Vietnam period:		
June 1965.....	110.1	102.8
December 1966.....	114.7	105.9
Percent change.....	4.2	3.0

Senator JORDAN. Now, referring to your statement, you say:

Our price performance in 1966 is not up to what we had earlier hoped.

Then, you go on to say:

In the last 18 months saw a rise of 4.2 percent in consumer prices and a 3-percent rise in wholesale prices.

Many economists believe that a tax increase should have been implemented about a year ago now. What is your reaction to that now, with hindsight, since you have had a year of operation?

What would have been the effect, say, of a 6-percent surcharge you are recommending now, to take effect in July, had it been implemented a year ago?

Mr. SCHULTZE. I guess it is a little bit easier to do it from hindsight than foresight.

I am not sure, Senator. You have got to remember that we did have tax accelerations; we cut off the excise reductions that were then in order, and there was at the time, although it was fortuitous in the sense it had been enacted earlier, a significant increase in social security taxes.

With all of these together, we pulled some \$10 billion out of the economy. I think going all the way back to November and December of 1965, in the context as we then saw it, and even allowing for some further increase in defense spending, although not as much as occurred, I think our policy decision then was right.

We did come in in September with suspension of the investment credit, and with these budget deferrals, which took a lot of the heat off of the economy. If we had put in a tax increase larger than we did, earlier, I am not sure where we would be. We might have been better off for the months of the summer and probably worse off now. So it is pretty hard for me to judge.

I don't think we missed it by too much. Let me put it that way. We took a lot of pressure off the economy.

Senator JORDAN. Are you satisfied year after year running up deficits here at the time when the economy is at its highest level of productivity and achievement we have had in many, many decades? Do you think it is wise to do that in the light of the dire results that are bound to derive from it?

Mr. SCHULTZE. I guess the first thing I would say, Senator, is that given a \$22 billion expenditure for Vietnam, in fiscal 1968, to have

budgeted for, on a national income account basis, a \$2.1 billion deficit during that period is not bad at all and fits in just about, I think, with the economic requirements.

If we had not had Vietnam, particularly in terms of the speed of the buildup, I am convinced that we would be running a significant surplus, and we may actually have been in the process of talking about a tax reduction. It is a little hard to know what would have happened if something else hadn't happened, I admit.

But you know, \$22 billion of expenditures for Vietnam on a \$2.1 billion NIA deficit gives you an indication of where you might have been had it not been for Vietnam, and looking at those two figures, I think it is not too bad a performance.

Senator JORDAN. I am sorry; my time is up.

Chairman PROXMIER. Mrs. Griffiths?

Representative GRIFFITHS. Thank you.

Mr. SCHULTZE, I must say that having sat with you for the last 4 or 5 days in the committee, you must feel this is a cold and friendless world.

Mr. SCHULTZE. Not as long as you are on the other side.

Representative GRIFFITHS. I would like to ask you are you estimating for 1968 something more than a \$2 billion deficit in the national income?

Mr. SCHULTZE. On a national income accounts basis it is \$2.1 billion.

Representative GRIFFITHS. Does this take into consideration a tax increase of about \$5 billion?

Mr. SCHULTZE. On an NIA basis; that is correct.

Representative GRIFFITHS. What do you estimate the effect of a \$5 billion tax increase upon employment will be?

Mr. SCHULTZE. Very roughly we would feel that with a \$5 billion tax increase, and with all of the other things that are going on, both Government and private, as we can best estimate it, the unemployment rate should remain, with obviously some minor fluctuations from month to month, about where it is now.

If you didn't have the \$5 billion tax increase but had everything else, then presumably the unemployment rate would fall. We believe that this at the same time would in this context lead to greater price rises.

Representative GRIFFITHS. And what is the unemployment rate right now?

Mr. SCHULTZE. 3.8 percent.

Representative GRIFFITHS. I observed, I believe it was yesterday or the day before, and I think it was in Wisconsin, milk being poured down the drain because people weren't getting the prices they wished. If unemployment were increased, would you still press for a \$5 billion tax increase?

Mr. SCHULTZE. Fairly obviously, Mrs. Griffiths, we hope we have the good sense to be flexible in the face of changing conditions, and I think we do have that good sense. At the present time, in our best estimates of what the economy requires, we think the \$5 billion is needed. If circumstances were to change, we would have to reevaluate this, but at the present time we see no need to.

Representative GRIFFITHS. Does it not really depend upon employment rather than upon deficits?

Mr. SCHULTZE. It is primarily a matter of a fiscal policy shaped for a given stable growth with low unemployment. That is right, yes.

Representative GRIFFITHS. Now I would like to say something about the decisionmaking process, too. If you had come in last year at any period during the year, with anything other than an absolute firm statement as to what the deficit would have been or is going to be, would you not in your opinion have been then forced to say you needed a tax increase, because of a buoyant economy, because we can afford a tax increase, or we should have to prevent inflation?

Mr. SCHULTZE. I am not sure how to answer that. Let me try.

The first thing that scares me a little bit about the question is after the last 4 days, which I believe you, Mr. Curtis, can attest to, if we had come in with an appropriation request not based upon firm requirements, on the basis of that 4 days' experience I hesitate to think what condition a number of us would have been in.

Representative GRIFFITHS. This is exactly right.

Mr. SCHULTZE. What the fiscal policy requirements would have been then, I can't even try to tell you, because I am not sure. I would have to go back and look at the whole thing.

Representative GRIFFITHS. But the real answer is that a large part of the decisionmaking process rested within this body. If you had come in and said that these are firm estimates, you would have probably been told, "Well, you can't prove it." If you had said they are anything but firm estimates, and we needed a tax increase, you certainly could not have anticipated getting it.

Mr. SCHULTZE. I think that is right.

Representative GRIFFITHS. And you are in grave danger this year of not getting a tax increase, no matter what you say, and no matter how you say it. So while we are putting you through the hoops, and taking you over the coals, for what you are doing, it is time, in my judgment, that the Congress of the United States, which would like now to say "Ah, last year was the year to have had a tax increase; this year we must wait," to think back on its own attitude at that time. Last year was not a year that you could get a tax increase, either. I know some of the recommendations and thinking current then.

I think we, Congress, should step up and take our full share of the responsibility for all of these decisions, and I am sure that if you would have come in with anything less than absolute statements, you would have been laughed off the Hill. I think you have done a very good job, Mr. Schultze.

Chairman PROXMIER. The next questioner will be Congressman Curtis.

Representative CURTIS. Thank you, Mr. Chairman. I am glad to see Mr. Schultze here in a different arena.

Mr. SCHULTZE. Welcome back, Mr. Curtis.

Mr. SCHULTZE. Is that a paraphrase of a better known quote? Will get a chance to get a word in edgewise.

Mr. SCHULTZE. Is that a paraphrase of a better known quote?

Representative CURTIS. You know, listening to this maybe others since the Democratic Party controls the Executive and—

Representative REUSS. What party?

Representative CURTIS. I called it the Democratic Party. Is that what it is? Well, whatever it is, I forget you are sensitive in this area. I should watch that.

Mr. SCHULTZE, there are two things that I would like to bring out. One is the emphasis that I find the administration places, public relations-wise, on the national income budget. It seems to me that the budget that most affects our policies right now is the administrative budget.

The national income accounts budget is no new budget as far as this committee is concerned, and certainly as far as the Congress is concerned. This has been used for years and served a very useful purpose, and as is often said, is the one that probably gives us a better concept of economics. But at this particular time, with our problems of last year in the area of high interest rates and inflation, in fact the interest rates exceeded anything going back three or four decades, it is the administrative budget, the deficits there, that bear directly on these problems, rather than the national income accounts budget.

This has been very clearly brought out in the testimony before the Ways and Means Committee last week and this week, too, on the problems involved in the debt ceiling.

In your testimony before the Ways and Means Committee, one of the points that you made in demonstrating why the estimates on expenditures had been in firm was the \$3 billion increase in expenditures resulting from increased interest rates that the Federal Government had to pay, plus, as I understand it, some of the impact resulting from the increases in the Wholesale and Consumer Price Index.

Mr. SCHULTZE. No, sir, not the latter.

Representative CURTIS. Not the latter?

Mr. SCHULTZE. Just the former.

Representative CURTIS. Just the former, just the interest rates.

Mr. SCHULTZE. Well, no.

Representative CURTIS. The Wholesale Price Index?

Mr. SCHULTZE. No, sir.

Representative CURTIS. Let's clarify that.

Mr. SCHULTZE. Let me clarify that. What I said in that testimony is that there was a \$3 billion increase in Federal expenditures this year on account of monetary conditions, both credit availability and interest rates.

Representative CURTIS. Yes.

Mr. SCHULTZE. There is that clarification.

Representative CURTIS. But in the monetary area, and of course as many economists, I think, wisely have pointed out, that as we look at 1966, and indeed as this was coming along, the argument was that we were putting entirely too much burden on monetary policy to try to meet the inflationary forces that were existing, and too little on the fiscal policy.

My own arguments have been that in the fiscal area, it was toward expenditures that the main thrust should be directed rather than increasing revenues through taxes, although I said at the time, after we had begun the proper exercise of going over what could be done on expenditures, I was willing to look at the revenue side, too. But I certainly wasn't going to look at the revenue side, that is, a tax increase, until I thought a thorough job had been done on expenditures.

What I am leading up to is again the emphasis by the administration in their public relations of calling attention to the national income accounts budget, when the serious problem for policy decision lies in the deficit of the administrative budget, particularly the \$9.7 billion for fiscal 1967. This has been gone into considerably, and the lack of better estimates of what this deficit was going to be, given to us in January 1966 in the 1967 budget.

Mr. SCHULTZE. May I speak to the national income accounts part of what you have said?

Representative CURTIS. Surely.

Mr. SCHULTZE. I don't like to count pages. That is not really the way to answer, but let me make two points. One, I think there are about 15 pages in this document essentially on the national income accounts, and 450 on the administrative budget.

Representative CURTIS. You are not responding to the question.

Mr. SCHULTZE. Let me finish. I will respond. I wanted to start out with that. May I?

Representative CURTIS. I want to be sure you understand what the point was. I said the public relations operation of the administration. I know of your budget. But I have seen the Washington Post devote almost the front page, and a whole full page talking about the national income accounts budget. But go ahead.

Mr. SCHULTZE. I presume they have done that and I congratulate them for it. But in any event, we carefully pointed out in the budget, and I tried in my testimony to point out also, that for purposes of overall fiscal policy, the national income accounts budget is the best measure.

Clearly, however, for purposes of analyzing individual programs, for purposes of congressional action on appropriations, it is the combination of administrative budget and trust funds which is most relevant, and of course we did, have done, and always will, present full information on those budgets.

Representative CURTIS. To pinpoint this question, I am not relating to that, although I am very much interested of course in the expenditure policy. If we are going to do anything on expenditure policy, we have to talk in terms of the administrative budget.

Mr. SCHULTZE. That is correct.

Representative CURTIS. But what I was talking about, and I have been on the debt ceiling, is the impact of debt management, the impact of deficit financing on monetary policy and interest rates and, I might add, that which has been forgotten too much by the administration, our deficits in international payments.

I am talking about the impact of the deficit showing up in the administrative budget. That is the crucial thing with respect to monetary policy interest rates, the amount of money created, and international deficits.

This is what I think becomes the crucial point, because it has shown up actually in expenditure policy by an underestimate of \$3 billion. Surely in 1966 it is quite clear what the damage of high interest rates did to the economy, and is still doing to the economy. Certainly the inflationary impact is clear, and that is still a problem. What I am saying is that the impact of the new deficit becomes important to Congress in making its decision in regard to these policies.

Would you care to respond to that?

Mr. SCHULTZE. Yes, sir. I think actually to get what you want, you really ought to look at the cash budget, as a matter of fact, because this is the one that influences how much borrowing the Federal Government does from the public.

Representative CURTIS. Ah, let's stop there, because I thought you would say it, and I wanted you to say it, because the cash budget includes the trust funds.

Mr. SCHULTZE. Correct.

Representative CURTIS. But let me say this. That is not the relevant budget. In light of what the Secretary testified, when he said that if we didn't give him the debt increase that maybe we would have to cut back on the payments to the people on social security. Then we said, well, why isn't the social security trust fund, which is supposed to be a contingent fund, available to pay those people. He suggested we would have trouble selling the securities.

Those securities that are put into the social security fund are supposed to be there so that they are readily salable to meet the responsibility of contingent liabilities, not a captive market.

Mr. SCHULTZE. But that—

Representative CURTIS. Now wait. You will get your chance. Not a captive market, just to put the Federal deficit in whatever form they please, but particularly not in the form of marketable securities. So I say it is the administrative budget that is relevant in this context. I see my time has run out.

May we have him respond?

Mr. SCHULTZE. I would love to have a couple of minutes to respond.

Chairman PROXMIRE. You may go ahead and respond.

Mr. SCHULTZE. In the first place, I thought you started out by saying the national income accounts budget is not the appropriate budget. I responded by saying it is, for purposes of fiscal policy. You in turn responded by saying that we also have to take into account the impact of Treasury debt management on the economy.

Representative CURTIS. That is right.

Mr. SCHULTZE. I in turn responded by saying that if you want to look at the impact of debt management on the economy, what you are after is the amount of debt that the Treasury has to float with the public. I am saying the amount of debt that the Treasury has to float with the public is approximately, aside from changes in the cash balances, the administrative budget deficit minus that part of the deficit sopped up by the trust funds?

Representative CURTIS. That is right.

Mr. SCHULTZE. I say nothing whatever about the nature—

Representative CURTIS. What was my response?

Mr. SCHULTZE. May I—

Representative CURTIS. Go ahead.

Mr. SCHULTZE. Let me point out in terms of the magnitudes involved, that what the Treasury has to float with the public is the \$9.7 billion deficit minus about \$3 to \$4 billion that will go in the trust funds, leaving \$5 to \$6 billion to be floated with the public. Now just one final point.

Representative CURTIS. Yes, but Mr. Director, please respond to the point where I said that under those conditions the trust funds would

have to be regarded just like any other source. If the trust funds are to be contingent, then those must be marketable securities, not just the—

Mr. SCHULTZE. All I am saying, as an economist, if I want to look at what the Treasury has got to lay on the market in any given year, I look at the administrative budget deficit and take off what the trust fund surplus is. I don't know how to respond beside that.

Representative CURTIS. Could I go a little further with the indulgence of my colleagues, and see if we can get the answer?

The point I am making is the Federal Government has the responsibility in those trust funds to keep their integrity, and if you approach it the way you say, lodging whatever debt you can in there, with a disregard for whether this debt consists of marketable kinds of securities, and that the overage is all the Government has to worry about then the integrity is compromised. I am not asking you to agree with me, I am trying to get you to discuss the points.

Mr. SCHULTZE. I guess then the only thing I can say in response to that, if you are getting at the reliability or the absolute security of what the trust funds are invested in, it is the U.S. Government that is behind them as special issues—fully as much, no more, no less than it is behind the Treasury securities that are marketed to the public. I don't understand the difference of the marketability business.

Representative CURTIS. Simply what the Secretary of the Treasury told us in your presence, that if we didn't give them the debt ceiling, that they would have to shut down on payment of social security funds, because the security holdings of this contingent fund were not readily marketable, so that these funds or these securities could be converted into cash to pay the people. That is the point.

Mr. SCHULTZE. But that is a debt limit problem. If the debt limit isn't raised all bonds are—

Chairman PROXMIRE. Go ahead, finish your reply.

Mr. SCHULTZE. My only point was that this is a debt limit problem. Of course, if the debt limit isn't raised, all securities are called into question.

Representative CURTIS. I thank the Chair.

Chairman PROXMIRE. Senator Ribicoff?

Senator RIBICOFF. Mr. Schultze, I noticed for the first time, I believe, in the history of the budget, you have a section on Federal assistance for the poor. Why do you categorize expenditures that way? You don't have one for the middle class or expenditures for the rich.

Mr. SCHULTZE. I am sorry. I am trying to look back at why we put it there, and it seemed so obvious I never thought it out. It is obviously because the major social concern of this country for many years, but particularly in recent years, has been the attack on poverty and the attempts to get at the poverty problem.

This doesn't mean, of course, that the country was never before concerned with it, but it has been a major concern of Federal social legislation in the last several years, and we thought it was important to bring out what the total funds were that are going into this problem.

Senator RIBICOFF. I am very curious. I notice about \$25.6 billion is being expended for the poor, and you include social security payments that make up about 30 percent. Now what right do you or anyone else have to include social security payments that people have by

way of right, in a welfare or aid category? This isn't aid. This is insurance that people have earned. If they are poor and they are receiving social security, they have got as much right to it as anyone else, and they are not receiving any aid or assistance from the Government.

Mr. SCHULTZE. To be perfectly frank, Senator Ribicoff, I have never considered the fact that putting the title on that table "Federal Aid to the Poor" indicated that this was in any sense a welfare category. It wasn't meant to be.

On the basis of your question, I guess I will have to admit, not having thought about it before, that maybe we should have chosen a different term. But I can say that all we were trying to do was to go through the Federal budget, program by program, in great detail and figure out how much of the total Federal cash outlay went to those who were poor.

Now you are quite right, some part of what goes in comes from insurance payments by the poor themselves. Much of that part of social security which goes to the very low end of the income distribution is many times larger than their actual contributions.

It is not that I am quarreling with your point. I am only saying that we were not trying to compile a welfare category. Many of these expenditures are not welfare at all. We were simply taking a look at the total Federal cash budget, which includes all of the trust funds, and estimating what part does go to the poor.

Senator RIBICOFF. But I think it is wrong. People make their social security payments and they receive their benefits, and I don't think that the poor, as you define the poor, receive about \$8 billion in social security payments. But you say now we are spending \$25.6 billion for the poor, see how generous we are. This has nothing to do with Government largess.

Mr. SCHULTZE. Nor do many of these others have to do with Government largess. I would like to make two points with respect to that.

In the first place, the problem of poverty did help to shape the nature of the administration's social security request this year. The fact that the very largest part of the increases go at the bottom end of the scale was in part shaped by concern over problems of poverty among the aged poor.

The second point is that many of the funds in here are not Government largess in that sense. For example, in the education and health area, I firmly believe, and I am sure you share my belief, that on just cold hard economic calculation, it makes sense to improve the productivity of these people, because in one sense—a very selfish consideration—by making productivity higher, you actually in the long run tend to reduce Government largess. So there is no attempt here to say this is largess in any sense.

Senator RIBICOFF. I agree with that statement, and let me go to the next point. We are talking about money. But your job is much more important than money alone.

Not many people realize it, but next to the President and the Secretary of State and the Secretary of Defense, you are the most powerful man in the Government of the United States, and more powerful than any member of the Cabinet. Basically you have the power to veto decisions.

Mr. SCHULTZE. All I am going to say, Senator, if I might, is a statement that Secretary Fowler often makes, that silence does not mean assent.

Senator RIBICOFF. I can understand it, because your power is shown in the backroom.

Chairman PROXMIRE. I might interrupt the former Secretary of the Department of Health, Education, and Welfare Ribicoff speaks from real knowledge.

Senator RIBICOFF. What I am interested in is the problem of how you evaluate the social and economic implications of programs. You talked about the programs that spend \$25.6 billion for the poor. When was the last time that the Budget Bureau recommended that a program be discontinued, once it was adopted?

Mr. SCHULTZE. I think perhaps Senator Proxmire can speak very closely to last year's proposal on the special milk program.

Chairman PROXMIRE. You didn't recommend that we abolish it. You wanted to make it a welfare program.

Mr. SCHULTZE. I shouldn't have said that. Another example is the impacted-area program for schools. Again we weren't abolishing it, but we were proposing to cut it roughly in half.

Another example is the small \$12 million program of assistance to land-grant colleges. We proposed eliminating it last year. Are you talking just of programs—

Senator RIBICOFF. Generally.

Mr. SCHULTZE. Another example is the Atomic Energy Commission. This has been a longstanding policy—I wasn't there when it was formulated, and I don't know how much the Budget Bureau was involved—but there was a proposed reduction of Federal assistance for light water reactors, once those got into a regular commercially successful form.

And if you go down the line on recommendations, there have been a number of recommendations for reduction—I must admit probably very few for actual abolition—but for substantial reduction and change. And as I say, last year's budget had a number of them: school lunch; special milk; impacted area aid; land-grant colleges. I do not recall all of them, but those are some examples.

Senator RIBICOFF. Let's go to the next point. Let us assume, as we are now, that we have money problems. There are many programs that compete for priority.

Do you ever sit down in the Budget Bureau to try to figure out priorities—where, when we don't have sufficient funds, we should spend the amount of dollars we have? In other words, there are certain programs that bring you a greater return for your expenditures than others. Do you ever consider coming to Congress with a list of priorities?

Mr. SCHULTZE. Well, in a sense, Senator, to agree or disagree with spending more money for specific programs is precisely what the whole budget is all about. It is by its very nature a setter of priorities.

Now usually, I would say in 95 percent of the cases, priorities are very seldom expressed or should be expressed on an absolute yes or no basis. What we really mean by priorities is, in any broad area or even narrow area, is whether we should put \$50 million more in for one program or take \$50 million out of another. Not in most cases do we take a whole program out and put a whole program in. The budget process involves balancing on a margin.

That is really what priorities are. Just as in defense, you don't take out all ships and put all aircraft in; you balance on the margin, the whole budget is precisely an exercise in priorities.

Obviously, people disagree about the priorities of the budget, what it implicitly contains, but I don't think that we either should or could come up with a categorical listing that the highest priority program we have is X and the next highest priority program is Y and the next highest priority program is Z because, for example, in terms of reductions, you might decrease Z by \$10 million before you decreased X by \$10 million.

But having decreased Z by \$10 million, you might go right back up to X and take something out of it before you took a second slice out of Z. So the idea of coming up with a straight list of priorities per se I don't think makes good budgetary sense. What does make sense is looking at the amounts you put in and adjusting those on the margin.

Senator RIBICOFF. You are making policies for the President, and every member of the Cabinet has to clear with you. Every member of the Cabinet in his own mind has his list of priorities, and that is as it should be in the administrative departments.

Then he comes to you with his list. Then you sit down with the President to make recommendations. Therefore, you are the one who has to do the sifting above and beyond each member of the Cabinet or any other department.

Now if you determine that there is a limited amount of money, and program X is more important than program Y, how do you arrange to cut down Y if you raise X, and tell the Congress that?

Mr. SCHULTZE. As I say, this is what the whole budget process is about.

Senator RIBICOFF. Let's take one specific. If there is anything that came out in the hearings on the cities, it is that the No. 1 priority; the No. 1 leverage point; the place to spend money on the basis of priorities; No. 1 was jobs.

Of everything in the cities, the basic task is to get unemployed people jobs, get unemployed youth to take jobs, and to provide training for jobs. Now what is there in your whole budget arrangement indicating that jobs are considered as the most important task?

Mr. SCHULTZE. There are two things. First, in terms of fiscal policy as to economic growth, 3 million jobs were found last year quite apart from any specific Government program, and this problem has been given, I would say, the highest priority in terms of the overall policy of the administration in the last 5 or 6 years.

I am not saying that other administrations didn't too, but speaking of this one, the problem of jobs has been given top priority in terms of its overall budgetary and fiscal recommendations, very high priority—in terms of millions of jobs, not hundreds of thousands.

Secondly, if you look at the budget this year, you will find—in a budget in which at least I believe we have, within the domestic side, some pretty sizable restraints—a significant expansion in the job training programs. These programs do not amount to billions of dollars; they are handled with millions of dollars. But we have put, for example, into the OEO budget a large expansion of programs for jobs in urban ghettos. These are now being much more closely combined within the Department of Labor in administering these programs. So I would say a combination of the fiscal policy pursued and the specific

budgetary recommendations pursued does indicate a very high priority on jobs.

That doesn't mean that we say education is a second priority; therefore, let's stop education and put it in jobs. It does mean that this is where the increases are very heavy.

Senator RIBICOFF. I have been told my time is up, so I can't pursue that with you further.

Mr. SCHULTZE. Might I call your attention to page 129 of the Budget, where we attempt to give some idea, not just only of the money, but the number of different kinds of people affected. And similarly, I believe you will find a table on Economic Opportunity Act programs on page 131 where we try not only to show the money being provided, but the number of people involved. This will give you some indication, I think.

(The tables referred to by Mr. Schultze are reprinted below:)

Department of Labor manpower programs

[Fiscal years]

Program	1966 actual	1967 estimate	1968 estimate
Manpower Development and Training Act programs:			
New obligational authority (millions)-----	\$400	\$390	\$402
Number of trainees (thousands)-----	(273)	(250)	(280)
Institutional training-----	160	125	112
On-the-job training (OJT)-----	94	53	48
Combination institutional and OJT training-----	19	72	64
Other courses (remedial and part-time)-----			56
Number of individuals served by experimental and demonstration projects (thousands)-----	48	34	45
U.S. Employment Service:			
Expenditures, including trust funds (millions)-----	\$287	\$310	\$325
Number of local offices-----	1,994	2,012	2,012
Number of special services offices-----	(151)	(169)	(169)
Applicants seeking work (millions)-----	10.6	11.0	11.2
Individuals counselled (millions)-----	1.3	1.3	1.3
Number of tests administered (millions)-----	2.6	2.7	2.7
Job placements (millions)-----	11.2	11.9	11.9
Unemployment Insurance Service:			
Expenditures for administration, including trust funds (millions)-----	\$235	\$256	\$273
Average weekly insured unemployment (thousands)-----	1,152	1,000	1,000
Federal and State benefits disbursed (millions)-----	\$1,990	\$1,755	\$1,805
Average weekly benefit (State programs)-----	\$38.51	\$39.69	\$40.70

¹ Includes the cost of operating 1,436 local offices.

Economic Opportunity Act programs

[Fiscal years. Dollars in millions]

Program	1966 actual	1967 estimate	1968 estimate
Work-training program opportunities (thousands):			
Job Corps enrollees (average number)-----	10	31	38
Neighborhood Youth Corps:			
In-school-----	106	125	130
Summer-----	209	165	165
Out-of-school-----	55	60	60
Work experience-----	64	46	30
New obligational authority for adult work-training and "special impact" programs-----		\$98	\$258
Community action agencies:			
Number operating-----	700	1,050	1,100
Grants to CAA's-----	\$488	\$681	\$929
Headstart children (thousands):			
Summer programs-----	573	550	550
Full-year programs-----	160	187	187
VISTA volunteers (average number)-----	1,771	3,300	4,200

Senator RIBICOFF. The only other comment I have is the question of how effective these programs are. So far, the Congress has no way of checking up. You are the only one that can really evaluate. We don't get the benefit of this.

Mr. SCHULTZE. It obviously takes time to get data and do evaluation. Many of these programs are only from 1 to 3 years old. But we are beginning to get a number of evaluations in.

For example, and this is reflected in the budget, on-the-job training probably pays off more than institutional training, not for everybody but for many. As a consequence, the Manpower Development and Training Act has been shifted around to give more emphasis to on-the-job training.

Second, we have also found that the hard-core unemployed need more than just training. They need a lot of followup. As a consequence, on the basis of that evaluation, which the Department of Labor made, the new adult work-training programs have a large component for very heavy followup of people, dealing both with the employers and with the individual himself.

So, we do these evaluations, and they do shape the nature of our programs. They are not dramatic, but the administration has turned the MDTA program in a different direction; adult job training programs have taken advantage of what we have learned over the last several years. We have, obviously, got a lot more to learn. But we are taking advantage of evaluation and more and more we are trying to build into the program specific requirements for evaluation.

Chairman PROXMIRE. Senator Percy?

Senator PERCY. Mr. Schultze, I would be less than honest if I didn't say I have enjoyed myself tremendously this morning. For 25 years I sat in your seat, defending budgets before boards of directors who would pick out almost any item on that budget and expect me to be an expert on it. So I feel sympathetic with you this morning. Your testimony has been exceedingly helpful.

I wonder if I could go back to a year ago, before we look at this budget. When I heard last year's message in a different position, and I saw a \$1.8 billion deficit, a lot of people were cynical. And it wasn't more than a few days after that that the \$1.8 billion mark was broken and we went over \$2 billion by congressional action on the GI bill for South Vietnamese war veterans. Certainly, the almost unanimous vote of that bill must have been apparent to the administration. But I understand you have to put in what you feel should be the program, not what you feel it might be.

But as these situations developed, and you saw the budget getting in more and more trouble—and there wasn't a day that new evidence wasn't presented that this budget of \$1.8 billion was absolutely impractical—as I see it you had two responsibilities. One, to call for increased revenue as spending went up, or two, to cut back other nonhumanitarian, nonessential spending.

Does the Budget Bureau have an initiative responsibility for pressing on the administration delays in programs or budget cuts as you see a condition unfolding which is unfavorable and unhealthy for the country?

Mr. SCHULTZE. Yes. I would say yes with one modification. I don't think I like the term "pressing on the administration" because some-

how it seems to indicate pressing on a reluctant administration, but apart from that, yes.

Now, may I list some of the things we did, which were obviously, not 100 percent successful. In terms of cutting programs, we were in one sense in a rather difficult position because we had sent to the Congress a number of recommendations for program reductions—first, practically none of which were accepted, and secondly, which has been particularly galling to me at least, we were accused of sending up cuts that we knew wouldn't be accepted. It was my own point of view—a lot of people disagree—that I could support every one of them. But, in any event, we did send up a number of reductions. They were not accepted.

In terms of sending up yet other reductions, the question of whose ox is being gored, the ones we had picked out I thought, at least, had some merit.

Secondly, at one time during the session, we ran a calculation on our best judgment of where the various authorization and appropriation bills might come out, and it turned out that there was a range of \$4 to \$7 billion over the President's request. Secretary Fowler and I, and the President, spent a lot of time with various congressional leaders. Congressional action ended up coming out not four to seven but \$2.6 billion above the budget. But I firmly believe that the action taken, particularly during the summer, made a significant difference in the ultimate shape of the budget and the authorizations as they came out.

Finally, in September we did come up for tax measures. Now this particular tax measure, the suspension of the investment credit, was not primarily aimed at getting revenue per se because it doesn't get a lot of revenue right away, but a cooling off of the boom. And at the same time, we did put into effect these deferrals and delays.

Now despite the deferrals and delays the budget is still up; there is no question about it. We did, however, take what I consider to be fairly vigorous action, at least measured by the protests we are still getting, it was fairly vigorous action.

Senator PERCY. It would have been much worse if you hadn't pressed forward on those programs and I think the Congress many times goes ahead and appropriates well beyond what the administration asks for and that presents a problem.

I think on the expense cutting end, some real work was done. How about on the other end, when you saw that still, despite this, for one reason or another, you were not going to come anywhere near the deficit forecast figure. Is it a fair question to ask you what the responsibility of the Budget Bureau is with respect to the administration in recommending a tax increase, coming back to this question whether it is acceptable to Congress or not. Did you make a recommendation to the administration that we have a tax increase last year, which in retrospect probably would have been a very good thing?

Mr. SCHULTZE. In the first place, the basic recommendations with respect to fiscal policy are primarily the function of the so-called "troika"—the Secretary of the Treasury, the Chairman of the Council of Economic Advisers, and the Budget Director—and as a matter of fact, this year much more so than last year, the Chairman of the Federal Reserve Board was drawn into these discussions fully.

Secondly, we did come up with tax recommendations at a time when there was a lot of talk that we would never get anything through the Congress. We did come up with tax recommendations, primarily not to gain revenues but to cool the economy off.

And thirdly, you will note that after about September or October, both in terms of price indexes and monetary conditions, there was a significant change in the environment, due in part—I don't say fully—but due in part, I believe, to those recommendations.

Hence, we did make such recommendations. They were accepted both by the President and by the Congress.

Chairman PROXMIRE. They were what?

Mr. SCHULTZE. Accepted by the President and the Congress passed them. And then there were the actions on the other side of it, the expenditure side, and all these measures did have an effect.

Senator PERCY. In the President's message he said:

"I am proposing in the 1968 budget to sell \$5 billion in participation certificates."

As I understand it, about \$4 billion of that will require congressional authority before he can go ahead and sell them. What would be the consequences if Congress doesn't provide that authority?

Mr. SCHULTZE. The administrative budget deficit would be higher by that amount.

Senator PERCY. By that amount?

Mr. SCHULTZE. The NIA budget wouldn't be affected because these don't enter into the NIA budget. One point on that by the way, Mr. Percy. Actually, we are asking for \$4,750 million of authority to give us some flexibility, but we are only forecasting the sale of \$4 billion.

Senator PERCY. In the President's state of the union message, I think it was a realistic presentation of problems. There were not too many areas of hope or inspiration in it. But one area of hope for me was that he did say, "We shall strengthen the Headstart program beginning with children 3 years old" and so forth.

And he also in the Economic Message said he would have an expanded operation Headstart, which I think was very well received, I know by me and by many, many others who feel this is a great investment in the next generation. Yet, I can't seem to find it in the Budget, in this Manhattan Telephone Directory size. Page 94, where it lists the children participating, it lists 737,000 children in fiscal year 1967 and 737,000 in fiscal year 1968. There is no provision for 3-year-olds. There is no provision for expanding either the summer program or the academic year program. Where is the expansion for Headstart?

Mr. SCHULTZE. The key point in this is that we are asking the Congress to put into the Office of Economic Opportunity's budget an additional \$135 million for a follow-through on Headstart.

Now this will, obviously, take some time to get started, and significant amounts of this money should be and probably will be used for planning how that Headstart followup is to be done. This is where our initial thrust is, right here in the follow-through. We still have a lot to learn about how to follow through, but we did put in this \$135 million to start. It will in all probability go through OEO, but be administered by the Department of Health, Education, and Welfare.

Senator PERCY. I would very much appreciate it if you would give me a little more detail as to what that expanded program will embrace.

Mr. SCHULTZE. I will do that.

Senator PERCY. Thank you.

(The following was subsequently supplied for the record in response to Senator Percy's request:)

The basic outlines of the FY 1968 Head Start program are contained in the President's message on America's Children and Youth, sent to the Congress on February 8. In that message the President stated:

"STRENGTHENING HEAD START

"Head Start—a preschool program for poor children—has passed its first trials with flying colors. Tested in practice the past two years, it has proven worthy of its promise.

"Through this program, hope has entered the lives of hundreds of thousands of children and their parents who need it the most.

"The child whose only horizons were the crowded rooms of a tenement discovered new worlds of curiosity, of companionship, of creative effort. Volunteer workers gave thousands of hours to help launch poor children on the path toward self-discovery, stimulating them to enjoy books for the first time, watching them sense the excitement of learning.

"Today Head Start reaches into three out of every four counties where poverty is heavily concentrated and into every one of the fifty states.

"It is bringing more than education to children. Over half the youngsters are receiving needed dental and medical treatment. Hearing defects, poor vision, anemia, and damaged hearts are being discovered and treated.

"In short, for poor children and their parents, Head Start has replaced the conviction of failure with the hope of success.

"The achievements of Head Start must not be allowed to fade. For we have learned another truth which should have been self-evident—that poverty's handicaps cannot be easily erased or ignored when the door of first grade opens to the Head Start child.

"Head Start occupies only part of a child's day and ends all too soon. He often returns home to conditions which breed despair. If these forces are not to engulf the child and wipe out the benefits of Head Start, more is required. Follow-Through is essential.

To fulfill the rights of America's children to equal educational opportunity the benefits of Head Start must be carried through to the early grades.

"We must make special efforts to overcome the handicap of poverty by more individual attention, by creative courses, by more teachers trained in child development. This will not be easy. It will require careful planning and the full support of our communities, our schools and our teachers.

"I am requesting appropriations to launch a 'Follow-Through' program during the first school grades for children in areas of acute poverty.

"The present achievements of Head Start serve as a measure of the distance we must still go:

"Three out of four Head Start children participate only in a summer program. The summer months are far too brief to close the gap separating the disadvantaged child from his more fortunate classmate.

"Only a small number of three-year-olds are now being reached. The impact of Head Start will be far more beneficial if it is extended to the earlier years.

"Head Start has dramatically exposed the nutritional needs of poverty's children. More than 1.5 million preschoolers are not getting the nourishing food vital to strong and healthy bodies.

"To build on the experience already gained through Head Start:

"I am requesting funds from the Congress and I am directing the Director of the Office of Economic Opportunity to:

"1. Strengthen the full year Head Start program.

"2. Enlarge the number of three-year-olds who participate in Head Start.

"3. Explore, through pilot programs, the effectiveness of this program on even younger children.

"I am recommending legislation to authorize a pilot program to provide school lunch benefits to needy preschoolers through Head Start and similar programs."

Chairman PROXMIRE. Congressman Brock?

Representative BROCK. It is nice to see you again, Mr. Schultze. I have enjoyed your testimony very much. Just a couple of questions on fiscal and monetary policy this year. Do you consider this projected 2-plus percent increase in price as a serious problem or is it manageable?

Mr. SCHULTZE. I would say it is higher than we want, but manageable. Quite clearly, as I think the Council's report brings out, it is going to take time to bring stability, because you get this fed into the cost structure and admittedly it takes time, so I would say it is higher than desirable, but we think manageable.

Representative BROCK. If you are going to follow a fiscal policy to a greater degree than last year to keep it manageable, in your opinion, is an increase in taxes more workable as a tool than a reduction in Federal expenditures?

Mr. SCHULTZE. I am glad you asked that.

Representative BROCK. I think you might be.

Mr. SCHULTZE. Well, no. I would like to make a distinction which I think would be very useful in discussing this. From the point of view of fiscal policy, in terms of either stimulating or restraining the economy, and obviously very roughly, a dollar increase in taxes or a dollar decrease in expenditures has about the same effect, in the overall sense of stimulating or restraining the economy. And I have always felt that it is this area where liberals and conservatives really don't have any ideological problem. If you are looking at the fiscal policy part of it, there is no magic in reducing expenditures versus increasing taxes.

In other words, it seems to me, if I can use the distinction—it is probably old hat—nevertheless, there is kind of a real ideological and legitimate debate between those who want less expenditures and those who want more, for particular programs.

So I would say therefore, finally, that a dollar of tax increase or a dollar of expenditure reduction has roughly the same fiscal effect, but obviously not the same effect in terms of your evaluation of the worth of the programs and everything else.

Representative BROCK. Those who are paying the increased taxes might disagree as to the effect. That is what you are saying. But insofar as its economic impact, it is about the same.

Mr. SCHULTZE. About the same, but I wouldn't want to be pinned down to the last decimal point on the effect.

Representative BROCK. Part of the impact that it does have is in the area of monetary policy, in the management of the debt that might or might not occur as a result of a tax increase.

Mr. SCHULTZE. Right.

Representative BROCK. Could you tell me this. What percent of our national debt is now in less than 1-year obligations?

Mr. SCHULTZE. Yes, sir.

Representative BROCK. And in less than 5-year obligations?

Mr. SCHULTZE. Yes, sir.

Representative BROCK. And what impact does this have on the monetary situation as opposed to the long-term obligations that we have?

Mr. SCHULTZE. If you will give me a moment to find the right table.

Representative BROCK. Are you with me?

Representative CURTIS. Page 281.

Mr. SCHULTZE. I know we have it back here somewhere.

Representative CURTIS. Page 281 of the Economic Report.

Mr. SCHULTZE. Thank you, Mr. Curtis. That is it.

(The table referred to follows:)

TABLE B-58.—Average length and maturity distribution of marketable interest-bearing public debt, 1946-66

End of year or month	Amount out-standing	Maturity class					Average length	
		Within 1 year	1 to 5 years	5 to 10 years	10 to 20 years	20 years and over		
		Millions of dollars					Years	Months
Fiscal year:								
1946.....	189,606	61,974	24,763	41,807	17,461	43,599	9	1
1947.....	168,702	51,211	21,851	35,562	18,597	41,481	9	5
1948.....	160,346	48,742	21,630	32,264	16,229	41,481	9	2
1949.....	155,147	48,130	32,562	16,746	22,821	34,888	8	9
1950.....	155,310	42,338	51,292	7,792	28,035	25,853	8	2
1951.....	137,917	43,908	46,526	8,707	29,979	8,797	6	7
1952.....	140,407	46,367	47,814	13,933	25,700	6,594	5	8
1953.....	147,335	65,270	36,161	15,651	28,662	1,592	5	4
1954.....	150,354	62,734	29,866	27,515	28,634	1,606	5	6
1955.....	155,206	49,703	39,107	34,253	28,613	3,530	5	10
1956.....	154,953	58,714	34,401	28,908	28,578	4,351	5	4
1957.....	155,705	71,952	40,669	12,328	26,407	4,340	4	6
1958.....	166,675	67,782	42,557	21,476	27,652	7,208	5	5
1959.....	178,027	72,958	58,304	17,052	21,625	8,088	4	9
1960.....	183,845	70,467	72,844	20,246	12,630	7,658	4	7
1961.....	187,148	81,120	58,400	26,435	10,233	10,960	4	4
1962.....	196,072	88,442	57,041	26,049	9,319	15,221	4	11
1963.....	203,508	85,294	58,026	37,385	8,360	14,444	5	1
1964.....	206,489	81,424	65,453	34,929	8,355	16,328	5	0
1965.....	208,695	87,637	56,198	39,169	8,449	17,241	5	4
1966.....	209,127	89,136	60,933	33,596	8,439	17,023	4	11
1965: Jan.....	214,411	86,798	57,886	43,902	6,107	19,718	5	5
Feb.....	214,863	89,829	59,703	39,532	6,106	19,693	5	4
Mar.....	212,507	87,517	62,135	37,120	6,106	19,630	5	4
Apr.....	212,451	88,126	61,487	37,116	6,106	19,616	5	3
May.....	210,954	89,901	56,178	39,172	8,450	17,253	5	4
June.....	208,695	87,637	56,198	39,169	8,449	17,241	5	4
July.....	208,664	87,635	56,192	39,166	8,448	17,222	5	3
Aug.....	208,402	92,446	55,266	35,032	8,448	17,210	5	3
Sept.....	208,381	92,444	55,264	35,027	8,447	17,199	5	3
Oct.....	212,097	96,491	54,952	35,024	8,446	17,184	5	1
Nov.....	214,619	93,392	60,593	35,021	8,446	17,167	5	0
Dec.....	214,604	93,396	60,602	35,013	8,445	17,148	5	0
1966: Jan.....	217,656	96,461	60,608	35,013	8,444	17,131	4	10
Feb.....	217,690	94,226	62,893	35,008	8,443	17,120	4	11
Mar.....	215,150	91,704	64,306	33,607	8,442	17,092	4	11
Apr.....	215,004	91,820	64,076	33,603	8,441	17,065	4	10
May.....	213,674	92,231	62,453	33,600	8,440	17,040	4	11
June.....	209,127	89,136	60,933	33,596	8,439	17,023	4	11
July.....	209,108	89,138	60,932	33,592	8,439	17,007	4	10
Aug.....	211,402	92,238	62,957	30,783	8,437	16,987	4	11
Sept.....	211,771	92,642	62,952	30,774	8,436	16,967	4	10
Oct.....	215,313	96,656	62,495	30,771	8,435	16,957	4	8
Nov.....	217,239	104,398	59,459	28,008	8,434	16,940	4	8
Dec.....	218,025	105,218	59,447	28,005	8,433	16,923	4	7

NOTE.—All issues classified to final maturity except partially tax-exempt bonds, which were classified to earliest call date (the last of these bonds were called on Aug. 14, 1962, for redemption on Dec. 15, 1962).

Source: Treasury Department.

Let's take December 1966. The marketable interest bearing public debt, at the end of calendar 1966, is \$218 billion, of which \$105 billion is within 1 year, about 48 percent, another \$59 billion is 1 to 5 years, and another \$53 billion over 5 years.

Representative BROCK. In other words, about 80 percent is in less than 5 years, and 60 percent is in less than 1?

Mr. SCHULTZE. That is generally correct. More precisely, 76 percent and 48 percent.

Representative BROCK. Now the real question, of course, is what impact does this have on our monetary situation, the need to roll over this tremendous quantity of debt. What would be the difference in interest rates, in the availability of money, if the debt were on a longer term basis?

Mr. SCHULTZE. Well, first, and I am sure you are aware of what has happened. We have kind of a V shape here. For about 3 or 4 years we were increasing the average maturity. In the last year and a half I think it has come down.

The closer the maturity of the debt—the more short term the debt is—the more liquid it is and the closer it is to money. Conversely, the longer term the debt is, the less liquid it is, and the further away it is from money.

In turn, this means that as you shift from short-term to long-term debt, you have two consequences. First, the total liquidity of your debt is less, and this is equivalent in general to some tightening of monetary policy. In other words, it has the same rough general effect as a tightening of monetary policy as you increase the maturity of your debt. I don't want to overstate that, but that is generally the case.

Secondly, from a management standpoint, it is easier if you don't have to roll the debt over as often.

Representative BROCK. Is it not fair to say that long-term debt can be carried at a considerably reduced cost in charges? Doesn't your short-term debt cost you considerably more?

Mr. SCHULTZE. No, sir. As you look at the normal yield curve, you will find short-term debt having a lower interest rate. Now the administrative costs of handling that are higher. But, net—and I don't think this is the way one should necessarily look at it—the normal yield curve will give you lower interest rates on the short-term debt even though the administrative costs are higher.

Representative BROCK. Do you mean to say, Mr. Schultze, that if we had the opportunity in the market to buy long-term bonds if you didn't have the ceiling on interest rates, that we couldn't sell them at less than what we are selling our 90-day Treasuries today?

Mr. SCHULTZE. No. I said the normal yield curve. Now you do get situations where that yield curve gets inverted and goes down.

Representative BROCK. Don't we have that situation today?

Mr. SCHULTZE. I don't think we do. Take a look at the yields.

Representative BROCK. I don't see how you can possibly say that.

Mr. SCHULTZE. I want to make sure I am not making a mistake. I don't think we do at the moment. I will be glad to confess error if I am wrong; I am wrong.

Representative BROCK. I thought so. Thank you.

Mr. SCHULTZE. But I will still stick to the proposition that in about 5 years out of 6, the normal case is for the shorts to be cheaper than

the longs, but you are quite right that right now the longs are being issued at lower interest rates than the shorts.

Representative BROCK. That has been the case for several months.

Mr. SCHULTZE. Correct.

Representative BROCK. In some degree I think due to the fact that we have been forced to concentrate on the short-term market, thereby driving up the short term.

Mr. SCHULTZE. I think there is something to that.

Representative BROCK. The competition for funds today in the money market is enormous. The competition is troubled by the impact of Government borrowings. Isn't it a fact that since we cannot sell long-term Federal bonds, because nobody is willing to purchase them at only a four-and-a-quarter-percent yield that the Treasury is forced to pay a tremendously high rate of interest today?

Mr. SCHULTZE. I wouldn't say a tremendously high rate. At the present time, short rates are modestly higher than long rates. But exactly what would happen to short-term and long-term yields if you went into the long-term market I am not prepared to say. It would, however, narrow the spread somewhat.

Representative BROCK. I have a further point I would like to pursue but my time has expired. I would like to ask, Mr. Chairman, unanimous consent to insert in the record at this point the report of the Federal Reserve Bank of St. Louis on the Federal budget trend for the fourth quarter of 1966.

Chairman PROXMIRE. Without objection, it is so ordered. The timing is excellent because the Senator from Missouri has arrived; and St. Louis is well represented on this panel.

(The document referred to follows:)

FEDERAL BUDGET TRENDS*

PERIOD ENDING: 4TH QUARTER 1966

Scope of this release

This issue of Federal Budget Trends presents data for fiscal and calendar years (page 2), for half years (page 3) and for quarters (page 4). The data are carried through 1966, and budget plans are presented for the following year and one half.

The budget program

The Federal Government plans to provide a substantial stimulus to the economy in calendar 1967. The national income accounts (NIA) budget is scheduled to move from a \$2.6 billion deficit (annual rate) in the last half of calendar 1966 to a \$5 billion deficit rate in the first half of 1967, and \$3 billion in the last half. Since the economy is expected to remain at full employment, the projected high-employment budget will move similarly. On this high-employment basis the planned deficit of \$4 billion for 1967 would indicate the most stimulative fiscal policy in more than a decade. This high-employment budget ran about an \$8 billion average surplus from 1961 to 1965.

This fiscal stimulus in the first half of 1967 arises because no major tax increase has been provided and spending, especially for defense, has continued to rise. The advance in spending in the first half of calendar 1967 does not reflect new programs requested in the January 1967 budget message, but rather a continuation of programs previously initiated. From early 1962 to early 1965, Federal spending (NIA basis) increased at about a 3 per cent annual rate. The rate of growth jumped to 8 per cent from the first to the fourth quarter of 1965,

*Prepared by Federal Reserve Bank of St. Louis: Released: January 31, 1967.

and to a 20 per cent rate from then to the end of 1966. According to the budget plan, expenditures will rise at a 10 percent rate from the last half of 1966 to the first half of 1968.

The planned decline in the NIA deficit from \$5 billion (annual rate) in the first half to \$3 billion in the last half of calendar 1967 reflects mainly the planned surcharge on income taxes. In addition, defense spending is expected to level off. Domestic civilian programs are to continue their advance, particularly in the form of expanded social security benefits.

Economic effects of the budget program

The budget plan is predicated on a forecast of sluggish growth in private demand in the first half of calendar 1967, with a resumption of more rapid growth in the last half. These fiscal plans are presented as having significance for monetary policy in coming months. The Council of Economic Advisers' Annual Report assumes that monetary actions will be less restrictive in calendar 1967 than in 1966.

When the fourth quarter 1966 increase in GNP is adjusted for some involuntary accumulation of inventory, a further slowing of production and attempts to reduce inventory are portended. Such a situation is believed to dictate a need for more stimulative economic policy. However, since fiscal and monetary policies affect total demand with lags (although their lengths may vary) excessive stimulation in the next few months might be too late to avert a slowdown in the first half, but create serious inflationary problems in the last half of calendar 1967.

FEDERAL GOVERNMENT BUDGETS ¹
Calendar and fiscal years

[In billions of dollars]

	Receipts			Expenditures			Surplus (deficit)		
	Adminis- trative budget	Cash budget	National income accounts budget	Adminis- tration budget	Cash budget	National income accounts budget	Adminis- tration budget	Cash budget	National income accounts budget
Calendar:									
1956.....	70.6	80.3	77.6	66.8	74.7	71.9	+3.8	+5.6	+5.5
1957.....	71.7	84.5	81.0	71.2	83.4	79.6	+6	+1.1	+5.7
1958.....	68.3	81.7	78.7	75.3	89.0	88.9	-7.1	-7.2	+4.1
1959.....	72.7	87.6	89.7	79.8	95.6	91.0	-7.0	-8.0	+7.1
1960.....	79.5	93.3	96.5	77.6	94.7	93.0	+2.0	+3.6	+13.8
1961.....	78.2	97.9	98.3	84.5	104.7	102.1	-6.3	-6.8	+11.2
1962.....	84.7	106.2	106.4	91.9	111.9	110.3	-7.2	-5.7	+7.2
1963.....	87.5	112.6	114.5	94.2	117.2	113.9	-6.7	-4.6	+12.3
1964.....	88.7	115.0	115.1	96.4	120.3	118.1	-8.2	-5.2	+5.4
1965.....	96.8	123.4	124.9	101.4	127.0	123.4	-4.6	-4.5	+3.5
1966.....	110.8	145.1	142.4	118.1	150.9	142.2	-7.3	-5.8	+2
1967 ²	123.2	165.2	158.5	128.6	167.7	162.5	-5.4	-2.5	-4.0
Fiscal:									
1956.....	67.9	77.1	75.8	66.2	72.5	69.8	+1.6	+4.5	+6.6
1957.....	70.6	82.1	80.7	69.0	80.0	76.0	+1.6	+2.1	+8.0
1958.....	68.6	81.9	77.9	71.4	83.3	83.1	-2.8	+1.6	+5.3
1959.....	67.9	81.7	85.4	80.3	94.8	90.0	-12.4	-13.1	+4.6
1960.....	77.8	95.1	94.8	76.5	94.3	91.3	+3.0	+8	+11.8
1961.....	77.7	97.2	95.3	81.5	99.5	98.0	+6.2	+3	+12.3
1962.....	81.4	101.9	104.2	87.8	107.7	106.4	-6.4	-2.3	+9.9
1963.....	86.4	109.7	110.2	92.6	117.8	111.4	-8.2	-4.0	+10.1
1964.....	89.5	115.5	115.5	97.7	120.3	118.3	-8.2	-4.8	+9.0
1965.....	93.1	119.7	120.6	96.5	122.4	121.3	-9.4	-2.7	+7.3
1966.....	104.7	134.5	132.6	107.0	137.8	132.3	-9.3	-3.3	+1.2
1967 ³	117.0	154.7	149.8	126.7	160.9	153.6	-8.7	-6.2	+3.6
1968 ⁴	126.9	168.1	167.1	135.0	172.4	163.2	-8.1	-4.3	-2.1

Sources: U.S. Department of Commerce, U.S. Treasury Department, U.S. Bureau of the Budget, Council of Economic Advisers, and Federal Reserve Bank of St. Louis.

¹ Prepared by Federal Reserve Bank of St. Louis, Jan. 31, 1967.
² Preliminary estimates obtained from Economic Report of the President except for the high-employment budget estimated by Federal Reserve Bank of St. Louis.

³ Estimates prepared by Federal Reserve Bank of St. Louis from 1968 budget.
⁴ Estimates obtained from 1968 budget except for high-employment budget estimated by Federal Reserve Bank of St. Louis.

Half year totals seasonally adjusted at annual rates

[In billions of dollars]

Half year	Receipts			Expenditures				Surplus (deficit)				
	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget
1955-2d	50.2	72.7	74.2	72.4	66.3	72.8	68.7	68.7	-16.1	-0.1	+5.5	+3.7
1955-1st	55.7	80.5	76.4	75.7	66.8	72.6	70.6	70.6	+18.7	+7.9	+5.8	+4.9
1956-1st	55.7	79.5	78.7	70.3	67.6	76.8	73.2	73.2	-11.9	+2.7	+5.5	+6.1
1956-2d	58.4	84.6	82.3	83.4	71.2	83.5	78.9	78.9	+14.2	+9.4	+3.4	+4.5
1957-1st	58.1	83.6	80.9	86.6	72.2	83.2	80.3	80.3	-14.1	+4.4	+6.0	+7.0
1957-2d	57.5	83.2	76.0	89.7	71.8	83.9	86.2	84.2	-7.2	-2.7	-10.2	+5.5
1958-1st	67.1	93.5	89.4	96.0	81.2	96.0	91.1	90.1	-22.3	-10.5	-10.3	+2.7
1958-2d	67.1	93.5	90.1	98.6	78.4	95.0	91.0	90.3	-2.9	-13.7	-1.7	+5.9
1959-1st	83.4	96.8	97.6	104.2	74.7	93.7	91.2	90.3	+13.7	+3.1	+6.4	+8.3
1959-2d	84.7	95.7	95.8	107.5	80.4	95.6	95.0	98.4	-9.7	+3.8	+4.4	+13.9
1960-1st	71.7	100.2	100.8	112.6	82.6	103.6	100.5	98.4	-14.6	-5.3	-2.8	+10.2
1960-2d	91.2	103.3	104.5	115.0	89.2	110.1	109.3	102.4	+2.1	-7.9	-4.7	+12.1
1961-1st	78.3	109.4	108.4	118.1	94.6	113.5	111.3	108.7	-14.6	-6.8	-4.8	+6.3
1961-2d	94.5	110.6	113.0	123.3	90.7	114.1	113.3	111.9	-16.3	-4.1	-2.9	+8.0
1962-1st	80.5	115.6	116.1	127.2	97.7	120.0	114.5	113.9	-17.2	-4.4	-3.3	+11.4
1962-2d	98.2	115.8	113.8	122.4	97.6	120.8	118.2	117.6	+3.8	-4.1	-1.7	+13.3
1963-1st	79.2	114.4	116.3	123.5	96.2	119.4	118.1	117.7	-17.0	-5.0	-4.3	+5.9
1963-2d	107.2	124.8	124.5	127.1	96.8	125.2	120.1	119.8	+6.0	-5.2	-1.8	+7.4
1964-1st	86.4	122.6	125.4	126.3	106.0	130.4	126.7	126.6	+10.4	-4.4	+4.5	+3.8
1964-2d	123.0	146.6	138.5	138.2	108.0	145.4	135.4	135.5	-19.6	+1.2	+3.1	+2.8
1965-1st	98.6	143.6	146.4	146.7	133.2	156.4	149.0	149.0	-24.6	-12.8	-2.6	+4.9
1965-2d	135.4	165.8	153.3	153.3	135.2	165.4	158.2	158.2	+10.2	+7.4	-4.9	-3.1
1966-1st	111.0	164.7	163.7	163.7	132.0	170.0	166.8	166.8	-21.0	-5.3	-3.1	-1.0
1966-2d	142.8	171.6	170.6	170.6	138.0	174.8	171.6	171.6	+4.8	-3.2	-1.0	-1.0

¹ Not seasonally adjusted.

² Preliminary estimates obtained from Economic Report of the President except for the high-employment budget estimated by Federal Reserve Bank of St. Louis.

³ Estimates prepared by Federal Reserve Bank of St. Louis from 1963 budget.

Sources: U.S. Department of Commerce, U.S. Treasury Department, U.S. Bureau of the Budget, Council of Economic Advisers, and Federal Reserve Bank of St. Louis.

Quarterly totals seasonally adjusted at annual rates

[In billions of dollars]

Quarters	Receipts				Expenditures				Surplus (deficit)			
	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget	Adminis- trative budget 1	Cash budget	National income accounts budget	High-em- ployment budget
1962-1	84.8	99.9	103.4	114.2	88.0	110.2	108.4	107.7	-3.2	-10.2	-5.0	+6.5
2	97.6	106.6	105.6	115.8	90.5	110.0	110.2	109.7	+7.1	-3.4	-4.6	+6.1
3	82.8	109.7	107.6	117.3	92.5	111.2	110.2	109.1	-9.7	-1.5	-2.6	+8.2
4	73.7	109.0	109.2	118.9	96.7	115.8	112.4	111.1	-23.0	-6.8	-3.2	+7.8
1963-1	90.0	108.3	112.0	122.4	90.3	112.8	114.4	112.5	-3	-4.5	-2.4	+9.9
2	99.0	111.7	113.9	124.1	91.1	115.4	112.1	111.3	+7.9	-3.7	+1.8	+12.8
3	83.7	114.8	115.0	126.2	95.9	120.5	113.8	113.4	-12.2	-5.7	+1.2	+12.8
4	77.3	116.5	117.2	128.1	99.4	119.5	115.1	114.4	-22.1	-3.0	+2.1	+13.7
1964-1	96.4	117.2	115.3	124.5	95.6	122.4	117.2	116.6	+8	-5.2	-1.9	+7.9
2	100.0	114.4	112.3	120.3	99.6	119.2	119.1	118.5	+4	-4.8	-6.7	+1.8
3	80.8	113.6	115.4	122.9	95.6	120.0	118.4	118.0	-14.8	-6.4	-3.0	+4.9
4	77.6	115.2	117.2	124.1	96.8	119.2	117.7	117.3	-19.2	-4.0	-5	+7.7
1965-1	97.2	118.9	124.0	126.9	91.6	120.7	119.6	119.2	+5.6	-1.8	+4.5	+6.8
2	117.2	130.6	125.0	127.3	102.0	129.6	126.3	120.3	+15.2	+1.0	+4.4	+7.0
3	88.8	122.4	123.8	125.6	102.8	128.4	126.3	126.1	-14.0	-6.0	-2.5	-1.5
4	84.0	122.8	125.9	125.0	109.2	132.4	127.0	127.0	-25.2	-9.6	-2	-1
1966-1	104.4	134.8	136.0	135.3	108.8	147.6	133.7	133.8	-4.4	-12.8	+2.3	+1.5
2	141.6	158.4	141.0	141.1	107.2	143.2	137.1	137.1	+34.4	+15.2	+3.9	+4.0
3	101.6	145.3	142.3	145.6	132.8	160.2	145.8	145.8	-31.2	-14.8	-5	-4.5
4	95.6	141.9	147.4	147.7	123.6	152.6	152.2	152.2	-28.0	-10.7	-4.8	-4.5
1967-1	135.4	165.8	153.3	153.3	125.2	165.4	158.2	158.2	+10.2	+4	-4.9	-4.9
2	111.0	164.7	163.7	163.7	132.0	170.0	166.8	166.8	-21.0	-5.3	-3.1	-3.1
3	142.8	171.6	170.6	170.6	138.0	174.8	171.6	171.6	+4.8	-3.2	-1.0	-1.0
1968-1												
2												
3												
4												

¹ Not seasonally adjusted.² Preliminary estimates obtained from Economic Report of the President except for the high-employment budget estimated by Federal Reserve Bank of St. Louis.³ Estimates prepared by Federal Reserve Bank of St. Louis from 1968 budget.

Sources: U.S. Department of Commerce, U.S. Treasury Department, U.S. Bureau of the Budget, Council of Economic Advisers, and Federal Reserve Bank of St. Louis.

EXPLANATION OF BUDGET CONCEPTS

Administrative budget

The administrative budget is the basic planning document of the Federal Government. Receipts and expenditures of funds owned by the government are included, and are generally recorded on a cash basis. Interest expense, however, is recorded on an accrual basis.

Cash budget

The cash budget measures the cash flow between the Federal Government and the rest of the economy. In addition to the activities included in the administration budget, receipts and expenditures of the trust funds and government-sponsored agencies are included. Surpluses or deficits in the cash budget indicate changes in cash borrowing from the public and/or changes in the Treasury's cash balance.

National income accounts budget

The national income accounts budget summarizes the receipts and expenditures of the Federal Government sector as an integrated part of the recorded activities (i.e., the national income accounts) of all sectors of the economy. Primary difference between the cash budget and the national income accounts budget are (1) on the expenditure side, spending is recorded when delivery is made to the government, and purchases and sales of existing real and financial assets are excluded, and (2) on the receipts side, taxes are in large measure recorded when the tax liability is incurred.

High employment budget

The high-employment budget is an estimate of the national income accounts budget which would prevail at a specified constant rate of resource use. By eliminating the major built-in stabilizer effects (i.e., the effect of changing levels of economic activity on Government receipts and expenditures), the high-employment budget indicates the impact of changes in tax laws and legal provisions for expenditures.

Reconciliation of various budget measures¹

ADMINISTRATIVE BUDGET

[In billions of dollars]

Receipts	1967	Expenditures	1967
Administrative receipts (cash collections other than trust funds).....	123	Administrative expenditures (cash payments other than trust funds)..... (Surplus or deficit).....	129 (-6)

CASH BUDGET

Administrative receipts.....	123	Administrative expenditures.....	129
Plus trust fund receipts.....	47	Plus trust fund expenditures.....	44
Less intragovernmental transactions.....	5	Less intragovernmental transactions.....	5
Equals cash receipts.....	165	Equal cash expenditures..... (Surplus or deficit).....	163 (-3)

NATIONAL INCOME ACCOUNTS BUDGET

Cash receipts.....	165	Cash expenditures.....	163
Plus:		Less net financial lending.....	-4
Excess of tax accruals over cash collections.....	-3	Plus excess of deliveries over cash payments.....	-1
Other adjustments.....	-3		
Equals national income accounts receipts.....	159	Equals national income accounts expenditures..... (Surplus or deficit).....	163 (-4)

HIGH-EMPLOYMENT BUDGET

National income accounts receipts.....	159	National income accounts expenditures.....	163
Plus adjustment for tax receipts due to deviation of economy from high employment.....	0	Plus adjustment for expenditures due to deviation of economy from high employment (unemployment compensation).....	0
Equals high-employment receipts.....	159	Equals high-employment expenditures..... (Surplus or deficit).....	163 (-4)

¹ All adjustments are not listed here; only the most important are included for illustrative purposes. Figures for receipts and expenditures correspond approximately to those expected in calendar 1967, but adjustments are rough approximations. Details of reconciliation procedure may be found in U.S. Department of Commerce, Survey of Current Business (July 1966), or in the 1967 Economic Report of the President, p. 288.

Senator SYMINGTON. Mr. Chairman, I am sorry but the consular treaty was before the Foreign Relations Committee this morning. Otherwise I would have been here.

Chairman PROXMIRE. Senator Symington was here to begin with and was called out.

Representative REUSS. Could I make a brief unanimous consent request? That there be included in the report of yesterday's hearings, following my colloquy with Chairman Ackley, the August 18, 1966, Report of the President's Advisory Committee on Labor-Management Policy. It is quite short.

Chairman PROXMIRE. Without objection it is so ordered.

(The report referred to appears on p. 25.)

Representative CURTIS. At this point, could I make a unanimous consent request? I thought inasmuch as we had a break, that for the same thing to include after the remarks here some material which I think we will probably be referred to, mainly two articles by Maurice Stans in regard to the Federal budget reform need and Federal expenditure goals and priorities which I think we will be referring to.

Chairman PROXMIRE. That material is rather brief and limited.

Representative CURTIS. I think it is relevant, Mr. Chairman.

Chairman PROXMIRE. Without objection, that will be done.

(The articles referred to follow:)

THE FEDERAL BUDGET NEEDS REFORM*

By Maurice H. Stans

It is clearly time to reform the budget of the United States. I am now speaking not of the figures in the budget, but of the way in which the budget is compiled and presented. Proof of the need for reform was supplied by the reactions of editors and commentators when the 1967 budget was sent to the Congress by the President last January.

The budget usually draws criticism from the press, but this year the criticism was unduly severe, and the integrity of the figures was seriously challenged.

Columnist Joseph Alsop referred to it as "jiggery-pokery." *Time* in an elaborate critique called it a "labyrinth [of] booby traps," and said it employed "every trick of legerdemain." The *Akron Beacon Journal* said that the budget "grossly—and we think deliberately—underestimated expenditures" and characterized proposed spending cuts as "phony." The *Wall Street Journal* said that the proposed deficit reduction hinged "heavily on gimmickry." The *Journal of Commerce* called it "sleight-of-hand." These are typical of press skepticism and distrust across the country.

It is both deplorable and destructive when the principal financial document in the nation is so cynically described. Unless the integrity of the budget is restored and accepted, the financial structure of the country can be permanently damaged. Confidence in the financial management of our government is the backing of our money at home and abroad.

And surely the taxpayer is entitled to a clear-cut, unconfused account of the way in which his money is to be spent!

It is not difficult to find the reasons why so much cynicism now exists. Some of it is based on a mere misunderstanding of details in a complex document. Some of it springs from the proliferation of overlapping programs throughout the government. Some of it stems from outmoded accounting treatments that originated years ago, usually to follow provisions in laws that are often inconsistent with each other on similar subjects. Some of it grows out of innovations introduced or practices expanded in the last year or so. Some of it comes from the obvious efforts in the 1967 budget to embrace conflicting forces of frugality and lavishness at the same time.

Here are some factors that add to budgetary confusion:

1. To begin with, there are *three budgets*, each of a different magnitude, each for a different purpose, and each producing a different result. The Administrative Budget for 1967 proposes revenues of \$111 billion and ends up \$1.8 billion in the red. The Cash Budget shows receipts of \$146 billion and a surplus of \$.5 billion. The National Income Accounts Budget shows income of \$142 billion and a deficit of \$.5 billion.

2. The budget is not a forecast (except as to revenues), but a Presidential program for government operation. Thus, it may contain proposals for spending or saving that the Congress will not approve, for political or other reasons, and in that sense the budget may not be realistic.

3. There are many inconsistencies of accounting in the budget, by which a type of item is treated one way in one instance and another way in a substantially similar case.

*Reprinted from the Journal of Accountancy.

4. Compounding all the weaknesses of earlier budgets, the 1967 budget employs a wide variety of new devices, or enlargements of old ones, to make it seem to be less spendthrift than it is. Some of these are of doubtful validity.

TRUST FUNDS

The difficulties of presenting an intelligible budget are compounded by the fact that Congress has in the past designated certain revenues as "trust funds." These trust funds make up a major part of the difference between the Administrative Budget and the Cash Budget. Most of these so-called trust funds are not such at all, but merely collections of taxes or charges by the government that are earmarked to be disbursed in a specific way.

The major trust funds in the budget are:

1. *Social Security Funds.* At the outset of the social security system, its tax collections from employees and employers were intended to be accumulated over the years in a fund equal to the accrued future benefits promised under the program. But this concept has long since been abandoned. The present balance of \$19 billion in the Old-Age and Survivors Insurance Trust Fund is less than one year's payout for benefits. The amount that would have to be in the fund for it to be actuarially adequate to meet its obligations is estimated at about \$350 to \$400 billion. Thus, the present "trust fund" is in essence merely an account in which one year's tax collections are earmarked to be paid out the next year as benefits. Any impression that an individual's tax payments are accumulated in trust for his own insured benefit is wholly fallacious. Each beneficiary relies really on future tax collections for his future payments.

The same is generally true of the so-called "trust funds" for disability insurance and hospital insurance; they are merely earmarked taxes.

2. *Highway Trust Fund.* This fund collects about \$4 billion a year in gasoline and automobile taxes and applies these amounts to highway purposes, largely to the interstate program. The amounts received are almost entirely paid out in the same year and the fund carries forward only a small balance. The receipts are merely earmarked taxes, and, except for the fact that the law calls them so, there are few normal elements of a trust involved.

3. *Unemployment Trust Fund.* This fund collects about \$4 billion a year, pays part of this to the states to administer their unemployment benefit plans, and credits the accumulated balance to the states to be drawn down by them as needed to pay benefits. In most years, receipts exceed expenditures and the fund has accumulated almost \$9 billion as a reserve for future needs.

The other "trust funds" are smaller. Monies of the District of Columbia government flow through the budget as trust funds. The railroad retirement system is a small private counterpart of the social security system and has accumulated \$4 billion with the government as trustee. The civil service retirement fund for government employees collects almost \$3 billion a year, pays out \$2 billion and has an accumulated balance of \$17 billion for future payments. Veterans life insurance funds have an accumulated reserve of \$7 billion. Almost \$1 billion a year of foreign aid funds flow in and out of trust fund accounts.

The carried-over balances in the various "trust funds," totaling \$65 billion, are invested in United States government obligations, so in the final analysis all these reserves rest on the faith and credit of the government, supported by its taxing power.

INCONSISTENCIES

The number of inconsistent treatments that have been built into the budget through the years is almost legion. They break down into these general groupings, with examples given for each.

Deposit reserves. Payments made by savings and loans associations to the Federal Savings and Loan Insurance Corporation to build a fund to guarantee their savings deposits are treated as an offset to government expenditures in the Administrative Budget; similar payments made by banks to the Federal Deposit Insurance Corporation to build their deposit guarantee fund are considered a trust fund credit and thereby appear only in the Cash Budget.

Earmarked collections. Earmarked revenues from sales of timber on government lands are taken into receipts, and the proportions of such revenues which the government has agreed by law to pay to the states appear as an expenditure, both in the Administrative Budget; earmarked taxes on gasoline and on auto and truck parts go into and out of "trust fund" receipts, and thus appear only in the Cash Budget.

Pensions. Retirement benefits to military personnel appear as an expenditure in the Administrative Budget each year. Retirement benefits to civilian employees of the government are partially financed by deductions from their pay and partly by government contributions through the Administrative Budget into a trust fund. Retirement benefits to railroad employees are provided from taxes on employer and employee that are wholly put into and paid out of a trust fund.

The methods of funding may vary. No fund of any kind has been accumulated for retirement benefits to the military. A fund of \$17 billion has been built up for retirement benefits to civilian employees, but this equals only about one-third of the accrued liability. The Railroad Retirement Trust Fund has been carefully built up to be actuarially adequate.

Loan collections. If the government gets a repayment on a loan made to a Rural Electrification Administration co-operative or on a loan for college facilities, the amount goes into revenues; but, if it gets a collection on a loan made to a small business or a small business investment company or to a farmer to improve his farm, it is shown as a reduction in expenditures.

Business-type activities. The money the Treasury collects from sales by Bonneville Power and other power administrations appears as revenue and the expenses of these agencies appear as expenditures; in contrast, the power sales of the Tennessee Valley Authority are used to reduce its operating expenses and only the net amount of its outgo appears in the budget. Revenues of the Washington airport go directly into government revenues, and the cost of the services appears in appropriated expenditures; but the Post Office spends \$6 billion a year to deliver the mails and only its net loss of \$800 million appears in the budget totals for expenditures.

Admissions and fees. Fees received by the Patent Office and the Passport Office are turned over to the Treasury as receipts; but amounts proposed to be charged to packers for meat inspection are applied to reduce costs of the Department of Agriculture; and fees of Agriculture for certain other inspection and grading services are treated as a trust fund and appear only in the Cash Budget.

Sales of assets. Sales of government civilian property go into government receipts, but sales of military equipment are credited against Department of Defense expenditures. Sales from the strategic stockpile go into revenues, but sales of metals and supplies bought under the Defense Production Act appear as a deduction from other budget expenditures; and sales of fertilizer by TVA are credited against costs of running that agency. Sales of government domain land go into a conservation fund and are respent from it.

Appropriations. If General Services Administration, the government's housekeeper, wants to build a new office building or Federal Courthouse, the full cost is funded at one time in the budget; but if the Corps of Engineers builds a dam or straightens a river it can start with \$1 million in the budget and come back year after year for more money.

Excluded agencies. The Federal Reserve banking system and several agencies in the Treasury Department are excluded entirely from the budget figures. Earnings from the Federal Reserve System, which in fiscal 1967 will amount to \$1.8 billion, are taken into budget receipts without detail or explanation.

Housing loans. If Federal National Mortgage Association lends money to a home owner, through its special assistance programs, the transaction appears in the Administrative Budget; if it buys similar mortgages in the secondary market the expenditures appear only in the Cash Budget.

Public debt. If the Treasury borrows money to finance government spending, the obligation appears as part of the public debt; if a government agency like Tennessee Valley Authority or Federal National Mortgage Association borrows money, it does not.

Subsidies. Some subsidies of the government, like those to farmers, to public housing, or to shipowners, are clearly identified, costed and separately appropriated; other large subsidies, such as low interest rates on rural electrification loans and on other government lending programs, are not identified or priced in the budget.

This hodgepodge of irrelevancies and inconsistencies exists because of the lack of guiding accounting principles as to what is revenue, what is a government enterprise, what is a trust fund, what is a subsidy, when should revolving funds be used, and similar determinations. The form dictated by a maze of inconsistent statutes has taken precedence over substance, and the result is confusion.

1967 BUDGET PROPOSALS

In addition to all of these inherited deficiencies, the 1967 budget carries a large number of proposals that have drawn fire from opponents and critics. None is improper, but all add to doubts about the realism of the budget.

1. *Reductions in politically sacred programs.* The budget proposed cuts of \$82 million for school milk, \$19 million for school lunches, \$191 million for aid to local schools affected by federal installations and \$12 million for aid to land-grant colleges. There are others, too, and the budgetmakers must have known from experience that the Congress would not accept them.

2. *Bookkeeping "cuts."* There are proposals to reduce expenditures in the Administrative Budget by changing the bookkeeping for them, like transferring the cost of highways on government lands and the cost of highway beautification against the gasoline tax money in the Highway Trust Funds.

3. *Nonrecurring items.* There are one-time cuts in expenses that can be spotted only by reading the fine print, like a "saving" of \$150 million in public assistance costs by shifting the dates of payment.

4. *Hopeless causes.* There are proposals to raise money or to cut expenses in ways which the Congress has many times refused to approve. One is by charging \$66 million to processors of meat and poultry for the costs of government inspection.

5. *Sales of assets.* One of the major devices used to make expenses of the government seem less than they are is the sale of almost \$5 billion of government loans and mortgages, using the proceeds, in the President's own language, "to reduce 1967 expenditures from what they would have been otherwise."

There are other items, large and small, in which 1967 reductions or savings in government costs are merely window dressing, such as:

1. Reductions of \$7 million in the cost of defense, and about \$24 million in other agencies, by spending government-owned foreign currencies without including them in the budget; in previous budgets, foreign currency spending was included in expenditures at its dollar equivalent.

2. A saving in the cost of the Food Stamp Program by a bookkeeping transfer of \$135 million from funds required by law to be used to purchase surplus agricultural products.

3. A serious understatement in costs of military personnel. The budget was based on beginning the fiscal year 1967 with armed forces of 2,987,300 on July 1; actually the Vietnam buildup had brought the total to almost 3,100,000 by that date, creating a deficiency of \$569 million in the budget year, which the Congress had to appropriate on its own initiative.

THE FICTION OF LOAN PARTICIPATION SALES

An extreme example of budgetary license, for size and character, is the proposal in the 1966 and 1967 budgets for \$7 billion in sales to the public of participation units in pools of loans owned by the government. In accounting substance, these "sales" actually represent borrowings by the government that conveniently circumvent the debt limit and the legal ceiling on long-term interest rates the government can pay. Since the proceeds of these loans are shown not as borrowings, but as a reduction of funds spent, they result in understating the cost of government and the budget deficit. For 1967 alone, the proposed sales of participation certificates amount to \$4.2 billion. If these certificates are properly classified as a liability, instead of as a reduction of government expenditures, the projected budget deficit for the year is correctly \$6.0 billion instead of the \$1.8 billion shown.

In legal form, the transactions are arranged by grouping a large number of government-owned mortgages or loans into a pool and selling "participations" in the pool to outside investors. In effect, the transactions are quite different: title to a share of the pooled loans does not pass to the buyer; the government continues to hold and service them at its expense; interest paid the buyer is subsidized at a rate higher than the interest on the pooled loans; the government puts in the pool up to 50 percent more loans than the amount of participations sold; the interest and principal are guaranteed by the government's Federal National Mortgage Association (which has the right to tap the Treasury at any time to make good on the guarantee); and the principal is due in fixed payments on fixed dates not related to the collection of the pooled loans.

ABNORMAL BUDGET REVENUES

The revenues forecast for 1967 are abnormally enlarged in the budget by the inclusion of nonrecurring items of considerable size. However proper, such one-time revenues overstate the level of government fiscal capacity and distort economic analyses.

The principal such items in 1967 are:

1. A nonrecurring increase of \$3.6 billion in tax collections from corporations and individuals by requiring them to accelerate payments and thus pay more than one year's taxes within the year

2. Abnormal "income" of almost \$1.6 billion from seignorage, the profit recorded by making quarter-dollars for 3 cents and putting them into circulation at 25 cents

3. Abnormal rents and royalties of \$400 million on Outer Continental Shelf lands released from escrow after years of litigation

Altogether, it can be estimated that revenues in the aggregate are about \$5 billion above normal as a result of such noncontinuing or unusual items.

The budget of the Department of Agriculture shows how a variety of budgetary practices are used. A first view of the totals shows that expenditures are reduced a net amount of \$1,090.3 million from the 1966 budget to 1967, thus indicating a commendable degree of frugality to justify (as is done in the budget) significant increases in Great Society programs. But when the accounts are broken down, these turn out to be the minuses:

	<i>Millions</i>
Proposal to charge fees for meat and chicken inspection, which Congress has regularly refused to do-----	\$66.2
Reduction in school milk and school lunch programs, which the Congress would not accept-----	70.0
Reduction in cost of removing surplus agricultural commodities, a permanent appropriation, which is used instead to finance the Food Stamp Program by a bookkeeping transfer-----	135.2
Reduction in cost of Commodity Credit Corporation farm price supports and foreign aid food programs "due to lower wheat and cotton prices," etc -----	371.6
Sales of participations in farmers' home loans-----	549.1
Increased collections on rural housing loans-----	5.9
Increased sales of loans from Agricultural Credit Insurance Fund-----	104.7
Total -----	1,248.7
Less increases in—	
Cropland Adjustment Program, net-----	131.5
Food Stamp Program-----	43.9
Subtotal -----	175.4
Total -----	1,073.3
Leaving actual net savings in small items-----	17.0

Thus, the actual net amount of controlled economies which are included in the budget "saving" of \$1.1 billion turns out to be only \$17 million. The difference is achieved mostly by bookkeeping and borrowing.

RECOMMENDATION

To bring order into this accounting chaos, I believe the President should appoint a high quality nonpartisan Commission for Budget Reform, consisting of professional accountants, bankers and business finance officers, to conduct a detailed study of budget policies and applications, and to make recommendations for improvement. Such a Commission could make an inestimable contribution to public understanding of government finances by laying down guidelines to govern the classification and presentation of items within the budget, and for the inclusion of additional important data. An independent Commission is necessary for this task because the Bureau of the Budget has neither the freedom of action nor the resources to accomplish the desired results.

Here are some of the questions which the Commission should resolve, and the answers which I would presume to propose to these questions:

1. How many budgets should there be?

One. The Administrative Budget and so-called Trust Funds should be combined into one set of consolidated figures approximately equivalent to the present Cash Budget. The final net results of the receipts and disbursements should then be broken into two figures: (a) an amount representing accumulations in reserve cash funds to be disbursed later to specific beneficiaries of those funds and (b) the balance, which then represents the deficit (or surplus) for the year.

2. Is the budget primarily an accounting document or an economic document?

The budget is essentially a fiscal accounting document of the money flow of the government, reflecting the President's program for the year. It has interpretive values to economists, lenders, businessmen, labor and others, but these are secondary. The "national income accounts" are not a budget at all; they should be demoted to a place with other analyses now subsidiary to the budget itself, and not allowed to confuse the results.

3. How should disbursements of earmarked taxes and revenues that by law are shared directly with states or political subdivisions be shown in the budget?

They should be grouped and deducted from the totals of receipts; they should not be included in expenditures because that overstates the cost of government.

4. How should government enterprises be shown?

An authorized business-type enterprise of the government should be shown in the budget at its net cash income or net cost to operate, as the Post Office is now shown. Activities such as the Washington airports, the government power agencies and similar enterprises should be shown at what they cost or earn for the taxpayers, net, instead of appearing on both sides of the budget. The Congress can and should still retain control over the level of such activities through the appropriations process.

5. How should the sales of participation certificates in government assets be shown?

As part of government debt, because such transactions do not represent transfers of title to the assets involved. They are borrowings, not sales, and should not be used as deductions to understate the cost of government or to reduce artificially the budget deficit.

6. Should revolving funds be used for government loan programs?

Why not? The net outgo in any year, after deducting collections, is the cost of the program to the government for that year. The Congress can keep control over such funds by authorizing the level of loans it wishes made in each year.

7. How should subsidies be dealt with?

Subsidies voted by the Congress for the benefit of any one segment of the public at the expense of all others should be clearly identified in the budget and priced out. This should be done not only with respect to services or funds provided directly without cost but also with those provided on a "bargain" basis less than cost. Interest rates on government loans at less than the cost of money to the government are subsidies that should be disclosed.

8. How should abnormalities and nonrecurring items be shown?

By applying the same standards of disclosure as are required by the Securities and Exchange Commission in business financial statements. Such items should be clearly identified as unusual by appropriate footnotes or other designations, and should be aggregated in summary figures, so that the regular costs and revenues are clearly apparent.

9. Should the government's "profit" on replacing quarters and other coins at face value, greatly above cost, be considered revenue?

No. There is no profit on the issuance of paper money, either. Such coinage is a liability of the government.

10. What about the government's pension liabilities?

The inconsistencies between various actuarial methods of reserving for retirement benefits, and the failure in some cases to provide any reserve, should be resolved in favor of a uniform formula for computing, funding and reporting such liabilities. The budget document should clearly disclose any actuarial deficiencies in such funds.

11. How can the public know where the level of the budget is headed?

There should be a five-year projection of costs for each agency in a form identical to the current budget. These projections should be presented as part of the budget document, for individual agencies and in the aggregate.

12. How can the taxpayer be further protected against extravagant government?

By requiring that the proponents of each proposed new program state in the budget its costs for the next five or ten years ahead. The law now requires that projected costs be given in advance by the proposers of a new program but the Congress is not insisting upon it.

13. How can the public be helped in understanding the financial condition of the federal government?

By the publication of a balance sheet (statement of assets and liabilities) of the government at least once a year, possibly as part of the annual budget. Every large business in the country is required to publish its condition in this form; why shouldn't the government? If such a financial statement is accompanied by five-year projections of both revenues and expenditures under going programs, the public and the Congress will have a far better basis upon which to evaluate the feasibility of adding new programs.

14. What about the debts of the government?

The national debt is now measured only by the government's direct borrowings (bills, certificates, notes and bonds). In addition, it owes massive amounts for unfunded obligations, a large part of these for past services. Obligations for social security benefits, retired pay of the civilian and military employees of the government, commitments for veterans compensation and benefits, and similar accruals, should be computed on an actuarial basis and included in the balance sheet.

The government has enormous contingent liabilities as well; as in the case of a business statement, these should be estimated and footnoted. Included would be deposit guarantees of banks and other savings institutions, guarantees of housing loans and export loans, the unfunded costs to complete construction in progress, long-term commitments for housing subsidies, ship subsidies and similar items, and funds appropriated in the past but not yet spent.

Altogether, the total of all these direct and contingent items, including the interest bearing national debt, ranges somewhere between \$1,000 billion and \$1,500 billion. These are amounts that cannot be blithely ignored in fiscal planning.

15. Are government accounting procedures adequate for all fiscal and budgetary planning.

No. The government's Financial Management Improvement Program has been lagging for some time. Although the law has required for about 15 years that all departments of the government must bring their accounting procedures to the point where the Comptroller General is able to give them his approval, only one-third of the accounting systems have met the requirements and not one Cabinet Department of the government has fully qualified.

While the proposed Commission for Budget Reform is dealing with these and many other important questions, it should also look into the procedures for permanent appropriations that renew automatically year after year; the technique of "partial funding" of large construction projects; the use of backdoor funds, by which money is made available to government agencies without being appropriated; and other weaknesses in budgetary procedures in the Executive Branch and in the Congress. It should also consider anew the recommendations of the last Hoover Commission for expenditure limitations; although the Congress adopted this principle by enacting it into law, it has ever since been ignored by the Congress and resisted by most of the executive agencies.

CONCLUSION

The budget of the United States is a document of vital significance to everyone in the nation. It affects every citizen's well being, his environment, and his taxes. It is used by economists to project the direction of the economy and to evaluate the soundness of national fiscal and monetary policy. It is studied by foreign nations who judge from it our strength of character and our power to meet international monetary and military situations.

For all these reasons, the federal budget must be impeccably sound in its accounting principles and presentations, and beyond reproach in its integrity. Its standards should be no lower than those which professional accountants apply in their practices or which the SEC requires American business to observe in financial reports.

FEDERAL EXPENDITURES—GOALS AND PRIORITIES*

By Maurice H. Stans

Right now, in Washington and in Johnson City, the President of the United States is in the throes of a concentrated annual process of decision-making that has frustrated many presidents before him. He has to choose the program goals and priorities for the nation for another forward year, and he must do this within limits imposed by available resources, considerations of national security, and due regard for political palatability.

Most Americans can sympathize with their President at a time like this. Budgeting means choosing between spending alternatives and it is never a happy chore or a popularity contest. There are always dedicated proponents of spending programs who believe their way is the only sure way to national Utopia. There are honest bureaucrats who sincerely believe that they could do twice as good a job if they only had twice as much money. There are pressure groups and special interests galore, urging action on their causes. And now there is also the problem of continuing a stubborn war that is already several years late in ending.

This year, as the 1968 budget is developed, the problem is more difficult than even, because the President finds himself deep in a trap. It is a trap that is partly of his own making, and he will find it very difficult to extricate himself. He is entrapped now by the consequences of decisions and indecisions of the past several years. He is entrapped by the massive dimensions of his 1967 budget. He is entrapped by inflation. He is entrapped by the military necessities of Vietnam. He is entrapped by a civilian economy that is growing increasingly sluggish. He is entrapped by a continuing unfavorable international balance of payments and loss of gold. He is entrapped by high interest rates on government debt, increasing pay scales for government employees, increasing cost of government purchases and increasing requirements for social security. He is entrapped by the advance commitments of his own ambitious spending programs and those of a runaway Congress. He is entrapped by the threat of a large deficit that may force him into sponsoring an unpopular tax increase. It may take the wizardry of the century to escape this many-sided predicament.

It is hard to guess today how the 1967 budget will turn out. It is even harder to foresee what the 1968 budget will show. The Administration has been highly secretive about current fiscal trends, and this year it has not produced the usual Mid-Year Review, customarily released by the Bureau of the Budget after the end of the Congressional session. The President recently announced spending cuts of about \$3 billion for the year, but part of this merely offsets add-ons made by the Congress over his original budget. And even with these cuts, the expenditures may be as much as \$15 billion above the original 1967 estimates and more than \$20 billion above the 1966 total.

Therefore, to estimate probable 1967 spending, it is necessary to estimate the effect of the Congressional add-ons, the increased cost of the Vietnam action, the extent of failure to sell or borrow on Federal assets, and the results of the President's current economy drive. The administrative budget originally projected outlays of \$112.8 billion, but it seems certain that this will be exceeded by a wide margin. Published and private estimates range from \$125 to \$135 billion, and there are few clues from which to make a more precise estimate. One item of evidence is the Treasury cash statement for the September quarter, which shows net expenditures of \$33 billion. This is at an annual rate of \$132 billion. While there is no certainty that spending in the first fiscal quarter will continue at that rate for the year, this has been the case in each of the last six years.

Revenues may exceed the original budget estimate of \$111 billion. Even if they grow to \$116 billion or so, however, it seems likely now that the year will end with a deficit of at least \$7 to \$10 billion, possibly much more. Even if this estimate misses the mark in one way or another, the problems of the 1968 budget remain, and this is where the subject of programs and priorities takes significance.

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LISTS PROBLEMS FOR PRESIDENTS

Here are some of the problems the President must resolve in setting the dimensions of the 1968 budget:

(1) 1967 revenues benefited from non-recurring amount of about \$5 billion, mostly in accelerated tax payments by corporations. This speedup is at the end of the road now, so no longer can the government tap corporations for more than a year's taxes every 12 months. Comparatively, this means an immediate loss in revenue of \$5 billion that has to be made up in other ways.

(2) Sales of government assets, amounting to almost \$5 billion, were subtracted from expenditures in the 1967 budget, but the President had to call a halt because government financing in this way was interfering with the money markets and was unduly costly. While the next budget may again use this device to make total expenditures seem less than they are, it is conjectural whether it will be any more effective next year than it has been this year.

(3) The inflation that hits the average man also hurts the government. Its wages and salaries, its pensions, and the things it buys are moving up in price. The 1968 budget will have to face this fact, to the tune of several billion dollars.

(4) The postal service is in trouble. It will lose about \$1.2 billion this year, besides being under constant attack for deteriorating mail service.

(5) The vast number of new programs initiated in the last few years had low price tags to start, but they are scheduled to grow rapidly. There is probably \$4 to \$5 billion of automatic built-in growth to be faced in the 1968 budget, unless the President uses a heavy ax on the Great Society plans.

(6) The Vietnam war, which was scheduled in the 1967 budget to end precisely on June 30, 1967, shows no signs of coming to an end. The same factors that are pushing up defense spending in fiscal 1967 by many billions will continue into 1968 and may even escalate some more. There is therefore no relief in sight for the military budget and it is likely to continue to advance in 1968 by several billions, at least. And this does not count the staggering cost of an anti-missile, if the Pentagon finally decides that it must have one.

(7) In the offing is the serious risk of a decline in tax revenues, especially on corporate profits. The economy is showing sluggishness on the civilian side, productivity is on the decline, wage demands are up, and the general outlook is for a considerable squeeze on earnings. Depending on whether or not this condition extends into a genuine recession, there could be a substantial decline in corporate income taxes. For every 10 percent reduction in corporate profits, the government loses roughly \$3.5 billion in taxes. The Administration obviously must do all it can to support a profitable business climate, or its loss of loss of tax revenue can be devastating.

These are just some of the major dilemmas the President is facing in the 1968 budget. Depending on how they are resolved, it is possible to foresee a wide range of possible forecasts in the budget. And depending on the course of the economic trend, it is possible to foresee a final outcome for the year anywhere between a balanced budget and a deficit of \$30 billion or more.

No President since World War II has had such a difficult range of choice or such a wide range of possible consequences.

What *can* the President do?

Since he is one who likes to spring surprises, it is reasonable to expect that some unusual items may appear in the 1968 budget. It is also likely that some advance conditioning of the public will begin to take shape in the next few weeks.

As for specifics, these are a number of likely candidates that will probably get his serious attention this year in the budget figures:

An across-the-board increase in postal rates.

Renewed effort to increase user charges, and to change budget bookkeeping by transferring costs against trust funds.

The long-due return of some American troops and dependents from the European theatre.

A substantial slash in government public works programs.

A reduction in foreign aid.

A stretchout in the space program and a substantial cut in its current costs.

A reduction in agricultural subsidies.

A cut in government-financed research.

A further scaledown in manufacture of atomic weapons and other AEC activities.

A major decrease in funds for government loan programs, except for housing.

Some reduction in the number of government civilian employees (the cost of which has grown from \$12½ billion to \$18½ billion since 1960).

An all-out effort to reduce the total of expenditures by sales of government loans, agricultural surpluses and stockpile materials (which amounts are used largely to offset expenditures).

It is a fair assumption that many of these moves will be made in the 1968 budget. It is unlikely that any notable new programs will be proposed. It is hard to envision any reduction in defense procurement or in the size of the military services, unless an assumption is again made of an early end to the Vietnam war. Even so, a supplemental appropriation of perhaps \$10 billion is expected to be asked of the Congress in January.

NEED TO CUT SPENDING FOR GREAT SOCIETY

The final area for possible reduction is the Great Society programs of recent years. The budget may retreat on these in some degree. If it does not cut them back significantly the likelihood of revenues and expenditures being in balance is quite remote.

This brings us to the delicate matter of a tax increase. Leaving aside all political considerations, there is still to be resolved whether or not a significant increase early in calendar 1967 will help or hurt the economy, or would help or hurt revenues. Some economists are already expressing fears that higher taxes, coming at a time of economic unsteadiness, could stimulate a recession. Whatever the President recommends, the Congress will probably want to take a long look at developing conditions before it passes a tax bill next Spring.

All in all, the program decisions this year are difficult and crucial. First priority, as always, goes to the needs of national defense. Many other items, including interest on the debt and veterans benefits, are uncontrollable. Every other item in the budget this year will have to pass a more stern definition of necessity than in any recent year.

For the best long-term interests of the country, I believe the President should:

(1) Enlarge his present campaign to reduce current spending in 1967, make still deeper cuts, and merge overlapping and duplicating Great Society programs to reduce waste and inefficiency. All this could help to reduce the deficit this year to manageable size.

(2) Propose a budget for 1968 that shows a small surplus, achieved entirely by curtailing present programs, and adopting no new programs. Hopefully, a surplus can be achieved without a tax increase. A balanced budget, with a small surplus, is essential to reduce inflationary forces and to provide the flexibility to meet emergency developments in the economy. But this can be accomplished without a tax increase only if the spending cuts are deep. I doubt that the President will heed this advice and I expect that he will propose a "temporary" tax increase of some size in January.

There are a few more things I would like to say in conclusion. The first relates to the current attitude of the American people. The second relates to the integrity of the budget. Both are important in this context, at this time.

I believe the election was evidence that the American people are truly concerned over the incessant increases in Federal spending and the endless new programs, many of them demonstrably wasteful or overlapping. Whether or not you call it the "Puritan ethic," the people are still basically uneasy about the way this nation continues to pile up deficits and debt and inflation. They simply do not trust what I referred to at a Tax Foundation meeting several years ago as "government by credit card."

Furthermore, I feel confident that the American public does not want a tax increase at this time. The public opinion polls show clearly that the people are unwilling, in a time of military action, to pay for nonessential social experiments, however noble, at the certain cost of higher taxes on the one hand or inflation on the other.

And, just as fundamental, is the need for reform in the budget document. Federal budgets in recent years seem to have been designed primarily as political documents. This has resulted in many accounting inconsistencies and even misleading totals. Compounding all the weaknesses of earlier budgets, the fiscal 1967 budget employed a wide variety of new devices—some call them gimmicks—or enlargements of old ones, to make it seem less spendthrift than it is. Some of these devices are of doubtful validity.

For the longer run, we need to restore the somewhat tarnished reputation of the budget. After all, the budget of the United States is a document of vital significance to everyone in the nation. It affects every citizen's well being, his environment, and his taxes. It is used by economists to project the direction of the economy and to evaluate the soundness of national fiscal and monetary policy. It is studied by foreign nations who judge from it our strength of character and our power to meet international monetary and military situations.

For these reasons, the Federal budget must be impeccably sound in its accounting principles and beyond reproach in its integrity. Accordingly, I believe the President should appoint a high quality, non-partisan Commission for Budget Reform to conduct a detailed study of budget accounting policies and applications, and to make recommendations for improvement.

Such a commission of private experts could make an inestimable contribution to public understanding of government finances by laying down guidelines for the classification and presentation of budget data and for inclusion of additional important data.

This is no time for half-way measures if we are to regain control of government finances: As I have tried to indicate, Federal expenditures have been increasing at a reckless rate that, if continued, may well put an insupportable burden on our economy. They have already encouraged a strong revival of inflation, the cruelest tax of all. New programs always proliferate in a something-for-everybody atmosphere. Piling new program on top of new program steadily whittles down the areas of private responsibility and action.

The importance of these developments cannot be overstated. The whole world is watching to see whether democracy can discipline itself. Since recent Federal budgets have shown little discipline or restraint, at a fearful cost to the nation, let us hope that the President this year will reverse the trend and bring back a return to old-fashioned fiscal responsibility.

Chairman PROXMIRE. Mr. Schultze, I am not going to detain you much longer on this \$10 billion error, but I would like to press it further, because I think that we can come to a constructive conclusion on it.

This assumption that the war would end on June 30, 1967, becomes more fantastic as I think about it, because, of course, the war could end on May 1 or June 1, and we still would have been \$10 billion off, or very close to it. So we not only assumed that the war would end on June 30, but we assumed we would know about it well in advance, and we could have slowed down our procurement so we wouldn't have procured anything to fight in the period subsequent to July 1, 1967, isn't that correct?

Mr. SCHULTZE. I can't answer that yes or no. I would like to point out that the assumption was made for the very reasons I indicated earlier, that it was impossible to forecast longer term requirements. For budgeting purposes, therefore, some assumption had to be made. It was a budget assumption, not a diplomatic assumption.

Chairman PROXMIRE. The assumption made was that the war would end on June 30, and we would know well enough in advance so we could trim, reduce our procurement, et cetera, in advance of this. Therefore, we must have had some knowledge. We would have had to know, say, by December or January.

Mr. SCHULTZE. Oh, yes, in that sense. All that the assumption really means is that the long leadtime items needed to carry the war on after June 30, 1967, were not in the budget; that is, that the money for ammunition, rockets, and procurement of aircraft for attrition after that date were not in the budget, not because of any diplomatic assumption that the war wouldn't go on, but because we were in such an explosive buildup we didn't know what those requirements were going to be.

Chairman PROXMIRE. Was there any feeling at all that if you did make these assumptions explicit and clear, rather if you did make the higher spending clear as time went on that you would not have served the national interest? Was the feeling that Congress would have become so alarmed that we would have cut other programs? Would there have been a feeling that there would have been an adverse reaction in some other way on the national interest if we had been told the truth about this?

Mr. SCHULTZE. No, sir, because in February Secretary McNamara told the committee that this was the assumption that the budget was based on.

Chairman PROXMIRE. Yes, and on March 23 Secretary Fowler flatly denied a statement made by Senator Stennis in which he said the best information we have is that the war in Vietnam is going to cost \$10 billion and that this is our position.

Mr. SCHULTZE. And what happened on that, what was kicking around at the time, if you will, were some estimates that if the war didn't stop, there would be a range of somewhere between \$5 billion and \$15 billion more needed. A lot of people took the middle of that range and came to \$10 billion.

Again, the Secretary of Defense and the President and I fully concurred, did not want to come before the Congress with a set of requests based on a range that large. In August, for example, when Secretary McNamara was testifying before the Senate Armed Services Committee, in the 72 hours before that testimony he got three different estimates of the Army strength needed to carry on the war.

Chairman PROXMIRE. Yes; but he wasn't off by a few billion dollars. He was off by 50 percent, \$10 billion.

Mr. SCHULTZE. Yes. I would ask you, Senator, to go back and look at the record of financing in any war. There were seven supplementals for Korea. This is not unusual. The difference here, there is one big difference that I will say is unusual, that in this case the Secretary of Defense, and I think quite properly, refused to come before the Congress with the supplemental before he had his requirements nailed down.

In Korea we didn't, and in Korea we ended up with substantial overfunding.

Chairman PROXMIRE. But you see, this committee has a major responsibility in Congress on economic policy to advise other standing committees and, of course, has a legislative responsibility. And if we can't discharge that responsibility, based on accurate information, we might as well fold up shop.

It would seem to me that I might make a suggestion and I would like to ask you to comment on this. Would it be in your judgment in the national interest for us to secure every 3 months, as long as the Vietnam war is on, estimates of, revised estimates of how much it is going to cost? Then we are in a position to advise on tax increases or advise on other spending cuts or advise on fiscal policy.

If you wait for a full 12 months or if we wait as we did before, when the estimate is made 18 months in advance, this committee it seems to me cannot be the kind of helpful, expert adviser to the Congress that it should be. Can you think about this possibility and discuss it with the President and the Secretary of Defense, because it is

a suggestion that is made with all seriousness, and I think many of us feel very handicapped.

Right now there are well informed competent people in the Congress who are saying the present estimates are way off. They may be right. If they are, our policies are going to be way off in the coming year. The best judgment on your part is going to do you no good if the basic facts aren't right, if the basic intelligence isn't correct.

Mr. SCHULTZE. And the opposite side of that coin, Senator, which is the one that does give me trouble about this, is that in this kind of a case we don't just give informal estimates, a range, a "guestimate." When the Secretary of Defense has to give an estimate, presumably that is backed by requirements. The real problem is when can you know how your requirements have changed. There is, as I indicated earlier—I am not sure you were still here—but in answer to an earlier question, I indicated that there is a significant difference, and for good reason, between the planning assumptions in the 1968 budget and the 1967 budget.

Chairman PROXMIRE. There weren't any significant changes last year.

Mr. SCHULTZE. Except it was made on a different assumption.

Chairman PROXMIRE. You still were way off.

Mr. SCHULTZE. That is right. This time, however, barring significant changes, we put in the long-lead-time procurement. The 1968 budget finances both long-lead-time procurement in case the war should go on longer, and provides for a further buildup, although at a lower rate than we have been having.

So that the 1968 budget is essentially based on a different set of planning assumptions than the 1967 budget, and because we have got 18 months of combat experience behind us, and because we are leveling off, or are more close to leveling off at least, we can make a lot firmer estimates.

Chairman PROXMIRE. A multiplier of 2.2 for Vietnam spending was pointed out yesterday. The impact on the economy is very, very serious, and if you could from time to time give us the latest intelligence you have on this, it is going to be very useful to this committee and to the Congress.

Now I would like to get to another area.

Mr. SCHULTZE. May I just get one point in that I wanted to get in earlier, which I think would be relevant in considering the point you have made, and that is the timing of these differences. As I indicated earlier, if you look at the economy in 1966, the inflationary pressure came in the first three quarters, roughly, and there was a substantial tapering off thereafter.

Consequently, if the defense estimates, the defense spending, was responsible for this, it must have been in the first 6 or 7 or 8 months, given the leadtime involved.

But let me give you two sets of figures that I think you will find interesting. First let me take the deficit-surplus situation, actual and predicted, and then total NIA expenditures, actual and predicted. For the first quarter of 1966, our original budget had behind it an implicit deficit of \$2 billion. As it turned out, we had a surplus of \$2.3 billion, or a difference of \$4 billion.

In the second quarter, the original budget on the NIA budget called for about a \$1.6 billion deficit. It actually turned out to be a \$3.8 billion surplus, or a difference of \$5.4 billion in the same direction.

In the third quarter, a \$2.1 billion deficit turned out to be only a half billion dollar deficit, a difference of \$1.6 billion. You might say the economy rose a lot faster because of inflationary pressures and you got a lot more revenues, so those aren't valid figures. I don't think that quite figures, but let's turn to expenditures and look at total NIA expenditures.

In the first quarter of 1966, the 1967 budget estimated a first quarter NIA expenditure of \$133.7 billion. Actual expenditures as published by the Department of Commerce—and you will find them in the Economic Indicators—were \$133.7 billion, no difference. In the second quarter \$136.9 billion was predicted, and the actual was \$137.1 billion—up two-tenths. In the third quarter, where we do come on expenditure changes, \$140.5 billion was predicted, the actual was \$145.8 billion, a \$5.3 billion difference for that quarter at annual rates. Thereafter, the economy moderated somewhat.

Chairman PROXMIRE. I think you are making a very strong case and it is extremely interesting, but it doesn't get around the fact that, rightly or wrongly, we don't have the right information if we don't have the right estimates. All the analysis in the world is going to be no good at all: you are just going to make serious blunders and mistakes.

I think you make a strong case that you cannot charge the inflation we suffered during most of 1966 to this particular blunder. But, nevertheless, I do think that the main point is the Congress was incredibly misinformed by your estimates last year. This has to be corrected one way or another, and I think this committee has a duty to do our best to correct it.

Now let me ask this. You said earlier, that *Life* magazine said the budget would not satisfy the pennypinchers. Well, it doesn't satisfy this pennypincher, and I am sure other pennypinchers.

First, take a look at Federal employees. You have a breakdown here which indicates that between 1955 and 1960 we had a stable situation, about the same number of Federal employees. In fact, it was precisely the same, 2,371,000. From 1960 to 1965 it went up 214,000—in 5 years—and in the last 3 years, 1965 to 1968, it has climbed by 217,000. I think a lot of people feel that the gobbledygook on dollars is hard to analyze because you fool around with participation certificates and juggling in all kinds of way, but when the Federal employees go up, you know the Federal Government is getting bigger.

What concerns me about this, particularly, is that for the first time in a long time we have 3 successive years in which the number of Federal employees in relationship to the Nation's population is increasing and increasing sharply. So I would like to have your answer on whether we should be concerned with a change now, a dramatic and serious change in the growth of the Federal Government?

MR. SCHULTZ. Let's break that into three parts. There have been very large increases for the Department of Defense. It takes civilian personnel to handle the Vietnam problem.

Secondly, there have been very large increases in the Post Office, for two reasons: One, because the volume of mail has been rising in the last several years in unprecedented amounts, and secondly, because we originally tried to reduce overtime, and in reducing overtime, you put more people on the rolls.

We thought at the time that was a good proposition for the Government. Now it turns out we have had to modify that somewhat and go back to some overtime, because we get the best mix of employees when we do that.

But the two biggest increases have been Defense and Post Office.

Now, in addition, you are quite correct, there have been significant increases in other areas of Federal employment. I happen to have in front of me the 1966 to 1968 figures. From 1966 employment will rise outside of Defense and Post Office, from 823,000 to about 870,000, or an increase of 47,000 in full-time permanent employees.

This comes heavily in several areas: in Health, Education, and Welfare, because of the number of new programs and in the Department of Housing and Urban Development where there are also a number of new programs. Undoubtedly this is a significant increase.

Last September we decided, in addition to trying to control dollars, to try to control employees. We put a freeze on the level of employment, excluding Post Office, Defense, and Selective Service, where we felt it just could not and should not be done.

Now quite frankly, we have had to break that freeze to some extent. Nevertheless, through the freeze, employment by the end of 1967 will be some 40,000 below the amount involved in agency by agency appropriations.

So you are quite right that employment has gone up even outside of Defense and Post Office. That is primarily associated with new programs. We did put a separate and special freeze on employment. It wasn't 100 percent successful, I will be the first to admit, but it did keep employment 40,000 below the number of employees financed in the appropriations.

Chairman PROXMIRE. My time is up. Congressman Curtis?

Representative CURTIS. I would like to ask this following right along the line you have been pursuing.

This point has to do with this question of reestimating. We are presented the Federal budget in January, which, as it has been pointed out, is based on assumptions that were made many months before. But as we go on through the year, Congress is faced with many policy decisions that require a reevaluation of those assumptions. I would raise a question of the semantics. Senator Proxmire says that we need to act with information and, of course, I think we all agree to that. But essentially, what I think we need here are the best estimates.

Now as Mr. Schultze knows, our little quarrel or discussion in Ways and Means was that in May of last year when we had the debt ceiling before us, we asked for the latest estimates, and they were no different from the \$112.8 billion given to us in the budget message in January. As late as last September, probably early October, when we had the same questions up involving what would we do about suspension of the investment credit, there was again, no revision.

Now here is what worries me about this. In your testimony before the Ways and Means Committee just this week, and that of the

Secretary of the Treasury, it was said that you didn't have accurate figures. It was the uncertainty and the war, and so on, that you gave as your reason.

I responded by saying I felt that when you were in this kind of period, it is all the more reason for coming in with more frequent attempts to give educated guesses. Certainly when you ask us to put the debt ceiling on the basis of an assumption of \$112 billion expenditures for fiscal 1967, I would say this was not your best estimates. You just refused to give us one.

Again, and I am repeating, in September during discussion on the suspension of the investment credit, you would give us no better estimate. If you will recall, at that time I said at least I can give you what I think, just using previous expenditure figures for fiscal 1967, the few months we had had. I gave you a figure of \$127.4 billion for fiscal 1967, which to my amazement came—

Mr. SCHULTZE. It was \$123 billion; but that is all right.

Representative CURTIS. What?

Mr. SCHULTZE. It was \$123.6 billion that you gave.

Representative CURTIS. Oh, no, no. We had an allowance. You had the additional thing because we added one other aspect. No, it was \$127 billion. But whether it is or isn't —

Mr. SCHULTZE. The point is you were higher, that is right.

Representative CURTIS. The point is that we needed some firm re-estimates. The question is, don't you think, that far from being the reason for not giving those estimates in periods of uncertainty, it is the very reason why you need to give up-to-date and revised estimates?

Mr. SCHULTZE. Let me break that into two parts, the May hearings and the September hearings, if I may.

Representative CURTIS. All right.

Mr. SCHULTZE. When we came up in May, we were faced with a situation in which the 1966 expenditures were about on the button, and in fact, they were slightly up in Defense and slightly down in the civilian area.

Representative CURTIS. But we weren't talking about that.

Mr. SCHULTZE. No; but my point is in terms of the actual record that we had to date, they were about the same.

Representative CURTIS. All the more reason we would be off our guard in regard to estimates for fiscal 1967.

Mr. SCHULTZE. But, notice the big change from the original 1967 estimate to the current 1967 estimate.

Representative CURTIS. That is right.

Mr. SCHULTZE. It was in three areas: First, Defense, which at the time we simply didn't know; second, the money market, which at the time we didn't know—we did know somewhat more clearly in September, but in May we didn't know—and third, reestimates of \$1.3 billion, netting out all other changes. That \$1.3 billion we didn't know at all at that time.

So I am saying it really boils down to this: In May we couldn't have given you much more. In September—

Representative CURTIS. I just want to interrupt to pinpoint our discussion. I said best estimates. You could have given us better than \$112 billion, couldn't you?

Mr. SCHULTZE. Not in May.

Representative CURTIS. Why not? You mean that you didn't know that \$112 billion was a poor estimate, and that you could not have said "Look, we don't know where it's going to be, but it's a lot more than \$112 billion." You could have said that in May.

Mr. SCHULTZE. Of all the items, the only thing that we might have known a little bit more on was that it was much more likely by May that the assumption of the war ending was not going to be correct. But not on the other items.

Representative CURTIS. The interest rates? You were saying what was happening on interest rates. Of course, you could estimate those things to give an estimate a lot better than \$112 billion that you gave.

Mr. SCHULTZE. But not between January and May.

Representative CURTIS. I am talking about between January and May. Take a look at what was happening.

Mr. SCHULTZE. We might have been able to give you another \$300 or \$400 million on interest rates, but that is about it.

Representative CURTIS. You ended up with the \$3 billion, but go ahead to the next bout, because there we had the actual expenditures of July and August.

Mr. SCHULTZE. Right.

Representative CURTIS. In front of us; and you probably had September pretty well in mind.

Mr. SCHULTZE. No; it was September 12, and we don't get the estimates for August until about the 18th or 19th of September. But, we had the first month.

Now again you will recall, Mr. Curtis, that both the Secretary and I did say Defense spending was going to be up. We didn't know how much. I said at the time quite explicitly that because of money market conditions, expenditures were going to be up.

I also had a long colloquy with Mr. Byrnes on congressional increases, which we might or might not be able to offset. So we gave you the three areas involved, but said that we couldn't give you an amount.

Take the money market as a case in point. As late as November, on the basis of calculations then, I gave the President some numbers which he used in a press conference that because of money market developments, expenditures might be off by \$4½ billion.

It turns out now, our best, best bet now is \$3 billion, because the money market is changed. So there were substantial changes then. We did know the areas where we were going to be off—we told you about the areas—but we didn't have the numbers.

Representative CURTIS. But what we asked you, and we are talking about best estimates, and I constantly referred to this, was whatever you could give us as a better figure than \$112 billion, because that was the figure you had given us.

What I am talking about—I think it is what Senator Proxmire is also discussing—isn't it important to give revised estimates? Previously, every administration, including this one, had given us mid-term estimates. We didn't get those last year. The first time we got new estimates was in the budget message that we just received this January.

Mr. SCHULTZE. Not quite. In late November and very early in December, the President did make some changes.

Representative CURTIS. Congress was out of session then.

Mr. SCHULTZE. Yes.

Representative CURTIS. But certainly the point is, it seems to me, that you have to give the Congress best estimates, even though you say at the time that these are guessimates. But you knew, certainly, that the \$112 billion was not sound, and yet you refused to revise that figure. You must admit that.

Mr. SCHULTZE. We refused to give a specific number for it; that is correct. We did indicate the areas where it was going to be up. We didn't give you numbers on it. The reason again is that when an administrative witness comes up here and gives numbers, those are official numbers. And particularly in the defense area, they would have involved things that we just didn't know.

Representative CURTIS. Thank you.

Chairman PROXMIRE. Mr. Reuss?

Representative REUSS. Just one quick question. Under the manpower training program, the number of trainees in the 1966 fiscal year was 273,000. These have been reduced in the current fiscal year to 250,000. What is the reason for that?

Mr. SCHULTZE. I must admit I don't know the reason for that specific reduction. I can give you what I think the answer is, and then perhaps, correct it for the record.

Representative REUSS. I believe they are up again to 280,000.

Mr. SCHULTZE. In 1968.

Representative REUSS. In 1968, but my question is, with a good program like that, with what everybody says is the way to come to grips with structural employment, what in the world are we doing cutting it down in this year?

Mr. SCHULTZE. I am almost sure what happened, Mr. Reuss, is that we have been making progressively a switch toward getting more and more of the hard-core disadvantaged into the MDTA program. Now I don't happen to remember the numbers, but there has been a very dramatic increase in the proportion of MDTA training for the hard-core disadvantaged. In terms both of personnel to supervise the program and in terms of funds, this approach costs a whale of a lot more per person. During the current year, the major shift to training of the disadvantaged is taking place so that the budgeted amount of funds covered a slightly smaller number of people, about 23,000 out of 273,000.

I am not positive of that. I will have to check it.

Representative REUSS. If the shift to the disadvantaged had been all that intense, I would have thought that the number would have gone up in 1966.

Mr. SCHULTZE. No, sir.

Representative REUSS. It must have been a shift away from somebody else.

Mr. SCHULTZE. No. What it means —

Representative REUSS. Why, at this time, when everybody admits our great problem is structural unemployment and training people, why are we this year, you still have five months of this fiscal year to live in, why are we reducing our manpower development and training program?

Mr. SCHULTZE. What I am saying is we are not reducing it so much, but that we are putting a lot more money and services in per person. It costs a lot more to take the hard-core disadvantaged and do a decent training job than it does with people with higher education and higher skills.

Representative REUSS. A lot more.

Mr. SCHULTZE. A lot more, yes. So with a given funding and a given number of trained personnel available, as you make this shift you find that result.

Representative REUSS. Why didn't we change the given funding to get on with the job of training our unemployed?

Mr. SCHULTZE. Remember, you are talking about a shift from 273,000 to 250,000 from 1966 to 1967. We are going back up again in 1968 to 280,000.

Representative REUSS. I know, but why? Didn't we make an awful mistake, and why are we making it today, and why don't we do something about it?

Mr. SCHULTZE. I just won't admit that 23,000 is an awful mistake.

Representative REUSS. We show a lot of adeptness in bringing in supplemental budgets for war. Why not show equally fancy footwork on bringing up one for a useful purpose.

Mr. SCHULTZE. Well, I guess in terms of the overall situation, we decided not to come up for a supplemental, for this and for many other things. But all I want to point out—

Representative REUSS. Note my dissent, PPB on that one.

Mr. SCHULTZE. I think I have given you the reason, but I am not 100 percent sure.

Representative REUSS. If there is a fuller explanation of what I regard as the sorry dropoff in MDTA programs on page 129 of the current budget,¹ let the administration spread it on the record at this point. And also, why they aren't asking for a supplemental, if there is any excuse for it.

The following was subsequently supplied for the record by the Budget Bureau:

In setting the MDTA program level for 1967, the basic aim was to achieve the greatest return on the Federal training dollar. With the improvement in the economy and the tightening of the labor supply, employers are hiring and training more of those previously assisted under the MDTA. The decision was made, therefore, to concentrate the program on the more severely disadvantaged unemployed who are not readily recruited for training by industry. This major redirection of effort requires more intensive and new types of services resulting in substantially higher unit costs. With MDTA concentrating more heavily on the disadvantaged, and with employers' increasing willingness to train the less disadvantaged, the total number of trainees should increase, even though there is a temporary dip (during FY 1967) in the number directly trained by MDTA.

The MDTA training effort in 1967 was therefore determined by the desirability of concentrating on the real hard core unemployed and the feasibility of achieving this redirection. In 1968, with the program redirection effected, the number of trainees to be provided for under the MDTA will rise to 280,000.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Mr. Schultze, again my apologies for not being here all the time. Last year the administration criticized the Congress for giving more money to defense than was wanted. It was a

¹ See table on p. 2, reprinted from p. 129 of the Federal Budget.

figure around \$952 million. That is months ago, but is as I remember it, and considered in excess.

Some \$570 million of that \$952 million was to pay the people that had been added, and also the increased salaries, both requested by the administration.

Defense took the position that they couldn't recommend we approve that money, because they didn't know exactly how much it would be, therefore, it should be included in the supplemental the following year.

I would hope that in the future, the Congress isn't criticized for appropriating money for the programs the administration requests.

Mr. SCHULTZE. Senator, I obviously will have to check those numbers to make sure that the statement I am about to make is right.

First, in working up tables on what Congress was adding to the budget, we only put in that part of the military pay raise which is attributable to moving the effective date from January 1, 1968, to July 1, 1967. The remainder of the \$952 million we never counted.

Secondly, we did not count the \$500 million plus added to the personnel accounts by the House, because as a matter of fact—

Senator SYMINGTON. I think the staff of the committee put it in, because they knew it was needed.

Mr. SCHULTZE. This is right. The House put it in—

Senator SYMINGTON. And I say inasmuch as they didn't know exactly what it was, say 580 or 560 instead of 570, they wouldn't ask for any of it. We thought that was a little unfair.

Mr. SCHULTZE. I am not at all critical of this. The point I am trying to make is that since it was put in by the House and taken out by the Senate, it was never in our computation of what the Congress added.

Senator SYMINGTON. It was finally taken out because we were told it wasn't needed. But we both knew it would be needed, and asked for in January. That was my only point.

Mr. SCHULTZE. I did read the colloquy from the record between Secretary McNamara and—

Senator SYMINGTON. Senator Stennis.

Mr. SCHULTZE (continuing). Senator Stennis on that, and also on the floor when the bill was presented, and my recollection is roughly the same as yours, that Mr. McNamara said "We have the authority to reprogram these funds now. I would prefer to come back and get it all in one lump sum." That is right.

Senator SYMINGTON. Thank you.

Chairman PROXMIRE. Congressman Brock?

Representative BROCK. Mr. Schultze, if I might pursue for a moment this question on the ceilings, you have mentioned several times the need for flexibility, not only in your operation on fiscal and monetary management, but this obviously would include management of the debt. Would it not put you in a more flexible position if you did not have the statutory limitation of four and a quarter percent on the interest payments?

Mr. SCHULTZE. I think I would concur fully with what Secretary Fowler has said on a number of occasions. First, some limited flexibility would be useful. Second, he did not think, and I fully concur with this, that the current debt limit proceedings are the proper oc-

casion to provide it. He indicated earlier he did think some flexibility would be useful. He then said this wasn't the time to do it. I concur in both of those statements.

Representative BROCK. Would you advocate at sometime in the coming months the removal of the four-and-a-quarter-percent ceiling on the interest rate?

Mr. SCHULTZE. I think it is certainly something that the Congress might well want to consider. From my own personal standpoint, some flexibility would probably be useful. I just don't think that right now is the time to do it. That is my point.

Representative BROCK. Right now never seems to be the time to do anything. I am trying to find out if you would appreciate it if the Congress did consider it.

Mr. SCHULTZE. I don't think I would appreciate it if the Congress tried to do it right now, because I think that would lead to all sorts of problems. It could delay the urgently needed debt limit increase. I wouldn't appreciate that; no, sir.

Representative BROCK. Let's get on with the debt discussion just a moment. One of the things that disturbed me most in our discussion with Secretary Fowler, who said if we didn't pass the debt ceiling increase, which may or may not be necessary depending on the point of view, but if we didn't, we may not be able to make certain Government payments, such as social security.

Now, Mr. Schultze, is social security limited by the debt ceiling? Are social security payments limited by the debt ceiling?

Mr. SCHULTZE. No, sir; but I think what the Secretary was referring to, is that in the immediate period, when this will be a problem—though I am not fully familiar with the actual month-by-month handling of this—that the way the funds come in, and in turn are allocated to the social security trust funds, and in turn the way those social security special debt issues are handled, it might very well be that because the cash flow couldn't handle it, there would be trouble in making those payments. That doesn't mean you wouldn't.

When you have a choice of a whole lot of areas, you might not be able to make payments in some, and he wasn't saying that this would be the one cut back. But he was saying there would be problems, not only with respect to the administrative budget, but, presumably, there could be with respect to the transactions on a cash flow basis for the funds in the Treasury as a whole.

Representative BROCK. Wasn't he, in effect, playing some rather practical politics when he mentioned social security in this respect?

Mr. SCHULTZE. I am not a very good judge of what is practical politics and what isn't. I have never been elected to any office.

Representative BROCK. But you would admit that the social security trust fund is separate and distinct.

Mr. SCHULTZE. Oh, yes, sir. All I am saying is that in the very short run, a matter of weeks, which is what is involved, that you get a total cash flow in. Don't get me wrong, I am not saying—and I don't think the Secretary was saying—that any of the items he mentioned would necessarily be the ones that would have to be cut. But he was listing the areas where there could be problems.

Representative BROCK. The reason you might have a problem with social security is the fact that the social security trust fund has brought

some Government obligations which might be affected by the debt ceiling; is that correct then?

Mr. SCHULTZE. I missed that. As I understand it, and I will admit I am not an expert in this part of it, there might be some problem with respect to marketing the debt necessary to cash in a special debt issue held by the social security trust fund, in the sense that the debt limit might give you some problems here with that financing.

Representative BROCK. The only conclusion I can draw from the statement is that either he was being most unfair in mentioning social security, or the actions of this administration have placed the social security trust fund in some jeopardy.

Mr. SCHULTZE. No, I wouldn't draw either of those conclusions.

Representative BROCK. I don't happen to think that that is true, but I do think that it was an unfair statement. I don't think it should have been mentioned. I think it was real poor judgment on the part of the Secretary.

Mr. SCHULTZE. As I say, the only thing I can draw from it is that in a short period of time—not long term, but a short period of time—there could possibly be some problems with respect to financing if he didn't have debt flexibility. I can't obviously say at this stage, and neither could the Secretary, exactly what payments and where, would be affected.

Representative BROCK. One final question. Just from a budgetary and accounting sense, should the participation sales of this Government, participation certificates, be included in the national debt?

Mr. SCHULTZE. You are asking me, should they?

Representative BROCK. Yes.

Mr. SCHULTZE. No, sir; I don't believe they should.

Representative BROCK. On what grounds?

Mr. SCHULTZE. On a number of grounds. First, they are not debt obligations of the agencies concerned, but guarantees of contingent liabilities. There are billions of dollars of guarantees of contingent liabilities that I don't think should be put in the debt limit.

There was a long legal discussion about this extending over 2 days before the Ways and Means Committee. To avoid repeating it, I will oversimplify my answer. Essentially, right now, the instruments subject to the debt limit are quite specifically defined. They exclude, obviously, participation certificates. Including participation certificates in the debt would mean including in that debt, guarantees of contingent liabilities. Once you take that route, you open up a whole host of problems.

Representative BROCK. I will conclude by saying that when you borrow money, if this is borrowing money, you are adding to the obligations of this Government, and I think I would have to disagree with you.

Mr. SCHULTZE. I realize that, Mr. Brock, and I would just reiterate my point, that this is the sale of a beneficial interest in a pool of loans. It is not the sale of a debt obligation. As a matter of fact, if you look at the history of this, the Federal Government for many years has used such techniques in its financing operations for CCC and a number of other agencies.

This is not unique. The amount is much larger than has ever been involved before, but not unique. I just don't think they are debt

obligations and I don't think they have any place in the debt limit. Nor do I think a lot of other things that the Federal Government does in the financing area, in its guaranteeing in particular, have any place in the debt limit.

Chairman PROXMIRE. Let me say, Mr. Brock, we are going to have the Secretary of HEW, Under Secretary Cohen as well as Secretary Gardner here and I think that Secretary Cohen will want to talk on the social security fund to document this position. This is a very interesting question and we will want to explore it a little. I think I can wrap my part up on this in a hurry.

I would like to say that I am delighted to have the ranking minority member join me in suggesting that, as I understand it, we get revisions as we haven't in the past. And also, as far as the Vietnam war is concerned, because it is uncertain, because the impact has a very dramatic effect on our economy, and a big one, with the 2.2 multiplier, that we would like to get 3-month revision figures. However uncertain the figure may be, it is bound to be better than the one that is 3 months old, and then we will be in a far better position to have an economic policy that will be based on facts.

Mr. SCHULTZE. All I can say is that, naturally, I have to take under advisement the problems this kind of thing will create.

Chairman PROXMIRE. I understand. Now you indicated when I was talking with you a few minutes ago, that new programs accounted for the increases other than the Defense Department and Post Office Department.

Mr. SCHULTZE. Not all.

Chairman PROXMIRE. This has always been true. We had new programs in the 1955-60 period. We had the space program, at least its beginning. We had medical research, the National Defense Education Act and all kinds of things. I think that former HEW Secretary Ribicoff, now Senator Ribicoff, was right in stressing that we don't kill the old programs. Somehow, when we have a steady climbing percentage of the population as Federal employees, it seems to me that it is something that we ought to be deeply concerned about, and that I agree we should have these new programs and I am enthusiastic for them.

We ought to find some way, however, of killing the old programs, or cutting them down.

Mr. SCHULTZE. First, let me take exception to one point, the steadily climbing percentage of—

Chairman PROXMIRE. You have got that percentage climbing in 1966, 1967, and 1968.

Mr. SCHULTZE. What we do have is the percentage actually dropping through 1965, and then going up, and the increase is largely due to Vietnam. It is an increase in the percentage, but the increase essentially is that associated with Vietnam. The percentage actually had been dropping until 1965.

Chairman PROXMIRE. Of course, Vietnam is one reason for it, but Vietnam is so much smaller in relation to our economy compared with the Korean war.

Mr. SCHULTZE. I realize that.

Chairman PROXMIRE. You agree that some of these increases, a number of them are outside the Department of Defense.

Mr. SCHULTZE. I agree. My only point was that if you take into account the increases outside of Vietnam, as a percentage of the total population, it is climbing only a tenth or two. I am not sure of the exact number.

Chairman PROXMIRE. Let me ask you a series of specific questions which you may not be able to answer, for the record. If not, I would appreciate getting this as soon as I can.

How much would be saved if we adapted the resolution introduced by Senator Mansfield and consponsored by 42 Senators to withdraw four of our six divisions from Europe?

Mr. SCHULTZE. I certainly can't give you the answer to that now. I would be glad to look into it and see what I can do.

Chairman PROXMIRE. Do you have any notion whether it is a billion dollars?

Mr. SCHULTZE. No, sir, I couldn't. The only thing I could point out in general is that in getting such an answer, you have to distinguish carefully between balance of payments costs and budgetary costs. In view of the required mobility of our military forces, for all I know the budgetary costs might be higher. There is a balance of payments saving involved, obviously.

Chairman PROXMIRE. Yes, indeed.

Mr. SCHULTZE. But the budgetary saving is obviously quite different.

Chairman PROXMIRE. Balance of payments saving has been estimated, as I understand it, at around three-quarters of a billion dollars, but I should think the budgetary saving would be bigger rather than smaller.

Mr. SCHULTZE. I do not like to get into the business of saying much about military strategy. This is not my field. But clearly you have got to make a distinction whether you are reducing your forces or—

Chairman PROXMIRE. I am not talking about strategy. This is another question I agree, but I want to know the dollars and cents.

Mr. SCHULTZE. In trying to even think about this, do you mean to reduce our forces by an equivalent amount or simply to shift their location from Europe to here?

Chairman PROXMIRE. Well, it would be my understanding that we would be able to reduce our forces by that amount. This wouldn't necessarily mean that we would send the four divisions to Vietnam. If we did, we would be sending them and not sending others that we would have had to draft and train and send otherwise. So there would be a net saving.

Mr. SCHULTZE. Again, I think in trying to get any answer to this question you have got to distinguish carefully between two questions. One is the decision to reduce the armed strength of the United States by this amount, and the other is to change their location from Europe to a strategically mobile force in the United States and these are two quite different questions from the budgetary standpoint.

Chairman PROXMIRE. I understand that. Of course, we have increased the size of our Armed Forces very substantially.

Mr. SCHULTZE. Yes, sir.

Chairman PROXMIRE. I understand we now have the largest Armed Forces in the world, larger than Russia and larger than China, for the first time in a long time, if ever. This doesn't include paramilitary forces.

Now what would \$1 billion cut from the \$5.3 billion space program involve, if you didn't cut the Apollo program? Would this be possible, or the supporting elements? You have the Apollo program at about \$3.8 billion, something like that.

Mr. SCHULTZE. Yes.

Chairman PROXMIRE. Then you have \$1.5 billion for other programs.

Mr. SCHULTZE. That is right.

Chairman PROXMIRE. Suppose you cut everything else, just left the moon shot program with another half billion dollars to provide for whatever you have to support it, and eliminated the unmanned probing of Mars for the time being. Could you do that?

Mr. SCHULTZE. There are two parts to the answer, without being able to put numbers on them. A large part of what is in the non-Apollo program is the development and technology for maintaining manned space flight. By that I mean the development of the things which go into maintaining manned space flight after Apollo. Hence, the implication of your question, I think, is that if you reduced these other programs by \$1 billion, you might as well then take out of that Apollo program the \$400 million we have in there for post-Apollo programs, because you wouldn't be able to support them.

So the obvious point is that what this really says is you are shutting your program down after Apollo, because that one and a half—

Chairman PROXMIRE. You can begin again.

Mr. SCHULTZE. I realize that. I am not arguing the merits of it but I am giving the implications of it.

Chairman PROXMIRE. Shutting down after Apollo.

Mr. SCHULTZE. That would be the implication of it. You wouldn't have the technology or the equipment or anything else to move ahead after Apollo—or to keep our manned space capabilities alive.

Chairman PROXMIRE. Now one last area. This is nondefense public works. As I understand it, my staff tells me that the budget provides for the Federal Highway Administration \$4.8 billion, the Corps of Engineers \$1.05 billion, Bureau of Reclamation \$217 million, GSA \$133 million, Bonneville Power \$119 million—all nondefense public works.

I understand you have made some cuts. You did make some cuts in arriving at these figures.

Mr. SCHULTZE. Yes, sir.

Chairman PROXMIRE. Your \$3 billion cut involved some of this. You cut the roads program, for example, which I think is very good under the circumstances.

What happens if you have a much more drastic cut? Say you cut \$3 billion or \$4 billion of this. You cut back the highway program very sharply, and reduce or virtually eliminate the Corps of Engineers civil functions. In other words, cut all the pork barrel out for the time being. Stop building Federal buildings and post office buildings for the next year, as long as we have Vietnam going on and the kind of economic situation we have. This is a substitute for the 6-percent surtax.

Mr. SCHULTZE. I can break my answer into two parts. First, you have got to think about new starts. In 1967, there are 58 new starts for the Corps of Engineers, 25 that we requested, and 33 that the Congress added. In the 1968 budget, there are nine, from 58 down to nine.

In the GSA area, we have proposed eight new buildings, compared to a normal running level for a Federal workload of something like 30 or 40. For the Bureau of Reclamation, we have recommended four new starts. Now you could cut those out, but that would have practically no effect on 1968 expenditures.

Secondly, we have in addition, stretched out and slowed down on-going works, starts begun a year ago, 2 years ago, 3 years ago, as much as we could do without running the cost up tremendously.

Chairman PROXMIRE. Without what?

Mr. SCHULTZE. Without running the total cost up tremendously. There is an optimum rate at which you build these. To be quite frank, we may have even slipped a little bit under the optimum rate by trying to stretch them out. You could, obviously, legally just stop those contracts and leave the dams or whatever it is half completed.

Chairman PROXMIRE. Some of these programs could well be stopped forever—the cross-Florida barge canal, for instance; some of the reclamation projects, which would bring more feed grain land in production while we are paying billions of dollars to take other lands out of production.

Mr. SCHULTZE. As I say, we have cut the new starts way down. And when you stop a continuing contract, I am told by my staff that what has very often happened in the past, in fact almost universally, is that even though legally the contractor is always given the contract subject to the availability of appropriations, there are almost always, whenever we do chop one of these off, special actions and he gets his money probably plus damages. So that we have, in terms of the controllable part of this, cut way back, but it doesn't have much of an impact in the first year on the budget, because you don't spend much in the first year on these programs.

So I am not suggesting we couldn't have cut another dime out. We could have. We could have stretched them out further, but we would have gotten well below the optimum rate of construction that you end up with higher costs, leaving us finally with the option of just stopping a lot of work in midstream, where in many cases at least, past experience would indicate, as I am told, that special actions are likely to be put into effect making good the contractor end of it.

Chairman PROXMIRE. We did this during World War II, didn't we? Didn't we just stop it cold? In the Korean war, didn't we pretty much stop?

Mr. SCHULTZE. In the Korean war, we slowed them down. In World War II we did stop them. I frankly don't believe this is of World War II magnitude. But I am told that you are quite right. In World War II we did stop either all or a large number of them right in midstream. I don't think we are faced with a World War II situation, however.

Chairman PROXMIRE. It all depends on how seriously you consider the impact of the tax increase.

Mr. SCHULTZE. I think that in considering a 6-percent surcharge compared to anything like World War II, there is no comparison.

Chairman PROXMIRE. I am not talking about World War II. I am talking about the 6-percent surcharge compared with cutting this spending. Largely, let's face it, this is pork barrel.

Mr. SCHULTZE. Let me let my hair down a little bit and tell you what would happen if we did that, exactly what happened last year when we sent up programs which we wanted cut, which are very difficult to cut.

Chairman PROXMIRE. What about the Congress? If you recommend cutting this, I think you would get a much different response this year than last year.

Mr. SCHULTZE. It may be. All I know is the experience we had is that we were accused of sending up in that year a phony budget because we had a lot of cuts in it which, it was alleged, we knew the Congress wouldn't accept. This is the accusation.

Chairman PROXMIRE. Just don't ask us to cut the school milk program.

Mr. SCHULTZE. I won't. You will notice we didn't this year.

Chairman PROXMIRE. Congressman Curtis?

Representative CURTIS. I have been enjoying this so much because this is exactly the kind of interrogation that I think the Congress through its committees should have been conducting for many, many years. We do need to get into the rescission area. We have now a \$125 billion carryover of expenditures.

Mr. SCHULTZE. That is about right.

Representative CURTIS. Along with the request for \$130 billion of new funds, and many of these programs of course by their very nature are cut back. Now take space. The Gemini program I am happy to relate, because a St. Louis concern is involved in the agreement, actually agreed to the termination of around \$250 million. I think the agreement came because it was felt that the essence of what could be achieved with Gemini was achieved.

I know of many programs that by their nature need revision, the same kind of revision we are talking about on the overall. Granted, the Executive may do some of this, and I think it does, and the Executive has said it has done \$3 billion worth of deferments. If they were able to do that, I suspect the Congress could do a similar job, if only we would undertake it.

Now here is where I must part company with my good friend from Wisconsin, because I am a Republican. If I had something to say about what our committees are doing, I hope this is what we would be doing. Unfortunately the Congress and the congressional committees are under the control of the Democratic Party, and they don't do this revision and deferment. Let me hasten to say that I am not unaware of the fact that Republican Congressmen have a lot of the same attributes as Democratic Congressmen. They are affected by projects in their districts and so on. It is a difficult task.

As I was talking with one of my colleagues, he said, "What program would you cut out?" I said, "If you don't put it in the context of what program you think has less priority than others you will never get anywhere." If you are just fighting for your budget cut against the world, you are up against it. When the budget was submitted I was one of the one or two voting against the veterans' pension bill. Yet I said this is a program that I thought probably deserved a great deal more priority than many of the things in the budget. And I said to my colleagues, "Yes, if you want this program then be willing to move out other programs that are in the budget to make way for it." These are the hard realities.

Now let me say further, the President does not have to sign these bills. I am a little bit tired of the rhetoric that indicates that Congress is solely responsible for the size of the budget, particularly when it comes to private bills, such as the kind a contractor might be able to get through. Not only is the President not forced to sign these bills, which he usually does, he doesn't have to create the atmosphere among the people which creates a demand for these kinds of bills, and then come along and say, when Congress responds as it frequently does to the demands of the Executive, that the blame is on Congress. But I do feel this area is one that we have all got to study, including the President and the Congress.

I might say one other thing on specifics. I am getting a bill ready, I think I am, at any rate, which I have had in mind for some time but for which I couldn't get the support. Now I think I have got considerable support to cut out about \$2 billion in the support programs in agriculture, which has a carryover into the foreign area because of Public Law 480. Maybe we can do something here. But I just love to get into this business because people ask me where can we cut, and believe me, I think in most instances we can cut and improve the programs, because we are flooding the carburetor.

Now let me pose a line of questioning that I don't expect to develop here. In fact, I think probably our Subcommittee on Economic Statistics will want to pursue it, but I want to mention it to you, Mr. Schultze, now that I have a chance.

In the national income accounts, of course, the difference between that budget and the administrative budget and the cash budget to a large degree is that we do not include what would be called "investments" in the NIA; am I not correct on that?

Mr. SCHULTZE. No, sir.

Representative CURTIS. All right.

Mr. SCHULTZE. The only item of investments which we exclude from the NIA is the net lending of the Federal Government.

Representative CURTIS. That is what I am talking about.

Mr. SCHULTZE. It is financial investment. You mean financial investment.

Representative CURTIS. Yes, financial. That is what I meant by the term "investment." I didn't mean capital. I would have said capital investment.

Mr. SCHULTZE. For financial investments the amount for 1968 in the administrative budget nets out to about a minus \$300 million; in cash budget terms it is \$1.6 billion.

Representative CURTIS. It hinges over the definition of what is to be considered an investment, and this leads to the line of development which I hope we will do in the Economic Statistics Subcommittee.

For instance, when we put in these 40-year development loan funds, and I think they are excluded, are they not, from the NIA? Aren't they excluded?

Mr. SCHULTZE. They may be, but let me check. Yes, they are excluded as lending.

Representative CURTIS. Well, these are the kind of things, and CCC.

Mr. SCHULTZE. No, CCC we put in. Most CCC commodity loans are in the NIA.

Representative CURTIS. You put them in.

Mr. SCHULTZE. Because such a large proportion of these loans end up as purchases of the commodity, the transaction is treated as purchases when the loan is issued rather than when it is defaulted.

Representative CURTIS. Now the other thing, and this is again just to develop the question, we will put in 2-percent paper and 3-percent paper and so forth. These are "hybrid" kinds of things I would say, because they aren't really marketable securities. Therefore, there is really a charge against the Treasury in the event that we seek to—well, in the long run—

Mr. SCHULTZE. That goes in.

Representative CURTIS. Do you put it in? I thought you didn't.

Mr. SCHULTZE. Let me make sure of that. The interest subsidy gets in because it is in the interest figure, but the loan or repayment is excluded.

Representative CURTIS. Well, this is the area that I need to become educated in myself, to relate what is in and what isn't. And it would revolve around, would it not, what we consider an investment? I guess the test we are applying is against the market on what is an investment?

Mr. SCHULTZE. No, sir. Well, what we are really doing is developing a consistent set of accounts for business, consumer, and Government, and adding them up in terms of expenditures and receipts to get total national income and receipts.

Now in doing that, we put in the spending of the Federal Government, but not its lending. Any expenditures that come from lending go into the sector which does the actual purchasing. So it is not a matter of whether it is an investment or not, so much as whether it is a financial transaction.

Representative CURTIS. Let me use the word "lending."

Mr. SCHULTZE. Right.

Representative CURTIS. Then we come to a definition of what is a real loan.

Mr. SCHULTZE. Yes.

Representative CURTIS. I regard these development loan fund loans as stretching the term "loan," but this is the area I would like to discuss, because then probably the thing revolves around the term what is "lending."

Mr. SCHULTZE. I agree.

Representative CURTIS. Is it really "lending" or "giving"?

Mr. SCHULTZE. You are quite correct, Mr. Curtis. I think what we really need are two things. First of all, we need the recognition that really no one budget concept serves for all purposes.

Representative CURTIS. I am highly in accord with the NIA budget, and think it is great. My only criticism at the beginning was that the crucial problems that face the Congress this year and faced it last year on fiscal policies had to do with the deficits in the administrative budget. And I just don't want the public's attention or the Congress distracted from the deficits in the administrative budget. I was afraid the rhetoric of the administration, in their new-found enthusiasm for the national income account budget, was doing that. I share the enthusiasm for the NIA budget.

Mr. SCHULTZE. Aside from taking exception to the word "rhetoric" I guess I will stay quiet.

Representative CURTIS. That is a perfectly——

Mr. SCHULTZE. It is a good Greek word.

Representative CURTIS. Now, it is a neutral word, isn't it? You can have good rhetoric and bad rhetoric.

Mr. SCHULTZE. With that emendation, fine.

Chairman PROXMIRE. And with that emendation we bring to a close this hearing. I want to commend you, Director Schultze, for a wonderful performance. You have been before the Ways and Means Committee for many hours, day after day. You have been before us for 3 hours this morning. We have disagreed with you on many things. You have kept your temper extremely well, and you have been very alert throughout this, and have been very, very helpful. Thank you very much.

Mr. SCHULTZE. Thank you, sir.

Chairman PROXMIRE. We will reconvene on Monday morning at 10 o'clock to hear the Secretary of the Treasury.

(Whereupon, at 1:15 p.m., the committee adjourned until Monday, February 6, 1967, at 10 a.m.)

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

MONDAY, FEBRUARY 6, 1967

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

The joint committee met at 10:05 a.m., pursuant to recess, in room S-228, the Capitol, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Talmadge, Symington, Jordan of Idaho, Miller, and Percy; and Representatives Reuss, Griffiths, Moorhead, Curtis, Widnall, and Brock.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Donald A. Webster, minority economist.

Chairman PROXMIRE. The committee will come to order.

Our witness this morning is the very able and distinguished Secretary of the Treasury, who is certainly right in the heart of economic policy in the administration.

Mr. Fowler, you have submitted a very excellent statement. We would be delighted for you to go right ahead.

STATEMENT OF HON. HENRY H. FOWLER, SECRETARY OF THE TREASURY, ACCOMPANIED BY JOSEPH W. BARR, UNDER SECRETARY; FREDERICK L. DEMING, UNDER SECRETARY FOR MONETARY AFFAIRS; STANLEY S. SURREY, ASSISTANT SECRETARY; AND ROBERT A. WALLACE, ASSISTANT SECRETARY

Secretary FOWLER. Thank you Mr. Chairman and members of the Joint Economic Committee. I will go through my initial statement; then I would like to make a few comments and deal with an additional supplementary statement which has been prepared for inclusion in the record.

We meet after a year of bumpy but successful economic transition. During this time, our fully employed economy has adjusted to the requirements of a rapidly expanding defense effort. From all present indications, the most difficult part of that adjustment now lies behind us.

In the past 18 months, the economy had absorbed a \$15 billion increase in national defense expenditures without resort to wartime controls, and this is no mean feat, gentlemen. I lived here through the war production board days, and World War II, and the Korean war days, then as Director of Defense Mobilization, and as Administrator of the Defense Production Administration, and it has been something of a marvel to me the way the private economy has responded in flexi-

bility to deal with the problems we have had for the past year and a half, without any necessity on the part of the Government to move into so-called direct controls.

We have had smaller price rises than in earlier periods. Last year's successful transition was aided by a significant shift in economic policy from stimulus in the last quarter of 1965 to measured restraint through most of 1966. The shift in policy was instrumental in relieving the economy of growing price pressures induced by the heavy demands of the defense buildup. Nevertheless, some strains and imbalances emerged during the year, and these will require our continuing attention.

Economic achievements were impressive last year:

- Industrial production rose 9 percent;
- Net income per farm rose more than 10 percent;
- Two million more workers found employment;
- Unemployment averaged below 4 percent;
- Corporate profits climbed 8 percent.

On the international side our gold loss was cut more than 50 percent—a loss due entirely to purchases by France. Except for these French purchases, we would have gained nearly \$200 million of gold from foreign countries.

On an "official settlements" basis, our balance of payments recorded a small surplus, for the first time since we began to keep such records in 1960. Mr. Chairman, you are familiar with this measurement, since your report as chairman of this committee's Subcommittee on Statistics developed the merit and utility of the official settlements concept. The deficit on a liquidity basis was up only slightly despite the increased drains directly due to Vietnam.

But there were problems, too. On the domestic side, prices rose more than usual, money markets became extremely tight, interest rates rose to excessive heights, and the accustomed flow of mortgage money fell off sharply. A severe adjustment was imposed on the housing industry, only now in process of recovery. On the international side, our trade surplus slipped as a rapid expansion in some sectors of the economy, particularly the defense sector and the plant and equipment sector, pressed very hard on our capacity to produce.

In the last quarter of 1966, it became clear that many of the heavy pressures on the economy had abated. Although unemployment remained low, sales and production increases slowed, larger inventory increases occurred, and surveys indicated a slower growth of investment. This made possible a welcome easing of monetary conditions and our position of fiscal restraint moved to a measured stimulus.

With different conditions facing us this year, we aim at a different mix of monetary and fiscal policies designed to keep the economy moving ahead steadily and safely. As noted, a monetary easing began in late 1966. The President's fiscal program will complement monetary easing by maintaining stimulus in the first half of calendar 1967. Later this year, when less stimulus is expected to be appropriate, the fiscal program is expected to encourage a continued monetary easing by moving toward modest fiscal restraint. This can be done by avoiding tax increases now, but financing through tax revenues the additional expenditures of our defense effort in fiscal 1968. Working in tandem, monetary and fiscal policy can continue to foster the healthy

financial environment within which our economy has flourished during the past half dozen years.

ECONOMIC DEVELOPMENTS IN 1966

With the President's Economic Report before you, there is no need to review the broad sweep of economic developments during 1966 in any detail. However, I would like to comment on major accomplishments—and unsolved problems.

In the sixth year of the current expansion, our gross national product increased a shade more than $8\frac{1}{2}$ percent in money terms and by about $5\frac{1}{2}$ percent after allowance for rising prices. The enormous productive power of the economy was bolstered by a record increase in industrial capacity, reflecting, in large part, the successful use in past years of investment incentives.

This added capacity helped meet the strong rise in defense and civilian production in 1966. Despite the emergence of the selective pressures that required by late summer the temporary suspension of the investment tax credit and accelerated depreciation, higher production was achieved with only about a 2-percent rise in the industrial component of the Wholesale Price Index. Let me note, in contrast, that industrial prices rose more than 10 percent between 1950 and 1951 under the pressure of the Korean buildup, and by more than last year's 2 percent in both 1956 and 1957, when no comparable defense buildup took place.

We can take satisfaction from the fact that unemployment averaged only 3.9 percent last year. There can, however, be no complacency about the unemployment problem while much higher rates persist for teenagers, minority groups, and the disadvantaged. Significant reduction of these higher rates is unquestionably a matter of high national priority. But further reductions in unemployment must increasingly depend upon our intensified efforts to improve training and educational facilities, upgrade skills, and remove remaining discriminatory barriers to job opportunities.

The economy cannot continue to grow as rapidly now as it did earlier in the expansion when there were relatively large amounts of unutilized industrial capacity and unemployed labor upon which to draw. Were we to permit or encourage total spending in the economy to rise as rapidly as it did last year, the result could only be sharply rising prices, undue strain on the balance of payments, and likely an eventual recession with a retreat to much higher rates of unemployment.

With the combined impact of sharply higher defense requirements, and the business plant and equipment boom, the economy did begin to pick up too much speed in late 1965 and early 1966. The need this posed for a shift away from fiscal stimulus was fully recognized last year when I appeared before your committee, and in the economic program we placed before the Congress at the outset of the year. A program of fiscal restraint, additional to the January 1966 increase of \$6 billion in payroll taxes, was contained in President Johnson's budgetary recommendations of a year ago. Prompt congressional action on the Tax Adjustment Act of 1966 enabled fiscal policy to move to a more restraining position early in the year.

Monetary restraint—signaled by the December 1965 discount rate increase by the Federal Reserve—was applied with increasing effect as the year proceeded. By late summer, strong credit demands and monetary restraint had led to an intensification and concentration of pressures which called at one and the same time for further fiscal action to restrain certain areas of excessive demand—notably in the business borrowing sector—and also for action to relieve the excessive burden of monetary restraint that was threatening the very functioning of our financial markets. President Johnson's anti-inflationary program of September 8 and responsive action by the Congress led to a dramatic improvement in financial markets and a lessening of inflationary strains.

This fiscal restraint—its nature, timing, and amount—was measured with care against the most realistic and updated picture of the Nation's economic condition that we could obtain. Our problem during most of last year was not primarily one of overall excess demand or insufficient total restraint. This is illustrated by the much slower advance in gross national product beginning by the second quarter of 1966, and by the flat trend in overall unemployment and industrial utilization rates during the same period. Rather the problems were those of selective imbalance and the financial strains that can develop with a sharply increasing degree of monetary restraint.

Some intensification of price pressures—aggravated by a rise in food prices due primarily to special and largely temporary agriculture difficulties—could not be avoided under the circumstances. But by yearend, the price situation was much improved. Wholesale prices had fallen back from their August peak, and the rise in consumer prices was slowing. The year-to-year increase in the Consumer Price Index was a little less than 3 percent, certainly more than we wished to see—but far less than the 8.0 percent between 1950 and 1951 during early stages of the Korean defense buildup, and even less than 3½ percent between the peacetime years 1956 and 1957.

FLEXIBILITY IN FISCAL POLICIES

In summarizing last year's fiscal action and that planned for the year to come, it is convenient to focus on the Federal sector in the national income accounts. This is the best single measure of Federal fiscal stimulus or restraint. Over time, it tracks the changing course of the Federal Government's fiscal impact, which both influences, and is influenced by, the pace of private spending and taxable income. As you know, the administrative and cash budget positions, while important from other standpoints, do not provide as meaningful information on the Federal fiscal impact in terms of current spending on the output of the economy.

A year ago when I appeared before your committee, I emphasized that there was a clear need for a shift away from the stimulative fiscal policies of earlier years. That shift took place as planned and is mirrored in the swing from stimulus in the second half of 1965 to a restraining posture through the first half of 1966.

Last fall, with further selective fiscal action being taken in reduction of nondefense spending and suspension of the investment tax credit, the need for overall restraint had clearly lessened. Mone-

tary policy was beginning to shift in the direction of ease. And, by that time, the national income budget had arrived at a mildly stimulating position that was also appropriate to the general economic situation.

Thus, the general contours of fiscal stimulus and restraint over the past year coincided closely with the requirements of the economy. Restraint was needed early in the year, and it was there. As the need decreased, so did the restraint. I will not argue that fiscal perfection was attained in 1966. But I do contend that the overall pattern of fiscal action was prudent and responsible in view of the manifold uncertainties that were present throughout much of the year.

The President's fiscal program for this calendar year has been carefully framed to provide maximum flexibility. It will continue to be important to apply restraint and stimulus cautiously and at the proper time. During the first half of this calendar year, we expect to see some adjustments taking place within the context of a generally rising and prosperous private economy. Defense expenditures will still be moving up, and a moderate advance should be taking place in other components of demand. But some moderation in the rate of growth in inventories, in line with recent sales trends, may well occur in certain industries. During this same period, the housing industry should be gaining momentum but will not have reached full speed.

All told, during this first half of the year, we are likely to need to complement a continuation of monetary ease with a moderate degree of fiscal support while some sectors of the economy are shifting gears. And that is what fiscal policy is designed to provide.

By the second half of calendar 1967, the economy is expected to pick up added steam and be in much less need of a fiscal push. An easing of monetary policy should lead to a significant revival in housing. Assuming favorable congressional action, personal incomes will be augmented at midyear by a rising stream of social security benefits, with higher payroll taxes to follow in 1968. And on current estimates, Federal expenditures for Vietnam and other defense outlays, as measured in the national income accounts, will rise by another \$5.8 billion during the fiscal year that begins this July.

The President has recommended a 6 percent surcharge on both corporate and individual income taxes to be effective at midyear and to last for 2 years or for so long as the unusual expenditures associated with our efforts in Vietnam continue. An exemption from this surcharge is provided for low-income taxpayers. The revenue effect of the surcharge would increase calendar year 1967 tax liabilities by \$2.8 billion—\$1.9 individual and \$0.9 corporate. In calendar year 1968, tax liabilities would be increased by \$5.8 billion—\$3.9 individual and \$1.9 corporate. In addition, legislation will be recommended to provide a further acceleration of certain corporate tax payments commencing in calendar 1968.

Assuming favorable action on the President's program, the national income budget would move into a smaller deficit position during the last half of this calendar year than otherwise would be the case. And, on current projections, the budget would exert an essentially neutral influence in early 1968, reaching balance, and possibly a surplus, by mid-1968.

As we learned from 1966 experience, projections cannot always hit the mark. The prudent course is to maintain a maximum degree of flexibility in order to meet unforeseen developments. But, our best judgment now is that the moderate tax increase the President has proposed will be consistent with the needs of the economy in order to prevent any resurgence of inflationary pressures. Furthermore, that increase would meet the fiscal 1968 increase in defense costs, keep our cash and administrative deficits within reasonable bounds, and provide extra leeway for a continued easing of money and credit, giving some insurance against a return to the monetary stringency of 1966.

FINANCIAL POLICIES AND DEBT MANAGEMENT

This is another factor which, I believe, has not been covered in previous statements.

Financial markets through the first two-thirds of last year were marked by extraordinarily heavy credit demands pushing against increasing monetary restraint. Interest rates rushed higher and at times the orderly functioning of the financial markets was threatened—especially in the late summer period. The avoidance of severe disruption testifies to the great strength and resiliency of our financial system—but the test was not one that bears repetition.

The heavy credit demands of 1966 came mainly from the private sector. Business borrowing, especially, made huge claims on the capital markets. Net debt and equity issues of corporations came to an estimated \$12½ billion, while business borrowing from banks rose \$10 billion. State and local government debt rose \$7 billion, and mortgage debt by \$25 billion (but this was \$5½ billion less than in 1965.) Federal credit demands on the private sector (netting out purchases by the Government investment accounts and the Federal Reserve) came to just \$3 billion, as a \$2 billion *decline* in Treasury issues in the hands of the public partly offset the \$5 billion increase in Federal agency debt and participation certificates.

By late summer, interest rates had reached their highest levels in four decades. With the announcement of the President's September 8 anti-inflationary program and the benefit of subsequent steps taken by the Congress and the financial regulatory agencies, a concerted easing of interest rates was set in motion. Since early October, there has also been a rise in average stock market prices.

From early December 1965—just before the discount rate rise, to the August-September peaks of last year, 3-month Treasury bills rose by nearly 1½ percentage points, and long-term issues also rose substantially. New issues of AA-rated corporate bonds rose about 1½ percentage points reaching almost 6¾ percent. The commercial bank prime lending rate also rose 1½ percent. Yields on new municipal bonds advanced about three-fourths percent. Rates on conventional new home mortgages as reported by FHA also rose about three-fourths percent, and the availability of funds to the mortgage market was drastically reduced.

Not quite 6 months later, rates have fallen back impressively. Three-month Treasury bills are lower by about 1 percent and long-term Treasury rates have returned to the level which prevailed before the discount rate rise. I am pleased to report that on our current

successful \$7.5 billion refunding the rates are the lowest offered in a Treasury refunding since November 1965.

Federal agency securities and participation certificates are also finding the markets much more receptive than a few months ago. Corporate and municipal yields have moved down substantially from earlier peaks, and the average cost of new State and local borrowing is below the levels of December 1965. Bank lending rates have begun to recede. Rate declines have been somewhat slower to come in the mortgage area, but there are signs that they are on their way, and there is welcome evidence of improvement in the flows of funds to the mortgage market.

Special measures were needed—and were taken—last year to cope with an abrupt hiatus in the normal flow of funds to thrift institutions and the mortgage market. Aggressive competition among financial institutions for time deposits contributed to an overall escalation of interest rates, and shunted funds away from the mortgage market. The Coordinating Committee on Bank Regulation—which President Johnson directed me to set up in the spring of 1965—provided a useful forum within which the regulatory authorities were able to hammer out an effective program to deescalate savings rates from their highest levels and mitigate adverse effects on the mortgage market.

A key element in that program was the legislation providing the regulatory agencies with temporary authority—which was immediately exercised—to set minimum rates on time and savings accounts. In addition, important offsets to the reduced flow of money into mortgage markets were achieved through expanded Federal home loan bank and Federal National Mortgage Association operations—in the latter case with the help of congressional action to expand FNMA's borrowing capacity.

As 1966 progressed, increasingly close coordination was achieved in the financial area. It should serve us well in the future. Last year's experience does emphasize the need to consider carefully how in the future the mortgage market might be spared the burden of excessive restriction in the wake of monetary tightening.

THE TRANSITION BACK TO COST-PRICE STABILITY

One consequence of the pace of expansion in 1966 was the extra pressure on costs and prices. The result was an unwelcome lapse from the remarkable record of stability that has prevailed throughout most of the current expansion. Against the standards of previous defense buildups or the investment boom of the mid-1950's, last year's performance was remarkably good. But, the upward drift in our price indexes since mid-1965 is cause for concern. We have acted, and will continue to act, to avoid price increases that would endanger an enviable record of stable economic growth and progress toward balance of international payments equilibrium in the 1960's.

The Consumer Price Index increase of 2.9 percent between the full year 1965 and 1966 was about twice the size of the average increases of recent years. Between December 1965 and December 1966, the index rose somewhat more—by 3.3 percent—but the rate of advance had slowed appreciably by late 1966. Wholesale prices rose by 3.2 percent

between the full year 1965 and 1966, but by only 1.7 percent between December 1965 and 1966, reflecting the downward trend that developed after midyear.

While there were signs that price pressures were abating by late 1966, labor costs per unit of output in manufacturing—and in other major sectors—were drifting upward. This, too, marked a departure from virtual stability earlier in the expansion. As yet, the increases are moderate by comparison with earlier expansions. However, it is essential to achieve an early restoration of cost stability in order to avoid a further push on prices.

We expect the more moderate advance of the economy this year to relieve selective pressures and provide the environment within which a transition to better cost-price performance can proceed. And, the Government will continue its other efforts to relieve cost-price pressures—through its training and employment service program, and in the areas of procurement, stockpile disposal, and farm programs.

But efforts of the Government alone will not be enough. As President Johnson has stated in his economic message, improvement will require the responsible conduct of those in business and labor who have the power to make price and wage decisions.

Before turning to a discussion of the balance of payments, I would like to take note of the recent study by your Subcommittee on Economic Progress entitled “U.S. Economic Growth to 1975: Potentials and Problems.” Your committee is extending its record of involvement with important economic issues. As I indicated in my remarks at a Loeb Award luncheon last May, our rate of overall economic growth must increasingly rest almost entirely upon the rate of growth in quantity and quality of new capacity and new manpower. Therefore, your study—and others—of our growth potential is welcome indeed.

BALANCE OF PAYMENTS

While full information on last year's balance-of-payments results will not be available for several weeks, I can outline the general picture. Our “liquidity” deficit last year was somewhat over \$1.4 billion—roughly \$100 million more than in 1965. This minor increase must be viewed against the far greater rise in *direct* foreign exchange costs associated with Vietnam—in the general order of magnitude of \$950 million—not to mention the increase in *indirect* balance-of-payments cost in the form of additional imports resulting from higher defense spending at home.

Our “official settlements” balance, in contrast, actually showed a slight surplus of about \$175 million on the basis of preliminary figures—the first surplus since 1960 when we first kept figures on this basis. This surplus was attributable to heavy borrowings from abroad by U.S. banks and the consequent accumulation of liquid dollar claims by foreign commercial banks, including foreign branches of U.S. banks. It reflected the tight credit situation in the United States and the unsettled condition of sterling during part of the year.

Ordinarily many of these dollars would have moved into foreign official reserves and some of them would possibly have been converted into U.S. gold. As it was, our gold loss for the year was \$571 million, in contrast to \$1.4 billion in 1965, excluding the \$259 million gold payment in connection with the increase in IMF quotas.

Last year our overall reserve loss—gold, convertible currencies, and IMF gold tranche position—was \$568 million. The comparable figure in 1965 was \$1.2 billion. It is worth noting that even with an official settlements *surplus* our net reserve position showed a *decline*—due mainly to continued heavy conversion of dollars into gold by France during the first 8 months of the year.

On trade account, our surplus declined by somewhat over \$1 billion—from \$4.8 billion in 1965 to about \$3.7 billion last year. Our exports rose by more than 11 percent, but our imports rose by almost 19 percent because of—

A rapid rise in gross national product,

Near-capacity operation in some sectors of the economy, and selected shortages of skilled labor,

A high level of military orders for specialized items, and

Certain special situations such as that arising from the elimination of duties on automobiles produced in Canada under the recent United States-Canadian auto agreement.

With the lessening of selective pressures in the economy and a more moderate pace of advance, growth in imports can be expected to taper off. In fact they showed almost no change between the third and fourth quarters of last year.

On the export side, the U.S. competitive position was maintained. U.S. wholesale prices rose faster than in some advanced countries but slower than in others. Unit value of U.S. exports in the second quarter of last year showed a decline from the comparable quarter in 1965, whereas the movement was upward for most advanced countries.

While we appear to be holding our ground, competitively, we are not making the gains we did up to mid-1965. To insure renewed progress toward a balanced payments position, an early return to cost-price stability is essential.

In the capital sector, incomplete data point to some decline in total private outflow for the year as a whole. We know, for example, that banks reduced their claims on foreigners by about \$300 million.

The spectacular change, however, in the capital accounts last year was on the receipts side. Long-term capital receipts included:

Investments of over \$400 million by international lending institutions in long-term CD's and in U.S. agency issues, and

Investments of over \$700 million by foreign official agencies in long-term CD's.

Some of the latter investment was made out of large dollar accruals to certain countries from our military spending abroad. Some represented shifts out of foreign official liquid dollar holdings in response to the high rates of return on time certificates of deposit and Federal agency securities.

The official reserve transactions balance, but not the liquidity balance, benefited from an unusually large accumulation (\$2.8 billion) of *liquid* dollar holdings by private foreigners, mainly banks—and including foreign branches of U.S. banks.

In very broad terms, last year's worsening in the trade and military expenditure accounts was offset by unusually large *receipts* of foreign capital. In 1965 when there was also a worsening in the trade and military expenditure accounts, the major offset was a reduction in the outflow of U.S. private capital.

We must strive for a better balance in the years ahead. The United States is normally a large net capital exporter—and it should be. It generates substantial savings, its capital markets are highly developed, and its business management invests heavily abroad.

But for the time being, the United States must be prepared to hold its net capital outflows to reasonable proportions. Our balance-of-payments program is tailored to this end. And, if net capital export is to be large in the future, we must achieve a strongly growing current account surplus.

In the current account area, we have—

Made the expansion of U.S. commercial exports a major activity of missions abroad.

Established a special rediscount facility at the Export-Import Bank.

To attract more foreign tourists to our shores, we are establishing a special task force of Government and business executives to make specific recommendations in this vital area. The lack of funds available to the U.S. Travel Service has been an inhibiting factor here.

I would like to bespeak the special interest of this committee in seeing that the U.S. Travel Service is adequately funded, in order that it can carry on an effort commensurate with the problem and with the challenge, and comparable with the efforts of other countries in this particular field. Our \$3 million is a fraction of that provided for encouraging tourist travel from abroad by a number of countries in Western Europe, such as Spain, the United Kingdom, and France.

In the Government area, we have—

taken further steps to ensure that AID-financed exports are “additional” to our normal commercial exports, and

worked closely with the international monetary institutions to insure that their financing in the U.S. market was consistent with our balance-of-payments policy.

In the capital area, recent actions include—

The request for authority from the Congress to adjust the rates of the interest equalization tax between zero and 2 percent, as relative interest rate changes and our balance of payments warrant.

The meeting last month with the Finance Ministers of the United Kingdom, West Germany, France, and Italy in Chequers to determine how interest rate policies might be better coordinated, and particularly to deescalate interest rates on an international scale.

Tightening of the guidelines under the Federal Reserve and Commerce Department voluntary cooperation programs.

Establishing a program for informing foreign investors of the benefits of the recently enacted Foreign Investors Act. That will be of course a program carried on and administered by the private financial sector, and not by the Government which will cooperate, however, in stimulating this informational effort. This will involve intensive effort in the months ahead as we establish new channels through which foreigners may take advantage of attractive investment opportunities here.

Other advanced countries have an important role in achieving a viable international payments pattern. The industrialized countries of continental Western Europe, as a group, tend to run continual and substantial current account surpluses with the rest of the world. In the period since 1957, they have imported more capital than they have exported. They have preferred to accumulate gold and other official reserve assets in payment for their current account surpluses rather than offset them with medium- and long-term capital outflows.

The United States has played the opposite role. It has supplied large amounts of capital to the rest of the world, financing not only its own current account surplus but also, indirectly, part of the current account surplus of the continental Western European countries.

A report on improving the adjustment process was made by Working Party 3 of the OECD in August 1966. It emphasized the responsibility of both surplus and deficit countries for proper international adjustment, and the special need for international consultation in the field of monetary policy to avoid undesirable levels of interest rates. Recently you have seen the efforts that have been made to develop and carry further this aspect of international cooperation.

As you will recall, the Treasury was asked some time ago by the Joint Economic Committee to comment on a proposal that wider exchange rate margins around parity might be useful in facilitating short-term adjustment. I hope shortly to submit our reply to this request, but I can say in general that this proposal does not seem to be a very promising one.

Mr. Chairman, the remaining pages of my statement deal with the better international financial arrangements which we have been most vigorously and persistently trying to effectuate over the last 2 years. We are optimistic. We are hopeful that a specific contingency plan for deliberate creation of new reserves will be formulated and ready for presentation at the meeting of the Governors of the International Monetary Fund this September. Whether optimism or pessimism will be borne out only time will tell, of course.

BETTER INTERNATIONAL FINANCIAL ARRANGEMENTS

In the economic message, the President called attention to the significant progress made during the past year toward strengthening the international monetary system. In that year the Fund quotas were increased by 25 percent, the general arrangements to borrow were renewed for another 4 years, and the network of bilateral swap arrangements between monetary authorities of the United States and other leading countries was enlarged from a total of \$2.8 to \$4.5 billion. These actions taken together have effectively broadened and strengthened the credit facilities that may be called upon to meet payments imbalances.

The President has placed major emphasis on the importance of reaching full agreement on a constructive contingency plan in the coming year. Two major forward steps were taken in 1966.

The first was to reach a wide consensus on basic principles for creating reserves, among the Group of Ten, as set forth in the Report of the Deputies in July 1966, and the Ministerial Communique of July 26, 1966.

The second was the broadening of the negotiations to include all members of the IMF through joint meetings between representatives of the Group of Ten and the executive directors of the IMF. The first joint meeting was held in Washington at the end of November, and the second took place in London on January 25 and 26, 1967.

Two major remaining problems concern the provisions regarding the acceptability and the holding and use of new reserve assets, and the procedures under which decisions are to be taken. These matters will be the subject of intensive negotiations during the spring of this year, and I believe there are already some signs that opinions are converging.

The outlines of a contingency plan are beginning to emerge, and I hope that the major elements will become sufficiently clarified for them to be presented to the annual meeting of the Board of Governors in Rio de Janeiro in September.

It is important to understand both what we can expect from a contingency plan for reserve creation, and what we cannot expect from such a plan. Over time, the new reserve assets, like any other reserves, will provide substantial resources that countries may on occasion use to meet short- and medium-term exigencies arising out of fluctuations in their international accounts. But they should not be regarded as a means for financing persistent deficits.

Nor should we regard reserve creation as a form of international assistance to developing areas. This, I believe, is fully recognized by the representatives of these developing countries. There is no doubt, however, that these countries need reserves and that an adequate growth in their reserves is one of their legitimate concerns. One of the major benefits which these countries may expect to derive from an adequate system of reserve creation is the indirect effect of a more liberal trading and investing pattern on the part of industrial countries, thereby enlarging the scope of their own trade and their capital availabilities.

These considerations have a bearing on a second aspect of the question of reserve creation—its urgency.

This committee and its members have made timely and imaginative suggestions in the field of international economics and financial co-operation, and they have recently called attention to the urgency of the problem. We are in full agreement that the events of the past year underline the desirability of establishing a contingency plan as early as possible. There is a growing recognition of this need in international circles.

CONCLUSION

As we enter the seventh year of the current expansion, the economy remains strong and further progress has been made toward better international financial arrangements.

Domestically, last year's shift from fiscal stimulus to restraint helped place the economy on a more sustainable path of advance. Now, we must maintain the forward momentum of the economy while restoring relative stability in costs and prices.

New challenges may be ahead. As in the past, these will require our best efforts. I am confident that flexible and sensible adaptation of our economic and financial policies will enable us to meet our responsibilities—at home and abroad.

Mr. Chairman, that concludes my statement and at this time I ask your permission to have just 3 or 4 minutes here to make some additional comments that have come into focus since my prepared statement was submitted to the committee on Friday. I know that these hearings are not occasions to award merit badges of good conduct medals, and I appreciate the give and take that they employ.

However, I would like to deal with a part of the record of Thursday's hearings in two particulars. There are many others I would like to deal with, but these particular two seem to me to be a matter that I should like to make on the record.

The chairman gave me honorable mention in the course of Thursday's hearings in referring to a speech of March 23, in which he indicated that I had assured the public that the estimated defense percentages for fiscal 1967 were good estimates, and that this was somewhat contrary to general information that existed at the time. This is characterized not by the chairman but by the press as not being forthright.

I want to ask the chairman if he would permit me to include in the record not only the paragraph of the speech of March 23 that he referred to, containing the assurance, but the preceding paragraph which makes very clear—and presents a very different picture of—what the intent of my statement was at that time. My statement was perfectly consistent with the large number of other statements made before congressional committees in January, February, March, May, and September, and I would be glad to provide them for the record if that is necessary. I did say on March 23, and I will read the paragraph which apparently you had reference to—

Chairman PROXMIRE. If I might interrupt at this point, Mr. Secretary, if you will, read both paragraphs.

Secretary FOWLER. I am going to read both paragraphs. That is the whole purpose of this exercise:

At the same time let me emphasize that our current estimates of Vietnam expenditures remain, in the view of those most qualified to judge, an accurate evaluation of our needs so far as we can now foresee, and I would hope that, when the need for responsible restraint is so great, no one will base his economic decisions on the purely speculative assumption that our Vietnam needs will exceed current expectations.

Now the preceding paragraph which I would like to include in the record reads as follows:

Over the longer run, of course, no one can predict whether we will need to schedule additional expenditures—expenditures beyond those contemplated in the fiscal 1966 and 1967 budgets—to meet our commitments in Vietnam. And Vietnam remains, therefore, an inevitable element of uncertainty in our budgetary as in our overall economic picture—an element of which we must always remain fully aware.

Now I have here a supplementary statement which I would like to submit for the record. I will not burden the committee's time with a full reading.

Chairman PROXMIRE. Without objection that will be printed.

Secretary FOWLER. I would like to read the first portion of my supplementary statement.

SUPPLEMENTARY STATEMENT OF HON. HENRY H. FOWLER

It has not been my practice in the past to spend time and energy answering "Monday morning quarterbacks," particularly when subsequent events have proven that the play they would have had called in the game would have lost rather than gained yardage.

Nor have I made it a practice to answer partisan criticism. My firm belief is that economic and financial policies and programs are good or bad on their merits and not because they happen to bear a Republican label or a Democratic label.

However, two circumstances cause me to depart from this past practice. First, because the reasoning and analysis as applied to a past event, that is, the absence of an increase in income tax rates in 1966, seems to be designed to prejudice a key element of what I believe to be the right economic and financial program for 1967—the levying of surtaxes on individual and corporate income taxes beginning next July 1 for the next 2 fiscal years.

Second, these hearings before the Joint Economic Committee of the Congress were opened by a statement from Senator Javits "on behalf of the minority on the committee."

I believe it important to correct the record that Senator Javits purports to make on behalf of the minority when he characterizes the year 1966 in the following terms: "With restraint lacking on the fiscal side, without some genuine spending cuts or a modest tax increase early in the year, monetary policy necessarily was drawn in to fill a vacuum."

Representative WIDNALL. Mr. Chairman, may I interrupt at this point? I would like to correct for the record and say for the record that I think your statement about Senator Javits purporting to make a statement on behalf of the minority has nothing in fact—

Secretary FOWLER. Then I take it this was in behalf of the minority?

Representative WIDNALL. This was after consultation with the minority. We worked out the statement together and all made suggestions in connection with that statement, so let me clearly say on the record it is a statement by the minority.

Secretary FOWLER. Then I am glad to know that.

This statement is full of error in all of its aspects.

The primary fact is that there was restraint on the fiscal side. All facts, figures, and subsequent events make this clear. The compelling proof is that the NIA budget shifted from a stimulative deficit in the latter part of calendar 1965 to a restraining surplus in the first half of calendar 1966.

Senators Javits, and the statement, is also in error in purporting to speak for the minority because, as I will demonstrate from the record, his espousal of income tax increases in the spring of 1966 found him in the not unaccustomed posture of being completely and unanimously overruled by his own party. The Republican coordinating committee, the Republican House leader, and the House Republican conference in March and April announced their opposition to any further tax increase than the one some of them had supported in the Tax Adjustment Act signed March 16, 1966. This position was reaffirmed formally in the report of the Republican members of the House Ways and Means Committee on the debt ceiling extension in June.

As I commented last week to the House Ways and Means Committee, the administration, including the Secretary of the Treasury, was in accord with the repeatedly stated policy of the official Republican spokesmen on tax and fiscal matters in refraining from requesting any income tax increases in calendar 1966, while urging that we hold down increases in appropriations and expenditures in fiscal 1967 as well as 1966.

The President espoused that same position in 1966 on many public and private occasions. During the spring and summer he met a number of times with the leaders of the Senate and House from both parties on holding down nondefense appropriations to the overall totals in his budget and whether or not an income tax increase proposal would gain congressional approval. He was told an equal number of times that there was little support for an income tax increase and that a recommendation would be defeated by an overwhelming margin.

Therefore, I find myself in the unusual position of having to defend the elements of fiscal policy followed and espoused by the Republican and Democratic leadership and a Democratic administration from the attack by one—and now I understand this is from the entire side of the committee—now speaking for the minority party.

Finally, Senators Javits' statement is in grave error in asserting that "monetary policy necessarily was drawn in to fill a vacuum" that existed early in the year.

The fact is, as everybody knows, that the country had been committed initially to a monetary policy of restraint involving tight money and higher interest rates by action of the Federal Reserve System early in December 1965. As I stated before this committee last year, it became the role of fiscal policy to shift to a course of moderate restraint following the steps already taken by the monetary authority, without risking economic overkill.

Looking ahead to the debate this spring on the President's surcharge proposals, let me underscore a vital point. There is a great deal of economic difference between advocating increased income taxes to pay the increased costs of war (a) when monetary policy is on the path toward ease, as it is this year, and (b) when monetary policy is moving in the direction of clear, positive, and increasing restraint, as it was last year.

There is a fundamental consistency in the position of those concerned with maintaining full employment and growth in refusing to advocate income tax increases when monetary policy is highly restrained and increasing income taxes to pay for increased costs of war when monetary policy is moving toward ease.

Mr. Chairman, I would like to submit the remainder of the statement for the record.

Chairman PROXMIRE. You may do so.

(Remainder of supplementary statement appears beginning p. 160.)

Mr. FOWLER. The remainder of the statement deals with a comment on a current bit of folklore that the U.S. Government and the President and the Congress and the leadership of both parties made a mistake in not raising taxes early in 1966. It is not a matter that I want to take up any further time with. I did want to submit this statement for the record. I want to show the particulars in which that position is wrong. I wanted to point to the analysis of some of the

other commentators on past actions who point up a very significant fact; namely, had we done last year what apparently is being advocated now we might have very well added too much restraint to a private sector which already had a substantial number of soft spots. And these soft spots developed even without the restraint of an income-tax increase last fall.

The statement also deals with the respective positions of the various analysts during the course of this particular period, how the early flush of many for an additional tax increase in March and April quickly paled by June when the returns on housing, automobile sales, and other fronts came along. It recounts the signals of the slowup in the private sector during 1966, and concludes with a series of questions which I think support the position I would certainly take.

1. Would additional restraint, say, an income-tax increase effective in mid-1966 over and above other fiscal increases taken, and the strong monetary policy measures then in being have involved the risk of a recession in late 1966 or early 1967?

I think the answer is clearly "Yes."

2. Would you approve in retrospect adding sharp fiscal restraint to the movement to sharp monetary restraint that characterized 1966 up until October?

I think not, if you were a responsible public official.

3. What assurance would you have had that the Federal Reserve System would have shifted its policy from increasing restraint to the direction of ease in the spring or summer of 1966, if the President had proposed a general income-tax increase?

None, since neither the President nor the Secretary of the Treasury could guarantee congressional passage of a general tax increase had one been submitted. Therefore, there would have been every prospect of an income-tax increase becoming effective when the full effect of the monetary restraint was being felt by the private economy.

4. Even if that delicate arrangement had been effected through coordination of the Federal Reserve System and the Congress, how would you have been sure that the move toward monetary ease would have had sufficient time to free up the private sector of the economy so that it could absorb the restraint of an income-tax increase without a serious risk of recession?

You could not be sure, and you would have had to conclude that imposing an income-tax rise on an economy stretched rigid by monetary policy would have run a serious risk of inflicting damage much greater than any of your other risks seriously threatened.

Happily, that risk is no longer present since the Federal Reserve System had already shifted last fall from a policy of rigid restraint to the direction of ease. Thus, hopefully, the surtax proposal can be appraised this spring in the context of an economy long removed from the monetary stringency of last year.

Thank you, Mr. Chairman.

(The portion of Secretary Fowler's supplementary statement not read to the committee follows:)

* * * * *

So I welcome this opportunity to comment on the current folklore that the U.S. Government "made a mistake" in not raising taxes early in 1966.

This is no more true than is the usual easy explanation of a complicated course of events. But I do not want to be understood by this as saying that this allegation is even partly correct. It is not. It is wrong, as I shall show you here.

It is wrong first of all because it begins by ignoring the fact that we did raise taxes by legislative action early in 1966—to the tune of \$6 billion.

It is wrong in the second place because this criticism means that it was a mistake not to impose a broad, blunt, general income-tax increase on individuals and corporations at that time. In this respect let me just point out:

Few of our critics, if any, were themselves convinced a year ago that a general income tax was needed, or, if they were convinced of it, they were not saying so in public, and

The condition of the economy early last year—as indeed the condition of the economy throughout the year—was a condition of *selective* excesses—together with selective softnesses—calling for the careful use of *selective* constraints. That is exactly what we used, in the Tax Adjustment Act in the winter, and under the President's anti-inflation message in September, including a specific new program for additional cuts in Federal expenditures in this fiscal year.

Third and most important of all, the assertion that it was a mistake on the administration's part not to propose a general tax depressant early last year is clearly and evidently wrong—as I shall be demonstrating—for the reason that some softnesses were already apparent in the economy at that time. These soft spots suggested to us—as they should have suggested to our critics, especially to some of the prominent economic analysts who took issue with us—that a general tax increase a year ago would very likely have resulted in a private economy that was softer in late 1966 and early 1967 than the current one which is now a concern to many of these same analysts.

This is now getting belated recognition. It was acknowledged in an article on January 17, 1967, in the Wall Street Journal, a paper that often disagrees with the Government's economic policies. This stated, among other things:

A question raised by many commentators after President Johnson proposed a 6 percent income-tax surcharge was whether such a levy might not bring on a recession in business.

Actually, the time to ask this question—as few then did—was early last year, when tax-increase proposals were already being made by analysts outside the Government.

At that time * * * signs that the rate of business activity might turn down were not lacking, although they were being given little attention.

The two clearest signs were declines in bond prices and in stock prices * * *. Such joint action is typical of the tops of booms.

Thus, it could be argued, as few analysts did, that if a tax increase were imposed it might aggravate a business downturn which, although not yet present, already seemed possible if not probable. The correctness of this analysis has since been confirmed, at least to the extent that a recession has occurred in much of the private sector even without a tax increase.

The author went on to point to declines, all but one of them as early as last spring, in automobile production, housing, commercial and industrial construction, appliance manufacturing, and steelmaking. He

concluded from this that "a recession in private industry has been underway for months * * *" and he wound up his analysis:

Private business may well be dragging bottom or even turning up before the Johnson 6 percent surcharge is passed or takes effect. If so, the tax may merely slow the recovery and keep prices from climbing, rather than aggravating a new downtrend as so many now fear.

The key word in that last sentence is "now" * * * "as so many *now* fear." It suggests the central difficulty, that critics of the Government's economic policy are suffering from an analytical lag, that has them currently applying their economic calipers to the conditions of a year ago, just as they were then applying them to conditions of unmitigated boom that was already receding perceptibly in the second quarter of 1966.

I want to go a little further into the economic record in support of the policy mix we used in 1966 to show you in somewhat more detail the real—as distinguished from the imaginary—conditions to which we tried to minister. Before I do, however, let me turn to a very recent article in the *Journal of Commerce* that puts the same kind of cautionary light upon the folklore concerning inflation in 1966 that the analysis I have just quoted thrust upon the herd-thinking that took place last year with respect to the need for tax action. Once again, I am calling upon the researches and conclusions of a newspaper not noted for its tender concern for governmental economic policy.

This article, on January 4, 1967, headed "Records Show 'Inflation' Last Year Was More Imaginary Than Real," said:

A year ago, it may be remembered, there was much clamor for a substantial income tax increase to cool down the economy and check inflation.

We didn't get the income tax increase. And, we didn't get much inflation. This latter is contrary to the general impression going the rounds that the inflationary kettle all but boiled over last year.

Actually, the records show, the heat under the general commodity price structure was lowered quite a bit last year.

From December, 1965, to December, 1966, the Bureau of Labor Statistics wholesale commodity price index rose from 104.1 (average 1957-59 equals 100) to 105.7 . . .

In the previous 12-month period, from December, 1964, to December, 1965, the BLS index rose from 100.7 to 104.1 . . .

The rise during 1966 was less than one half that during 1965. In August last year, the BLS index worked up to a record high of 106.8 before it leveled off and then began to ease. But, even at the August rate, the rise was less than in 1965.

The author went on to point out that at the retail level prices rose by 2.7 percent from December 1965 to December 1966 as compared with 1.6 percent in the previous 12 months, but he noted:

1. That much of this occurred in meats and vegetables, due to weather and other conditions not connected with the general business picture, and

2. That the real villain in last year's price picture was the sharp rise—some 5 percent—in the cost of consumer services, heavily influenced by the adoption of Medicare.

Now, I do not go bail for either of these analyses. They are newspaper articles, and as such can have neither the length nor the breadth to support fully accurate examination of the development of the entire U.S. economy over a full year, and they are not, of course, the full nor the unmitigated truth.

I cite them, however, as illustrations of the dark side of the moon that we as the responsible policymaking officers of the Government of this Nation knew existed, and took into account, in our policy choices throughout the year.

Whatever they may lack in completeness, these articles point to the essential fact about the economy in 1966—we were not on a one-way street to inflation and bust in 1966. Rather, we were picking our way along a high and narrow ridge, with substantial risks on either side—risks that those actually responsible for the well-being of the Nation could not ignore, however, blithely they could be ignored by those not actually responsible.

I do not join in spirit with our critics and claim that we were always right. My claim is much more modest—and it is my only wish, where our critics are concerned, that they would show a like modesty, perhaps by adopting the same policy: I claim only that at all stages along the way of the terra incognita through which our unexampled economy, growing and benefiting the Nation it serves in unparalleled fashion and degree, passed during 1966—we were at all times prudent.

What stands out—what I emphasize, what prudence always reminded those of us responsible at the bar of history, is the fact that at no time during the year was there a clear signal for general tax restraint, as distinct from the selective fiscal restraints employed.

Let us look for a moment at a few of the details of the pilgrimage of the American economy in 1966 as it felt its way through economic uplands higher, richer and more beneficial to more people than was ever the case before with any economy, while at the same time it was bled and buffeted by the economic ravages of a war conducted under conditions of uncertainty common to all wars.

It was a year in which very little was unequivocally certain—about the U.S. economy, about the world economy, about our international payments, or the national economy or the international payments of others, or about the economic portent of our defense of freedom in Vietnam—except to our critics.

To our critics—academic, political, journalistic and institutional—all was clarity.

At the outset of the year it was clear to them that something needed to be done, but—with the exception of some bank letters notable for consistency if not accuracy—they had nothing to recommend except the time-tested cliché of cutting Federal spending. They put this forth without the slightest nod—much less bow—to the fact that President Johnson had been rigorously holding down Federal outlays, which contributed to a far smaller deficit in the administrative budget in fiscal 1966 ending June 30 than had been previously estimated and an actual surplus in the NIA budget. They put this forth without regard for the fact that the President's new budget continued to call for increases almost balanced by cuts and new revenues.

In the spring of the year, it suddenly became clear to some outside analysts—I say it was clear to them because they all said the same thing all at once—that the U.S. economy had to have an income tax increase, to be saved. It was not clear what kind of tax increase, and their demands were now put forward with little regard for the fact that we had in fact had large tax increases early in 1966, beginning with payroll tax collections for medicare and other social security benefits in

January and with the effects of the Tax Adjustment Act in March, amounting to some \$10 billion in calendar 1966.

In the summer, it began to be clear to many tax-increase proponents that their previous insistence that a tax increase, and only a tax increase, could keep the U.S. economy from bursting the bounds of reason might have been wrong.

In the fall, it became clear to them that whereas they previously could see nothing but an economy puffing up to the bursting point, there had been factors at work all along creating the conditions for a possible recession, and this—it is *currently* clear to some of the earlier proponents of a tax increase—makes the idea of a tax increase clearly unacceptable.

There may be a small element of exaggeration in this thumbnail description of economic criticism during the past year. But I indulge in it, if that is the case, only for the sake of clarity.

Before we take a brief look at what in fact happened, let me direct attention to the record of comments on this subject by a spokesman for the Republican minority in Congress.

On March 21 last year Senator Javits, as reported in the New York Times, called President Johnson's anti-inflation policies "timid" and suggested a "modest and temporary tax increase"—which, together with Federal spending cuts, should come to some \$6 billion over and above what had already been provided in the Tax Adjustment Act of 1966. It might be noted that this was in fact approximately the effect of the increased social security collections that had begun in January.

Senator Javits soon found himself overruled and lonely in his own party.

On March 25, March 29, April 4, April 6, and June 6 press reports reflected the view that the Republican Coordinating Committee, the Republican House leader, the House Republican conference, and the Republican members of the House Ways and Means Committee were opposed to any further tax increase than the one some of them had supported in the Tax Adjustment Act signed March 16.

The Republican leadership preferred—at this time—the policy that was in fact being followed by the administration: a policy of holding down Federal outlays to the full extent possible consistent with the increasing requirements of Vietnam.

But, all undismayed by growing evidence of economic uncertainty, as by his party leadership's concurrence in this field and at this moment with administration policy, Senator Javits took lance in hand, and charged again, in August. He offered legislation calling for depressants in the form of deep cuts in Federal construction and space projects (where President Johnson had already put in force a careful economy program), a special temporary increase, across the board, in income taxes, and a credit restraint program modeled upon the economic controls put in force during the Korean war. This last added to the growing list of realities the Senator's policy suggestions ignored: the fact that in the Korean war we had to use 12 to 14 percent of our gross national product for defense purposes, compared with 8 percent in 1966, and the fact that during the Korean war we had to reset and build up a military establishment that had been all but dismantled, whereas we confronted the Vietnam crisis with the

finest military establishment, at the highest point of readiness, ever known.

Finally, to complete this brief summary of Republican disarray, Governor Romney—whose silence had until then been his chief distinction on this subject—came upon the scene in December entirely innocent of what has been transpiring during the previous 11 months of the year and recommended the very policy mix the administration had been following throughout the year: “* * * a combination of tax increases and firm budgetary policy.”

So much for positions taken last year.

Let us take a closer look, although a brief one, at some of the main developments in 1966. I would like to start with a review of expectations at the outset of the year, for these expectations set the tone of the year.

The program of fiscal restraint proposed in the January 1966 budget was developed against Government expectations for economic activity in 1966 that was far more realistic than those of nearly all private forecasters.

In January 1966 the Government projected a 6.9 percent increase in 1966 GNP—a rise of \$46 billion to \$722 billion on the basis of the national account levels then prevailing.

In contrast, the median private economist's forecast of 1966 GNP made during the September 1, 1965, to January 24, 1966, period was \$713 billion, according to a survey of forecasts made by the Federal Reserve Bank of Philadelphia. At the end of September, a poll of the National Association of Business Economists projected 1966 GNP at \$700 billion; the Pittsburgh Conference on Business Prospects in October projected slower 1966 growth than in 1965; Steel's Panel of Experts projected \$702 billion in October; the Michigan University econometric model projected \$712 billion in November; Prudential Insurance projected \$714 billion in November; McGraw-Hill projected \$711 billion in December 1965; Moody's Investor Service projected \$710 billion in December; etc.

SIGNALS OF SLOWUP IN 1966

A large number of developments signaling the need for caution in economic policy emerged during the course of 1966, in contrast to the dominant pattern of overall expansion. A chronology of those developments includes:

While *first quarter 1966 GNP* scored one of the largest increases since the Korean war:

Standard & Poor's stock price index declined in February, initiating a descent which continued throughout 1966. Stock prices in March declined nearly 5 percent below the January peak.

Contracts for construction included in the commercial and industrial building statistics declined 6.0 percent in March, and thereafter continued down through most of 1966. Until late in the year, when the effects of the suspension of the accelerated depreciation provisions for building under the President's anti-inflation program were felt, this decline was chiefly felt in commercial building, such as shopping center projects, due to tight money.

Among so-called leading indicators of business activity, February or March marked a peak for nonagricultural placements, business formations, ratio of profits to income originating in corporate business, and industrial materials prices.

Second quarter GNP rose only \$11 billion, down from \$16.8 billion in the first quarter, the smallest increase since the auto strike-affected fourth quarter 1946. Many economic projections appearing in the press began to be revised downward in view of cutbacks in production and sales of consumer durables, the weakening in housing starts and higher-than-anticipated income tax yields which moderated the rise in disposable personal income.

Personal consumption expenditures rose only \$3¼ billion in the initial national account estimates, compared with increases of \$10 billion in each of the two preceding quarters. Consumer purchases of automobiles declined \$3 billion from the first quarter, exceeded even the large drop in auto purchases in the strike-affected fourth quarter of 1964.

Output of passenger cars in May and June declined 7 percent below the January-April average, after seasonal adjustment. Announcements were made of earlier-than-usual automobile factory shutdowns for 1967 model changeover.

Housing starts averaged 1,368,000 units, annual rate, from 1,518,000 units in the first quarter initiating a decline which was to continue throughout 1966. On a monthly basis, starts fell 12 percent in May and 3 percent in June. The statistics on housing permits presaged an even sharper drop in 1966 housing activity.

The gain in fixed business investment was below that of previous quarters. However, inventory investment rose by a third to a rate of \$12 billion a year, from an annual rate of \$9 billion in the first quarter, with much concern generated by the involuntary accumulation of automobiles at car dealers.

The unemployment rate in May and June rose to 4.0 percent, up from 3.7 percent or 3.8 percent rates of the previous 3 months.

Following accelerated increases in late 1965 and early 1966, wholesale prices rose slightly in May, June, and July, as prices for the quarter averaged only 0.2 percent over the February and March level. Wholesale prices of farm products fell during each month of the quarter, and averaged 1.7 percent less than March prices.

Among "leading indicators" which declined in the second quarter were nonagricultural placements, construction contracts, housing starts and permits, business formations, ratio of profit to income originating in corporate business, stock prices, and industrial materials prices.

In the *third quarter*, the signals coming in from the economy changed sharply: GNP registered a brisk rise, with personal consumption, defense, and business fixed investment expenditures the principal constituents. Unemployment rates turned down, capacity utilization edged up, and prices rose.

Nevertheless, some contrary signals were also registered.

Outlays on residential and nonresidential structures declined sharply.

Total industrial production declined in September, as the production of nondurable goods eased together with the decline in housing and commercial construction. Production slipped at least 1 month during the quarter in such industries as primary metals, fabricated metal products, machinery, and lumber and wood productions. Steel production for the quarter averaged 6½ percent less than that for the second quarter.

Wholesale prices of all commodities registered no change from August to September following a rise of 0.4 percent in August. Wholesale prices of industrial commodities, exclusive of farm and foods, remained unchanged throughout the 3 months of the quarter.

Fourth quarter GNP also rose sharply, although some evidence emerged of strains and imbalances.

Industrial production fell in November, largely due to declining production of durable goods. Primary metals production continued the slide initiated in the previous quarter and lumber and wood products remained below previous quarter levels due to the continued sagging in construction activities.

Retail sales declined in October largely due to reduced sales at durable goods stores. November sales were a bit higher but December again registered a decline, after seasonal adjustment.

Surveys of planned plant and equipment expenditures indicated a smaller increase than in previous quarters.

Among production declines registered during the fourth quarter were steel production, auto production, wholesale prices, new orders for durable goods, and prices of industrial materials.

I do not think that anyone disposed to look with reason upon this record would attempt to maintain that the administration's fiscal policy in 1966 was mistaken.

I think, on the contrary that the administration's economic policy as a whole in 1966, including our prudent use of selective fiscal tools as supplementary to general and severe monetary restraint, brought the economy through a trying time of transition and uncertainties with minimum damage, and—what the prudent man is always supposed to achieve—with minimum risk of damage at all times.

This was not accident. We changed directions early and consciously, trying at all times to keep the economy in balance despite radical changes in the forces affecting it and despite uncertainties such as the always unpredictable course and costs of war. Let me, if I may, cite some of the voluminous evidence available to anyone who wants to get the facts indicating that we were in touch with reality, and that we bent our sail quickly and selectively to winds bearing down upon the national well-being.

First: President Johnson went to the Congress with a budget, and with a tax program at the outset of the year that shifted administration policy from stimulus to moderate and selective economic restraint. This was at a time when those who now say our policy was mistaken, had little or nothing to suggest.

The President continued and increased the pressure he had been exerting for years upon Federal spending.

The Tax Adjustment Act of 1966, sent to the Congress in January and signed into law in March, together with other measures, used

the fiscal tool to take some \$10 billion out of the economy in calendar 1966.

On March 22, when he was reminded at a news conference that "a lot of economists would like you to raise taxes" and was asked what he was going to do, President Johnson reminded reporters of the tax increases already in effect through social security and the Tax Adjustment Act.

And he disclosed—but those who were demanding severe tax action were apparently not listening—that there was evidence suggesting that the economy was in an uncertain condition, calling for caution in handling it, such as declines in retail sales, in new orders for durable manufacturers, and in housing starts; while some farm and food prices were leveling off, the growth of business loans had slowed, and many municipal and some corporate bond issues had been postponed, thereby reducing potential new orders and other activity of many kinds, and that unemployment was still above 6 percent in almost a score of major labor markets.

He told reporters that he had just asked all departments and agencies of the Government to take a new look at expenditures, and to forgo what could be forgone. And he concluded:

We will watch very closely and see what happens in these employment markets, in retail sales, in housing, and in the money market, and then take whatever action is indicated.

We don't want to act prematurely. We don't want to put on the brakes too fast, but it is something that requires study every day, and we are doing that.

Speaking on March 23 at the National Press Club, I reminded my audience that the President had warned against acting prematurely or putting on the brakes too fast.

I said that we expected the very recently signed Tax Adjustment Act to "serve as a growing force for economic restraint" over the coming year, together with the restraining influences of monetary policy and the \$6 billion annual rate increase in social security and medicare taxes in effect since the beginning of the year.

I stressed the uncertainties of Vietnam, saying that—

No one can predict whether we will need to schedule additional expenditures—expenditures beyond those contemplated in the fiscal 1966 and 1967 budgets—to meet our commitments in Vietnam. And Vietnam remains, therefore, an inevitable element of uncertainty in our budgetary as in our overall economic picture.

I reminded my audience that in 1957 and 1959 overzealous use of anti-inflation measures had turned expansions into recessions.

And I concluded that—

In our domestic economy there is still room for reasonable doubt as to whether additional restraints should be imposed by public action on private demand in our economy.

That reasonable doubt persisted. By fall it was clear that we had a boom that was threatening to run beyond the bounds of our capacities to produce in terms of business investment and in the face of competing demands from the war in Vietnam, while at the same time there were, as I have indicated earlier, many persistent signs of economic weakness wrapped up and hidden away by the continued overall advance.

In the face of this very special situation, with danger on all sides, and in the face of concomitant tightness in the money market that forced interest rates to their highest point in four decades, we took special and carefully selective action in the anti-inflation program announced by the President September 8. This took pinpoint action against the business investment boom by asking the Congress to suspend—as it did—tax incentives to business plant and equipment investment. And it took pinpoint action to relieve the money markets, by reducing the effects of Federal borrowing through postponement of participation certificate sales and scaling down of agency borrowing from the public, and by giving the bank regulating agencies powers designed to correct the distorted flow of savings.

The consequence of this year of timely and prudent economic policy change is an economy that still has great strength for new growth, that is proceeding under its own competitive powers, free of the apparatus of economic controls that ordinarily weighs down and distorts an economy in wartimes, an economy in which productivity remains high, unemployment remains low, an economy that gives every sign of correcting the imbalances that crept into it, and an economy in which prices and money rates are giving signs of easing.

Let me ask four questions in conclusion, and supply the answers that I believe the record just cited makes imperative:

1. Would additional restraint, say, an income tax increase effective in mid-1966 over and above other fiscal increases taken, and the strong monetary policy measures then in being have involved the risk of a recession in 1966 or early 1967?

Yes.

2. Would you approve in retrospect adding sharp fiscal restraint to the movement to sharp monetary restraint that characterized 1966 up until October?

I think not, if you were a responsible public official.

3. What assurance would you have had that the Federal Reserve System would have shifted its policy from increasing restraint to the direction of ease in the spring or summer of 1966 if the President had proposed a general income tax increase?

None, since neither the President nor the Secretary of the Treasury could guarantee congressional passage of a general tax increase had one been submitted. Therefore, there would have been every prospect of any income tax increase becoming effective when the full effect of the monetary restraint was being felt by the private economy.

4. Even if that delicate arrangement had been effected through coordination of the Federal Reserve System and the Congress, how would you have been sure that the move toward monetary ease would have had sufficient time to free up the private sector of the economy so that it could absorb the restraint of an income tax increase without a serious risk of recession?

You could not be sure, and you would have had to conclude that imposing an income tax rise on an economy stretched rigid by monetary policy would have run a serious risk of inflicting damage much greater than any of your other risks seriously threatened.

Happily that risk is no longer present since the Federal Reserve System had already shifted last fall from a policy of rigid restraint to the direction of ease, and, hopefully, the surtax proposal can be

appraised this spring in the context of an economy long removed from the monetary stringency of last year.

(The material which follows is placed in the record at this point at the request of Representative Widnall. See p. 187.)

[Minority Views, excerpted from 1966 Report of the Joint Economic Committee, March 17, 1966*]

INTRODUCTION AND SUMMARY

The administration's economic program exposes the American people to the twin dangers of serious inflation this year followed by a recession in 1967.

Recent increases in both consumer and wholesale prices—the largest in many years—demonstrate that inflation already is a fact of life. There is no excuse for further delaying needed action.

The administration admits that inflation is a serious threat, but stubbornly refuses to concede that effective anti-inflationary action is needed now. It promises to act sometime in the future should the situation require. But what evidence or degree of inflation is needed to trigger action by the administration? Must the country first experience price increases comparable to the early years of the Korean war?

The administration claims that its economic program, including a disguised form of price and wage controls, is adequate to hold down the cost of living. The fact is that the budget for the current fiscal year as revised in the January budget message is highly expansionary, while the 1967 budget is contrived to give the appearance of restraint but actually continues on the stimulative side.

The 1966 economic reports of the President and the Council of Economic Advisers are remarkable for their facile dismissal of mounting evidence of price pressures from both the cost and demand sides. The administration refuses to admit the full extent to which it has used illegal powers to restrain price increases and continues to express unwarranted confidence that the system of wage-price guidelines—a leaky dike at best—can hold back the tide of inflation without the exercise of restraint by Government itself.

CONSISTENT UNDERESTIMATES

In the past the administration has consistently underestimated the costs of the Vietnam war as well as the underlying strength and composition of demand in the private economy. Today it underestimates the pressures that will develop from increases in capital spending, a shrinking supply of skilled and experienced manpower, near capacity operation of plant and equipment facilities and rising unit labor costs.

The administration has in effect denied the presence of inflationary pressures by—

- sharply increasing both spending and new obligational authority in the current fiscal year;
- seriously underestimating budget expenditures for fiscal 1967;
- covering up planned increases in 1967 expenditures by sales of Government financial assets that will have little effect in curbing overall demand;
- proposing revenue adjustments that largely affect the timing of tax payments and which, by their very nature, will do little or nothing to curb inflationary pressures;
- continuing its critical attitude toward the Federal Reserve Board for its timely move toward monetary restraint last December and virtually ignoring the impact of debt management in complicating the task of monetary policy;
- insisting the Nation is still enjoying a peacetime expansion when it has, in effect, moved into a wartime economy.

While the administration heats up the economy, it asks the private sector to hold the line and does little itself to effectively attack structural imbalances in labor skills and productive capacity. To enforce "responsible restraint" by management and labor, it engages in implicit or explicit price and wage fixing and other forms of harmful interference with the functioning of our economic system. This policy of economic interventionism will sap private initiative and inventiveness, impair efficiency and retard the Nation's long-term rate of growth.

*H. Rept. No. 1334. Report of the Joint Economic Committee on the January 1966 Economic Report of the President, pp. 31-52.

INFLATIONARY PSYCHOLOGY DEVELOPING

In the absence of appropriate administrative policies, speculative excesses, such as recent inventory building, will continue to mount and an inflationary psychology, already taking hold among our people, will dominate economic decisionmaking in the year ahead. Unless stopped now, this could lead to a distortion of cost-price relationships such as the Eisenhower administration was obliged to correct through its economic policies in the late fifties. This difficult but vital action of the Eisenhower administration left a sound legacy of stability which until recently permitted rapid expansion with relatively little inflation.

Barring a further acceleration of Vietnam spending, a recession next year is a likely reaction to growing inflationary imbalances and excesses already in evidence today. The tendencies toward recession will be strengthened since failure to take action to halt inflation now may force the administration to slam on the fiscal and monetary brakes later this year. Restraint—which is required now—would then begin to take hold just when economic conditions may call for a somewhat easier budget policy.

The administration's inflationary economic policy will have other serious consequences as well. The continuance of this policy will—

- severely harm those segments of our population least able to sustain economic injury, such as lower income groups, including social security beneficiaries and other pensioners, and young people trying to get a college education, buy a home, and start a family;

- intensify capital outflows from the United States, reduce further our already shrinking trade surplus, drastically worsen our balance-of-payments position, and intensify the gold outflow;

- result in a breakdown of delicate international discussions on monetary reform and threaten the successful conclusion of the Kennedy round of trade negotiations.

The relevant choice is not between “guns and butter.” Our private enterprise system is flexible and inventive enough to provide both in an atmosphere of confidence fostered by wise and cooperative Government policies. The critical choice today is between inflation and a stable rate of growth which will strengthen, not weaken, our capacity to solve our domestic problems as well as meet our international commitments.

MAINTAIN BUT MODERATE THE EXPANSION

Rapidly increasing civilian, military, and Government demands are beginning to exhaust available resources. As pressure mounts throughout the year on the shrinking reservoir of employables and production facilities, an opportunity is needed for the economy to adjust. An adequate but noninflationary advance can be maintained if Government policies are restrained until the adjustments take hold.

This requires a balanced and moderate program of Government fiscal and monetary restraint. However, monetary policy cannot carry too heavy a burden in tempering the boom. Interest rates already are at a high level and a further sharp and abrupt rise in rates will create serious disturbances in the financial markets. Fiscal restraint also is essential to hold down the level of demand for funds.

A reduction in the growth of the money supply and bank credit in keeping with the real growth of the economy should be accompanied by an immediate deferral of Federal spending for nonessential and low-priority projects and the elimination of those that are redundant and inefficient.¹ The administration should aim for a surplus on the national income accounts budget in calendar 1966 rather than the substantial deficit now anticipated.

If the administration is unwilling to reduce spending, an increase in taxes will be necessary, which would cause economic damage itself. Increasing taxes is a less desirable way to moderate the boom than by deferring expenditures. A cut in tax rates that are already too high is a sound way to lower barriers to economic growth. To raise taxes now would restore an obstacle to long-term

¹ Senator Javits would support necessary reductions or deferrals of expenditures for nonessential domestic programs, but he considers that recently enacted programs in education, welfare, and antipoverty and other human investment measures to be essential. They contribute to the Nation's economic strength and its capacity to fight inflation. He would rather increase taxes to fight current inflationary pressures than to accept material curtailment of these programs.

growth. At the same time, another turnabout in tax policy reducing some of the high rates might be required next year if recession threatens. If more stimulus is needed next year, it would be far simpler to increase expenditures deferred this year than to cut taxes again.

The most certain way for the administration to protect the gains of the past and to insure social and economic gains in the future is by promoting a balanced and sustainable expansion without inflation.

The remainder of these minority views will elaborate on the need for immediate action to stop inflation, the inadequacy of the administration's program and the policy best suited to provide the degree of restraint required by current economic conditions.

THE ANATOMY OF INFLATION

A. The price record in 1965

Last year witnessed a marked acceleration of the upward drift of the cost of living and a dramatic departure from the stability of the wholesale prices that prevailed for seven years.

The Consumer Price Index rose 2 percent from December 1964 through December 1965 after an annual average rise of 1.2 percent over the previous 7 years. Between January 1965 and January 1966 the wholesale price index rose 3.6 percent. From October 1965 through January of this year, wholesale prices rose at an annual rate of 6 percent.

Actually these increases understate the magnitude of inflationary forces in the economy. The reduction or removal of Federal excise taxes last year had a downward influence on the Consumer Price Index of about 0.3 percent. In the absence of these tax changes the index would have risen by 2.3 percent over the year. The index also has a downward bias to the extent that while corrections are made for quality improvements in durables they are not made for quality changes in services, which the Bureau of Labor Statistics admits "deteriorated further" last year.

The wholesale price index also masks a high degree of "hidden" inflation. The Council admits that in a period of weak demand list prices are discounted or lowered, freight absorbed and other terms of transactions changed. The wholesale price index fails to take fully into account the shaving of discounts and other changes in the terms of transactions, amounting to price increases, in a period of strong demand. The February 1966 issue of *Fortune* magazine reported that many executives say that prices of goods they buy have advanced faster than the price indexes, suggesting that actual prices are perhaps rising faster than list.

GUIDEPOSTS SUPPRESS INFLATION

The wholesale price index also would have been higher except that the administration suppressed some price rises by the coercive use of the wage-price guideposts. Chairman Ackley admitted before the committee that industrial prices would have risen more in the second half of the year if the President had not made clear his view "that the guideposts really ought to be taken seriously." Not only have the guideposts suppressed price increases in the highly visible steel, aluminum, and copper industries but also, according to Dr. Ackley, "in a large number of industries" where the actions received no publicity.

The administration frequently denies that strong inflationary forces now exist. What forces was it acting to control in these situations if not forces of inflation? The problem is that the basic economic pressures for price increases still remain in spite of artificial restraints, and they are likely to break out sometime in the future unless fiscal and monetary restraint is pursued.

B. The price outlook for 1966

Although honest men may differ over the seriousness of the price inflation experienced last year, there can be little doubt that 1966 will see a substantial acceleration in the rate of price increases. Food and clothing prices will continue their strong upward trend, while other commodities and services will show larger increases than last year. There is little price weakness anywhere today. Increases in prices are being balanced off less and less by price declines.

The National Association of Purchasing Agents reported in February that its monthly survey of members showed 63 percent of those queried paid more for their purchases in January than in December, compared to 39 percent reporting higher prices from November to December. Less than 1 percent reported lower prices in January, while the number reporting higher prices was the largest in 7 years.

C. Sources of Inflationary Pressures in 1966

The sources of inflation will strengthen this year on both the demand and cost sides.

The Council predicts that gross national product will grow 5 percent in real dollars at a time when output is already pushing against capacity and when a number of industries already are at or above the preferred operating rates. Pressures on the labor supply are already strong, and the labor market will tighten even more throughout the year. Demand for bank credit also continues at exceedingly high levels.

Some private economists are predicting an even greater increase in GNP this year than the Council, which last year badly underestimated the pace of the advance. Forecasters already are raising their sights for the year. If Vietnam spending increases more than anticipated—which is probable in light of the administration's past underestimates—then the economy will be under more severe strain than now anticipated.

Capital spending by business is continuing at a high level, and the volume of fixed investment expenditures in 1966 is expected to run well ahead of earlier projections. Dr. Walter W. Heller recently noted that in 1965 investment for the first time equaled high employment private saving. He said that in 1966 investment "threatens to exceed high employment saving and exert inflationary pressures."

Inventory accumulation is gathering speed as a hedge against price increases and as a response to rising sales. In the final quarter of 1965, inventories increased at a seasonally adjusted annual rate of over \$10 billion, \$2.4 billion more than in the third quarter and the highest increase since the Korean war. For all of 1965, inventories rose by \$8.2 billion, almost double the increase for 1964 and the largest annual increase since 1951.

In spite of the increase in the discount rate in December, the rate of increase in money and credit continues at a high level. Bank loans to business rose 20 percent in 1965 after increasing by an average of 7 percent in the preceding 4 years. Consumer credit rose 12 percent, compared with an average of 8 percent in the preceding 4 years. Total private debt rose nearly 10 percent, or slightly faster than the average increase since 1960. Concern about the quality of private credit is voiced in many quarters.

The money supply rose nearly 5 percent in 1965, while money supply and time deposits together rose almost 10 percent. The rate of expansion of credit and money actually increased within the year itself. The increase in the money supply was nearly three times greater in the last 6 months of 1965 than in the first 6 months.

PRESSURES IN DEFENSE INDUSTRIES

Pressures will be especially great in the defense and defense-related industries, which are receiving a flood of new Government orders. As Charles L. Schultze, now Director of the Bureau of the Budget, pointed out in a 1959 Joint Economic Committee study, inflation can originate in excess demands in particular sectors and spread to the rest of the economy through the cost mechanism. The recent sharp increases in demands in the defense industries ultimately could give added impetus to the inflation originating in excess overall levels of demand.

It is true, as the administration claims, that supply problems will be eased as the result of new capacity now being built. However, this overlooks the possibility that the growth of demand will soar even more than the growth in new capacity and particularly in those components of demand where supply is already hard pressed. This argument also fails to recognize that a considerable "shakedown" period is required for new capacity to become efficiently operative.

The greatest demand pressures will be felt on the labor force. The economy is now below the administration's 4-percent interim unemployment goal, although it should be noted that this administration over the past 5 years has added 300,000 to the Armed Forces, 200,000 to Government employment and hundreds of thousands to the munitions industry. The current aggregate unemployment rate conceals tightness within key sectors of the labor market. In February, the unemployment rate was down to 2.6 percent for adult men and 1.9 percent for married men. For the entire full-time labor force, the unemployment rate was 3.3 percent. Unemployment in manufacturing was at 3.5 percent in the final quarter of 1965.

Other signs of a tightening labor market include the fact that in late 1965 the hiring rate was at the highest point in 12 years, while layoffs were at the

lowest point in 12 years. The factory workweek was at its highest since December 1945. For the first time since 1957, about one-half of the unemployed had been looking for work less than 5 weeks. One-third of the 150 major labor areas—nearly twice the number of a year ago—achieved unemployment rates of 3 percent or less. At the same time, immigration continues to fill more and more of our skill requirements.

In a presentation to the Joint Economic Committee, the Bureau of Labor Statistics admitted the existence of emerging labor shortages and signs of tightening labor markets. The Bureau called attention to unemployment rates for certain occupational groups, the low over-the-year increase in the employment of adult men and the quality of the 1.2 million adult men still unemployed. After making allowances for seasonal and fractional elements, the Bureau said that of the remaining unemployed "some have such severe educational and other handicaps that they are unlikely to enjoy steady work even in the most active job markets." The Bureau's report went on to point out that "mature, experienced, and capable workers were increasingly hard to find in 1965," although the report reassured us that the situation had not reached "the critical stage."

GROWING SKILL SHORTAGES

The Bureau expressed the greatest concern about industries most closely related to the defense effort, where there were growing skill shortages, sharp increases in the hours of work, and a substantial increase in the ratios of unfilled defense orders to shipments.

This year the Bureau expects 1.8 million new civilian jobs will be created. It says that "The increase in demand for workers in 1966 will be substantially above the long-term trend rate of growth." At the same time that civilian labor demands are soaring, the military services are absorbing about 300,000 young men.

What about the supply of labor? The Bureau says that male entrants under 25 "may be no more than 100,000 instead of the 420,000 implied by labor force trends." The main additional source of male workers for the civilian economy will be the increase of 230,000 in men 25 and over.

The outlook, according to the Bureau, indicates intensifying manpower demands requiring "more workers with better qualifications." Yet, the Bureau then says, "young workers and women remain the primary source of additional labor supply, with relatively few adult men."

What makes the situation even worse is that the Bureau admits the labor pinch will be felt this year in those industries, occupations, and areas already squeezed in 1965. Areas and occupations of high unemployment won't be affected. Aside from the fact that many of the unemployed are not able to fill job vacancies, they may also not be in the right place. As a result, there are grave questions as to how much a reduction in unemployment will be able to contribute to manpower needs this year.

The picture of the labor market painted by the Bureau clearly indicates that shortages of skilled manpower will be a source of inflationary bottlenecks in supply and that productivity increases are likely to be no better and possibly worse than this year.

The slow growth in productivity and strong upward pressures on wages will combine to create a substantial upward movement of unit labor costs in the private economy. This will represent one of the greatest sources of inflationary pressures throughout the year.

PRODUCTIVITY GROWTH SLOWS DOWN

Productivity in the private sector last year increased only 2.8 percent (and some private sources put the gain even lower). The increase was far below the average postwar gain and even farther below the 3.8-percent annual increase experienced from 1960 to 1964. Even the Bureau of Labor Statistics concedes that the increase "does seem low" and suggests that it should have been 3.5 percent.

The reasons for the slowing of productivity gains are found in the pressure on resources. Lower quality labor was drawn into the labor force last year and more of the same can be expected this year. Also, as the economy continues to operate at higher and higher levels, less-efficient, idle or standby facilities will be drawn into the productive process with a consequent diminution of productivity gains.

Although the Bureau cited several factors which will contribute to increasing productivity, it admitted that "some of the factors which contributed to the smaller productivity gain in 1965 can be expected to continue to operate for the next few years, particularly should output continue to increase at a high rate."

Add to this outlook the likelihood of increasing wage costs and a picture of a classic cost-push inflation emerges. In 1965 wage adjustments negotiated and scheduled to go into effect in the first contract year amounted to 3.9 percent, disregarding fringe benefits, which by themselves added another 0.75 percent to wage costs. This compares to increases of 3.2 percent in 1964 and 3.0 percent in 1963. The increase without fringes comes to 3.3 percent even when averaged out over the life of the agreements, far above the 3 percent of 1964 and the 2.3 percent of 1963. Adding fringes puts the 1965 figure far above the wage guideposts.

The situation is even more disturbing with regard to unorganized workers. Here the Bureau admitted that there were "more frequent or widespread wage increases than in previous years." The proportion of unorganized workers in manufacturing plants who got wage increases in 1965 rose to 70 to 75 percent from the 50 to 60 percent of recent years. Next year the increases among unorganized workers are likely to be even larger. For one thing, the Bureau notes that "the consumer price index is a major factor in bargaining and in wage determination among unorganized workers." Other factors noted by the Bureau that might cause larger increases in wages in nonunion firms in 1966 include growing shortages of workers and the reduction in take-home pay resulting from higher social security taxes.

A recent Labor Department study of 306 major collective bargaining agreements shows that all but 12 provide for possible wage adjustments in 1966. The number of workers scheduled to receive deferred wage increases is the greatest since 1957. About 35 percent will get increases between 10 and 11 cents an hour, compared to 1965 when the largest concentration (32 percent) received 7 to 8 cents an hour. Over 4 million workers will get deferred increases averaging 3.2 percent. In addition, 2 million of these will get another 2 to 3 percent in accordance with escalator clauses based on the consumer price index.

PAYROLL TAX BITE

Employers are already feeling the effects of the increase in social security taxes and the increase in the taxable wage base. The Council has estimated that this tax increase raises hourly labor costs two-thirds of a percentage point. However, the Council unrealistically does not believe that these legislated payroll costs should be considered as a wage increase or fringe benefit for purposes of the guideposts. Even if negotiated wage and fringe increases were within the guideposts this year, the increase in social security taxes would impose a clearly inflationary cost on business.

The administration's recommendations for an increase in the minimum wage and a broadening of its coverage may also be inflationary and have the additional effect of pricing unskilled labor out of the market. Whatever the merits of the minimum wage, there is a widespread feeling—apparently shared by some in the administration—that any increase that is granted should be noninflationary.

When asked whether the proposals to increase the minimum wage and its coverage would increase costs and prices, Chairman Ackley replied, "I should suppose that the effect of any increase in the minimum wage would depend on how large an increase were involved * * * an increase in the minimum wage that was consistent with the general average gain in productivity in the economy would probably have minimal effects on labor costs." Since all increases suggested so far greatly exceed the guidelines, it is obvious that current proposals would be inflationary, particularly if they were to take effect this year. The upward pressures, of course, would not only be felt at the lowest rung of the wage scale, but all through the wage structure as competing groups strive to maintain their differential wage advantages.

To the extent that the administration's proposals to change the unemployment compensation system increase employer costs, they will also be inflationary. This should be one of the primary considerations taken into account by the Congress in debating both the unemployment compensation and minimum wage proposals.²

² Senator Javits thinks the minimum wage should be reasonably increased to meet new cost-of-living demands and believes we should adjust in other directions to meet inflation.

If wage adjustments last year were greater than the guidepost figure, they are likely to be even larger this year. The Bureau of Labor Statistics estimates that "except for social security taxes, other components of hourly labor costs will probably rise about as fast, on the average, in 1966 as in 1965 or perhaps slightly faster." Taking into account that new payroll taxes raise labor costs two-thirds of a percentage point, the situation will clearly be one of serious cost pressures.

The combination of an inadequate growth of productivity and a strong upward pressure on costs—particularly wage costs—will mean sharply rising unit labor costs. Unit labor costs for the private economy, as Chairman Ackley told the committee, "increased almost 1 percent in 1965—which is appreciable and obviously a subject of concern."

The administration's assumption of an improvement in the growth of productivity this year is the key to its optimism about restricting inflation. As we have shown, however, this optimism is unfounded. Combined with a strong upward push on wages—which is clear from labor's complete rejection of the guideposts if not from other evidence—the combination spells a distortion of our cost-price relationships which may require strong corrective medicine sometime in the future unless prevented by timely action now.

THE INADEQUACY OF THE ADMINISTRATION'S ECONOMIC PROGRAM

How does the administration's economic program fall short of effectively combating the clear and present danger of serious inflation?

The administration's claim that its present and proposed fiscal policies are mildly restrictive or neutral was questioned by the majority of private economists who submitted testimony or written statements to the committee. Prof. Richard Musgrave, of Harvard University, examined the current fiscal impact by comparing calendar year 1965 to calendar 1966 and concluded that "fiscal policy is substantially more expansionary than it was last year." The "main thrust," he said, "would come in the first half of the year."

Professor Musgrave made an important point in presenting a calendar year analysis and in calling attention to the national income and product account budget—the most useful for studying the economic impact of Federal fiscal activity. Although that budget showed a surplus of \$700 million for 1965 as a whole, it was in heavy surplus in the first half of the year and progressively moved into large deficit in the second half. The deficit will continue to be substantial in the first half of the current year, but will probably taper off later in the year.

However, the deficit for calendar 1966 as a whole will be substantial and represents a major expansionary shift when compared to the surplus of 1965. This shift toward expansion comes precisely when the margin of unused resources has been reduced to the vanishing point.

Another sign of the growing Federal impact on commodity markets is the sharp increase of \$6.2 billion in Federal purchases of goods and services between fiscal 1965 and 1966. This increase compares to a decline of \$1.3 billion in such purchases between fiscal 1964 and 1965. Although the 1967 budget predicts a smaller rise from fiscal 1966-67, the increase will still amount to a hefty \$3.7 billion. For the two fiscal years from 1965 to 1967, Federal purchases of goods and services will rise by \$10 billion, compared to only \$3.6 billion in the three previous fiscal years.

PROCUREMENT EFFECTS

Prof. Murray L. Weidenbaum, of Washington University, has shown that the primary effect of military procurement on productive activity "occurs in advance of actual Government expenditures." He points out that—

It is at the order stage that the Government action normally will have its initial and often major impact on the markets for labor, raw materials, and financial resources.

This is the situation today. New obligational authority is soaring this year and will probably fall off in fiscal 1967, barring further escalation in Vietnam. Appropriations and other new obligational authority, which are an approximate measure of the Government's intentions to spend and let new contracts, will increase 18 percent from fiscal 1965 to 1966. Most of the new spending com-

mitments are coming in the first half of the current calendar year, a fact which Business Week noted will provide "a whopping fiscal stimulus" over the next few months.

It is this immediate situation which calls for restraint in nonessential and deferrable expenditures.³ To date, the administration has refused to exercise the required discipline on current spending and instead directs attention to the allegedly restraining character of the 1967 budget.

The question may be raised whether the 1967 budget should not be more expansionary than it in fact is. The committee heard expert testimony that the budget will be too expansionary during the final half of this calendar year and too restrictive during the first half of next year. Although it is obviously impossible to predict conditions a year hence, this observation may have merit if revenue and spending estimates turn out as the administration predicts. This is particularly true if one concedes that an inflationary boom may be laying the groundwork for a recession next year.

However, we doubt that the 1967 budget will be overly restrictive next year, and we feel certain that it will be too expansionary in the second half of this year. The January budget estimates this year are a less reliable indication of what actual results may be than is usually the case.

Spending will almost certainly exceed the administration's estimates. Not only are some proposed outlays underestimated, but Congress may very well increase spending on programs where the administration—with tongue in cheek—has asked for reductions, such as the school milk program. Some observers have indicated that the \$4.8 billion reduction in nondefense expenditures is largely concentrated in programs controlled by law. The \$5.4 billion increase in nondefense expenditures, however, is said to be in those areas where the Executive has a freer hand in determining the level of spending.

REVENUE MEASURES

On the revenue side, the tax measures requested by the administration will yield about \$4.8 billion in additional income, but since these (except for the reinstatement of excises reduced in January) do not involve any increase in tax rates, their effect on demand will be minimal. To the extent that the acceleration of tax payments affects liquidity and interest rates, it may have some secondary effects in dampening demand, but the overall impact is likely to be small.

Another factor temporarily swelling revenue is the unusually large seigniorage profit from converting silver coins to copper, estimated to total close to \$2.5 billion in fiscal 1966-67 combined.⁴ As Prof. Raymond J. Saulnier has pointed out, to the extent of these profits "budget expenditures are being financed in a thoroughly inflationary manner."

The massive sale of \$4.7 billion in Government financial assets proposed in fiscal 1967 also will have the effect of producing a lower level of expenditures and deficits than would otherwise be reported in the budget. They do not, however, reduce the Government's demands on the already hard-pressed credit and capital markets, nor do they affect the actual volume of Federal outlays. In effect, these proposed sales amount to another way of financing the Federal deficit.

In connection with the sale of Government assets, we wish to call attention to a bill (H.R. 13102) introduced by Congressman Widnall to limit and gradually reduce the use of the Federal National Mortgage Association to guarantee the sale of participation certificates for Federal Housing Administration and Veterans' Administration mortgages (\$1.2 billion sold, \$410 million due in March) and new participation certificates for the Farmers Home Administration, Office of Education, Small Business Administration, Veterans' Administration, and the Department of Housing and Urban Development, for an anticipated total of \$3.2 billion. The program to sell financial assets should not become an unlimited pipeline to the Treasury. We urge early consideration of this bill by the appropriate committees of Congress.

³ See Senator Javits' footnote, p. 33.

⁴ It should be noted that when Congressman Widnall predicted last August the amount now conceded to be available through seigniorage profits, and cautioned on its possible use for budgetary purposes, his statement was discounted by administration officials. A Presidential committee, appointed in September to report on the use of these profits for proposals such as the Republican water resources trust fund, has never submitted its report, though it was due in December.

Not only does the administration refuse to move toward fiscal restraint, but it also continues to be critical of efforts to reduce the massive rate of growth of bank credit and the money supply. It continues to carp at the Federal Reserve Board for its "fall from grace" last December, although one suspects this public posture conceals a private sigh of relief that the Board moved when it did.

BANK RESERVE GROWTH

Although interest rates have firmed further since the discount rate increase in December, the Federal Reserve has not yet taken sufficiently effective action to curtail the growth in bank reserves and bank credit to more accurately reflect real and anticipated economic growth. However, the move toward further monetary restraint must be neither too large nor too abrupt. The level of interest rates is already high by historical standards and a further sharp movement to higher rates would be likely to create serious disturbances in the financial markets.

It is for this reason that we believe monetary policy cannot do the whole job. The degree of monetary restraint which the economy can absorb at this time without undesirable side effects would not be sufficient to provide reasonable price stability under current conditions.

A reduction in the supply of money and loanable funds will raise interest rates and reduce demand for credit. However, credit demand for marginal projects can also be reduced by a more restrictive fiscal policy. Harnessing fiscal policy and monetary policy together in this fashion would result in reducing the overall level of demand but at a lower structure of interest rates than would be true if emphasis were placed on a restrictive monetary policy alone. Therefore, fiscal policy must reinforce monetary restraint while debt management considerations must not be permitted to impair its effectiveness.

Another phase of current administration economic policy is designed to reduce residual unemployment through structural measures to improve the training and skills of the labor force and to generally strengthen the performance of labor markets. While it is true that this approach will augment the ability of the economy to absorb increases in demand without inflation, the administration has too often pushed the wrong programs while letting those with real potential languish. Even when effective, these programs will not have any substantial effect in alleviating current pressures. Considerable lags exist between the beginning of training and the time the trainee is able to fill a pressing job vacancy.

While the administration now talks as though structural attacks on unemployment are another of its unique contributions to the economic expansion, the fact remains that the administration began to fashion structural tools only after persistent Republican pressure and then in a tardy and limited fashion. We have long pushed for and continue to urge improvement of training programs to update skills, ease adjustment to technological unemployment and improve the opportunities of minorities.

Much remains to be done in this area in order to reduce residual unemployment to a minimum while avoiding inflation. We shall comment at greater length on this critical aspect of economic policy later in these views.

THE WAGE-PRICE GUIDEPOSTS⁵

The administration hopes to restrain inflation by wage-price guideposts that were first enunciated in 1962 as a guide to private action but which have since become a disguised form of direct control over the private economy.

We Republicans believe that our economic system is designed to economize our natural and human resources and to channel and allocate them among alternative uses through the impersonal operation of the market system. We have placed chief reliance upon the forces of (1) free independent initiative and choice, (2) profit motivation, and (3) competition between independent sellers, seeking the favor and purchases of independent buyers, trying to get the "most-of-the-mostest" for their money. Through these forces our system is designed to maximize employment, production and purchasing power, and achieve the optimum use of resources at the level and in the directions we desire.

⁵ Senator Javits agrees with much of the discussion of the guideposts advanced by his colleagues, particularly regarding their inflexibility and the coercion used by the administration to enforce them. However, he believes that the guideposts perform a useful and necessary function in a complex modern economy now burdened with the Vietnam war. He believes that they provide some economic guidance to the private sector and thus help to avoid the need for mandatory controls to curb inflation.

The risk is that we will drift or be led into a new pattern, downgrading collective bargaining and the free market system. The proper role of Government under our political and economic system should be to create and maintain the market machinery in good working order—not undertake to substitute for it, or confuse the issues of its imperfections by admonitions that it do better.

This is precisely the risk that we face today. We do not believe that the guideposts can restrain inflation in a period of tight labor and commodity markets, nor do we believe that they should be relied upon for this purpose even if they were effective.

From past experience, we would expect that the failure of the guideposts will lead the control-minded policymakers in the administration to seek more direct and damaging restraints on private economic decisionmaking.

The debate which would certainly follow a forthright request for authority to impose direct controls would have a healthy effect. If the administration believes controls are needed, we would prefer controls imposed and limited by statute to the ambiguous and arbitrary exercise of economic power now assumed by the administration without sanction of law or provision for redress of grievances.

A full-scale study within the Congress, such as we have urged the Joint Economic Committee to undertake, might convince well-meaning proponents of the enforcement of the guideposts of the long-run perils to which systematic interference with the market mechanism exposes our free economy. If such a debate did nothing else, however, it would make abundantly clear the technical difficulties which stand in the way of devising a satisfactory formula governing the changes in wages and prices in our economy.

VARIETY OF EXCEPTIONS

The complexity of the guidepost concept is demonstrated by the fact that there are a variety of exceptions which are not as clearly dealt with as behavior under the general rule. Since the average rule is more easily administered than the numerous exceptions, inefficiencies in allocation of resources may result, as Professor Musgrave pointed out to the committee.

The Council's decision to scrap the 5-year moving average as an appropriate indication of the general productivity trend and to retain instead the 3.2-percent guidepost of last year illustrates another inherent weakness of the guidepost concept: the problem of developing a measure of the trend growth of productivity. What time period truly represents the trend value of productivity in the U.S. economy? Should this value reflect only output per man-hour or output per unit of total factor input? Should the national increase in productivity include the large gains in agricultural production along with the smaller increases in the nonagricultural sectors? Should wages go up 3.2 percent in industries which experience substantially larger productivity increases? These are a few of the difficult questions which should be debated. Depending on the answers, the value of the wage-price guidepost would be vastly different.

Another difficulty with the guidepost concept is that the approach lends itself more readily to markets in which a few firms are dominant and wage settlements involve large contracts. Inescapably, their enforcement becomes selective and discriminatory.

The guideposts also miss the mark in concentrating on industries rather than individual firms, where much of the wage determination and price setting actually occurs. The concept of an industry of homogeneous enterprise has been blurred in recent years. Even if an industry could be clearly identified, the position of individual firms within that industry differ markedly from one another.

The guideposts are intended to deal with cost-push inflation caused by market power, even in the absence of excess demand. The argument that specific industries or unions exercise a high degree of arbitrary market power is often overstated. Among other factors, it frequently overlooks the competition of domestic substitute products as well as imports. For the most part, price or wage increases in these highly visible situations are a response to rising demand and limited supply, just as is the case with other industries.

THE EUROPEAN EXPERIENCE

In any event, spreading wage and price increases are only possible if a rapidly increasing supply of money supports an excessive level of aggregate demand in the economy generally. If aggregate demand is held within nonin-

flationary bounds, guideposts will not be needed. If aggregate demand is permitted to get out of hand, the guideposts will be ineffective. The European experience with "income policies" offers persuasive evidence of the futility of trying to restrain inflation through such devices in an overheated economy.

Administration officials who castigate private decisions as "not in the public interest" or "unpatriotic" assume a depth of understanding of what constitutes the public interest that is almost mystical. Would the increase in aluminum prices which the administration rolled back have been in the public interest? If prices had been allowed to rise, resources would have been drawn into the aluminum industry, raising investment and ultimately output. Higher output would have meant lower prices sometime in the future. Higher prices now might also have shifted demand to substitute domestic products, where demand pressures may be less.

The administration's extensive arguments about the effectiveness of the wage-price guideposts in restraining price increases in the private sector have obscured the vital role that prices have to play in a predominantly free market economy. Prices are sensitive and reliable indicators of the relationship of supply to demand, and price changes serve to direct creative effort and materials to their most productive uses. A price rise indicates that more resources should be devoted to a particular productive activity, while a price decline indicates that resources can be profitably withdrawn and utilized elsewhere. In other words, prices serve as traffic signals directing resource flows to the most efficient activities in terms of satisfying demand. When the traffic signals are replaced with essentially static guideposts, there is little assurance that resources are being directed to their most productive uses. There can be no assurance when the guideposts are fixed in an arbitrary manner. A product's price rise persuades consumers to shift their demands to substitute products, thus lessening demand pressures on the more expensive items. A price rise also induces producers to increase supply by opening up opportunities for greater profit. This increased supply further lessens upward price pressures. When this adjustment mechanism is perverted, both high demand and low supply continue with no alleviation of inflationary pressures.

ANTITRUST POLICIES

Where private market power does exist to thwart the working of the price system, it can be dealt with most effectively by diligent and determined pursuit of policies to make competition more effective, including both antitrust action and lowering the barriers to imports from abroad.

If the guideposts divert attention from fundamental fiscal and monetary policies, they will have an upward bias of their own to changes in demand and weakening the capability of the economy to adjust to changes in demand and technology. Prof. Paul W. McCracken, of the University of Michigan, has said:

An economy whose pricing system operates according to the guidelines as enunciated would certainly find its capability for progress severely weakened.

As Professor McCracken points out, there are serious dangers in attempting to apply aggregative rules relevant to the general price level to the ever-changing relationships among individual prices.

Budget Director Charles L. Schultze, in a paper written for the Joint Economic Committee in 1959 while professor of economics at Indiana University, maintained that it was essential to economic stability for wages and prices to be responsive to changes in demand. Commenting on guidepost policy, he said:

Public policy statements in recent years have emphasized that wage-rate gains must stay within the bounds of productivity advances if inflation is to be avoided. This study on the other hand stresses the importance for price stability of the responsiveness of wages and prices to changes in demand. There is no single formula which can specify the appropriate relationship between changes in productivity, prices, and costs in particular industries. In a flexible economy individual wage-price-productivity relationships should reflect the strength of demands in each industry. If businessmen and labor leaders would become more demand conscious and less cost conscious, the overall wage-productivity relationship would take care of itself, so long as intelligent monetary and fiscal policies were pursued. Hence, if one must preach to business and labor about their obligations to the "public interest," the

emphasis should lie on the need to orient price and wage decisions more closely to market conditions. The continual invocation of the phrase "wage-rate gains on the average should not exceed productivity gains on the average" is not sufficient to enable management and labor on an individual basis to determine the kind of price and wage behavior on their part needed to achieve a greater stability of the price level in a full employment economy.

We believe the guideposts have been useful in conducting a more intelligent public dialog. But we reject as inequitable and damaging to our economic system the selective, arbitrary, and punitive enforcement of what were intended to be no more than guides to private action.

REPUBLICAN POLICY PROPOSALS RESTATED

In the preceding discussion of administration policy, our views on the appropriate course of economic policy in the current inflationary environment have been implied but not precisely stated. In this section, we wish to set forth our policy proposals more fully.

The basic assumption upon which these proposals are based is that immediate steps are required to reverse the ever-worsening inflation in the economy. Further delay in applying anti-inflationary restraints will require a stronger and more disagreeable dose of restrictive medicine in the future.

A. MONETARY POLICY

The Federal Reserve Board should reinforce its increase of the discount rate last December by moving to slow down the growth of bank reserves. The Board should supply a level of reserves that will restrict the growth of bank credit to about 5 or 6 percent in the coming year in contrast to the growth of nearly 10 percent last year. The increase in the money supply (currency and demand deposits) should be held to the current and anticipated real growth of the economy and not permitted to continue at an excessive rate of increase.

A monetary policy such as we advocate would permit the economy to grow at or near its current real rate but would avoid an acceleration of the inflationary boom. However, even this degree of monetary restraint probably will not prevent a substantial increase in the cost of living this year in the absence of fiscal tightening designed to reduce the demand for credit.

B. FISCAL POLICY

The administration should reduce the administrative budget deficit of \$6.4 billion projected for the current fiscal year and, at a minimum, produce a small surplus in fiscal 1967. The national income and product account budget for calendar 1966 should also show a surplus instead of the substantial deficit that will result from present policies.

These results should be achieved through strict control over Federal spending.⁶ If expenditure control is not pursued with sufficient diligence and determination, then an increase in taxes faces the American people. These measures should be in addition to tax changes already requested by the administration.

The administration should move immediately to defer nonessential civilian expenditures, to stretch out planned spending wherever possible and to eliminate redundant and inefficient expenditures. We do not suggest a meat-ax approach to expenditure control, but rather an approach that takes cognizance of the limited skilled and professional manpower and physical plant capacity in particular areas of the economy. The Bureau of the Budget should set forth strict but carefully formulated spending priorities in this spirit, recognizing that not every dollar of Federal spending is of equal importance to the national interest.

The need to set priorities for Government spending is well illustrated by the continuing housing needs for low and moderate income citizens, and the refusal of the administration during hearings this year before the House Special Subcommittee on Housing to back a Republican amendment to the urban renewal laws which would redirect the urban renewal program by setting priorities for using available funds in projects designed for this necessary housing.

Prior to the enactment of the 1964 tax reduction, administration officials maintained that reductions in spending would be virtually impossible to make.

⁶ See Senator Javits' footnote, p. 33.

Republicans insisted that the tax cut should be accompanied by reductions in the administration's proposed spending, and time has proved the wisdom of that position. If spending had increased in the past 2 years as rapidly as in the 1961-63 period, the inflationary overheating of the economy would have occurred much sooner and would have been more severe. In fact, it is likely that tax cuts accompanied by rapid expenditure increases would have resulted in more serious inflation before the achievement of 4-percent unemployment. It was not until the administration stepped up its level of spending last fall that overheating of the economy began to appear.

Congress Should Exercise Restraint

We also urge the Congress itself to exercise restraint in considering the administration's 1967 budget requests. There may be selective cases when the Congress will increase administration requests. If so, these should at least be balanced by reductions in other areas.

Above all, we hope that discussion of expenditure deferral until economic conditions are more favorable will avoid the emotionalism that generally surrounds appeals for expenditure restraint. No one believes that the underprivileged in our society should bear the costs of the Vietnam war. But neither can anyone doubt that numerous programs of marginal value to our society can be slowed down without harm to the national interest. In some cases, a less rapid and more carefully considered buildup of Great Society programs would avoid the redundancy, inefficiencies, errors and controversy that accompany well-meaning efforts to do too much too soon. We would also remind the administration that—in the words of the minority members of the Ways and Means Committee—"we cannot win the war on poverty if we lose the war on inflation."

Whether a tax increase can be avoided depends upon monetary policy, debt management policy and a change of heart by the administration so that expenditures are held down in the coming year.

If too little is done in these areas, then taxes will have to be increased, which is preferable to increasing the debt. We would regret the necessity for a tax increase. Experience has shown that high tax rates are an impediment to economic growth. Our hope is that as Federal revenues grow in the future, expenditures will grow by a smaller amount, permitting regular tax cuts that will stimulate long-run economic growth.

We recognize that changes in tax rates starting from a level of exceedingly high rates can be a powerful weapon for economic stabilization. We would not hesitate to use the tax tool when necessary. However, our feeling is that a tax increase can be avoided today if our recommendations in the fiscal and monetary areas are followed. As we have already stated, we feel that an increase in taxes this year might be followed by a reduction again next year if recession threatens. It would be considerably more difficult and time consuming to cut taxes again next year than to reinstate the expenditures deferred this year.

However, if a tax increase becomes necessary, we believe that a flat percentage increase in corporate and personal rates would be the simplest and quickest method to pursue.

We believe that consideration should also be given to elimination or temporary suspension of the investment tax credit as part of any proposed general tax increase package.⁷ Since capital expenditures are at an unsustainably high level and apparently going even higher, there is a danger that the economy may face a situation of excess capacity sometime in the future. It would be desirable under these circumstances if some currently planned capital spending were deferred until next year or beyond.

On the other hand, new capacity increases aggregate supply and enables the economy to absorb higher levels of aggregate demand without inflation, particularly in distribution and services where bottlenecks and shortages are particularly serious. More efficient capacity also strengthens our international competitive position and produces a larger growth in productivity and downward pressures on costs at home. Our long-run policy should continue to em-

⁷ Senator Javits believes the prevailing priority should continue to be the encouragement of real production, and he is, therefore, for retaining the investment tax credit. He wants to see it broadened to include manpower training expenditures by business which are approved by the Secretary of Labor and in addition to normal training already being carried on.

phasize the importance of a high level of savings and productive investment in the economy.

D. DEBT MANAGEMENT

One of the most important but least debated economic issues is the impact of debt management on monetary policy. Although the Treasury-Federal Reserve Accord of 1951 was designed to free monetary policy from the iron grip of debt management, the flexibility of open market operations is still impaired to some extent by Treasury debt financing. If monetary policy is to serve its purposes effectively, considerably more understanding is needed of the relationship that exists between the operations of the Federal Reserve and the debt financing of the Treasury. We have consistently advocated that the Joint Economic Committee study this issue as a part of its continuing interest in the tools of monetary policy.

Recent developments point up our concern. Since mid-1965 changes in the composition of the debt have tended to be stimulative because newly issued debt has been relatively short term. The legal interest rate limit on long-term Government bonds is no longer competitive, forcing the Government to borrow in the form of "near money" securities with short or intermediate maturities.

The legal interest ceiling has also affected the term structure of interest rates. Yields on Treasury bills and intermediate-term securities have risen abnormally relative to yields on long-term Government bonds.

We believe that the administration must recommend immediate lifting of the 4½-percent ceiling on Government bonds. Removal of the ceiling would facilitate noninflationary, long-term Government financing and at lower interest costs than are now possible through financing at shorter term.

Chairman PROXMIRE. Thank you very much, Mr. Secretary.

You say you are not here to get merit badges or a good conduct medal. I am going to give you one whether you like it or not. I agree with you wholeheartedly on not increasing taxes last year. As you say, there were certain restraints and fiscal actions taken, including some increases in revenue. If I got up on the floor of the Senate once I must have gotten up 10 times to praise the President in his position in not yielding to the pressures of many people and for not asking for a tax increase.

I think that was good sensible economic policy and I still think it was. However, at the same time I think it makes sense to press for a reduction in spending even beyond what the President had recommended.

I just want to make one other commendation before I get into questions. I think that you have done an excellent job in working to try and improve the international liquidity position. This is very complicated, but enormously important for world trade. You have worked very hard and ably to keep international interest rates reasonably down so we don't have pressure from that source to add to our stringency here at home, and you deserve a great deal of credit.

This is complicated. It takes subtlety, diplomacy, exercise of wisdom, and you have exercised all of those virtues.

As far as your statement of March 23, however, I am glad you read that other paragraph and frankly, I can't see that it adds anything. There is no question in my mind, Mr. Secretary, that there is uncertainly involved in Vietnam. There is no question that it is hard to estimate whether you were going to have a \$10 or \$11 or \$12 or \$9 billion war over there. But you had a \$20 billion war. That kind of mistake has not been explained by you or anyone else in the administration.

I don't want to spend much time on this, and I am sure you don't either. I would like to emphasize that what we needed was a cor-

rection of the clear error that had been made as time passed. Now when you made your statement on March 23, we knew that there was going to be an escalation of 400,000 troops in Vietnam at the end of the year, and certainly by June or July we had a much clearer picture of what Vietnam was going to cost, and yet there was no revision of those figures on behalf of the administration until late November of 1966, after Congress had adjourned. If we had gotten this correction in June or July, there is no question in my mind that the efforts of many of us to cut spending and the efforts of the President to keep spending down would have been greatly strengthened.

What I am asking you because I do want to make this as constructive as I can, and not simply to beat a dead horse, what I am asking is whether it wouldn't in your judgment be sensible to come up with more frequent estimates of the cost of the war in Vietnam, in view of the uncertainty involved, in view of our record in the past, and in view of the immense importance to economic policy in having as accurate, up-to-date estimates as we can get?

Secretary FOWLER. Mr. Chairman, I think there wouldn't be any objection from me as to the desirability of having the best information updated from time to time. The recommendations made by the Commission on Money and Credit some years ago suggested that a quarterly updating of estimates, both of expenditures and revenues as well as general outlook would be desirable. And I am sure that the Director of the Budget would cooperate if this committee and the Congress feel that more frequent estimates are helpful to it.

I will not go into the problems that these more frequent estimates would present. The business of estimating is a perilous task always, and one does not rush happily into the practice of forecasting any more than is necessary.

I do think, however, that there is much confusion over whether or not the revised estimates of Vietnam costs had the real consequences for economic policy that have been expressed or made implicit in many of the statements. I would like to develop that point because I think it is important.

Chairman PROXMIRE. May I interrupt at this point to say, wouldn't you agree that if the Congress knew, had a firm figure that the deficit was going to be as big as it would have been with an additional \$10 billion of spending in Vietnam, wouldn't it have been more likely that Congress would have supported the efforts to keep the spending down, than they did, and wouldn't this have been in retrospect in the national interest?

Secretary FOWLER. That brings us to the part of this picture that I think you have omitted. You have to look at the entire picture. At the same time defense expenditures seemed to be increasing, civilian expenditures were decreasing, and revenues were rising. We had estimated in January 1966 that Vietnam expenditures in fiscal 1966, would be \$4.7 billion. At the end of that fiscal year, 6 months later, they proved to be about \$5.7 billion. Meanwhile, however, civilian expenditures fell below the estimate. Moreover, revenues exceeded the estimates so that the deficit in fiscal 1966, which was estimated at \$6 billion, actually proved to be on June 30, \$2.3 billion. The improvement in the form of lower civilian expenditures and higher revenues more than compensated for the increase in defense expenditures that had been projected for the first 6 months of calendar 1966.

Chairman PROXMIRE. You were wrong on both sides. The error on one side helped to mitigate the error on the other.

Secretary FOWLER. The fact we were conservative—

Chairman PROXMIRE. You were wrong.

Secretary FOWLER (continuing). In our estimates of revenues and the fact that the President held down nondefense expenditures compensated for the fact that there was an increase in defense expenditures, to a degree that changed the estimated deficit for fiscal 1966 in January from \$6.4 billion to an actual deficit of \$2.3 billion. I didn't provide any reestimates of receipts for fiscal 1967 because I was afraid I might encourage a little more spending and appropriations at that particular time, and I want to come to that part of the picture. But there were estimates—

Chairman PROXMIRE. At that point, Mr. Secretary, don't you think it is wise to always give Congress the best and the most up-to-date figures, the most accurate figures you can give, regardless of what Congress does with them?

Secretary FOWLER. Yes, that is right, and had there been a reestimate of all of the consequences—civilian expenditures and defense expenditures as well as receipts—I would have played my role and given a reestimate of receipts. But, we did not reestimate either side of the equation in terms of the debt limit.

I went up for a debt limit based on an estimated deficit of \$1.8 billion, which I thought in May was still a good figure—that increases in revenues would roughly offset higher defense spending. In determining what to ask for in the way of a debt limit, the outlook for the deficit is a prime consideration.

Now, in May, however, the staff of the Joint Committee on Internal Revenue Taxation had made its own estimates. They had estimated that revenues would be—this was in a published report—\$116 billion instead of the \$111 billion that had been carried in the January budget. So, it was clear from all sides that revenues were moving very smartly up during the winter and spring of 1966, and that receipts would then be projected well in excess of the original estimates.

Now everyone remembers very well that there was a great range of uncertainty in the amount of funds Congress was going to appropriate for civilian purposes—whether they would be greatly in excess of the President's budget as seemed to be indicated in the early part of the summer, or whether they would be pulled down in the appropriations process to the overall totals of the President's requests or under.

I think it is well known—to some members of this committee, at least—that I spent a great deal of time coming up here urging economy in the early summer, June and July of 1966. I saw almost every member of the Senate Appropriations Committee, and talked and worked with Senator Dirksen in connection with his side of the aisle, trying to impress upon everyone the importance of holding down these additional appropriations at least to overall totals that were included in the President's budget, because of the indefinite character of Vietnam expenditures.

Chairman PROXMIRE. I recall that very well, but Mr. Secretary, it just is very difficult for me to understand why it is so hard to come within a country mile or 10 billion country miles of the cost of Viet-

nam as time goes on. It is very hard for me to accept the notion that Secretary McNamara, one of the ablest men we have ever had in Government, a man with great emphasis on precision, and a meticulous estimator and forecaster, and so forth, missed it by this much in January. The notion that he would miss it this much again, if he had reestimated in April, and again in July is something else.

Furthermore, Mr. Secretary, on another aspect of it——

Secretary FOWLER. May I just say in behalf of my colleague that I think you are being unfair to him.

Chairman PROXMIRE. I am not being unfair at all. I am trying to understand why he did. I am saying he is a man of particular precision and great intellectual capacity and integrity, but I am just saying he was wrong and I want to find out why.

Until we find out why, it is going to be hard for this committee to recommend economic policy with any assurance to the Congress of the United States.

Now, to get back to your own responsibilities——

Secretary FOWLER. Could I at this point, Mr. Chairman, say that there has been submitted to another body a statement of Secretary of Defense Robert McNamara before the Senate Armed Services Committee, and the Senate Committee on Department of Defense Appropriations, on January 23, and this part of it has been declassified, and it is available. It contains Secretary McNamara's own explanation of this particular question, and the detailed record of his detailed explanations to the Congress, to the Senate Armed Services Committee, beginning on February 25, 1966, as to both the planning assumptions that he used and the reasons he used those planning assumptions, and, therefore, the qualifications everyone should have reasonably carried into their minds about the nature of the so-called expenditure estimates for Vietnam.

I would like to make this available to the committee, if it has not been given to the members. It is Secretary McNamara's own explanation on this particular point.¹

Chairman PROXMIRE. Yes. My time is up. I am well aware that Secretary McNamara said again and again, as did you and many others, that these estimates were subject to great qualifications and great uncertainty, which once again emphasizes the necessity and certainly desirability, and I think the necessity of getting more frequent estimates, because the latest estimates are just bound to be in the long run more accurate, based on greater intelligence.

Secretary FOWLER. And no matter how——

Chairman PROXMIRE. Until we have those later estimates, we are in a position where it is extremely difficult for us to act with any sense on appropriations policy.

Secretary FOWLER. You will never have accurate estimates of how much it takes to fight a war until you can read the mind of the enemy, and no one here has yet devised a means whereby we can determine what Ho Chi Minh or the men in Hanoi are going to do, how much force they are going to throw in, in what proportions, of what nature.

The question of military requirements and military estimates has always been the most variable of calculations, and it doesn't seem

¹ Copy of the material referred to is in the files of the Joint Economic Committee.

to me that it should cause this great commotion and surprise—especially given all the care and qualification that is implicit in the Secretary's repeated statements—that we are spending more money in Vietnam in fiscal 1967 than we thought we would in January 1966.

Chairman PROXMIRE. You and I are on exactly the same side. We agree. All I am saying is that because we have an uncertain situation, because war is unpredictable, because it is hard to tell, we should have regular updated information on what the best estimate of this very competent Secretary of Defense is on how much the Vietnam war is going to cost.

Unless we have that, our policy is not going to be informed. It is not going to be as effective, and we are going to make the kind of serious mistakes we made last year.

My time is up.

Secretary FOWLER. I don't think it would have made a bit of difference in terms of the economic policies that were followed by the Congress or by the administration if we had brought a new estimate up here last July or last August. We all fought just as hard as we could to reduce the level of appropriations. I know I did. I know the President did. I know you did, by amendments on the floor. I know many other Senators and Congressmen did.

I don't think it would have made a bit of difference in terms of recommending a tax increase. With all this information now out on the table, I don't see any great rush of men dropping bills in the hopper to increase taxes with the retroactive date effective January 1, 1967.

We are following the same policy that we would have followed had that information been available earlier, and therefore, I think you have to take the total picture into account, and I believe much too much is being made of it. That is just a personal judgment.

Chairman PROXMIRE. Mr. Widnall, I see you have fire in your eyes.

Representative WIDNALL. Thank you, Mr. Chairman.

Mr. Chairman, I would like to ask unanimous consent to insert in the record immediately after the supplementary statement of Secretary Fowler, the views of the minority members of the Joint Economic Committee included in the committee's report of March 17, 1966.

Chairman PROXMIRE. Without objection.

(Material referred to appears on p. 170.)

Representative WIDNALL. In those views, the section entitled "Maintain but Moderate Expenditures" this was said:

This requires a balanced and moderate program of government fiscal and monetary restraint. However, monetary policy cannot carry too heavy a burden in tempering the boom.

Later:

Fiscal restraint also is essential to hold down the level of demand for funds.

And then in another paragraph:

If the Administration is unwilling to reduce spending, an increase in taxes will be necessary which would cause economic damage itself. Increasing taxes is a less desirable way to moderate the boom than by deferring expenditures.

I recall very well that when economists appeared before this committee last February they said:

"The restraint in your program was more apparent than real." I believe you will find that in the record.

All through the hearings and in later statements, the minority members of this committee urged fiscal restraint. We never felt there was a proper mix or a recognition of the problem until just within the last couple of months.¹

I feel personally that housing was made the goat, and for many, many months the entire defense as to what was going on was action by the Federal Reserve in December of 1965, but it became apparent months later that the administration intended to sacrifice the housing industry. It was apparent in the lack of attention to what was taking place throughout the economy in this particular very important segment of the economy.

I would like to say also on behalf of the —

Secretary FOWLER. Will I have an opportunity to comment on these statements?

Representative WIDNALL. Let me just finish. On behalf of Senator Javits, who can speak eloquently for himself, he unfortunately is absent today, but I am sure he will want to answer the personal attacks that were made on him, in connection with the supplementary statement. Now you may comment.

Chairman PROXMIRE. If the Congressman will yield, certainly in the judgment of the chairman there was no personal attack. There is a clear disagreement on policy, but I am sure that the Secretary has expressed no derogation of Senator Javits. He has always expressed admiration for Senator Javits.

Secretary FOWLER. I want to make very clear to you Mr. Widnall, and everyone else that I have the greatest respect for the Senator and count him as one of the most able and effective analysts and legislators of our time. I only pointed to the Senator's position, if you will read the entire statement. He came out in March of 1966 and espoused an income tax increase. The only point I was making about Senator Javits on that question is that he was a minority of one insofar as the Republican leadership is concerned. That was in no sense a reflection in any way on him at all.

Representative WIDNALL. Mr. Secretary, I withdraw the characterization, if I misunderstood what you intended. But I noted several times here, where you made the statement that Senator Javits purports to speak for the minority, when he actually was issuing a statement that the minority itself had prepared. This is entirely different from the individual attacks that he has made at one time or another on certain actions within the economy.

Secretary FOWLER. You have made very clear that he was speaking for the entire minority of this committee.

Now, with reference to your comment about the report last year, I find in this statement the view that increasing taxes is a less desirable way to moderate the boom than deferring expenditures; a cut in tax rates that are already too high is a sound way to lower barriers to economic growth; to raise taxes now would restore an obstacle to long-term growth; and another turnabout in tax policy reducing some of the high rates might be required next year if recession threatens. This attitude of preferring to reduce nondefense expenditures, which was espoused by the minority of the committee last year, is the policy that

¹ January 1966 Economic Report of the President, hearings, pts. 1-4, February 1966. See also H. Rept. 334, Joint Economic Report on the 1966 Economic Report of the President, March 1966.

we in the administration felt was the appropriate policy, and during the spring and summer, as I have indicated we did go to great effort to try to hold down increases in both authorizations and appropriations that would give rise to this thrust for increased expenditures. Indeed, in response to this policy, the President came forward in September, as you recall, and pledged himself to identifying and locating to the extent of \$3 billion reduced expenditures on the nondefense side. The particulars of that program have been given by Budget Director Schultze to the House Ways and Means Committee in hearings last week. So I find no difference in our attitude and your attitude as expressed on that particular score a year ago.

Now with reference to housing being made the goat, this was pointed out by the President on December 7, 1965, when monetary action took the lead. As to the administration standing by and watching it idly, that is just not the fact.

On the week following that action by the Federal Reserve Board, I convened a meeting of the Coordinating Committee on Bank Regulation in an effort to find ways and means of dealing with this new situation that would minimize the drift of funds away from the savings institutions and the mutual savings banks. You and I worked together to get the so-called interest rate escalation legislation enacted. We were in hearings on that I think as early as May of last year.

But all during the spring period, you will find there were, and I will be glad to detail them for you, very determined efforts on the part of the Treasury Department and other agencies of Government to arrest what to us was a very serious situation in the housing industry.

Representative WIDNALL. By the administration's own admission, interest rates were dangerously high last year. Isn't the fact that monetary policy was necessarily tight evidence that this policy did not do an adequate job in restraining the economy?

Secretary FOWLER. The evidence, it seems to me, is clearly that there were certain selective areas in the economy that were in a boom condition. One of them was defense expenditures, and I don't know how you avoid that, if you are going to properly finance and carry forward a war.

The other was the so-called capital goods boom. The President in March, through voluntary means, convened those men that are responsible for the great bulk of plant and equipment expenditures in the country, and pleaded with them collectively to do everything they could to scale down their expenditures during this particular period. He got excellent response, I know personally, from a number of them.

But despite the responses of individual companies here and there, the sum-total effort was not sufficient. We did have to come forward with the proposal to suspend the investment credit in order to ease the pressure of this boom—which it really was, in terms of excessive demands for money. It was a question of stockpiling money and credit for all known and contingent needs. We did take fiscal action. We took selective fiscal action to deal with selective prices, and we imposed selective restraints.

I still do not think that during 1966, in addition to the general steps that were taken, there was need for a general income tax increase. I thought it would have been a dangerous thing to do at that time and I also think so in retrospect.

Of course, I would have welcomed further reductions in the levels of appropriations. I think it is unfortunate that the President had to go to the extent he did in withholding and deferring expenditures.

Representative WIDNALL. I believe Dr. Ackley said at the time that it was a very close question as to what to do, if I am quoting him correctly.

My time is up, Mr. Chairman.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Secretary Fowler, I am very proud of the job that you and your associates have done in international monetary reform in the last year.

Secretary FOWLER. Thank you.

Representative REUSS. I think you have tabled before the leaders of the free world a very constructive program looking toward the evolution of a new international monetary medium. I wish you all success, and I hope you will get it at the IMF meeting next September.

This committee joins me in that hope. However, we must always be concerned at the prospect of what happens if your valiant efforts are not successful, and if we don't get an agreement, and if we are then in the same old position where the dollar has to bear all the burden of being the world reserve currency and being liable to destructive actions by gold demands of other countries.

I think we ought to plan against that dire contingency. My own proposal, on which I would like your comment, is that if that happens, I would like to see us (1) remove forthwith the gold cover on currency, so that our full \$13 billion-plus of gold is available, and (2) try to get agreement among the trading countries of the world on a reasonable and constructive method of holding reserve; specifically some procedure whereby the countries which would be parties to the agreement would agree to hold dollars rather than demand gold for their full foreseeable needs of trade and investment, and not capriciously and destructively to demand gold; and as to those countries, like, say, France, which on past performance aren't likely to agree to such constructive behavior, then deny them certain benefits, such as, for example, the right to come into this country in the capital markets, by, say repealing the interest equalization tax except for countries who are destructive with their gold demands, and perhaps saying that we aren't going to give them the benefits of American tourism, and that American tourists to their countries will be cut off as long as they persist in their dog-in-the-manger attitude.

How do you like that contingency plan?

Secretary FOWLER. Well, Congressman Reuss, first let me say that I would like to return the compliment in this sense: That I think this committee and the Subcommittee on International Exchange and Payments matters, of which you have been the chairman, have made a very signal contribution in the series of reports that have been made.

Representative REUSS. I appreciate this very much, but don't use any of the 10 minutes on flattery.

Secretary FOWLER. Not at all. But it has been a contribution, and I think your colleagues are entitled to know that it has been a very influential document. I refer particularly to the 1965 report on "Guidelines for Improving the International Monetary System." It has been widely used and quoted in the negotiations that have been occurring.

Secondly, I think the recent document which——

Representative REUSS. Thank you very much, but how do you like the contingency plan?

Secretary FOWLER. Well, I am hopeful that it won't be necessary. I am hopeful that we are going to have accord, and that we are going to be able to maintain and improve the international monetary system pretty much in terms of its universality of operation, without going off into separate camps.

Representative REUSS. Thank you very much. I won't press you further on this unless you want to be pressed.

Secretary FOWLER. However, I think we must always think of contingency plans. That is why I welcomed the recent compilation of statements and views that this committee released last week. They are receiving careful study and attention, and although we hope we won't have to use any of them, I think that the one you mentioned would be one of the leading candidates for consideration, should such a contingency arise.

Representative REUSS. Thank you.

Let me turn to another aspect of the balance-of-payments situation.

As you have demonstrated, the big cause of our current troubles is the war in Vietnam, which accounts for \$1 billion-plus of our balance-of-payments deficit.

What happens is that we pay American troops and contractors in dollars over there, they translate them into Vietnam piasters, and the Vietnamese central bank ends up holding large numbers of these dollars, many of which I suspect leak out to French importers and so add to our troubles there.

Why don't we do what the United Kingdom did in World War II, and ask that our allies block their accounts of our currency? That would defuse a very major item on the balance-of-payments deficit. So why don't we do that?

Secretary FOWLER. Because we don't think it is necessary, after careful examination of that situation. It has been repeatedly looked into since the summer of 1965, when we sent Mr. Zagorin from the Department over to view this.

Now the possibility of our Vietnam expenditures adding to the gold drain is one we have been aware of, and as I say, as soon as the buildup of our forces was initiated, we took steps to minimize this possibility. While we can't claim 100 percent success, we do believe that any such drain is relatively small, and well below the estimates that are frequently seen in the press. I would like particularly to note that we don't spend dollar currency in Vietnam.

Representative REUSS. Military payment certificates.

Secretary FOWLER. Yes. Our piaster needs and those of our contractors for both official purposes and the expenditures of personnel are acquired through the Vietnam National Bank.

Furthermore, the aid is very largely tied directly or indirectly to procurement in the United States, and aid funds are not used to import goods from France.

Representative REUSS. Aid is tied, but local expenditures by members of the U.S. Armed Forces and local contract work performed by the U.S. military are not tied.

Secretary FOWLER. No, but that is in piasters. That is not in dollars.

Representative REUSS. Yes, but do not dollars get into the Vietnamese central bank as a result of that?

Secretary FOWLER. They do, but I don't believe that—

Representative REUSS. Some of the colleagues echeloned behind you are making no with their heads, but would you give me at this point in the record a Treasury statement on that?

Secretary FOWLER. Let me complete this short one, and I will give you a very, very long one I have here.

Representative REUSS. I appreciate it.

Secretary FOWLER. I am just trying to deal with it shortly.

(The material referred to and subsequently supplied for the record follows:)

VIETNAM COSTS AND FRENCH GOLD PURCHASES

Since the buildup of U.S. forces in Vietnam beginning in 1965 the Treasury has been quite concerned about leakage of dollars to other areas where they could bring pressure on our gold supply.

To deal with this problem and to channel our expenditures out of blackmarkets and into official Vietnamese hands where they may be constructively used, a number of steps have been taken.

In the summer of 1965 the Treasury sent an expert, Mr. Bernard Zagorin, to Vietnam to specifically look into the problem and suggest corrective action.

This mission resulted in the introduction of the MPC system whereby our forces, third country forces, and our civilian personnel, including those of contractors, were paid in a form of scrip, the Military Payment Certificate. This device did away with the previous practice of paying in regular U.S. dollars, which were spent directly in the economy and which afforded a ready means for blackmarketing. Instead, local currency needs are now met through piaster purchases through official sources. Along with adoption of the MPC, a special exchange rate, more favorable to the U.S. forces, was negotiated to reduce incentive for blackmarket activities. This rate has since become the principal rate in Vietnam.

In early 1966, a program was instituted to reduce the local spending of our forces by facilitating savings and remittances to the United States. The increased rate of interest which the Congress recently authorized to be paid on the accounts of our Armed Forces personnel, and the establishment of military banking facilities by branches of American banks in Vietnam—two major U.S. banks have opened offices there this year—have reinforced this program.

In an effort to improve the administration of local *customs* and *taxing* functions in Vietnam, which may relate to blackmarket activities as well as general loss of revenue, the Treasury has supplied personnel in both fields to assist the Vietnamese Government.

Of special significance in the drive to curb blackmarketing was the far-reaching stabilization program adopted by the Government of Vietnam in July of this year. An important feature of the program was a major devaluation of the piaster.

In summary, as a result of a variety of steps designed, first, to restrict the flow of dollars into the Vietnamese economy and, second, to stabilize the economy itself, we believe that the opportunity and incentive of individuals and businesses in Vietnam to acquire dollars and to remit them elsewhere has been effectively minimized.

RELATION OF U.S. EXPENDITURES TO FRENCH GOLD PURCHASES

A number of articles and statements have appeared alleging that much of our gold loss to France stems from dollar flows from Vietnam. These have been placed in the hundreds of millions of dollars.

Our analysis does not lead us to believe that anything approaching such a magnitude is likely or possible.

U.S. local expenditures, including those of contractors, are now all made in piasters which are acquired centrally by the U.S. Disbursing Officer with the

proceeds going into official Vietnamese reserves where their use can be controlled by the Government of Vietnam and observed by the U.S.

The charge that the U.S. in either its military or nonmilitary program pays out dollar currency to local civilians is incorrect. Furthermore, the large part of the AID program does not represent payments of any kind in Vietnam but involves the importation of goods, most of which come from the United States. Imports other than from the U.S. are primarily limited to developing countries in the area and are financed with letters of credit the proceeds of which in turn can be used only for imports from the United States.

Of the foreign exchange which accrues to the Vietnam National Bank a relatively small part, estimated between \$10-\$15 million, is used to import goods from France but both Vietnamese and French sources indicate a substantial portion of this outflow is offset by income from exports from Vietnam to France. There are also some invisible remittances to France such as for travel, study, debt payments, etc., but it is our understanding that remittance of current profits by foreign businesses in Vietnam allowed for nationals of most nations have not been permitted to those of France.

We have also examined the problem from the standpoint of French dollar accumulation. If the allegations were true we should see a sharp rise in French dollar gains beginning in 1965. The contrary is true. French reserve gains, on which their gold purchases are based, were about \$200 million less in 1965 than in the two preceding years and it appears fell approximately another \$200 million in 1966.

Further, the French balance of payments gains are fully accounted for by their surpluses with other areas.

It might also be noted, as a separate matter, that Vietnam holds its reserves almost entirely in U.S. dollars and holdings of French francs are now negligible.

In summary it appears clear that as far as the U.S. expenditure of official funds and those of official personnel in Vietnam are concerned, for both military and non-military activities, no benefit accrues to France. Similarly it appears that official and commercial transactions between Vietnam and France give rise to only a relatively small gain of dollars to France.

Consequently, any significant flow of funds to France would have to be the result of illegal transactions. Obviously no statistics can be gathered on black-market transactions, let alone what portion may be of benefit to France. Certainly such transactions do take place in a war-torn country such as Vietnam but in view of the measures taken to curb blackmarketing and the fact that many participants would have no ties with France it is reasonable to assume that any benefits to France are small.

Representative REUSS. Let me turn to the proposed 6 percent tax increase.

Last year we tried super-tight money, and that didn't work. It played havoc with the housing industry and with small business. It is now proposed to increase the tax on everybody right down to the poverty level, exempting poverty cases, at the rate of 6 percent, in order, I gather, to take some of the heat off monetary policy.

Secretary FOWLER. No. There are three reasons.

Representative REUSS. Three reasons. One, dampen inflation by slowing down—you tell me the three reasons.

Secretary FOWLER. The first is to pay for the war. Our estimate is that in fiscal 1968 the war in Vietnam is going to cost between \$5 and \$6 billion more than it cost in fiscal 1967.

Representative REUSS. One, pay for the war.

Secretary FOWLER. That is right.

Number two, we want to hold the deficit, both in the administrative budget and in the NIA budget, into a measured confine.

Representative REUSS. Why? For cosmetic reasons?

Secretary FOWLER. No, no.

Representative REUSS. Well, why? I mean why is this reason additional to paying for the war?

Secretary FOWLER. Because as a real matter and as a psychological matter we think that the——

Representative REUSS. Psychological is cosmetic.

Secretary FOWLER. You call it cosmetic. I would call it real and psychological.

Representative REUSS. What is the real part?

Secretary FOWLER. A lot of people live by these things.

Representative REUSS. That is the psychological?

Secretary FOWLER. That is psychological.

Representative REUSS. So that real equals the psychological, which I claim equals the——

Secretary FOWLER. And in addition to the psychological, we think to pull back the level of the NIA deficit in fiscal 1968 will be economically desirable, assuming, as we do, that the social security program that the President has proposed will be enacted, and that some of the sectors that have been faltering, such as the housing sector, are in the process of responding and coming back to somewhat normal proportions.

Representative REUSS. Let me state, you having stated the pre——

Secretary FOWLER. The third reason is the monetary.

Representative REUSS. Yes.

Secretary FOWLER. We think that what is most needed in terms of a balanced economy in the period ahead is the assurance to the businessman that money and credit are going to be available on reasonable terms. We believe that avoiding a return to any monetary stringency of the sort that characterized 1966 will be highly desirable. We believe that the surcharge is some additional assurance that that will not be the case.

Representative REUSS. Thank you for stating your reasons. My difficulty with the whole business—and I want to return to this later—is the reasons you have named for the tax increase—easing monetary policy, and paying for the war, and diminishing the deficit, for real or cosmetic or any other reasons. Your 6 percent tax increase, if it works, and I think it probably would, is going to diminish consumer demand and investor demand, and raise our unemployment, particularly of Negroes and teenagers. In fact, there is a perfectly good way, though it takes some courage, of achieving the fight the war and reduce the deficit and reduce the impact on monetary policy aims, and that is to have a big loophole plugging tax operation.

The Economic Report mentions some scandalous loopholes in interest exemption of high-bracket taxpayers, and there are a lot more, such as abuses of capital gains, that aren't even mentioned. Why not send up a good loophole plugging program that raises \$3 to \$5 billion, and let Congress take the onus.

(The material referred to by Mr. Reuss is reprinted from page 167 of the Annual Report of the Council of Economic Advisers, January 1967.)

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OTHER ISSUES OF TAX COORDINATION

Among other problems requiring better coordination of Federal-State-local taxation is one dealing with the exemption from taxation, under the Federal individual income tax, of interest paid on State and local government securities. Because of the exemption, these governments can borrow more cheaply—paying