THE 1967 ECONOMIC REPORT OF THE PRESIDENT

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETIETH CONGRESS

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CONTENTS

STATEMENTS

FEBRUARY 15, 1967

	Page
Heller, Walter W., professor of economics, University of Minnesota	497
Burns, Arthur F., president, National Bureau of Economic Research	542

FEBRUARY 16, 1967

Tobin, James, professor of economics, Yale University	577
Culbertson, John M., professor of economics, University of California, on leave from the University of Wisconsin	582
Hansen, Alvin, Littauer professor of political economy, emeritus, Harvard University	617
McCracken, Paul W., Edmund Ezra Day, university professor of business administration, The University of Michigan	624

FEBRUARY 17, 1967

Sprinkel, Beryl W., vice president and economist, Harris Trust & Savings Bank, Chicago, Ill	655
Goldfinger, Nathaniel, director, Research Department, AFL–CIO	668
Madden, Carl H., chief economist, Chamber of Commerce of the United States	680

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

WEDNESDAY, FEBRUARY 15, 1967

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

The joint committee met at 10:10 a.m., pursuant to recess, in room 318, Old Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Symington, Javits, and Percy; and Representatives Patman, Bolling, Reuss, Griffiths, Curtis, Widnall, and Rumsfeld.

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

Chairman PROXMIRE. The committee will come to order. The committee reconvenes its hearings this morning on the President's Economic Report. We are privileged to have as our witness one of the Nation's leading economists, former Chairman of the President's Council of Economic Advisers under both President Kennedy and President Johnson, Dr. Walter Heller.

Dr. Heller has been a very helpful witness in the past on many occasions, and it is most comforting to have him before us this morning when, as many of us observe, the economy seems to be on the knife edge between inflation and contraction.

Let me add a personal note. Dr. Heller has come here at my request in face of a most demanding schedule, and we owe him a vote of thanks for that. Dr. Heller, you may proceed.

STATEMENT OF WALTER W. HELLER, PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Mr. HELLER. Mr. Chairman, it is a pleasure to appear before this committee. I feel very much at home, particularly to appear under your chairmanship. As a fellow midwesterner, and having my roots in Wisconsin, I take particular pride in your chairmanship of a committee for which I have such great respect, and which has contributed so very much to the advance and understanding of the economic matters of this country. So it is a real pleasure to be here. I will proceed if I may with the reading of my statement.

Chairman PROXMIRE. Go ahead.

Mr. HELLER. As I once again enjoy the privilege of appearing before your committee, I hope you will indulge me in a moment's reflection on the changing character of our national debate over economic policy.

Four years ago, for example, in defending President Kennedy's tax-cut proposal, we found that the very principle and propriety of fiscal

stimulus—in the face of existing deficits and a rising economy—were under attack; not so much in this committee, as in the country.

Today's policy debates, though often sharp and heated, proceed in the reassuring environment of growing public understanding and bipartisan recognition—to which as I said a moment ago this committee has contributed so much—growing public understanding, and bipartisan recognition:

First, that the Federal Government can and should manage its tax, budget, and monetary policies so as to keep total demand pretty much in step with the economy's rising potential—and I suppose I should add that that, after all, isn't much more than the Employment Act of 1946 requires;

Second, that, as a result, the economy will operate considerably closer to its potential and be much less prone to recession in the future than in the past; and

Third, that this can and will be accomplished without danger to individual freedom of economic choice.

I observe that a stock market that rises as the economy softens—and spurts whenever peace threatens to break out—seems to reflect this underlying confidence.

But to say that there is growing agreement on basic principles is not to gainsay that the job of applying them is far tougher in today's economy—precariously perched on the knife edge of full employment, a term just used by the chairman—than it was 4 years ago when the $30 billion production gap gave us far wider margins for error. Nor have I noticed any lack of controversial grist for the committee's mill in these hearings. Vexed and vexing questions still abound, for example:

(*a*) Are this year's economic forecasts right as to level and pattern?

(*b*) Can economic policy be made flexible enough to deal with mistakes and surprises?

(*c*) Are budget forecasts—or even hindcasts—credible or incredible?

(*d*) Should taxes be raised or budgets be cut?

(*e*) How far can we go in trading easier monetary policy for tougher fiscal policy in the face of balance-of-payments deficits?

(*f*) When should the temporary suspended investment tax stimulants be restored?

(*g*) Where should official wage-price policy go from here?

In the following comments, I address myself to several of these questions—and the committee will probably address me to the rest.

Uncertainty and Flexibility

The administration's economic policies for 1967 seem highly responsive—both in overall budget impact and in the proposed fiscal-monetary mix—to the needs of the economy as they can be discerned at this time. And they are equally responsive to the need for maintaining flexibility—of keeping open our economic policy options as we try to keep the economy on the narrow road of full employment in the face of such crosswinds as—

—some slowdown in the advances of the private sector, while those in the public sector continue unabated;

—reversal of the downtrend in housing during the year coupled with a slowdown in expansion of plant and equipment;

—a slowdown in the first half of the year as inventory accumulation falls off, coupled with a speedup in the second half as easier money boosts construction and Congress boosts social security benefits.

Both the basic pattern of overall budget impact and the specific fiscal-monetary proposals of the administration seem to fit these emerging circumstances very well.

In 1966 we moved from a budget surplus of nearly $3 billion—at annual rates—on a national income accounts basis in the first half of the year—and the administration is to be warmly commended for the primacy it has now given the NIA budget, especially in discussions of economic policy—to a growing deficit in the second half of 1966 ($0.2 billion in the third quarter and an estimated $4.5 billion in the fourth quarter), and the budget will move from a $5 billion deficit in the relatively soft first half of 1967 to a rough balance in the first half of 1968, when private demands should again be nearing normal strength.

The temporary surtax. Quick and fine tuning of economic policy must be the order of the year in which we expect first an ebb and then a flow in the tides of economic advance, all the while operating near full employment, with continued cost-plus inflation. In this context, the case for the midyear effective date for the proposed 6-percent temporary surtax is clear.

But it is equally clear that we are loading a heavy burden on the back of economic forecasting

—a burden that may be greater than our present forecasting techniques should be asked to bear;

—a burden that can be lightened by increasing the flexibility and responsiveness of economic policy.

For 1967, a major part of that flexibility can be provided in the timing and terms of the temporary tax increase:

(*a*) If a slowdown in the economy is more pronounced or lasts longer than expected, or if monetary easing is halted in midstream, or if social security and other Government program increases are slow in coming, the effective date of the tax increase could be postponed.

(*b*) If the first-half lull unexpectedly persists throughout the year, the tax increase could be dropped for 1967.

(*c*) Obviously, if the overall level of demands for the year is either stronger or weaker than expected, the surtax rate could be raised or lowered.

(*d*) As another option, depending on the strength of investment and consumer demand and the course of prices and corporate profits, together with action on the investment credit, one might want to consider limiting the surtax to corporate income.

Expenditures. Government expenditures, primarily transfer payments, offer another important element of flexibility. Social security benefit increases are the primary case in point. The effective dates of those increases—in particular, whether they are made effective January 1 or July 1 of this year—can be an important element in the fine tuning of economic policy. Effective dates of any accompanying payroll tax increase offer another potential response to economic developments. I might add that I think these timing options can take place within whatever actuarial principles govern the social security trust funds.

Other expenditures offer some possibilities for speedup or slowdown—the Federal highway grants are a case in point. But given the inevitable lags in such spending, the practical stabilization potential of these shifts should not be overestimated. And as I suggest below, we should not let short-term stabilization policy pervert our longer term order of national priorities. Our high-priority domestic programs should be considered on their merits and not as vulnerable dollars in our stabilization arsenal.

Investment credit. Another important element in flexible policy is provided by our currently suspended investment tax stimulants. Perfect foresight would have called for an earlier suspension date than last October. Had we cooled off the investment boom a little earlier, the prospect for restoration of the investment credit and accelerated depreciation before the scheduled January 1, 1968, date would now be quite bright. Even as it is, a reinstatement of these tax privileges by, say, midyear of this year may make sense to avoid the threatened air pocket in investment spending during the second half of the year. But the air pocket could also be avoided by extending the suspension for an additional year, to January 1969. The important thing is not to prejudge that issue now, it seems to me, but to treat it as an open question, to be resolved in the light of (*a*) overall strength in the economy; (*b*) the relative strength of consumption and investment, taking particular account of the pressures in the machinery and equipment industries; and (*c*) the balance between the competing interests in modernization of our capital stock and the need to avoid overcapacity.

Present estimates suggest that investment is expanding manufacturing capacity at a rate close to 7 percent a year, almost matching, for example, the 2-year expansion of capacity (7.7 percent) for 1962 and 1963. Should actual operating rates in most industries be well below preferred rates by summer, it might be more prudent for the longer run to delay reinstatement of the investment stimulus. This would be especially so if capacity pressures continue to plague the machinery and equipment industries, while operating rates are slackening elsewhere. This prospect becomes more likely in the light of the most recent McGraw-Hill survey under which:

—Planned investment outlays rise in each quarter of the year. As I recall, the rise was 6½ percent for the year—which by the way, would place fourth-quarter investment spending at an annual rate of some $3 billion over what I have been projecting in my own forecast.

—These plans were made against a background of average operating rates at 88 percent in December, although several industries—notably electrical machinery—were still above preferred rates of operation.

It is true that we originally instituted the credit in 1962, when operating rates were well below preferred levels. But at that time, we knew that industrial output would rise sharply as we pushed toward full employment: Indeed, it rose by one-third—32 percent—between 1962 and 1966. Over the next 4 years, a rise of only perhaps two-thirds this much—20 percent—is all one can reasonably count on, because we don't have the unused resources in the economy to draw on. Thus with additions to capacity outpacing additions to output in most lines, and investment goods industries continuing under capacity pressures, an extension of the credit suspension may be worth considering

as a way out of the air-pocket problem later this year. It is not an easy question to settle, nor do these calculations offer a very clear guide at this time. For the long pull, this country is firmly committed to a high-investment policy and the accompanying investment incentives. But for the immediate future, considerations of overcapacity must also enter our thinking.

THE FISCAL-MONETARY MIX AND POLICY IN 1966

This brings us to our frontline of flexibility in economic policy; namely, monetary policy. Though I speak in terms of flexibility, I should at the outset make it clear that, however pleased we may be at the monetary easing we have already witnessed—an easing that represents a welcome response to current and prospective movements of total demand rather than to cost-push echoes of past demand pressures—our policy objective must be a lasting return to lower interest rates and more stable financial markets. The administration and Congress, in turn, do their part by taking pressure off the monetary authorities through adequate fiscal measures, continued vigilance on discretionary wage-price decisions, and sufficient administrative measures to keep our balance of payments under control.

The monetary and fiscal authorities are confounding the critics and skeptics by pulling together in a coordinated sequence of easier money and higher taxes. One wishes the confounding had started sooner. Indeed, the administration, the Federal Reserve, and the Congress would have served the cause of economic stability and balance well by putting through a similar package in 1966. In economic logic, it is hard to see why an ounce of prevention in 1966 would not have been worth at least an ounce of cure in 1967—and probably a good deal more, even if I cannot go all the way to a pound.

And while I'm on the subject of 1966 economic policy—which can rightfully claim, of course, that magnificent advances in output, incomes, profits, and wages were accomplished with a degree of inflation that almost any country in the world except the United States would call modest—I doubt that I can escape without expressing some views on fiscal policy. Fortunately, I have already expressed those in my recent book—*New Dimensions of Political Economy*—which went to the printer last August. I stand on that judgment, as expressed in the following excerpts from the section—of the second chapter—on "The 'New Economics' in High-Pressure Prosperity":

> Speaking solely as an economist, and with the benefit of hindsight, I come to this judgment on the tax issue: a temporary tax increase early in 1966, with special focus on the investment sector, would have cost us little in employment opportunities and gained a lot in (a) reducing the pressure of demand inflation in 1966 and of the echoing wage, cost, and price increases in 1967; (b) easing the adverse pressures of the boom on both imports and exports; (c) relieving the undue burdens on monetary policy; and (d) giving us a handy tool—in the form of tax surcharges removed and investment credits restored—to offset the post-Vietnam slack in the economy.

I recognize that this judgment on purely economic grounds cannot be the full measure of the performance of the administration and Congress in 1966. Again, as I said in my book:

> Reviewing the course of the economic policy debate in the first half of 1966, one is struck by its generally high level. There was no lack of informed and responsible public discussion. There was no lack of economic understanding

in high places. There was no lack of public conditioning to a possible tax increase—indeed, various polls show there is evidence that a substantial majority of the people expected a tax increase.

I am not saying the polls showed they wanted it, but they expected it.

But the situation was plagued with uncertainties as to the demands of the war in Vietnam, the economic responses of consumers and business, and the resiliency of the economy in dealing with these pressures. So, even had the President been able to live by economics alone—which, of course, he can never do—he would not have had an open and shut answer: among his official and unofficial advisers on economic matters, the ranks of the "do-it-now" hawks were infiltrated by a substantial number of "wait-and-see" doves.

And a final quote:

Having viewed at close hand the Presidential dilemma in Kennedy's summer of fiscal discontent in 1962, when the economy plainly needed a tax cut but political reality barred the way, I am not disposed toward a harsh judgment on the 1966 decision. I count on our growing economic maturity to keep on lowering the political barriers to sound economic decisions.

May I add that, both in terms of 1966 and for the future, standby powers under which the President, subject to congressional veto, can activate precooked temporary tax increases and decreases become all the more important if we are to get a proper balance between the call to action and the forces of inertia.

BUDGET POLICY

Let me return for a moment to the overall impact of Federal fiscal policy in 1967–68 as measured by the surplus or deficit in the NIA budget. Let me add to my earlier word of commendation on the use of the NIA budget the further thought that it was particularly courageous to bring it to the fore at a time when it is in substantial deficit at full employment. Courage, no doubt, arose out of the conviction—one I share—that the pattern of a deficit this year turning into balance next year is appropriate to the most probable pattern of economic developments.

In particular, the propriety of a full-employment deficit in the NIA budget this year seems to be supported by the saving-investment balance in the U.S. economy. Private saving at full employment is generally estimated at some 15½ to 16 percent of GNP in our U.S. economy. Normally, net private investment, or dis-saving, can be expected to match or exceed this slightly, permitting, and indeed requiring, all levels of government combined to run a balanced full-employment budget or surplus (saving). But this "normal" amount of private investment is subject to variation, particularly in response to monetary policy and to cyclical factors affecting the motivations to invest. This year, the strength of private investment is expected to be below normal:

The continued high level of business fixed investment will be more than offset by low levels of residential construction activity—even with the upturn during the year—by reduced rates of inventory accumulation, and a somewhat below-average trade surplus.

All told, these private investment components are likely to total only 15 to 15½ percent of the GNP this year, falling short of absorbing all of private saving.

Further, State and local governments have been running unusual surpluses. The economic lesson for an appropriately flexible fiscal

policy is that the Federal budget should be in deficit during much of the year, even at full employment, and even though such a deficit would have been highly inappropriate as recently as a year or even less ago.

Finally, some comments on what we can afford.

WHAT CAN WE AFFORD?

In allocating our abundant resources among priority uses, we should, as I noted earlier, consider our vital domestic programs on their merits and not as ready candidates for sacrifice on the altar of economic stability. Abandoning or weakening such programs at the first need for fiscal restraint would be both inefficient and inequitable. Our 1967 fiscal plan must make room for them.

In doing so, one should not rule out the possibility that the economy will soften enough later in the year to finance the increases in Vietnam and Great Society costs without added taxes; i.e., by drawing on resources that would otherwise have stood idle. But I consider this highly unlikely.

Much more likely is an economy in which sufficient resources for pursuit of war in Vietnam can be made available only by cutting into private spending by higher taxes or into public spending through budget cuts.

In making this choice, each of us could compile a list of wasteful or postponable Government expenditures that should get the axe or at least the pruning knife. Mine would include many a maritime and irrigation subsidy, rivers and harbor projects, impacted school aids, and so on. Senator Proxmire, from earlier in these hearings I gather, would prune the space, European defense, and public works programs. Others would have their own pet lists. But my judgment is that few, if any, of these cutbacks are likely to show up on the voting lists of 51 Senators and 218 Congressmen. And we are surely not going to stint on Vietnam.

So the choice, almost inexorably, boils down to restraint in private spending versus restraint in public spending on programs that benefit the poor and disadvantaged, that attack the urgent, but unfortunately accustomed, problems of ugliness and urban blight. Before the Congress concludes that the war in Vietnam requires cuts in the War on Poverty, on slums, on crime, on air, water, and land pollution, it should consider these facts on public spending and private affluence:

Defense spending in fiscal 1968 will take only 9 percent of a GNP of some $800 billion, virtually the same ratio as in 1960, when GNP was about $500 billion. This is below the near 10 percent figure that prevailed during the mid-1950's and far below the 13.4 percent of 1953 during the Korean war.

Total Federal purchases are only 11 percent of GNP this fiscal year and are expected to be 11.3 percent next year, which is well below the 1955–59 average of 11.4 percent, and far below the 1953 peak of 15.6 percent.

Total Federal expenditures in the NIA budget, including trust fund activities, grants, transfer and interest payments, are 20 percent of GNP this year and will be 20.8 percent in fiscal 1968. Despite the enormous advances in the largely self-financed trust programs, this is only modestly above the 19 percent of the 1958 to 1960 period.

Or if we take the trust accounts out, and use the administrative budget for a moment, I think it is impressive that even with these enormous advances in Vietnam and the advances in the Great Society programs, it is still running a smaller percentage of GNP today than it was in 1955 or 1959 when it was 17 percent. The fiscal 1968 administrative budget is about 16.6 percent of GNP.

These figures may be a bit repetitive and tedious, but they make a telling point. Even with Vietnam, the Federal Government is not drawing more heavily on the economy than it was in peacetime, and meanwhile the American public is better off than ever.

Real disposable income per capita—that is, after taking out all price increases—which is the single best measure of our growing affluence as private consumers, has risen by 24 percent in the past 6 years—much as it had risen in the previous 13 years.

To look at the wealth side, financial asset holdings of American families have grown by $470 billion in the last 6 years, while their debts have grown by only $150 billion. So the net financial position of the American family today is $320 billion stronger than it was 6 years ago.

Now finally, a quick perusal of the budget for fiscal 1968 shows requests of about a billion and a quarter of additional spending for the economic opportunity programs, education, pollution control, urban problems, model cities program and water and sewer facilities.

It may be that these requested increases are held to such modest levels by considerations of administrative efficiency, by the speed limits that prudence puts on expansion of new programs. I cannot imagine that our national priorities are such as to call for cutting or gutting these modest increases in order to facilitate more rapid increases in general private spending. Indeed I should think that the reverse of that statement would be true.

What I am saying in sum then, Mr. Chairman, is that the President's tax increase proposal fits well into the Nation's need, not only for flexibility in the face of economic uncertainty, not only for restoration of economic balance in the economy through a decisive easing of money, but also for a fair distribution of the economic burdens of war.

Thank you.

Chairman PROXMIRE. Thank you very much, Dr. Heller, for your usual superlative, clear, and persuasive statement. This is a very welcome statement as far as I am concerned, because I like its flexibility.

As I understand it, you feel that we should keep our powder dry as far as a tax increase is concerned. That if in May and June the situation seems to indicate that the economy is going to expand, that unemployment is likely to drop or that resources are going to be pressing against plant capacity, then you would definitely favor the 6-percent surtax.

On the other hand, if the situation is less optimistic, if it seems that unemployment may be increasing and so forth, you would feel under those circumstances we might postpone it.

Let me ask you a more specific question to try and tie this down a little bit. Roughly that would be the order of the indicators as far as unemployment and plant capacity are concerned, which in your judgment should persuade Congress to postpone a tax increase until

September or October, as late as possible in the year? What would the order of those indicators be in May that would persuade you to do this?

Mr. HELLER. Mr. Chairman, let me say first of all that I would look at more than just the economic indicators.

Chairman PROXMIRE. I know you would.

Mr. HELLER. I would look at whether monetary policy were being eased further and sufficiently. I would look at what was happening to the appropriations process in terms of some of these essential civilian programs. But, as far as the economic outlook is concerned, I would want to look not only at the immediate levels of activity, but whether they were moving up or moving down.

For example, suppose we were at a million housing starts, but one could see that the trend was going to push us up to the million and a half that I think we are going to have by the end of the year. That would be a bullish indicator. But that same million was bearish on the way down last year.

A second indicator: Suppose we were at 4-percent unemployment, and it looked as though we were going to hold there or go down. Then I think the stage would be set much more firmly for a tax increase than if our unemployment was edging up and threatened to continue to rise.

One would want to look at the operating rates in industry. Was there a lot of slack in them or did it look as though we were going to take up that slack?

Chairman PROXMIRE. If I could interrupt at this point, then your position would be that if the situation is about as it is now, if unemployment goes up, say from 3.7 as it is now to 4 percent, if operating capacity is at about 88 percent, which is the expectation that it might be during the year, and if it seems that construction, home building, may be moving ahead, then under those circumstances you would probably still favor a tax increase.

Mr. HELLER. Yes; and particularly as I say, if monetary policy were such as to make it a good counterpoise; that is, were easy enough to offset the tax impact.

Chairman PROXMIRE. But monetary policy is something that Congress just can't possibly anticipate, because for understandable reasons the Chairman of the Federal Reserve Board has said he is not going to tell us what it is and he can't. If he did, there would be speculative opportunities and so forth. Whether he can or not, he is not going to. So that we have to simply take what he has done up until say May or June, and then assume that the same pattern will be followed, though it may not be.

Mr. HELLER. I think that is right. We have made a very encouraging start, and I think by May or June you have to decide whether that start is going to be pressed forward, and whether the commitment seems to be one for further monetary ease.

Of course, the plans of Congress with respect to social security liberalization also have an important impact here.

Chairman PROXMIRE. I am somewhat concerned, Dr. Heller, because you have been, I suppose more than any other man in America, identified with the new economics, for many reasons and many good reasons. And yet you seem to be satisfied with the rate of growth of

the GNP this year, which is the rate of growth settled for by the present Council of about 4 percent.

I say you are satisfied by it, because even if the situation gets a little worse than it is now, you still would favor the tax increase. A little worse, that is if unemployment goes up a little bit, operating rates continue to deteriorate a little bit, you still would favor the tax increase.

The reason I come to this is because in the Department of Labor's "Projections 1970," the Department contends that unless we have a growth rate of about 4.3 percent on the average between 1965 and 1970, that we aren't going to be able to maintain unemployment at this level.

Furthermore, our experience in the past has been that when we stabilze unemployment at a fairly low level, we can even press it down further without price increases. We had that in 1953, for example. We took off price controls; unemployment was down around 3 percent or a little less than 3 percent—prices didn't go up.

Now under these circumstances, I wonder if this is a fair statement of your position, that you still, on the asumption that monetary policy remains as it has been, that you still would favor this more restrictive fiscal policy.

Mr. HELLER. Mr. Chairman, I am, let me say, never satisfied unless the economy is moving as fast as its growth in labor force, productivity, and plant and equipment expansion permits.

Furthermore, let me say that when we set the interim target of 4-percent unemployment in 1961, we intended that to be interim, and I don't think we should settle for that.

Chairman PROXMIRE. That is why I am concerned about your assertion here.

Mr. HELLER. That is why I want to make my longer term objectives perfectly clear. I, too, want to get below 4-percent unemployment. And I, too, want 4.3-percent growth if that's what it takes to absorb all of the resources that become available to the economy. But it seems to me we have a practical situation this year, in which in exchange for a tax increase we can purchase, so to speak, a better monetary policy, and a better distribution of the burden of war—by advancing some of the essential programs in this country. At the same time, we would not retard the advance in the economy, if we achieve the elements of strength that I see in the second half of this year and the first half of next year.

Now if we are wrong on the latter, and you can get the former—monetary easing and adequate support of essential programs—without the tax increase, then as my statement clearly implies, I would forgo the tax increase.

Chairman PROXMIRE. I very much appreciate the latter part of that. Let me make sure again that I understand. You say you would forgo the tax increase, if you can do so and still get the kind of monetary policy.

Mr. HELLER. That is correct.

Chairman PROXMIRE. And budget policy which you think would be constructive.

Mr. HELLER. That is right.

Chairman PROXMIRE. All right, that is clear.

Then, would you feel that we ought to have some new goal for unemployment? After all, as you say, back in 1961 or 1962 you set this 4 percent. We are down below it now. We have been for more than a year. Prices for the last 3 or 4 months especially have been reasonably stable. The last increase was one-tenth of 1 percent. Wholesale prices have been generally going down.

I wonder if we can't work toward some quantitative guidepost here. Can it be qualified, do you think, at the present time? Should we aim now at 3½-percent unemployment?

Mr. HELLER. I hope that by this time next year, enough of what we can call "echo" inflation, the cost-push inflationary pressure, will be out of the economy so that we can reconsider the guidepost, and I am talking about an official reconsideration. I presume that the continued cost-push inflation in the economy was an inhibiting factor in that consideration this year.

But as we approach stability, and you are quite right, we seem to be on the way: for example, the wholesale prices in the past year have only gone up 1½ percent. As we move back gradually toward economic stability, I don't think we should settle for a 4-percent unemployment goal. We ought to push it down.

Chairman PROXMIRE. And yet as I understood your statement, you said at one point in your statement that we are at full employment, in evaluating something else. I forgot precisely what it was.

Mr. HELLER. This is true.

Chairman PROXMIRE. How long are we going to continue to hold on to that unacceptable level? This means 3 million people out of work. It means a situation in which there is less pressure on management to train employees and to break through the structural problem than there is if unemployment is lower.

Mr. HELLER. You have the very difficult problem of balancing that very important consideration against the expression of that pressure in a wage-price spiral, however modest. It is a question of striking the balance at a point where you do raise your goal, but at the same time, where you don't invite a continuation of the kind of inflation we had last year, and the kind of cost-push pressures that we have this year. We must address ourselves to this problem. By the way, I think we are.

I think our manpower training programs, a good part of the poverty program, the Job Corps, et cetera, all of these are going to improve the skill structure and the mobility of the labor force and help us raise our employment sights.

Chairman PROXMIRE. We have had these programs for a couple of years now. We are at the point where as a matter of fact we project a very, very modest increase in these programs in 1968.

Mr. HELLER. Too modest.

Chairman PROXMIRE. I think too modest, and yet we still have this 4 percent unemployment on the whole. One of the great points of these programs was that they would be able to move us to a position where we could have 3½ or 3 percent unemployment.

Mr. HELLER. Of course, Mr. Chairman, the payoff on those programs is slow, as it is in education investment generally. It's a big payoff, but it is not a fast payoff.

Chairman PROXMIRE. But isn't it true also though, Dr. Heller, that the real force here is in private training, on-the-job training, by em-

ployers, who will bring people into the labor force, and who will do their very best to take people who previously haven't been acceptable to them—teenagers, inexperienced workers, women, minority groups, and so forth, and that when the pressure is on them, they are going to do this. And if we take the pressure off, if we are going to say well, 4 percent is all right, then we are not going to get that kind of training, and we are not going to be able to have that force that will help eliminate the structural problems.

Mr. HELLER. You won't find me disagreeing with that, and indeed World War II and the Korean war period demonstrated this, and it has surely been demonstrated in the last year or two, too. That is to say that a great deal of ingenuity has been used in converting square pegs to fit them into round holes.

Chairman PROXMIRE. Thank you very much, Dr. Heller. My time is up. Congressman Rumsfeld?

Representative RUMSFELD. Dr. Heller, when do you predict the major impact of a July 1 tax increase would be felt? Would it be fairly soon, in the second half of 1967, or would it be the following year, the early part of the following year?

Mr. HELLER. Mr. Rumsfeld, I have worked those numbers out at one time or another in terms of the quarter-by-quarter growth in the impact. I can't cite them to you exactly. I would say that it takes about a year, three quarters to four quarters, for the full or nearly full multiplier effect of such an increase, to work itself out. That, of course, is another reason why, even though the economy may not be doing everything you want as of July 1, let's say, but is on a strong uptrend, you might want to have the tax increase in terms of the full impact hitting later in the year and in the following year. But I can't give you a quarter-by-quarter number.

Representative RUMSFELD. If it is generally as you suggest, then really how good is our ability to foresee whether a tax impact would be appropriate at the time it's full effect would be felt? I have been impressed as a new member of this committee with the great number of things which even our brightest minds don't know about the future, and the effect of these various things, the various tools that are available, and it concerns me, if this is the case. Do you feel good enough about our ability to look into the future that with that type of a delayed effect that that would be prudent?

Mr. HELLER. Mr. Rumsfeld, I would make two comments on that. First of all, I agree with you entirely that our ability to forecast isn't so reliable and perfect that we aren't going to make mistakes and aren't going to be surprised at times.

On the other hand, all policy life has to be based on projections into the future, and even if you take no action, that is a forecast and a projection.

What you have to do is use the best knowledge that is available, make your forecasts and form your policy on that basis, and then—and this is my second point—make policy flexible so that if you make mistakes, you can backtrack. If you put in a temporary tax increase, there ought to be provisions for taking it off in case you are wrong.

Representative RUMSFELD. Let's look at one side of this. The Council's report suggests that business is going to be relied upon to resist further inflation by shaving profit margins. I don't know

how reasonable that hope is, in view of the suspension of the investment tax credit, the forthcoming increase in payroll taxes, the predicted slowdown in sales in the latter portion of the year, the increase in the minimum wage which was enacted during the 88th Congress, and the possibility of a proposed corporate income tax increase. Couldn't this result in rather serious reduction in margins to the point of some detrimental effects on the economy as a whole? That sounds like an awfully heavy load.

Mr. HELLER. If you put it in terms of possibility, yes, there is this possibility. My own forecast of profits for this year is about 5 percent below last year, which is a little more bearish than the official Government forecast. But I would say this, that the present level of profits from which this slight erosion is going to take place is a very high one indeed.

I think we should keep in mind that profits after taxes of corporations are running just about double their level in early 1961, and they are doing so on a much more solid base of depreciation allowances.

So the fundamental position of business is very strong, and I think that the administration quite properly points out that given the prospects for a more stable economy, a slightly more modest profit objective, if you will, may be in order. One of the reasons for high profits in boom times has generally been that you had to have the feast in order to prepare for the famine.

We may still have periods of undernourishment, but I think the periods of famine are gone in our economy. As a consequence, the long-run profit picture of corporations is extremely favorable, and perhaps their margins don't need to be quite as high as they were in the days of greater instability.

Representative RUMSFELD. I am a little confused by your reference in two points in your statement to the effect that domestic programs should be considered on their merits. This is true, but it suggests you don't then consider them one against another, which of course Government must do, and I assume that when you say that, you mean they should be considered on their merits separately and then they have got to be plugged into a system of priorities for over-all Government spending. You mean this, I take it?

Mr. HELLER. As an economist, I couldn't agree more. But what I am trying to emphasize is that the draft that the Federal Government is making on the resources of the economy, even with the expenditures in Vietnam, is modest enough so that we don't have to make any drastic cuts in the advances in these programs. Our economy has sufficient resources, but it may require making some private consumption move over for awhile, through this tax increase.

Representative RUMSFELD. I had the feeling in your statement that you moved away from a discussion of economics to a position favoring certain domestic spending programs over other domestic spending programs.

Mr. HELLER. Mr. Rumsfeld, you are very acute. Yes, I moved out of my role as economist when I got into that last section and talked about what I thought our national priorities ought to be. That is not something that I can scientifically determine as an economist. There are some programs that I think I could say, well, we ought to put more into this because we will get a good return on our investment—educa-

tion and perhaps in some cases pollution, and so forth, but others are just my own ethical, social, or value judgments.

Representative RUMSFELD. We have had testimony before this committee in recent days to the effect that the net difference in impact between a reduction of Federal spending as opposed to an increase in tax revenues is just about even. That there aren't great differences in the economic impact on the country, whether you take one tool or another tool. Is this generally your view?

Mr. HELLER. As far as the relaxation of demand pressures are concerned, you can accomplish the same thing through the two instruments, but there are substantial differences in the speed with which you can do it. And obviously there are also substantial differences in what values you serve, and for that matter, what kind of return you get on the investment of your funds.

Representative RUMSFELD. I appreciate there is a difference in values to be served, but would it not be correct that if the net effect is similar from an economic standpoint, that you can achieve a much more rapid impact by reduction of Federal spending?

Mr. HELLER. No.

Representative RUMSFELD. Than you can by the imposition of additional taxes.

Mr. HELLER. No, it is not. That is just where the rub comes in, although——

Representative RUMSFELD. So you feel it would be beyond your response to my first question concerning the impact in a tax increase, it would run beyond that because of inventories?

Mr. HELLER. Let me clarify the difference that I did try to make in the opening statement, perhaps not sufficiently clearly, that when you are dealing with transfer spending, that is when you increase social security benefits, for example, or if you were to decrease them, that is virtually equivalent to increasing or decreasing taxes, because taxes are negative transfer payments or transfer payments are negative taxes.

But when you are dealing with the resource using Government expenditures, whether it is a highway program or a program for education or what have you, then the speedup and slowdown process is a very sluggish one, and it simply doesn't compare with taxes as a stabilization instrument.

Representative RUMSFELD. Specifically how much longer, roughly, in something like highways? My time is up.

Mr. HELLER. It depends so much on the particular program.

Representative RUMSFELD. Highways.

Mr. HELLER. Highways? I would think there would be a lag. It's terribly hard to estimate, but it would be at least half a year's difference, but that is a very unscientific off-the-cuff judgment.

Representative RUMSFELD. Half a year more in the tax increase.

Mr. HELLER. Yes, by the time you get the resources moving or slowing down through all the processes from giving the grant or taking it away, or getting the money pumped into the program, and so on, it would be slower. Although again so much depends on the program—if you wanted to put it into cleanup work on the highways, that could be done very quickly. But if you wanted to actually do it on the construction process, that is likely to involve a considerable delay.

Chairman PROXMIRE. Congressman Patman?

Representative PATMAN. Dr. Heller, if you were to evaluate the present monetary policy of the Federal Reserve, would you say that you were satisfied with it, or would you say it should be more aggressive or less aggressive?

Mr. HELLER. Congressman Patman, I tried to indicate in my statement that I think it should be more aggressive.

Representative PATMAN. More aggressive. That is the answer to my question.

Now then, I haven't had the privilege of interrogating you before congressional committees since the action of the Federal Reserve on December 6, 1965, which raised the interest rates 37½ percent. Think back to that time, Dr. Heller, if you will. There was the Federal Reserve Board telling the President of the United States that they were going to raise the rates—did raise them—without consulting with him. They insisted on doing it, although the President pleaded with them to at least wait until they could see his budget and pass on the question of raising interest rates at that time and not do it before then.

Do you believe the Federal Reserve did the right thing, in effect, defying the President and going ahead and raising the rates 37½ percent, or do you think that they should have waited as the President requested?

Mr. HELLER. Clearly, they should have waited, as a matter of cooperation and coordination of policy. There are two separate questions. One is the matter of propriety and cooperation, and what I think has been over the years, since 1961, a rather close, not always agreement, but rather close cooperation in exchange of views, and so forth, between the Federal Reserve and the administration.

Here, the Federal Reserve, it seems to me, slipped out of harness. They did move ahead. They felt that inflationary forces were gathering. The prospects both on the budget, plant and equipment expenditures, and so forth, seemed to make the move substantively desirable, and I think as part of an integrated, balanced policy, tighter money made sense. But it certainly did not make sense to step out ahead, in effect, to take the pressure off of fiscal policy, which might otherwise have been different, and to violate the spirit of the quadriad, which is, as you know, a spirit of cooperation in that group.

Representative PATMAN. We have a lot of confusion in that field, as you know. It occurs to me that we have reached the point when we must decide whether elected representatives of the people, like the President, should represent the people or whether unelected representatives of the people, who really have no obligation directly to the people, and the people are helpless to hold them accountable, should make these decisions.

They can hold the President accountable, because he must seek reelection, or election if he wants to, but the members of the Federal Reserve Board, the unelected officials, can't be dealt with by the people if they make a mistake. The people are just helpless.

So in effect, don't we have two governments here in Washington, Dr. Heller? We have one that is operated by elected representatives of the people, the 435 Members of the House and the 100 Members of the U.S. Senate, and the President of the United States, but we have another government here which seems to have much more power sometimes than the one elected by the people; the government that controls

our monetary affairs. I don't think they legally have the power to do it.

My personal opinion is they have just seized that power. It was never intended to give it to them. But they are exercising this power; and with these two governments, one elected and one unelected, which should yield to the other?

I will shorten it a little bit by asking you if your testimony correctly implies that we should have a tax increase in order to encourage the Federal Reserve to keep——

Mr. HELLER. This is part of——

Representative PATMAN. Part of it?

Mr. HELLER. Part of a coordinated policy. In other words, that we got out of whack last year when monetary policy got excruciatingly tight and hit the housing industry about an $8 billion blow, by the Government's estimate, in other words, hit it to the point where it was running $8 billion below the level that it otherwise would have attained.

So that I feel we need to put this right. Now it is possible that we could put it right without a tax increase, but it is more likely that we would put it right with a tax increase.

Representative PATMAN. It's shocking to me that you would say that, because they had in effect a gun at the President's head, saying "Now if you don't stand for a tax increase in the Congress, we are going to raise interest rates." It occurs to me, Dr. Heller, you are yielding to that feeling. Am I incorrect about that?

Mr. HELLER. I think you are incorrect.

Representative PATMAN. Yes?

Mr. HELLER. With all due respect. I think if you look at it from scratch and ask yourself what is the appropriate role of monetary policy and of fiscal policy, then you would say, "Well, by hindsight we would have been better off last year if we had had somewhat tougher fiscal policy and somewhat easier monetary policy. These two things have to work in harness." Even though we had some tax action, we did not have an across-the-board increase.

Representative PATMAN. Well, if we have a head-on collision between the President of the United States and the Federal Reserve Board, who should cooperate with whom? Should the President cooperate and yield or should the Federal Reserve cooperate and yield?

Mr. HELLER. I guess I would have to get out my dictionary and see the definition of the word "cooperation." I think that takes two parties.

Representative PATMAN. We will use another word then. Leave "cooperate" out and say, who is going to yield?

Mr. HELLER. It shouldn't be a case it seems to me of one party, either one, abjectly yielding to the other, but of the two working in a cooperative harness that brings about balance. And it seems to me we have some reasonably good evidence right now, Mr. Patman, that there is cooperation. We are getting a monetary easing, at least the first installment of it.

Representative PATMAN. At a terrific price.

Mr. HELLER. Well, it went far too high.

Representative PATMAN. But I mean billions of dollars a year extra interest. We had to yield to them.

Mr. HELLER. That is why we need to lean a lot further in the direction of low-interest rates than we have so far.

Representative PATMAN. I have seen estimates that the action of the Federal Reserve Board of December 6, 1965, cost the people of this country from $10 billion extra to $25 billion extra last year. Do you believe that is reasonable?

Mr. HELLER. I haven't made any calculations of this sort. One always has to look at the two sides of it. What is the actual cost impact of the interest rates and to what extent did that cause people to buy less, to invest less and so forth, and thereby reduce the amount of inflation.

You have to balance the plus side of reduced inflation against the minus side of the actual increase in costs of mortgages and the rest.

Representative PATMAN. You certainly do not look with favor upon the cost of servicing of the national debt, $14.2 billion in fiscal year 1967, when according to the rates that we had over a long period of time, in the worst times of our history, wartime and other times, the rates would have been one-half that.

In other words, we are paying $14 billion a year now instead of $7 billion a year, which we could have been paying for the same service. Is that rather shocking to you, being the second largest item in the entire budget of the United States, second only to national defense, in view of the cost of interest in the past and our success in getting interest at a reasonable rate?

Mr. HELLER. For a well balanced growth economy, we need lower interest rates. There is no question about it. One of the arguments that supports that is at the same time we would have less of a transfer problem for the interst payments of Government, no question about that.

Representative PATMAN. You know, too, from your excise tax stand that if you pour money in at the bottom, the lower income groups, it will percolate up, and everybody gets a little benefit from it. It helps everybody more than pouring the money into the top and expecting it to trickle down. You assume from your theory about the excise tax, where you collect about a billion-and-a-half dollars at the end of the year for every billion dollars that you reduce the tax on the low-income groups, that by letting the low-income groups have the benefit helps more than coming in from the top.

Mr. HELLER. In other words, they spend a higher proportion of their dollar.

Representative PATMAN. That is right.

Mr. HELLER. And therefore, you get a bigger bang for a buck if you have tax reductions in the lower income groups.

Representative PATMAN. And it goes into the business trade and commerce rather quickly and it helps everybody.

Mr. HELLER. There is a difference, even though it is not as great as we once thought.

Representative PATMAN. Thank you, Mr. Chairman. My time is up.

Chairman PROXMIRE. Senator Percy?

Senator PERCY. Dr. Heller, it is very good to see you here. I have great respect for Mr. Patman, but I should like to say that I consider Mr. Martin one of the finest public servants that we have in

this country. Having just returned from Europe, I know having him in this job is one of the most stabilizing influences we have in the confidence of people abroad, the bankers and the soundness of the dollar, and I certainly hope and pray that he shall be given encouragement to stay on in this job and that April 1 he will be reappointed.

I would like to ask your help on three questions—the balance of payments, tax credit for human investment, and possibly a comment from you on the role of housing rehabilitation in strengthening the economy in the future.

On the balance of payments, this morning's New York Times indicates that the 1966 deficit was about $87 million greater in 1966 than in 1965.

Mr. HELLER. That is on the liquidity basis.

Senator PERCY. Yes.

Mr. HELLER. On the so-called official settlements basis, which most of the rest of the world uses, there was a very sharp improvement of course. We actually had a surplus.

Senator PERCY. But in actual payment deficit it was $1,424 million against $1,337 million. I wondered if you could give us your feeling as to what the outlook will be for this year, and whether you consider this a serious problem to which the committee should be devoting itself.

Mr. HELLER. Senator, if the business of economic forecasting, the GNP is tough, the business of forecasting the balance of payments is far tougher, because that after all bears the marginal impact of a great many forces in the economy.

Having made that disclaimer, I will go ahead and forecast it. My feeling is that, in spite of the very heavy draft on our balance of payments of Vietnam, and in spite of some increased outflow on the financial side as we lower interest rates, we are not likely to have much more of a deficit this year than we had last year on the liquidity basis, the one that you are now using.

Having had a surplus on the official settlements basis last year, I hope that we don't this year suddenly shift to the official settlements if we do somewhat less well on that basis than we did last year.

What I mean is that the amount of holdings in official hands overseas of dollar is likely to rise, and that of course means a deficit in the official settlement basis.

But I think it is much more important to talk about the forces that will be working on the balance of payments than it is about a particular number.

We will have crosscurrents. Financial and capital movements will probably work somewhat against us while the trade elements should be moving for us. Because of the degree of inflation last year, particularly because of the overheating of the plant and equipment and machinery area—we often bought machinery and equipment overseas even though it was inferior to ours just because we could get delivery—and because of inventory building, we had an unusual sucking in of imports. It went up some 20 percent in 1 year.

Now I think we are going to have a considerable relaxation of pressure on imports this year. With the continued growth of exports, especially as our prices gain in competitive advantage over the rest of the world, I rather think that our trade surplus is going to improve this year.

Senator PERCY. Secondly, on the investment tax credit, I was delighted to see your position is inflexible with the thought of perhaps restoring it earlier. However, as I recall the original discussions about this, we were talking about making this a permanent part of our tax structure. I think it was the hope of the business community that it would not be something that would be turned on and off, that business could really plan on this to help keep our competitive position.

My own arguments as a businessman were three. First, it would make our labor more productive and would enable us to increase wages, and thereby the buying power of labor.

Second, it would help us lower our consumer prices, which would help combat inflation and improve our standard of living.

Third, it would make our goods more competitive with foreign products. I have had my share of this type of competition in past years.

If these three things are so necessary for our economy, why wouldn't it be a good thing to move forward to make this a permanent part of our tax structure and not keep turning it on and off?

Mr. HELLER. Let me say that the very factors that you mention are the ones that led us strongly to urge the adoption of the investment credit when the Treasury and the President proposed it back in 1961.

After all, if you are going to try to achieve full employment side by side with price stability, with rapid growth and balance-of-payments equilibrium, you have to have a policy to increase productivity, both by investment in human beings and by investment in machinery and plant and equipment, and in research and technology. But when you are making a decision for a particular period in time, and want to keep a stable economy, you have to balance the demand factors involved in plant and equipment against the obviously desirable long run supply factors, and you have to balance the capacity argument against the modernization argument.

What I tried to suggest is that in striking that balance, we may, first, still find excessive demand in the plant, equipment, and machinery area, which would cause continued sectoral inflation in the economy and hurt our balance of payments. And, second, we may be expanding capacity to a point where it might give us the kind of trouble, I would hope not in the same degree, as we had in 1957 when we expanded plant and equipment to a point where consumption did not keep up with it.

So while I want to be flexible, and while the air pocket consideration certainly is an important one, I think we have to keep an open mind on whether we want to restore the investment credit and accelerated depreciation in the middle of this year, or possibly extend it in order to get over the air pocket. This will depend on the balance between these entirely tenable points you make, and the short-run impact on demand and the problem of overcapacity.

Senator PERCY. My own experience would lead me to believe that the leadtime is so disparate for these decisions that when you change the investment tax credit, you don't get an immediate impact. It is the kind of a tax change where the impact is the longest and farthest out. You don't get a change when you need it. You may get the adverse effect at the very time when you don't want it. But I will defer to Senator Symington at some point to have him comment from his own experience in this field.

Mr. HELLER. I would only add one brief note to that, and that is that it depends on whether you are talking about factories and actual plant and heavy equipment or whether you are talking about things you can essentially buy off the floor, like trucks and business equipment, photographic equipment, et cetera.

Senator PERCY. That is true, but machine tools require 6 months, 4 months, 7 months, 8 months leadtime.

Mr. HELLER. But that is partly because of the huge backlogs which today are larger than is really good for the economy or good for the balance of payments.

Senator PERCY. All of this is needed to combat inflation, to get our costs down, and to make us more competitive with other countries, almost all of whom have far more liberal writeoff programs than we have in this country—Switzerland, Germany, Japan, and so forth.

Mr. HELLER. Basic policy—there is absolutely no disagreement between us. Possibly a difference in timing.

Senator PERCY. Could I ask for your comment on the discussion that we have had on the tax credit for human investment. The cost of our Job Corps program is very high indeed. I was up yesterday to see the Philadelphia program again with Reverend Sullivan. I am happy to have in the audience today Reverend Nussear from the Woodlawn organization who is trying to find employment for unskilled, uneducated people.

It would seem to me that if we decentralize the responsibility of taking people who do not now have the skills and ability and who are now on public aid rolls, and if we find ways to train them and move them onto the private payrolls of industry, by giving an incentive to companies all over the country through a tax credit to take these people and do the extra training required to make them employable, that this would be a highly desirable objective. Would you care to comment as to whether you have given thought to this and whether or not it is a program that you would feel we ought to move toward.

Mr. HELLER. Senator, I agree with the objective wholeheartedly, but I am concerned about using the tax mechanism for so many of these objectives that should perhaps be attacked directly by Government programs. After all, if we put through the tax mechanism all kinds of special benefits designed to accomplish these ends, we would begin to make sort of second structure appropriations committees out of the tax committees.

Now obviously my position on this isn't pure because I am for the investment credit. But you have to be terribly sure, first of all, that the objective is terribly important—and your objective is important.

But second, you have to be sure that the tax mechanism is really the best way to do it. I am not sure that it is in this case, and I haven't given it enough study to say 100 percent that it is not.

Senator PERCY. I agree in principle with you. I don't like to see this complicated tax structure, but with the million people coming in the job market that haven't the skills to get jobs, and with the tremendous cost of such programs as Job Corps per person, I don't see any alternative other than to use all the resources of industry now to do this job of hiring the unemployable today, this hard core of unemployables, and it is the best that we have been able to come up with, and I think we will tend to pursue it as much as we can. Thank you.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

Dr. Heller, as one of your admirers it is a privilege to see you here this morning, sir.

Mr. HELLER. Thank you, Senator.

Senator SYMINGTON. I would associate myself with the remarks made by Senator Percy with respect to the ability and integrity of the Chairman of the Federal Reserve Board. Because of my belief in the importance of the integrity of the dollar, I also believe in the importance of the integrity of the Federal Reserve. Both the Chairman and membership of the Board and the Office of the Comptroller General are appointments made by the President, then confirmed by the Congress. I would hope the Federal Reserve would not be completely subservient to the White House any more than the Comptroller General should be completely subservient to the White House. Otherwise, the Fed would be no real check on the fiscal and monetary activities of the rest of the Government.

Now in discussing the debt in your recent thoughtful book, you noted—

> It has been declining as a proportion of the Gross National Product from 58 percent in 1960 to less than 45 percent in 1962. Moreover, in the five-year period from 1961 to 1966—

You note further on that—

> The GNP advanced by $218 billion. But during that same period the United States balance of payments on a liquidity basis was in large and persistent deficit.

If as you seem to indicate, the GNP is the key yardstick in measuring the strength of our economy, would you see any reason for the United States to ever balance its international payments?

Mr. HELLER. Senator Symington, may I as a prelude to the answer to that question comment on the comments that have just been made about Chairman Martin. I wanted to make this comment while Mr. Patman was here.

I think I share the same regard for the ability and integrity of the Chairman. However, that does not mean that there aren't points at which one will dissent and differ on policy, and I think those two things should be very sharply differentiated.

Senator SYMINGTON. I agree with that. But I would like to see one person in Government who has some independence with respect to these rapidly moving fiscal and monetary developments.

Mr. HELLER. I would also say on that score, that given the cooperation between the Federal Reserve and the White House, the Council, the Treasury, it has to be a two-way affair. That is, if the Federal Reserve wants to influence or have its say on fiscal policy, obviously the executive branch has to have its say on monetary policy.

Senator SYMINGTON. I don't want to use all my time on this.

Mr. HELLER. I am sure you don't.

Senator SYMINGTON. But would, as long as you have brought it up, say this. I think it has been particularly unfair to Chairman Martin for the Government, in effect, to first turn over the entire problem of inflation to him. There are only two things he could do to handle this on a monetary basis.

One, restrain credit, the other, raise interest rates; and they go together. And then after he does his job, which as you point out,

was done with little or no cooperation from a fiscal standpoint, he is heavily criticized by many.

I have an answer to my first question.

Mr. HELLER. This question about the relationship of our balance-of-payments deficit to the GNP—the answer really doesn't depend simply on this ratio. The answer depends on how the rest of the world treats the dollar. Now my guess is that particularly if we don't accomplish some international monetary reform and expand the international medium of exchange, that the rest of the world is going to want to hold an increasing number of dollars for its transactions balances, and as a store of value, and so forth.

If that is the case, and as long as that is the case, then we can run a deficit without any danger to the stability of the world's monetary system, or without any danger to our domestic economic situation.

Senator SYMINGTON. When you say the rest of the world——

Mr. HELLER. To the extent that the rest of the world in order to finance an expanding world trade and international flow of finance and commerce, to the extent that they want to hold dollars for that purpose, an increasing flow of dollars, it may be that equilibrium in the broadest sense might be at a level of say, a billion dollars a year deficit in our balance of payments. I am simply stating that as a possibility which we ought not to ignore.

Senator SYMINGTON. If the country doesn't balance its international payments account ultimately, how can it maintain its present gold standard?

Mr. HELLER. The answer to that is really implicit in what I was saying. If the rest of the world wants to hold those dollars and not cash them in for gold——

Senator SYMINGTON. What is France doing?

Mr. HELLER. ——then we are all right.

Senator SYMINGTON. But let's take a practical premise.

Mr. HELLER. But if all the rest of the world did what President de Gaulle does, and cashes in all of its dollars for gold, obviously we would be in a very tough spot, no question about that. Fortunately, there is such a thing as international cooperation. Fortunately, not every country tries to translate every bit of financial advantage into political advantage as France does. They do feel a sense of cooperation and interchange with us, and therefore we don't have to treat the dollar and gold as if every country were going to be as tough as France on this score.

Senator SYMINGTON. I was told that at the American Bankers Convention in Madrid last May some of the more friendly foreign central bankers in Europe told our people—was told on good authority— that unless we did something about correcting this unfavorable balance of payments, we could expect to see a heavily increased movement of paper gold dollars into gold bullion, the demand coming from Europe.

With that premise, do you believe they were kidding or do you think they meant it?

Mr. HELLER. Some of the other countries get somewhat itchy fingers when they see what France is doing, but they are restrained by several factors. One is, if you put your money into gold rather than into securities, into dollars, you lose the interest on it.

Senator SYMINGTON. That is right.

Mr. HELLER. The principles of compound interest tell us that President de Gaulle is going to lose money unless the value of gold doubles every 15 years at present interest rates. But he obviously has other purposes for accumulating gold. So they do get somewhat itchy fingers. They are, however, restrained by the loss of income.

Secondly, they are restrained by the fact that they want the dollar. They need the dollar as the preeminent medium of world exchange. And they recognize it would be against their self interest to bring the dollar into serious trouble, and as a consequence, they are willing to cooperate in maintaining the dollar.

Third, they simply need many of these dollars in the normal course of business, and therefore are not about to cash them in.

Senator SYMINGTON. This is our first dialog on the subject. Do you think it is important to stay on the gold standard?

Mr. HELLER. Well, we are on a gold exchange standard. If the world had different views of gold versus other metals, it wouldn't be important. But given the world's view of gold, I guess it is. It is also worth mentioning, Senator, we are the only country in the world that freely cashes in its currency for gold. I mean when we get criticism from the rest of the world on this, we ought to keep in mind that we put one ounce of gold on the barrelhead for every $35 that a foreign central bank puts to us.

Senator SYMINGTON. Do you think we should continue to do that?

Mr. HELLER. I think we should, yes.

Senator SYMINGTON. Then let me ask you this. Do you think that it's right for this country to be the only country in the world where its private citizens are not allowed to hold gold? To the best of my knowledge it is the only country in which you can't buy and hold gold as a hedge. I ask with the premise that of all the gold that was mined in the free world last year, practically none of it went into Government holdings.

Mr. HELLER. That is correct.

Senator SYMINGTON. All of it went to people who apparently do not believe, in effect, in all the fiscal and monetary policies we believe in. On my recent trip abroad I found that many people were rapidly accumulating gold. Yet alone among all countries, our citizens are forbidden to hold any gold. At the same time, we are the only people who will buy and sell gold at $35 an ounce; so there seems to be some dichotomy from a practical standpoint regardless of theory.

Mr. HELLER. Maybe there is a correlation. Maybe it is the fact that we do stand ready to exchange gold for dollars that causes us to have this restriction in our domestic market.

It is true that the net amount of gold that went into the monetary reserves of the world was virtually zero last year. People have been betting against the dollar. They have been betting on devaluation for years, and they have been losing money on it. They are sitting there with their sterile gold hoard as far as any——

Senator SYMINGTON. They have been losing money, but we have been losing gold.

Mr. HELLER. Yes.

Senator SYMINGTON. And we have only about 10 percent of free nonmonetized gold available to pay off our current obligations abroad. Even if we cancel out the 25 percent reserve, we still have less than

half of the gold necessary to pay off if the other countries get the same itchy fingers you talked about that France has. Under those circumstances, don't you think American citizens should have the right to have a little gold in their box too, if they are willing to sacrifice the interest?

Mr. HELLER. I think our current policy is a sound one, in spite of the fact that the rest of the world does permit its private citizens to hold gold, and I have a good deal of optimism about our increasing the world's monetary supply through monetary reform, which would help take some of this pressure off of gold and really defeat the gold speculators. I don't think the gold speculators are going to find that it is a good speculation.

Senator SYMINGTON. Thank you, Dr. Heller. My time is up.

Chairman PROXMIRE. Senator Javits?

Senator JAVITS. Mr. Heller, you are famous for being at least one of the main partners in the so-called Heller-Pechman plan of tax sharing. I am not nearly as famous as being the fellow who first put in the bill for it.

Mr. HELLER. A superb bill, too, Senator.

Senator JAVITS. Thank you. I would like to hear from you whether you have been shaken in your views on that matter by the charges that you and I and people like us want to take it out of the backs of the poor and others who would be benefited by specific grant-in-aid programs, and therefore what is your argument for your plan, now that we have heard a good deal of criticism on it?

Mr. HELLER. That argument certainly does not shake me, because I think it is exactly contrary to the facts. Let me say that I don't have any particular patent on a given form of the revenue sharing plan. I think the basic philosophy of it is very important, and quite contrary to that criticism, Senator, I believe that it would have the opposite result.

If you take a piece of the Federal income tax and say we are collecting it on behalf of the State and local governments, and route it directly into a trust fund and pay it out in accordance with the principle of the Javits bill, it would in the longrun substitute for what otherwise would have been higher property and sales and excise taxes, precisely the taxes that are tougher on the poor. And in the longrun, revenue sharing would result in a better and more adequate level of services at the State and local government. And every study that has ever been made shows that those are very heavily concentrated in the lower and modest income groups.

So that charge simply falls to the ground, unless it is assumed that everything you put into the revenue-sharing plan would be taken away, let's say, from the war on poverty, and I just don't believe that.

One would route the revenue shares through a trust fund, distributed on a per capita basis, preferably with an extra portion—say, 10 percent—reserved for the poorest States. It would be an earmarked revenue collected for the States and localities under the plan that you have put into bill form. There are other plans that would do it differently, but under your approach and mine the support for those direct programs and for the grant-in-aid programs would continue. The revenue sharing would be an additional source of State-local funds.

Senator JAVITS. And it is entirely practicable—and I hope my bill doesn't, but other bills can, take into effect awards for efforts so that the States should not be replacing money they are taxing for, it should be effectively administered and so-called compensation for the poorer States with below average comparative income, and some requirement that the money should find its way into lower levels of government, all of this conditioned upon the fact that it shall be effectively used, and if not, then the Federal Government can proceed directly. Isn't that your understanding of it?

Mr. HELLER. Those principles seem entirely sound.

Senator JAVITS. I thank you, Dr. Heller. I am sure you will be here fighting for this concept. I think you have rendered an enormous service to federalism in our country. We are but instruments of your ideas, myself and others who have put in bills.

I think the idea is a great one. I think it will come into being. I think the whole country will be indebted to you, because I really think that federalism is on its way out, until the Heller plan came along to give it the lift that it urgently needed.

Mr. HELLER. Thank you, Senator.

Senator JAVITS. Now I would like to ask you one or two other questions. I noticed with tremendous interest your position on the tax increase that should have been in 1966. I am sure you, too, noticed with some amusement the fact that the Secretary of the Treasury is now testifying as if it was Treasury's idea, not yours and some of us here. But be that as it may, I gather that you, too, like the present Chairman of the Council of Economic Advisers, give us—roughly speaking—an order of magnitude of 90 days to have a look at it before we jump now. In other words, this is not a case of "better late than never."

Mr. HELLER. This is absolutely correct. In many ways I think of it, Senator, as a second best alternative to some kind of system of actual standby tax powers. In other words, we must eventually move to the point where, through a system that will protect the congressional prerogative, we have pushbutton tax increases and decreases. Under carefully devised guidelines by the Congress, the President would activate these tax changes subject to congressional veto. That kind of flexibility is essential to the stability and the growth of a highly refined and modern economy.

Senator JAVITS. Now would you recommend that we do that on a trial basis, that is, give the President the authority rather than impose the tax ourselves, in respect of this particular 6-percent tax surcharge, allowing him, with protections, and you have named them, the joint resolution technique which all of us are familiar with, where we can act without the President's signature, revoking authority—I think it has been sustained constitutionally—would you suggest therefore that we give him the 6-percent surcharge authority, and in answering that question, would you bear in mind—and I know you didn't do this invidiously, you served the President loyally, and you are loyal to him to this day, but you did note that it was political, which is not invalid, and I am not throwing rocks at him, considerations rather than economic, which made the early 1966 decision not to tax.

Now under those circumstances, would you still advocate that we try an experiment in this particular 6-percent surcharge, that we give

him the authority rather than to levy the tax increase ourselves, notwithstanding the character of the 1966 decision?

Mr. HELLER. Speaking purely as an economist, perhaps a political economist, I think it would be an interesting alternative, and one that would make a lot of sense. I have no idea what the views of the rest of the Congress or of the administration might be on this, but it would be a most interesting first step toward the kind of flexible policy that we need in the longer run.

I do recall, Senator, that when I came before this committee for standby tax powers—or supporting the opposite proposal—which President Kennedy had made in 1962, Mrs. Griffiths reminded me with a certain amount of irony, that it was a great plan for the Congress to hand to the President of the United States the privilege of reducing taxes. Here you want to hand him the privilege of increasing taxes, which is a somewhat sterner test. But if he asks for the 6-percent tax increase, as he has, it seems to me, a perfectly sensible responsibility to put on the Executive. And, indeed, had he had the pushbutton tax power last year, even in the face of uncertainty, political considerations, and so forth, I think the chances would have been very considerably greater that he would have put through a tax increase.

Senator JAVITS. Dr. Heller, may I point out that if we give him the power to increase, we also must give him the power to take it off.

Mr. HELLER. I agree.

Senator JAVITS. So he has both sides of the political coin.

Mr. HELLER. I agree.

Senator JAVITS. And I might tell you that I am inclined that way. This is my own view right now as to the proper way in which to do it.

Now your testimony, and this is critically important, because my beloved friends who write about us would immediately label this as buck passing, but if you say, and many like you will say, that it is sound economics, and an intelligent practice, you will buttress us enormously in that, so we don't shy away from what ought to be done, because we don't like the handle that is put on it.

I have one other question, Dr. Heller. Mr. Chairman, do I have time for one more question?

Chairman PROXMIRE. Yes, indeed.

Senator JAVITS. You may want to put your answer to this in writing because it is quite a complex question I would like to ask you. I am speaking in sort of a postgraduate way. You will understand.

There has been a lot said about the fact that if the United States succeeded in balancing its international payments tomorrow, there would be a world crisis of liquidity, because of the resistance to monetary reform—Senator Symington and I have debated this many times—of the very nations which are profiting from the dollar imbalance that we have. They, themselves, would be the first to feel the squeeze in some deflationary way.

Now, coupled with that is the fact that we notice, and Professor Machlup of Princeton has called attention to a rather marked decline in the taste for dollars since 1965, and the greater appetite for gold which was perhaps engendered by President de Gaulle, or otherwise.

Now under these circumstances, would you tell us, first, whether or not this is a tendency we had better be afraid of, that is that even

aside from France there is now serious danger of a very basic impairment of our gold stock, the need for repealing the 25 percent cover et cetera, or 20 percent I think it is now, the 20 percent cover, and, second, is international monetary reform therefore more urgent than ever?

Should the United States take a strong initiative in that because we may be very much under the gun, not withstanding our wealth and productive power, because of the completely obsolescent system of world reserves under which we live?

Mr. HELLER. In brief, I would say I don't think we are up against any immediate crisis, yet the cause of international monetary reform is very urgent. May I comment on both of these quickly.

As to the position of the dollar, I would like to cite very briefly some findings, some views that I found in a month long survey that I made in Europe last October. Indeed, it is fair to say that in areas where people didn't have an ax to grind, that is where they are objective—and perhaps I am subjective in picking out who is objective about the dollar—it seemed to me that the confidence in the dollar was higher than at any time since convertibility. Indeed, an official of the Swiss National Bank told me he had just made a study of the relationship of the dollar to other currencies for that period—well, actually from 1960, but he said it would have shown the same results from 1958 on—which showed that the dollar was never stronger relative to other currencies than it was last year.

The hunger for dollars—and we have increased that hunger at least temporarily, by drawing some of them out of Europe, so this is partly self-enforcing if you will—seemed quite strong indeed.

Secondly, of course, it is an encouraging development that France hasn't been piling up as many dollars. With its own commitment in expansionary policies domestically, it is less able to run a balance-of-payments surplus and pile up the dollars that it converts into gold. Not that its basic policy is changed, but I just don't think France is quite as flush as it was.

Third, and quite facetiously, the French counterfeiters are expressing the greatest confidence in the dollar that you could ask for. They are printing more dollars than any other currency, Senator Javits, and if you do that under penalty of life imprisonment, it must be a pretty strong currency. If you want to strike that from the record——

Senator JAVITS. No, it is very good. Anything you say disagreeable on that subject we like.

Mr. HELLER. But I do believe—and you probably know from my previous appearances here and from your colloquys with my colleagues over the years in the Council of Economic Advisers—that I have felt for some years that the time has arrived for expanding the world's international currency.

The more recent developments of this effort of the Group of Ten, as negotiations have moved into the IMF, have been somewhat encouraging. I hope that we will be able, so to speak, to quarantine France in these operations, if they continue their oppositionist tactics on this issue.

The crisis isn't on us now, but the present system will gradually put a restrictive impact on the world's economies if we don't give our-

selves more elbow room in international currency. We ought to get ready—now.

Chairman PROXMIRE. Mr. Bolling?

Representative BOLLING. Thank you, Mr. Chairman.

It is a pleasure to have you back, Dr. Heller. I think the greatest contribution you have made is unnoticed in the title of your book. You termed it "New Dimensions of Political Economy"—what it should have been for a long time.

Mr. HELLER. That, Congressman Bolling, was the old 19th century title of the whole field of economics, as you know.

Representative BOLLING. I am well aware of that, but I am delighted in that we have returned to a sound beginning, because the myth that economics is a science that can be in the Federal field separated from politics is to me one of the most damaging myths that we have, that prevents us from behaving adultly, I think is the way to put it, particularly with regard to fiscal policy.

I was somewhat amused to read—I wasn't here—of the attack apparently made on Senator Javits by the Secretary of the Treasury. I came on this committee so many years ago that the first job I had was to defend a Democratic Secretary of the Treasury from a Democratic Senator. This is Snyder versus Douglas way back about the time of the accord. And I think that Mr. Fowler made a ghastly mistake in his direction of attack, because he forgot to read the unanimous majority report of the Joint Economic Committee on last year's economic report [1], and I would like to read it into the record.

The Joint Economic Committee's majority declared:

> The President's fiscal program, formulated in December and January, was shaped in a context of monetary restraint combined with some uncertainty as to the course of events abroad and the probable extent of the economic expansion at home."

Then on the next page:

> The committee is convinced that flexibility in fiscal policy must operate in both directions, countering recessionary influences, when appropriate, and moving to restrain total demand when inflationary economies are clearly the dominate danger.

This is in late January or early February of 1966.

> Unless our hopes for peace in Vietnam are realized soon, we will have to face up quickly to a need for a tax increase.

And then to skip some more, down toward the middle of the next paragraph:

> The most likely need this year will be for a tax increase and that quickly.

That wasn't Senator Javits, the Republican from New York. That was the unanimous report of the Democratic majority of the committee with some exception taken by our distinguished chairman. And I think the record should be clear that Secretary Fowler somehow or other managed to get his targets mixed up.

Now, Senator Javits has said what I would have said and asked the question that I would have asked with regard to surtax. I think you may be aware that for years I favored a limited power in the

[1] H. Rept. 1334. 1966 Joint Economic Report: Report of the Joint Economic Committee on the January 1966 Economic Report of the President, pp. 4 and 5.

hands of the President, with a veto, to raise and lower taxes, and I think very clearly in the light of the evidence that has been presented to this committee so far, this would be the wise course, because there are enough uncertainties as to whether we should act and when we should act, so that this clearly almost proves the need for giving the President a limited authority in this field.

Personally, I go farther than you do with regard to the Fed, and I guess that leads me to the only question that I really want to ask. Do you believe that there should be an independent Federal Reserve?

Mr. HELLER. This is a very tough question. I think on balance, the answer is yes. The President does have the power of appointment of the members of the Federal Reserve. This is not an inconsiderable power in influencing what will happen to monetary policy.

By the way, Congressman Bolling, my answer might have been different before I came into Washington in 1961, and that suggests that with the exception of that December incident where I agree entirely with Mr. Patman that the Fed slipped out of the harness of cooperation, there was a surprisingly good degree of cooperation among the various members of what we call the quadriad.

By the way, I don't know whether the members of this committee are aware that the dictionary defined a quadriad as "a group of four. Rare." It is a rare group, and yet, by and large it has worked well together, and the present operations of monetary and fiscal policy in 1967 are evidence of good cooperation. So, I am trying to suggest that there are some mitigating circumstances of this independence.

Representative BOLLING. I would only comment again as I did when Mr. Martin was here, that I think the deficiency, the failure in the total mix of policy, is very clearly placed in one place, and it is on the Congress. I do not think that the executive or the Fed or any other element of the Government has been nearly as deficient in achieving in approach to what they call now the "new economics." I guess you rightly point out that it is still political economy.

I think the only branch of Government that is really backward remains the Congress. We talk a great deal about cutting budgets—we don't. We have been doing this in all the time that I have been here. We talk about not liking Keynes—and we adopt half of it, but not the other half.

And I think it's about time that everybody, including the press, starts looking at where the fault really lies. It's not really with the executive. It's not really with the Fed. It is really with the House and the Senate.

You don't need to comment on that. Thank you.

Mr. HELLER. You apparently noticed a discreet silence.

Representative BOLLING. Thank you, Mr. Chairman.

Chairman PROXMIRE. Mr. Reuss?

Representative REUSS. Thank you, Mr. Chairman.

I want to add my welcome and appreciation for the superb job you are doing here, Dr. Heller, particularly on the balance of payments and gold. I think your "bedside manner" is very reassuring to this committee.

I would like to pursue that a bit. You have said that international monetary reform is highly desirable and there, of course, you express the unanimous view of this entire Joint Economic Committee. We all

hope that it will come to pass and take some of the strain off gold and the dollar.

Senator Symington a moment ago was pursuing with you the point, what if that does not happen, and what if there is a concerted gold-grabbing move on the part of foreign central banks and treasuries, which between them do admittedly hold more dollars than the present $13 billion of gold that we have.

I agree with you, Dr. Heller, that that is most unlikely. My own observation about France is that right now she has probably done her worst. Her dollar holdings are probably less than $1 billion. She needs practically all of those for current purposes, unless she wants to engage in self-destruction. Her nagging demands on our gold are likely not to be very serious. Is that your impression, too?

Mr. HELLER. I would feel that is the case, but I would also stress that I doubt, as I said before, that there has been any change in the fundamental policy of the French Government. It is just a change in the amount of dollars they have available to cash in.

Representative REUSS. As you have said then, the self-interest in holding dollars rather than gold on the part of foreign monetary authorities is, I should think, a reasonably good assurance that even if we run modest; that is, $1 billion deficits in our balance of payments for a few more years, in the absence of monetary reform, this need not be in any way catastrophic. However, I want to present the worst possible case, and that is: let us suppose the foreign monetary authorities, like the Biblical Gadarene swine rushing toward the abyss, all converge on us and demand the $13 billion worth of gold, the Congress having providently removed, let us assume, the remaining portions of the gold cover.

I still do not think that that need necessarily be catastrophic. What would happen then, with the last U.S. gold gone overseas, the dollar would then become de facto a floating exchange rate dollar; with the strength of the American economy, I should think the dollar would be a very desirable currency to hold, and it's quite likely that the dollar might even appreciate in value. If it fluctuated downward in terms of other currencies, this could be a de facto amendment of the Bretton Woods philosophy of 1944, and would be one way of our attaining at that time balance-of-payments equilibrium.

What I am getting at is this: Would you agree with me that while we certainly wouldn't want such a concerted drive on our gold, that for us to quail and shiver endlessly about this possibility is not necessarily conducive to our own future sound judgment, and that if the worst that people can do to us is no worse than what I have outlined, we can survive?

Mr. HELLER. Yes, I think so. I don't regard it as equivalent to a nuclear holocaust. At the same time, we have to keep it in the perspective of a very unlikely event, one we would hardly welcome, but yet one that wouldn't bring this country to its knees.

I also like your emphasis on the fact that it is the fundamental economic strength of this country that gives the world the confidence in the dollar. It is interesting that such confidence grew in the 1960's as this economy showed that it could make full use of its resources with a reasonable degree of price stability.

So I really believe that the kind of alternative or the kind of possibility you are talking about is remote. The world needs those

dollars, and they are going to continue to need those dollars. But to keep the international monetary system from having a restrictive effect on domestic economies, we of course ought to press forward with reform.

Representative REUSS. Now let me turn to the Heller plan, which Senator Javits touched on. I, too, am most sympathetic to the general outlines of the proposal of you, Dr. Pechman, and others. I have been concerned, however, that our local governments very much need modernization, and that the States, since they are the creator of local governments, are the agencies to do it. Our rural governments, our counties and towns are archaic and inefficient, and in our great cities, we have the bare beginnings of sensible systems of managing our metropolitan affairs.

I am wondering, therefore, if it would not be possible—I think it is—to combine the Heller plan notion of unrestricted bloc grants to the States, with some initial incentive to the States to get on with the job of modernizing State, and particularly, local governments.

In presenting that to you, I have in mind the notion of Federal strings. What is in my mind is to ask good faith demonstrations from the States that they are on their way toward modernization, and then for a period of 3 to 5 years, have the Congress make available pretty much unrestricted grants to those States which show a good faith creative effort at the beginning. What would you think of that gloss on the Heller proposal?

Mr. HELLER. I said earlier, Congressman Reuss, that I certainly don't have a patent on any particular plan in the sense that there aren't a great many variations on this central theme that might make good sense. I would hope that some of this reform that you are talking about would be facilitated simply by lifting some of the terrific financial stringency from the backs of progressive Governors and mayors, and so forth, by giving them some funds without matching requirements, and that this would facilitate a movement that is going on toward modernization, but going on at a snail's pace, I grant you.

Your proposal strikes me as a very interesting possibility, a possible variation on the basic theme. The objective is one I fully agree with, but I wonder whether this would perhaps inhibit the introduction of the plan to a point where we might not get it at all. What I am trying to say is, that the need is so great in the longer run, and the fundamental purposes to be served so important—a better distribution of our tax burden, a better financing of State-local expenditures, greater equalization—that I am willing to take something that is short of a perfect solution because we are serving these very broad objectives.

I would very much like to see the modernization you are talking about. This might be one of those cases where the Federal Government would in effect be saying to State and local officials and civic groups, and so forth: "We are going to force you to do something you really want to do, but are unable to do because of the competing special parochial interests."

This might be called a benevolent form of coercion, something to be handled gingerly, yet not to be ruled out. I see it in our metropolitan are in the Twin Cities. We are trying to do something. There is a strong urge for metropolitan areawide finance, and for some sort of coalition. Yet, as you know, the specific interests and the fears of

consequences at the polls keep people from doing what they regard as sensible when they stop and look at it logically and analytically and objectively.

I certainly would consider this as a possibility that ought to be seriously considered.

Representative REUSS. Thank you. Let me now turn to the guideposts you mentioned in your statement, that the administration and Congress must exercise continued vigilance on discretionary wage-price decisions. What do you think of the guidepost section of this year's economic program? I am disappointed in it because I don't like to see it left in as vague condition as the report leaves it.

Mr. HELLER. First of all, let me say that it is a very soundly, not to say brilliantly, argued defense of the guidepost principle. Also, it chronicles some very important efforts that were made behind the scenes to fight the battle against cost-push inflation with respect to both prices and wages, and I think this administration should be commended for those efforts. They have been far greater, I think, than the public has realized.

President Johnson has put his back to this problem, and I do believe that the guideposts, both on the price side and on the wage side, have had a material effect in slowing the increase in prices and the generation of a wage-price spiral.

We ought to start with that commendation, and we also ought to recognize that the arguments in the report on the wage-price guideposts are just unassailable in principle. We have to have some sort of standards for these areas in which business and labor have discretionary power that can be exercised at the expense of the public.

Representative REUSS. I join you in your commendation of past performance. It is from here on out that I have my difficulties.

Mr. HELLER. Of course, I have a bit of the feeling, having followed the guideposts and the attacks on them over the years, that the 3.2 number is revered more in death than in life. It seems to have suddenly gotten—and I am not referring to you, Congressman—it seems to have gotten a lot of supporters who weren't entirely visible. They seem to have come out of the woodwork once the 3.2 was abandoned.

Let me say that it is my impression from looking at this document, that the Council and the administration are in effect sitting this one out. I don't think they have left the dance. But they are saying it would be "counterproductive"—one of my most unfavored words in the bureaucratic lexicon, but it does fit this situation—to set up a set of guideposts, specific guideposts that we know are going to be flouted. It is like passing a law that you know is going to be violated right and left. It encourages a disrespect for the principle.

They were in a bind, no question about it, and the way out of the bind is in effect, as I say, to sit this one out and to say that we won't have a specific criterion this year because obviously 3.2 percent isn't going to be respected. Yet, if we say 4 or 5 percent specifically, then we are sanctioning wage increases that are very substantially in excess of productivity increases, and this would officially sanction cost-push inflation. This would set a precedent that would be hard to move back from.

Representative REUSS. You would hope, then, that when the dust settles, the wage-price guideposts could be reconstituted and reconstructed in a way so that he who runs may read?

Mr. HELLER. Yes, we would not necessarily go back to one specific figure. We would probably have to go back to a range. Nor would it necessarily be done by administrative fiat, but perhaps by bringing in management, labor, the Congress, and so forth. This is a dilemma that every free economy faces, especially at full employment, and we can't just run away from it. In spite of the fact that I regret that we don't have a firmer standard on which to judge the wage increases at the present time, I think that the administration has taken a sensible middle position for the current period.

Senator PROXMIRE. I want to follow that up, Dr. Heller, because I am very disturbed with the present recommendation on wage-price guideposts, and I want to refer to your book. I consider you the one who had done more to educate us on the desirability of the wage-price guideposts than anyone, and I am not a Monday morning quarterback on this. I have spoken many times in favor of the wage-price guideposts last year and the year before. You say:

> The wage-price guideposts fit well into the heading of education because they rely for much of their effectiveness on their informational content, their specification of responsible wage-price behavior.

Then further on you say:

> The major thrust then has been the process of informing labor-management and the public of explicit ways which wage and price decisions should be geared to productivity.

Further on you say:

> The public now has a better yardstick for determining whether particular wage and price decisions are economically defensible.

You use the term "yardstick".

Then later, when you sum up the advantages of the guideposts, you say:

> First though they have been a poor instrument of consensus, they have been a good instrument of education.
>
> Second, judged by both privately expressed opinions of business and labor and by careful comparative studies of wage and cost trends, they have gotten results.
>
> And third, what would wage guideposts haters have us do? Simply accept cost-push and price-push inflation, impose a wage and price ceiling, hold wages and prices down to keep the economy slack?

And so on.

I think this is a devastating defense. I think it is extremely logical. But I can't come to any other conclusion—although you make the most persuasive defense I have heard—but that the administration is just kissing this off.

You say they are sitting out the dance for one round, but they are sitting it out at the very time when we need this more than any other. Now I know it is difficult and it is unrealistic and would be grossly unfair to say 3.2 percent. On the other hand, I am not so sure that a 5-percent level, for example, would be so unacceptable.

It would mean that labor would get a real increase in wages, not quite to match their productivity increase, but a real increase. It would mean there would be a standard you could judge by. It seems to me it is a modest and a moderate point at which we could zero in.

After all, if you are going to abandon wage-price quideposts now, it means that any time you have inflation they are no good. As long as you don't have inflation and prices don't rise, they are all right.

At least this is my reaction. That is why I would hope that you would reconsider now and try and give us your notion on why some figure, 5, 5½ percent, even 6 percent, isn't better than no figure.

Mr. HELLER. First of all, I have to agree with something implied in your question, Senator Proxmire, and that is that wage-price guideposts are not a substitute for fiscal and monetary policy to manage or control——

Chairman PROXMIRE. I would say that explicitly.

Mr. HELLER. Aggregate demand, and the breakdown of course of the guideposts——

Chairman PROXMIRE. I hate to interrupt again, but let me just say that the time you need them is exactly when you don't have the demand-pull inflation, but it seems to me the cost-push inflation—and this is the situation many of us feel we are getting into now—especially with so many settlements coming up this year.

Mr. HELLER. But you know this is really sort of a period of afterglow of last year's overheating. It is a period of echo inflation, so that a good part of this cost-push is really a reflection of the demand-pull inflation of last year. So it is a very tough situation to cope with.

Now if you had specified, let's say, 4½ percent or 5 percent, it seems to me that at the very least you would have to say is so-and-so-much is the productivity element and so-and-so-much is a one-time——

Chairman PROXMIRE. Cost of living.

Mr. HELLER. Catchup element. You can't build the cost of living into this thing forever, or it becomes an engine of inflation, yet the Council, the President, and the Congress, I am sure, recognize that you can't ask labor to sit back under the circumstances and stick to the productivity limit, when they have had this kind of a cost-of-living increase confronting them.

It is possible that some other formula could have been worked out as a holding position. I take it that the Council and the President are really only taking a holding action here. The Chairman of the Council, Mr. Ackley, made very clear that the productivity standard still applies. It is around 3 percent; but they didn't want to specify it because of this problem of its being flouted.

It is extremely hard to judge whether some other formula could have been put together which says:

> Look, for the longer run three per cent has got to be it, but we recognize it may be a two per cent add-on over this year or two years for cost of living purposes brings us temporarily to a five per cent standard.

Yet there is a very great danger, if they once explicitly OK 5 percent, it tends to get embedded, and it is terribly hard to retreat from.

It is much more likely that we would be able to restore something in the 3-percent range later on, not having explicitly sanctioned the 5 percent. That is the best defense that I can see for it.

Chairman PROXMIRE. I can see it is a good defense, but I am not asking for a defense. You are no longer of the administration. So that it would seem to me you can be critical and objective if you would care to be, and I take it you don't feel you are constrained.

Mr. HELLER. Not at all.

Chairman PROXMIRE. You don't feel——

Mr. HELLER. I hope the course of my testimony this morning might suggest that, that I don't feel constrained.

Chairman PROXMIRE. Maybe I should try again because this is so important. You are telling us that you feel we might as well sit out the wage-price situation this year, with some efforts on the part of the President and the Council to say restrain yourself to labor and restrain yourself to management. Keep wages down as low as you can. We aren't going to zero you in on a figure. And then maybe next year try again.

But next year won't we have a worse situation, or at least the same kind of a situation? If prices rise, as predicted, by 2½ percent, it is going to be unreasonable to expect labor to take a 3-percent or 3.2-percent increase. Just how long can this go on? Don't we have to, (a), be realistic and recognize the increase in prices and, (b), be specific enough so that there is some basis for holding an accountability?

After all, when you read the Council's report, they say 6 percent is better than 8 percent. Eight percent is better than 10 percent. I suppose that you can find some construction union that is going to get 15 percent this year, and all the settlements that are less than that are better, or more statesmanlike.

So if you throw away any specific national guideline here that takes into account productivity, takes into account to some extent the increase in the cost of living, you are building in, I think, a much worse engine of inflation.

Mr. HELLER. This is just a terribly hard thing to judge. You may be right. At the same time, if we had a 5-percent average rate of settlements this year—let's say 3-percent productivity and 2-percent price increase—and then next year it became apparent that we were going to go back to our sort of traditional inching up of prices of maybe a half to three quarters of a percent per year, there is no reason for setting 5 percent as a precedent for succeeding years. It is in their attempt to find a way out of this dilemma at the same time that they exercise continued restraint that the administration reach this conclusion. I am not trying to defend the administration. I am trying to say that it looked to me like about as good a solution as you could come to under the circumstances that prevail, even though it is regrettable that it leaves us without a more solid criterion for judging wage increases.

Chairman PROXMIRE. But even under the kind of price stability we had from 1961 to 1965 or through 1965, we had a rise in the Consumer Price Index of 1.4 percent on the average. Labor's productivity was around 3 percent. The guideline was around 3 percent.

Now wasn't labor being cheated in terms of their real income? Those who stuck to the wage-price guidepost had approximately a half—close to a half—of their increase in real income eroded by a price increase.

Now to acknowledge this and recognize it, it would seem to me that a fair adjustment would be to have had the productivity increase together with a cost of living written into it, and there it is true that that would have had some degree of inflationary impact, but it would have been realistic, and it would have been fair, and I am not sure in the long run that it wouldn't have provided for a greater price stability than what we are doing now. Isn't that a possibility to consider in the future?

In other words, tie this into the real, as much as you can, into the real income of labor, so that their real income can be compensated for their productivity increase?

Mr. HELLER. The difficulty is that when you put in cost-of-living escalators, either in specific bargains or in a wage price guidepost, you are in effect building into your formula a certain spiral of wages and prices which, over the longer run, is going to erode the value of the dollar. In other words, it builds this result right into the formula.

Chairman PROXMIRE. If you don't do that, you are expecting labor to take the full brunt of the increase in the cost of living, which they did take to a considerable extent. The result was that profits increased by what, 80 percent during this period, wages increased by a much smaller amount, and those who stuck by the guidelines religiously didn't receive their real productivity increases. They were handicapped.

Mr. HELLER. Of course the productivity increases were very large in this period. In real terms, 19 percent per man-hour is the average productivity increase in this 5- or is it the 6-year period. That's the main point on which we should focus in the longer run; namely, to reconcile the demands for wage increases and the demands for profits by increasing productivity more rapidly.

Also it is worth noting that even though the wage rate increases per man-hour, for example, last year averaged around 4 percent, the compensation per man-hour went up by 5, somewhat over 5 percent.

Chairman PROXMIRE. Close to 6 percent.

Mr. HELLER. Yes.

Chairman PROXMIRE. But the reason it went up is because people were moving off the farms.

Mr. HELLER. Upgrading.

Chairman PROXMIRE. And so forth.

Mr. HELLER. That is right.

Chairman PROXMIRE. Into higher paying jobs.

Mr. HELLER. That is right, and upgrading of particular labor, so there is over the longer run some more or less automatic protection of the real income of the labor force as a whole by this process of upgrading. There is no neat solution.

I mean we come to that point time and time again. But if your objective is the longer run stability that sets the stage for true full employment—and by that I mean something below 4 percent unemployment over the intermediate term, not just the long term—and sets the stage for continued competitivity in the world, you have got to be somewhat tough in setting guideposts—for both wages and prices.

Chairman PROXMIRE. That is what we are trying to do. I think Congressman Reuss and I are trying to do that.

Mr. HELLER. Yes.

Chairman PROXMIRE. My time is up. I do have other questions. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman. On this question of gold and its importance, Dr. Heller, let me emphasize what worries me is that the Government keeps on saying each year that it is a very serious matter and we intend to correct it in the following year. But for 18 years we haven't corrected it, with the exception of 1957. If it is a serious matter, then it should be corrected. If it isn't serious we should forget it.

I would hope that the idea gold isn't really important now being developed is not because we are losing all our gold, because if that happened to be wrong we would be in for very serious troubles indeed. As you say, it is becoming more importance to get into a new currency position of some kind either through the International Monetary Fund or some other way. I would hope that we have a little gold left when we sit down to trade it out with those people you referred to the Committee of Ten.

Going ahead with some of the questions the chairman asked, and Congressman Reuss, in your book you note also that the "unexpectedly strong surge of real GNP in 1966 underscores again that this country, with its prodigious productive capacity, faces no runaway inflation, no breakaway price-wage spiral."

President Johnson in his current Economic Report emphasizes the importance of price stability and states that—

Last year the record was blemished

That is his word—

with a 2.9 per cent rise in consumer prices, and a 3.2 per cent rise in wholesale prices from the previous year.

In that connection, what percentage price rise would you say our economy could absorb, without causing undue inflationary pressure and at the same time maintain stability?

Mr. HELLER. First of all, by the way—the President's figure of 2.9 was year over year. When you take December to December, the figure was somewhat worse, almost 3.4 percent inflation. That is certainly more than we can or should stand still for, so to speak, if we want to maintain our strength and leadership in the world's economy.

I do feel that something in the order of half to three-quarters of a percent increase in the price level per year is really not much more than the increase in the average quality of goods and services that can't be discounted, so to speak, in the price index or at least that isn't, given our present resources. That represents essential stability.

Now a second criterion is to have a slower price rise than the rest of the world, and on this, of course, we have done just spendidly, whether you take the last 10 years, the last 7 or the last 5, even the last 3. With the exception of Canada, you find almost no industrial country in the world that matches our record of price stability, and that has to be one of our criteria.

Part of the criterion is domestic, what do you do to the people on fixed incomes and so forth, by price inflation. But the other is what do you do to your international competitive situation, and except for 1966, and the later half of 1965, that competitive position has been improving in spite of some price creep in this country, because we have had so much better a record than the rest of the world.

Senator SYMINGTON. Thank you. Back to the question of balance of payments, I note this morning a headline in the Wall Street Journal which says "U.S. Balance-of-Payments Deficit Deepening in the 1966 Period. War Appears as a Factor."

There is an excellent book out by Henry Brandon which points out how we worked with the British on the pound problems. It is hard for me to see why this continuing unfavorable balance of payments could be such a serious problem to other countries not tied up so

tightly with us as we are with the pound as a result of the Bretton Woods Agreement.

Many people say that, after all, we do not have to worry because our gross national product is so high. But on that Dr. Stevens has a quote which interests me. It reads:

> Whatever may have happened to the world dollar shortage, it is a fact of life that economic, political and military attitudes once well established certainly do tend to persist. Today when our economy still remains unrivaled in the world, if the popular premise that economic strength always confers financial strength were sound, people might still think it natural for the United States to be running an international payment surplus, provided various frictions and temporary obstacles to its achievement could be removed. But the simple argument, the basic economic strength and continuous financial strength is not valid, and there is no natural payments balance. A country's balance of payments at any one time depends on many things, only one of which is the productive power of that country's economy.

Every time now a representative of any agency comes up, Defense, AID, any other program, and you question the additional expenditures, the answer invariably is, "Oh, we don't have to worry about that because it all is a lesser percentage of the gross national product than before."

I suggested to one witness, "Why don't you fix it this way next year?" If the cost of the Vietnamese war increases materially, by your fomenting a few strikes, paying the workers what they ask for, putting in the additional cost in the price of the merchandise and the tickets. Then the GNP will be even higher, so you will be able to justify your additional fiscal and monetary moves or lack of moves, and additional spending, again on the basis of the percentage the new figures are of the gross national product.

We say it is a serious problem. But when we fail to lick it, we say, well, after all, it doesn't amount to a great deal. This worries me and that is why I am interested to be here and have the advantage of your thinking.

I understand you have been quite complimentary of British action and what they are trying to do. Would you agree with the rigorous measures that are being applied in Great Britain, both fiscal and monetary, to correct the serious imbalance in their international accounts; and if so, as a corollary course, is it something we should consider here because it is important there?

Mr. HELLER. Well, to take these things in order, first of all, let me say I do feel that the administration has taken a long list of measures, and I believe Chairman Ackley reviewed those with you, that have been designed to minimize and bring down this balance-of-payments deficit.

After all, the performance isn't bad. It is not as good as we would like, but the performance isn't bad, when you consider we were running about a $4 billion deficit at the end of the 1950's in a peacetime situation, and with the economy operating at a much lower percentage of capacity, and so forth, and it has been brought down to this $1 to $2 billion range in the liquidity basis, and really a very good performance of a surplus on the official settlements basis last year.

Secondly, I agree entirely with Mr. Stevens that you can't use the money GNP willy-nilly as a criterion for how large the balance-of-payments deficit should be or how much you should be concerned about it.

I am talking about the GNP as an indication of the strength of this country economically, which in turn imparts strength to the dollar. In this context, you have to talk about a noninflationary growth in GNP, not an inflationary growth, and I couldn't agree more with that point.

Furthermore, it is true that you have to take not one but two things into account. One is the fundamental inherent strength of the country economically. But the other is what is your position as banker to the world? The truth of the matter is that we are lending long and borrowing short. We have a tremendous responsibility to invest and lend money to the rest of the world, since we are the most affluent country, and we have the most highly developed capital markets, and the rest of the world wants that money.

That means that when we can't develop a big enough trade and services surplus to finance that, then we have to borrow short by putting our dollars overseas, and we have to recognize that fundamental relationship.

Some people want to solve the problem by saying to the rest of the world, "Look, you ought to accept that. If you want our long-term investment, you ought to hold our short-term debt and agree to hold it and not cash it in for gold."

Nevertheless I do think that the facts of life are that as a banker to the world, we have to take into account these possibilities of a run on the dollar and a run on our gold, and that is one of the constraints that has pushed the administration, both the Kennedy and Johnson administrations, to take a whole series of measures. And I think further measures could be taken if need be, particularly on the administrative constraint side.

But as to the United Kingdom, I don't think in nearly as exposed or vulnerable a position. We don't have to squeeze down our whole domestic effort, in order to achieve our balance-of-payments objectives. Given our resources, that would be a self-defeating undertaking, and would hurt the rest of the world just terribly. It is up to us to keep our economy going full tilt, to lower our interest rates so we relieve the pressure on the European economies and on the underdeveloped countries, and try to get the rest of the world to cooperate with us. We did that at the recent Chequers meeting. I think most of the world will cooperate, and I hope that that degree of cooperation will be enough to overcome the difficulties that the French may generate in this situation.

So, fundamentally, I see the problem you are stating, Senator, but I think that our position is strong enough and the prospects for international monetary reform are good enough so that it will not develop into a crisis.

Senator SYMINGTON. Thank you, Mr. Chairman. My time is up. I would ask this one short question. You approve of the action the British have taken?

Mr. HELLER. Yes, I do.

Senator SYMINGTON. Thank you.

Mr. HELLER. Fundamentally I think they were courageous, and they were in the right direction, but they go beyond what the United States would have to do under any circumstances I can foresee now.

Senator SYMINGTON. Thank you.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. I agree with you, Dr. Heller, that flexibility is the most important stance in considering this 6-percent income tax surcharge slated to go into effect on July 1, if the Congress approves. In discussing flexibility, you mentioned that the proposal for granting wide areas of discretion to the President, first advanced I believe by President Kennedy, is a worthy proposal, but stands little chance of being adopted by the Congress.

I am wondering if there isn't a little ground which would keep the power in Congress, where Congress wants to keep it, yet achieve flexibility, because specifically in this year's context, would it not be sound for the tax writing committees of both the Senate and the House to address themselves rather promptly to the President's 6-percent across-the-board surcharge proposal, amend it, approve it, do with it what they will, bring it to the floor, have the Congress enact it with the following important proviso: That it not go into effect until and unless the President shall request it and the Congress, by a joint resolution, approves that request.

Such joint resolution could go through Congress in a day or two, whereas inevitably Congress should and will take some months to debate the details of the tax proposal itself. Wouldn't that give us pretty much flexibility and still keep the center of authority in Congress, where Congress evidently wants to keep it?

Mr. HELLER. That strikes me as a very reasonble approximation of flexibility or pushbutton tax policy, and indeed it comes very close to what I had suggested just a year ago at the Twentieth Anniversary Symposium on the Employment Act of 1946, where I suggested a contingency planning kind of action by Congress, where it would enact something and have it ready to go under joint resolution. Having been for it under those circumstances, I must say that I respond very sympathetically to it under this year's circumstances.

Of course, we all know the tactical problems of the Ways and Means Committee being preoccupied with other things, but we are talking about what would be a desirable flexible fiscal policy, and this would be desirable.

Representative REUSS. Let me turn now to the interesting subject of the investment credit, which I am glad you brought up. I agree with you that back in 1962 when we enacted that, it made sense. Then the economy was in something like a recession. We had you say $35 billion of wasted GNP that wasn't being produced, some being even higher.

Mr. HELLER. Yes. Well, it was about $50 billion in 1961, but it had shrunk somewhat by 1963.

Representative REUSS. Yes. It could then be said to those who would have argued, "Why don't you put all your tax and fiscal emphasis on the demand side, let the consumers have more money in their pockets, they will want to spend it and then factories want to invest?" it could have been said, in answer to that, and in my mind it was said, "Yes, but your deflationary gap is so big, $50 billion," or whatever it was, "that you had better do something for both the consumption and the investment side."

Actually I felt we should have been doing something for consumption back in 1962, and so I suspect when you write your memoirs, it

will turn out you did, too, but in any event it was better to do something than nothing, so I was for it.

However, in the present situation I wonder really what foreseeable sets of economic events will cause it to be sensible to reinstate the investment tax credit; if we have full employment and if value judgment people that the economy at that full-employment level is not putting enough into plant and equipment and is putting too much into current consumption, then the remedy is not to restore the tax credit. That will simply cause inflation. The remedy would be to increase taxes on consumption or income taxes generally, so you quiet down consumer spending. I should think that would follow.

Similarly, if we are a little away from full employment, I should think the remedy to get us to full employment would be to ease up on taxation, on consumers generally. In either case I can't see much of the case for restoration of the investment tax credit. If we got into another 1962-type situation, which I hope we do not, then I would be much more receptive to it. Will you comment on my quandry?

Mr. HELLER. It seems to me you are putting your finger on the problem of balancing the current impact on demand, in either an inflationary or flabby economy, versus the interest in getting a longrun improvement in productivity and expansion of the country's capacity.

What you have to look at as the year wears on is where the sluggishness is in the economy, if there is sluggishness; where the ebullience is in the economy, if it's ebullient. This is the current demand side of it.

If the sluggishness is in consumption, then it might not be very sensible from that point of view to restore the investment credit as a stimulant. You might rather say lower the surtax or postpone the surtax. And then you have this intermediate consideration of possible overcapacity weighted against the need for modernization.

These things all have to be weighed together, and I agree that you can be in a situation where it may turn out at midyear or even at the end of the year, leaving aside the air-pocket problem, to be desirable to extend the suspension rather than to end it early. But that does depend very much on the set of circumstances as they develop, and I think we just have to keep an open mind.

It also depends on what you do with the rest of the package. It is possible you would want some increase in the corporate income tax and restoration of the investment incentive, if the combination of developments in the economy made that a good fit.

Representative REUSS. And that fragility of the investment tax credit philosophy makes one wonder if we really were right in saying, "All right, we are going to imbed this into the tax structure," back in 1962. That is what we implied, and that is what caused Secretary Fowler so much honest anguish.

Mr. HELLER. Absolutely.

Representative REUSS. That was last year. That is why he doesn't go for its repeal and suspension until September.

Mr. HELLER. But I think you may know, Congressman Reuss, that when the economists who first thought of the incentive in that form originally developed it—they explicitly suggested, people like Richard Musgrave and E. Cary Brown and others—they explicitly suggested that it would be an excellent instrument in the arsenal of stabilization.

That is by either raising or lowering or suspending or restoring the credit.

Now granted that isn't as pleasant and simple and easy as something that simply stays in the tax law, but I think a 7-percent credit occasionally suspended when there is overheating in the investment sector is better than no 7-percent credit at all, given a national economic policy that stresses a high level of investment for economic growth.

Representative REUSS. Thank you.

Chairman PROXMIRE. I will try to be as brief as I can. I apologize for keeping you so long, but you are such an excellent and significant witness that this is part of the price you pay.

In your statement, where you refer to your book, you indicate that one of the reasons why there was no tax increase last year was because, as you say, "We are plagued with the uncertainties as to the demands of war in Vietnam."

Now this is a nice, friendly, uncritical way of saying the administration was wrong 100 percent in their estimate of the cost of the war. They said it would be $10 billion. It cost $20 billion. They never did revise their estimates until late November after Congress had gone home. It was too late for us to act.

The other part of it where you say also, "The situation is plagued by the economic responses of consumers and business." Well, that is always true. So wasn't that really the principal reason for this effort that was made?

Mr. HELLER. Mr. Chairman, when I wrote that I had in mind the honest-to-goodness uncertainty about the cost of Vietnam rather than any lack——

Chairman PROXMIRE. You wrote this when, about June?

Mr. HELLER. I wrote this in August, actually.

Chairman PROXMIRE. In August. When you wrote this in August, you didn't have the advantage of revised figures. What I am getting at is this: It seems to me that this committee, and the Congress, would be well served by the administration making their estimates on the cost of Vietnam at least quarterly. This is so uncertain. It changes so rapidly.

And it is true that supplementals constantly come up. It is true they made the assumption that by hindsight looks ridiculous. But what is wrong with having revised up-to-date information, recognizing that the old information gets out of date swiftly, if we are going to have economic policy that is going to work?

Mr. HELLER. Well, the economists, of course, always respond favorably to the concept of more information with which to work.

Chairman PROXMIRE. What is wrong with it? Why shouldn't we have it?

Mr. HELLER. Well, I think in order to have a revision of this kind, take the midyear budget review, that is an enormous operation.

Chairman PROXMIRE. We didn't get it last year.

Mr. HELLER. That is one of the reasons, because it is a tremendous operation, and I suppose the Budget Bureau would have trouble doing this four times a year rather than once or twice.

Chairman PROXMIRE. I am not asking it for the whole budget, but I am asking it for the Vietnam war.

Mr. HELLER. Well, certainly if it were possible to do it within the resources of the Budget Bureau, it would help us all. But may I come back just to——

Chairman PROXMIRE. Let me interrupt for a second to say within the resources of the Budget Bureau, supposing they do have to hire a few more people to do this. This is so vital, so important to have economic policy that is based on intelligence and the best possible understanding of what the facts are, wouldn't it be worth it? Wouldn't this be a good investment?

Mr. HELLER. I find it hard to reconcile my appetite for data as an economist with the practical limitations that may exist in this process, on which I am no expert. Charles Schultze, as the Director of the Budget, is the expert.

Chairman PROXMIRE. No witness to my knowledge has given us any specific reason why they can't make a quarterly report on Vietnam. I am sure that the President of the United States must ask for reports more frequently from the Secretary of Defense than once a year or 18 months in advance.

Mr. HELLER. I suppose when there are highly uncertain figures, sometimes it is better not to use the figures charged with uncertainty than simply to wait until the elements in the situation are clearer.

Chairman PROXMIRE. But each quarter they get better, as we get closer to the——

Mr. HELLER. Yes, in recent years, Mr. Chairman, we have moved very substantially toward explicit forecasts, economic forecasts, budget forecasts and all the rest. When you look back to the late fifties, we are of course doing far more today of laying it on the line in our Government than we were then. But may I just go back for a moment and say two things about last year's numbers?

As I understand it, the actual difference between the estimate and the final expenditures in 1966 was a differential of about $4 billion.

Chairman PROXMIRE. Yes, you are talking about calendar 1966.

Mr. HELLER. Yes.

Chairman PROXMIRE. I am talking about fiscal 1967.

Mr. HELLER. Of course that is what had the immediate impact on policy. And secondly, there is the difference between what people were able to infer in their economic forecasts, and whatever problem of relations between Congress and the administration there might be. I went back to my own forecasts, by the way, because of the fact that there had been a good bit of discussion of this point before this committee.

Chairman PROXMIRE. Yes.

Mr. HELLER. We at Minnesota were using numbers—Prof. George Perry and I, who make a joint forecast three or four times a year—we were using numbers that were reasonably close to the final results as early as last July, without any special access to information. So were other forecasters. In my September bank letter I was anticipating a $10 billion supplemental, or even more.

Chairman PROXMIRE. Maybe we should ask you instead of asking the Budget Director.

Mr. HELLER. Hardly. But I am trying to suggest, Senator, that there are two questions. One is how does this lack of flow affect economic forecasts and the resulting policy, and the other is what is the proper relation between Congress and the administration.

Chairman PROXMIRE. Yes, but you see we have a situation where the chairman of the Preparedness Subcommittee, Senator Stennis, would get up on the floor and say this was going to cost $10 billion more, and Secretary Fowler would say this is wrong, and he did that. On March 23, Secretary Fowler said, "We stand by our original estimates."

Mr. HELLER. That wasn't true by——

Chairman PROXMIRE. This wasn't said once. It was said repeatedly by the administration.

Mr. HELLER. I think that wasn't true by summer. They were talking about the necessity——

Chairman PROXMIRE. Later on they were vague on it, but once again if you give an estimate, it is going to cost more; more doesn't mean much in the Congress when we determine what we are going to do in the Finance, Ways and Means, and Appropriations Committees. This would have very definitely affected our policies I think. If not, it would have been our responsibility, not the President's. We didn't act in a way that would have given us a better economic policy.

Let me ask a couple of other things as swiftly as I can. You said that we should look at both sides in evaluating the impact of higher interest rates on prices, and I wonder if on the basis of the testimony of Chairman Martin, I don't know if you have seen it, if he does look on both sides. He indicated when I asked him this question that they had no specific breakdown of the impact of tight money on specific commodity prices.

For example, it is clear that high interest rates and tight money don't have much influence on the price of food, because, after all, the demand side is important, and also because it doesn't affect our demands. When interest rates go up, we are still going to eat.

Another element in the cost of living that is very vital is the medical costs. It is doubtful if tight money has much effect on medical costs, which have been the most exclusive part of the increase in the cost of services.

Then a third element in this is the Council's report shows that one-third of the entire rise in services last year was because of the increase in the cost of credit. That mortgage interest went up something like 12 or 14 percent in 1 year.

Now given all this, I wonder if it wouldn't be greatly improved economic policy if you could persuade the Federal Reserve Board, our money managers to make a specific analysis of the impact of tight money on prices when they act, especially recognizing the difference.

If you have a demand-pull situation, then the impact can be quite stabilizing. On the other hand, if you have a cost-push situation, it is conceivable that tight money might not have much impact or might even have a reverse impact. Don't we need that kind of a specific analysis?

Mr. HELLER. Yes, I think that could be very useful. The BLS probably, because of the fact that it has to compute the price indexes—and it does show that a good bit of that price increase in services last year was due to higher interest rates—would be able to be very helpful to you on this subject, and for that matter, to the Federal Reserve as well.

I agree entirely with the implication of your comment, that increased interest rates are at the very best a blunderbuss way of han-

dling cost-push inflation. To try to whittle away or cut down on demand as a means of bringing labor and business into line on wages and prices is a far too expensive way to do it. Indeed, the increase in interest rates would add, does add somewhat to the cost-push, where in a demand-pull situation, as you recognize, the net balance obviously is favorable to the inflationary problem.

Chairman PROXMIRE. And so you would favor getting this kind of information available to our money managers, so that they would be on top of this?

Mr. HELLER. Within the limits of the difficulties of getting it, it would be very good information to have.

Chairman PROXMIRE. Let me ask you if I can point up another difference between you and Chairman Martin for our enlightenment. Chairman Martin indicated that he would favor a tax increase beginning July 1, even if the economic situation were worse, particularly because it would put some stress on the fact that our budget deficit might be substantial in the event of worsening economic conditions. At least he would give weight to the budget deficit.

It seems to me I would recognize the budget deficit as a reason why we might recognize that the economic situation should demand that we not increase taxes. If the economic situation is bad, it seems to me we must put almost our entire emphasis on what the economy is doing. That in the event the economic outlook is not good in June, it would be a mistake for use to increase taxes as of July 1.

Do you agree with that?

Mr. HELLER. I have not read the chairman's testimony.

Chairman PROXMIRE. I don't want to misquote him.

Mr. HELLER. But just taking the factual situation, if we were backing into a larger deficit because the economy was weak and soft and sliding, obviously that is an argument against the tax increase, not for it, from an economic point of view.

Chairman PROXMIRE. And you would put your stress on the economic outlook, not on the particular deficit that we have?

Mr. HELLER. Absolutely.

Chairman PROXMIRE. One final question. On the investment credit you talk about the air pocket that we have at the end of this year, and I am delighted that you do so. Other witnesses haven't given this the attention I think we should focus on it.

If we do reinstate the investment credit as of January 1—which the law now provides, it would take no change—there will be, I think, a significant dropoff in the purchase of machine tools and other equipment.

What do you think of another compromise proposal? We begin to restore the investment credit at the rate of 1 percent a month, say, on July 1, so that there isn't this air pocket, recognizing that the McGraw-Hill predictions, and so forth, suggest that investment is going to increase at a far lesser rate this year than it has in any of the last 3 years?

Mr. HELLER. It seems to me, without having studied this particular proposal, that anything that can ease the transition back to the full effectiveness of the investment credit ought to merit very serious consideration, because we are going to have the air pocket.

If we don't have the air pocket problem this year, suppose we extend the suspension to a year from next January, we will have an air

pocket problem a year from then. Now, maybe we will want an air pocket by then. In other words, you will want to study the strength of total demand before making a final decision.

Chairman PROXMIRE. Maybe the macroeconomic situation, but looking at Giddings & Lewis in Fond du lac in Wisconsin, for instance, and the thousands of people who work for them, this could be pretty disastrous to try to pay for leveling this thing out on an overall basis.

Mr. HELLER. Transitions are something we haven't really learned to handle smoothly enough in this matter of economic policy, and I think that kind of an instrument should be considered. But it always has to be considered in relation to the strength of overall demand as well as the particular industry.

Chairman PROXMIRE. Dr. Heller, I want to thank you for a superlative performance. You are certainly most helpful to us and have given us a great deal of enlightenment on these complex problems.

Mr. HELLER. I enjoyed it; and I wish to thank the committee again for the opportunity to testify.

Chairman PROXMIRE. Our witness this afternoon will be Arthur Burns, president of the National Bureau of Economic Research. The committee will recess until 2 o'clock.

(Whereupon, at 1 p.m., the committee adjourned, to reconvene at 2 p.m. the same day.)

AFTERNOON SESSION

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

The committee is fortunate to have as our witness, Dr. Arthur Burns, a most able and eminent economist who served as the Chairman of the Council of Economic Advisers under President Eisenhower.

Dr. Burns is currently president of the National Bureau of Economic Research, which, of course, serves as a great lighthouse in the economic world. Like Dr. Heller, he has come here at some personal sacrifice. There are inordinate demands on his time, but characteristically he has taken the time to come here and give us the benefit of his wise counsel. I wish to state that you are mighty welcome, Dr. Burns. Will you proceed?

STATEMENT OF ARTHUR F. BURNS, PRESIDENT, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. BURNS. Thank you, Senator.

I am glad to have the opportunity once again of discussing economic issues with the members of this committee.

Your wish, as I understand it, is that I appraise the administration's financial policies in relation to the Nation's economic condition and prospects.

There is hardly any need for me to tell you that we are now in the midst of a tremendous upsurge of Federal spending.

According to the national income accounts budget, for which the President has recently expressed a preference, Federal expenditures in fiscal 1965 amounted to $118 billion. In fiscal 1966, expenditures reached $132 billion. Now, a total of approximately $154 billion is projected for this fiscal year and a total of $169 billion for fiscal 1968.

The successive annual increases thus come to $14, $21, and $16 billion, an overall increase of $51 billion in just 3 years.

This growth in spending represents a violent break with the past. From 1960 to 1965 the increase in Federal spending averaged $5.4 billion per year. From 1955 to 1960 the average annual increase was $4.8 billion. Now, according to the President's budget, the increase from 1965 to 1968 will reach $17 billion per year. That is more than three times the rate of increase experienced during the preceding decade.

Of course, the upsurge in Federal spending is to a significant degree attributable to the war in Vietnam. In fiscal 1965, expenditures for the support of Vietnam operations were negligible. In fiscal 1968, they are expected to reach $22 billion. This is a very heavy cost, but it accounts for less than half of the $51 billion increase in Federal spending between 1965 and 1968.

If we put aside the spending attributable to the war in Vietnam, we are still left with an increase of $29 billion between fiscal 1965 and fiscal 1958, or an annual increase of about $10 billion. This is 2½ times as large as the annual rate of increase in total Federal spending during the 3 preceding years; that is, from fiscal 1962 to fiscal 1965.

Clearly, neither the war in Vietnam nor, for that matter, total defense expenditures are a sufficient explanation of the spurt in Federal spending that got underway in 1965.

Information concerning Federal expenditures is not provided in much detail by the national income accounts budget. There is, however, a table in the budget which, while confined to the short interval from fiscal 1966 to fiscal 1968, reveals the general character of our present expenditure policy.

This table, given on page 43 of the document entitled "The Budget of the United States Government: 1968," shows expenditures for each of a dozen functional categories. One of these is national defense, another is international affairs and finance, and so on. The table discloses a projected decrease for only one category, space research and technology, between fiscal 1966 and fiscal 1967, and it is a small decrease at that. Between fiscal 1967 and fiscal 1968, there are two projected decreases, both small.

No one reading this table, or the budget message as a whole, can very well escape the impression that Federal spending is now growing in nearly every direction.

(The table referred to follows:)

TABLE 3.—*Federal receipts and expenditures in the national income accounts*

[In billions of dollars]

BY NATIONAL INCOME ACCOUNT CLASSES

Description	1966 actual	1967 estimate	1968 estimate
RECEIPTS			
Personal tax and nontax receipts	57.9	65.5	76.8
Corporate profits tax accruals	30.7	32.3	35.3
Indirect business tax and nontax accruals	15.9	16.5	16.9
Contributions for social insurance	28.1	35.5	38.1
Total receipts, national income basis	132.6	149.8	167.1
EXPENDITURES			
Purchase of goods and services	71.7	83.6	91.9
Transfer payments	34.3	39.8	46.6
Grants-in-aid to State and local governments	12.9	14.8	17.6
Net interest paid	9.1	10.0	10.5
Subsidies less current surplus of Government enterprises	4.5	5.4	3.5
Total expenditures, national income basis	132.3	153.6	169.2
Surplus (+) or deficit (−), national income basis	+.3	−3.8	−2.1

EXPENDITURES BY FUNCTION

Function	1966 actual	1967 estimate	1968 estimate
EXPENDITURES			
National defense	56.5	68.3	74.1
International affairs and finance	2.8	3.1	3.2
Space research and technology	5.9	5.6	5.3
Agriculture and agricultural resources	3.7	3.7	3.7
Natural resources	2.4	2.7	3.0
Commerce and transportation	6.8	7.2	6.7
Housing and community development	.6	.8	1.2
Health, labor, and welfare	33.0	39.2	46.4
Education	2.2	3.3	4.0
Veterans benefits and services	6.2	6.3	6.7
Interest	9.8	10.7	10.9
General government	2.3	2.5	2.6
Civilian and military pay increases			1.0
Allowances for contingencies		.1	.4
Total expenditures, national income basis	132.3	153.6	169.2

NOTE.—For fuller explanation, see special analysis A (pp. 394–402).

When a nation's budget gets into such a condition, the first and foremost necessity facing the Congress is to subject every expenditure program to the most searching reexamination.

For, unless a determined effort is made by the Congress to check the proliferation of Federal spending, the foundations of our economy may be weakened. With public revenues increasing rapidly in these good times and the public debt still growing, there is a danger that scarce resources are being applied to projects of marginal or even doubtful value. Not only that, but the recent spurt in public spending is bound, sooner or later, to lead to higher taxes. This already happened last year and the President is now requesting additional tax increases.

I firmly believe that the main strength of our economy comes from the resourcefulness of private enterprise, and that we must guard against the weakening of incentives that occurs when an excessive portion of people's income is siphoned off in higher taxes. Only a short time ago this was also the belief of the Congress.

Let me remind you of the great fiscal debate that stirred our Nation during 1963. Some citizens urged that the Government seek to stimulate the economy by larger Federal spending. Others argued for tax reduction. Still others urged that we travel both roads at the same time. President Kennedy belonged to the latter group, but he put much the heavier emphasis on tax reductions. Even so, the Congress balked.

In the revenue bill passed by the House in the fall of 1963, Congress took the unusual step of spelling out its fiscal philosophy. The preamble of this bill explicitly assigned top priority to tax reduction, with debt reduction next. Congressman Wilbur Mills described the preamble as a "firm, positive assertion" that the Nation is choosing tax reduction, and rejecting larger spending, as its "road to a bigger, more progressive economy."

President Kennedy accepted this declaration of policy. So, too, did President Johnson. His first budget message, presented in January 1964, called for smaller expenditures under the administrative budget in fiscal 1965 than in fiscal 1964. With this much assured, the Senate promptly passed the House bill with only minor revisions.

In line with the new fiscal policy enunciated in the tax reduction bill, Federal spending actually stopped rising for a time. From the third quarter of 1963 to the first quarter of 1965 cash expenditures moved along a horizontal trend. Then, despite numerous signs of pressure on available resources, spending began to climb again. Expenditures rose rapidly both for defense and for civilian programs.

Since the economy was already booming in 1965, governmental revenues also rose, but the increase was held in check by new tax reductions. The deficit mounted, and this fresh injection of money into the economy was reinforced by a great wave of spending and borrowing by business firms and consumers.

As was bound to happen, the economy became overheated in the process. To be sure, when 1965 ended, the unemployment rate was finally down to 4 percent. But the widespread exuberance of both public and private spending produced also other and less-welcome results—in wholesale markets, prices that were 4 percent higher than in mid-1964; in consumer markets, prices that were nearly 3 percent higher; in the labor market, wages that were beginning to rise at an accelerated rate; and in the money and capital market, interest rates that were moving up sharply, despite an enormous expansion in the supply of credit.

Much has been said and written about the causes of the recent inflation and distortion of our economy. In particular, the Government has been blamed for not raising income tax rates at the beginning of 1966. But I believe that the fundamental mistake of policy was made in 1965, not in 1966. It was in 1965 that we pursued boldly and simultaneously a policy of tax reduction, accelerated spending, and credit ease.

Certainly, both monetary and tax policy moved toward restraint last year. In the spring, the Federal Reserve authorities shifted to a policy of credit restriction quite bluntly. Changes on the tax front were much less dramatic, but their significance should be not underestimated. Higher social security taxes went into effect at the beginning of the year. A little later some excises were raised, and in the fall

the investment tax credit was suspended. Income tax rates remained nominally constant, but they rose in real terms as a consequence of applying a progressive tax schedule to inflated incomes. This January, social security taxes were lifted another notch.

The President has now proposed additional increases in tax rates. The most important of these are, first, a surcharge of 6 percent on the income tax liability of individuals and corporations, starting July 1, second, an increase in the social security tax on January 1, 1968, and again on January 1, 1969.

These tax recommendations are obviously related to the administration's spending plans. In particular, the higher social security tax is directly linked to the higher social security benefits that the President has recommended, with the first hike in the tax coming 7 months after the benefits are to be lifted.

In judging the President's new tax program, it is necessary to consider not only the wisdom of the proposed expenditure plans, but also the magnitude of the tax burden that is already borne by the American people.

Our gross national product in 1966 was about $58 billion larger than in 1965. Federal revenues, according to the national income accounts, were $17½ billion higher. Thus, the Federal Government absorbed 30 cents out of every additional dollar of gross national product.

The States and localities took another 10 cents. Thus, taxes siphoned off 40 percent of the increment of the gross national product last year. During the past dozen years or so, this figure was exceeded only in 1956 and in 1960. It may not be entirely an accident that these years were followed by recession.

In 1963, when the administration urged a massive tax reduction, it rightly put great emphasis on the fiscal drag of our tax system. The argument was that the tax system draws off so large a portion of a rising national income that it tends to choke off the process of expansion. Yet, in 1963, Federal revenues absorbed only 27 cents of every additional dollar of gross national product, in contrast to 30 cents in 1966.

If our economy in the years ahead is to grow and prosper, as it both can and should, we will need the stimulation that comes from an improving tax climate. Unhappily, under present circumstances, tax reduction is impracticable. But we should at least try to avoid tax increases, and we can do so by curbing the growth of Federal expenditures.

If increases in social security benefits are kept within modest limits, there will be no need for any early increase in employment taxes. And if the growth of other Federal civilian programs is moderated, there will be no need to raise income taxes this year.

I realize that the rapid growth of civilian expenditures is often defended on the ground that we have excessive poverty in our land of plenty. But I know of only one sure weapon for waging successful war on poverty; namely, full employment together with rapid improvement in the productivity of labor. This should be our prime economic objective. I am inclined to doubt if the increase in Federal aid to the poor from $13 billion in fiscal 1963 to $22 billion this fiscal year has really done very much for poor people.

Let me now turn from these basic and longrun considerations to the question of how an increase of income taxes, such as the President has recommended, would affect economic activity this year. The argument of the Council of Economic Advisers appears to be that the private economy may be moving ahead "too rapidly" in the second half of the year and that the "President's tax program will be moderating the advance."

This is sheer conjecture. Neither the Council's ability in forecasting, nor that of other competent economists, is sufficiently good to attempt such delicate, pinpoint prediction.

The Council has itself recognized that there are forces that may make for sluggish private demand in the first half of this year. In my judgment, doubts about the short-term economic outlook extend beyond the next few months.

The economy is now full of crosscurrents. On the one hand, the aerospace and machinery industries are continuing to boom. On the other hand, the homebuilding industry is experiencing serious depression. There is also noticeable weakness in the building materials trades, in the automobile industry, in the appliance trades, in the steel industry, and in the textile-apparel-leather sector. The curve of total industrial production has flattened out. In the first quarter of last year, the production index rose about 3 percent, in the second quarter 2 percent, in the third quarter only 1 percent. In the last few months the index has not risen at all.

Price trends have also become mixed. Consumer prices are continuing to rise at a disconcerting pace. On the other hand, wholesale prices of farm products and industrial materials have weakened, while the rate of advance of prices of finish industrial products has appreciably slackened.

Meanwhile, the advance in wages has accelerated. Lately, the rate of increase of output per manhour in the economy at large has not only slowed down, but has fallen below the rate of increase of wages per hour. Hence, the labor cost per unit of output, which was so remarkably steady in recent years, is now rising.

Precise measurements of this ominous development do not exist; but the available data suggest that unit labor costs are now 3 or 4 percent higher than a year ago. As a result of the divergence in industrial prices and production costs, corporate profit margins have been shrinking during the past 9 to 12 months. More recently, total corporate profits have begun to slip.

With the scope of economic expansion narrowing, with labor costs rising, with profit margins shrinking, with construction costs high and running well above investor's estimates, with interest rates on business loans still relatively high, with the stimulus of the investment tax credit suspended, and with the business and investing mood gradually becoming less exuberant, powerful forces are now operating to restrain business investment. New investment commitments appear to be waning. Of late, anticipatory indicators of business capital expenditures, such as the formation of new firms, orders for machinery and equipment, commercial and industrial construction contracts, and new capital appropriations, have all been displaying some weakness.

Other branches of private investment also lack vigor at present. In many industries, manufacturing and distributing firms feel a need

to bring down the ratio that inventories bear to sales. Hence, inventory investment is likely to move to lower levels this year.

To be sure, the recent easing of credit should in time lead to improvement in the homebuilding industry, but as yet it has not had a significant impact on the mortgage market. In the best of circumstances, several months will need to elapse before expenditures on residential construction can begin to recover from the drastic decline in building permits last year.

The prospects of consumer and export markets are also not especially bright. Retail sales have been sluggish of late, and surveys of consumer buying intentions suggest that this conditions may well persist for a time. One clear reason for the sluggishness is that many families are forced by the rise in the cost of living to practice stricter economies. As far as exports are concerned, they will probably continue to grow at a moderate rate. But a rush of export orders is highly unlikely, since the rate of expansion is slowing down materially in the world economy, not only in our own.

In view of the slackening of demand pressure that is so evident in the private economy, the economic case for an income tax increase is weak at present. Such a measure, if adopted early in this session of the Congress, could tip our delicately poised economy toward recession despite the strong upward trend of governmental spending.

In expressing this judgment, I am not unmindful of the continuing threat of inflation. Demand is no longer pulling up prices as it did a year ago, but higher costs are tending to push up prices.

Workers and their leaders are insisting on much larger wage increases than have recently been customary. The wage push will continue, as workers seek to adjust to recent trends in profits and prices, and it will gain strength from the increase of the minimum wage that Congress recently legislated. Hence, the troublesome advance of the consumer price level, which reflects higher labor costs directly as well as indirectly, will continue this year; but the prices of industrial products in wholesale markets will probably rise much less.

The scope of constructive governmental action for dealing with the present price and cost inflation is, I think, quite limited. Unhappily, even a mild recession would probably not suffice to bring cost inflation to a halt under current conditions. The reasons are all the stronger, therefore, for avoiding governmental measures of an inflationary character.

In dealing with the President's legislative recommendations, it is particularly important to consider the psychological impact of a 20-percent boost in social security benefits, besides the fiscal implications and the direct economic effects. It would not be unreasonable for working people to feel that if retired folk are entitled to a 20-percent increase in the income put at their disposal by the Government, then those who are productively engaged deserve more than just a 5- or 6-percent increase in wages.

In summary, my advice to this committee on the fiscal issues that now face our Nation is as follows:

First, it is highly important that the Congress make a strong and determined effort to curb new appropriations and thereby pave the way for an early return, once the hostilities in Vietnam make this possible, to the policy of tax reduction which served our Nation so well from 1962 to 1965.

Second, any increase in social security benefits this year should be limited to the level justified by current employment taxes.

Third, the Congress should take no action at present on the President's recommendation of a 6-percent surcharge on the income tax liability of individuals and corporations. The wise course would be to watch economic and fiscal trends closely over the next few months and judge the tax issue in the light of developments. If it should become clear several months from now that the pace of economic expansion is again quickening, an increase of income taxes may become necessary, especially in case little progress is in the meantime made by the Congress in scaling down requests for new appropriations. On the other hand, if signs of weakness in the economy multiply, the case for a tax increase will become even more doubtful than at present.

But if the Congress is to be adequately informed, the flow of fiscal information will need to be improved. This need extends, of course, beyond the immediate future and beyond the halls of Congress. Just as the Federal Government now makes public each quarter the information that it compiles on business sales expectations and investment intentions, so it should also compile and make public each quarter its estimates of the Government's own revenues and expenditures. These reports should include fiscal projections both for the ensuing quarter and for the remainder of the fiscal year.

I hope that the Congress will consider legislation to this effect in the interest of keeping itself, as well as others both within and outside Government circles, adequately informed. Once this new fiscal tool becomes generally available, we will be better equipped as a society to deal with the difficult and changing requirements of fiscal policy.

Chairman PROXMIRE. I want to thank you very, very much, Dr. Burns, for a forthright and strong statement, and one which in many respects confirms my own prejudices, which makes me approve a great deal of it. I am especially impressed by the very strong case that I think you have made against Congress acting in the near future to enact an increase in taxes, and your feeling that we should wait and see.

I would like to ask you a number of things; first, with reference to the table which you referred to in your discussion of increased spending, I have that table before me at the present time. It indicates that of the increase in Federal spending between 1966 and 1967, $18.4 billion of the $21.3 billion were in two categories. One in national defense and, secondly, health, labor, and welfare, almost all of which was in social security, a great deal of which was.

In 1967 and 1968, the increase is $15.8 billion in these two categories of a total increase of $17 billion. In other words, these two categories account for 85 percent of the increase in the first year, and 90 percent in the second year. Consequently, it would seem to me, if we are going to do anything about the increase in Government spending, we have to either reduce or hold down the national defense area, which I take it you would agree depends on conditions that are not economic.

Secondly, follow a prescription which you have been very definite about, of not increasing social security, as you say, above the amount permitted by present taxes, which would be, I take it, about an 8-percent increase; is that correct?

Mr. BURNS. Approximately that, I would judge, yes.

Chairman PROXMIRE. Now, that alone, of course, would still mean we would have a big increase in Federal spending resulting from Vietnam, the national defense factors associated with that, and with social security. Can you suggest any other area where we can reduce spending?

Mr. BURNS. This is a very difficult question, as you well recognize, Senator, and in making my suggestions, I inevitably will be reflecting my own prejudices and preconceptions, as well as the economic knowledge that I possess.

I am inclined to believe that a substantial sum of money can be saved on our agricultural price-support programs. I am inclined to believe that we would be better off if our space program were cut back substantially, and not by the very small amount the President has recommended. I am inclined to believe that we could save some money on public works programs, though I might be embarrassed if you asked me to specify details.

I am inclined to believe that our antipoverty program is proving wasteful, and that some money can be saved in that area. And as I look at the actual world and our finances, I am inclined to believe that some money can be saved in the defense program itself.

There are some military bases around the country that perhaps are no longer necessary, and I have grave doubts about the wisdom of retaining so large an army as we now have in Western Europe. This is a drain on our budget, and it is also a burden on our balance of payments.

In short, I think money can be saved. It will not be easy for the Congress, because of the push and the pull of different interests.

I have given you a list of particulars. If I knew more, the list would probably be longer. Other witnesses will give you a different list. This, I think, is a political question that has to be worked out by a process of compromise.

Chairman PROXMIRE. I think that is a very specific and helpful list. Would you agree, however, when you talk about cutting back the antipoverty program, that the manpower training aspects of this, while I suppose we can administer all of our programs more efficiently, and this is a new program, a lot of money and a lot of people are involved, it is a very difficult program. Would you agree or disagree that this kind of training is helpful in cutting down—let me put it this way—this kind of training tends to be deflationary inasmuch as it tends to bring people into the labor force.

It trains people in skills which are needed, and it means then, instead of being a drain on the economy and being on welfare, and absorbing Government spending, they contribute to the autonomy and pay taxes. Isn't most of the antipoverty program designed around this, whether it is Headstart, which has obviously a very long period before your kindergarten children are working, or the Job Corps program, which has a much shorter period of time——

Mr. BURNS. Senator, I am and have been consistently over the years sympathetic, even enthusiastic, about training programs.

I have the impression, however, that we have a large number of training programs at the present time, poorly coordinated and very costly. I would be surprised if we could not get much larger substantive results at smaller expenditures.

As far as the Headstart program is concerned, there I feel quite unhappy. Some of my colleagues at the university who know a great deal more about this than I do tell me that the Headstart program performs near miracles for a short period, and then the advantage is lost. I have the uneasy feeling that the trouble with much of our America is that fathers no longer play the role in family life that they once did, and that the wholesome role that the family used to play in the educational process of children has very much diminished.

I think the Headstart program needs reappraisal by professional educators. I hope that Congress will then look into it sympathetically, of course, but also with an eye to advantage in financial cost.

Chairman PROXMIRE. Let me move to another area quickly. I take it you would concentrate, in your judgment, as to whether or not we should have a tax increase, on the economic situation, in May or June, and that this would be your virtually sole determinant. That is, you would determine whether we should have a tax increase, based on the economic outlook, not based on budgetary considerations.

You see, what I am getting at is that if the economic outlook is pessimistic, conceivably the deficit could be larger, and in spite of that, you would not favor a tax increase under those circumstances. Am I wrong or am I right?

Mr. BURNS. That is correct, Senator.

Chairman PROXMIRE. Now, let me ask you this, Dr. Burns.

You seem to be pretty pessimistic, and what we can do about this cost-push inflation. You previously have indicated a feeling that the wage-price guideposts are of not much use under these circumstances, or not now. You say that even a mild recession would not bring cost inflation to a halt. I am sure you don't advocate a stronger dose, so what do we do about it, just relax and accept it?

Mr. BURNS. I am not even advocating a mild dose.

Chairman PROXMIRE. I am sure you are not. But what can we do about it? Are we just impotent in the face of this inflation? Do we just have to take it for a couple of years, let it ride its way out, or is there something that we can do that we can't see here?

Mr. BURNS. Well, Senator, once an inflationary spiral gets underway, I am afraid there isn't a great deal that can be done constructively. A severe recession would bring it to a halt, to be sure, but no one of us wants that.

Chairman PROXMIRE. How about controls, credit controls?

Mr. BURNS. Well, if we move back toward a policy of severe credit restriction—we are shifting away from that now, fortunately—if we move back to that, the chances are that we will bring on a recession.

Chairman PROXMIRE. I said credit controls. I didn't say tighter money, but say, consumer regulations which would require a larger downpayment and a shorter period of amortization of the debt. We have had those before. We had them in the Korean war, as you know. We had them during World War II.

Mr. BURNS. I hardly think this is the time to do that. Our automobile industry is not prosperous at present, and the appliance trades are not prosperous at present. This would be a very poor time to move toward a specific type of credit control such as that.

Chairman PROXMIRE. And you think that, regardless—I shouldn't say regardless—but supposing we do have a situation in which wage settlements are very high, and as you say, profits are dropping now

and the pressure on prices would be most severe. Do you see any prospects that this might constructively require us to have price controls?

Mr. BURNS. I would be greatly troubled about our Nation's future, if we move toward price controls under conditions that I can now foresee. The great strength of our country lies in our free economic system.

Price controls would impede and weaken our economy. There are circumstances under which I would grudgingly concede the need of price controls, but I don't definitely believe that we should seek to deal with a mild inflationary push from the cost side by imposing price and wage controls.

Chairman PROXMIRE. I am certainly inclined to agree with you. My frustration is trying to push hard to get some kind of an answer to an unfortunate economic situation in which inflation is going to be so painful for so many people. It is so hard to see any solution on the basis of your testimony.

Mr. BURNS. Well, you see, this is a lagging adjustment. In recent years profits rose, and rose sharply. The consumer price level rose very sharply last year. Wages also advanced. But the real wage-per-hour did not increase significantly last year.

The working people now want to catch up, and this is not merely the sentiment of a group of labor leaders. It is a widely shared sentiment and it will have to work itself out in the course of this year.

Chairman PROXMIRE. Thank you very much. My time is up. Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman.

Dr. Burns, I was particularly gratified reading your statement and listening to your testimony wherein you state very concisely the relations of our gross national product to Federal revenues, and I think you have put together in just a few sentences a clear summation of our problems today. I would like to repeat for the record, before I ask a few questions, what you said that impresses me so much:

> Our gross national product in 1966 was about $58 billion larger than in 1965. Federal revenues, according to the national income accounts, were $17½ billion higher. Thus, the Federal Government absorbed 30 cents out of every additional dollar of gross national product. The States and localities took another 10 cents. Thus, taxes siphoned off 40 per cent of the increment of the gross national product last year. During the past dozen years or so, this figure was exceeded only in 1956 and in 1960.

And then, this sentence is impressive:

> It may not be entirely an accident that these years were followed by recession. In 1963, when the Administration urged a massive tax reduction, it rightly put great emphasis on the fiscal drag of our tax system. The argument was that the tax system draws off so large a portion of a rising national income that it tends to choke off the process of expansion. Yet, in 1963, Federal revenues absorbed only 27 cents of every additional dollar of gross national product, in contrast to 30 cents in 1966.

You also stated earlier in your testimony some remarks with respect to the 20-percent increase in social security, and I take it from what you said in connection with that, that you felt an increase would be warranted, if it could be related completely to the stability of the fund, and as I understand it 8 percent would be warranted at this time. Do you think that this would be sound at this time?

Mr. BURNS. I should say merely that some increase in social security benefits under present circumstances, in view of the rise that we have had itn he cost of living, seems farily inevitable to me. I think it is a matter of equity that the Congress cannot entirely ignore.

Representative WIDNALL. But everything beyond 8 percent would involve additional taxation and an additional burden as far as the individual is concerned, and the employer is concerned.

Mr. BURNS. Yes, and beyond that, the psychological impact would be unfortunate. The psychological impact is bound to be inflationary, in my judgment.

Representative WIDNALL. Thank you. Now, is it true that the Government debt management operations were expansionary during 1966, because of the need to finance at relatively short term?

Mr. BURNS. The ceiling on interest rates on long-term governmental obligations made it necessary for the Government to borrow on short-term. That increased interest charges rates sharply at the short end, and also added for a time to the pressures of demand in the money and capital market. This was later responsible in a measure for the severe credit restriction that was imposed by our monetary authorities.

Representative WIDNALL. Would you recommend raising or removing the 4¼-percent ceiling on Treasury issues on maturities over 5 years?

Mr. BURNS. I would recommend removal of the ceiling, or in the absence of that, raising it. I think the Government would then be able to borrow at more advantageous terms.

Representative WIDNALL. If the economy grows by 4 percent next year, as the Council expects, do you believe that unemployment will increase somewhat by the year's end?

Mr. BURNS. If it grows by 4 percent in physical terms, I would not think so. But I am inclined to doubt if the economy will grow that much next year, and therefore, I would expect some increase in unemployment.

Representative WIDNALL. Have you made any projection yourself as to how much you think the economy might grow during the next year?

Mr. BURNS. I am unable to give you a quantitative estimate in which I myself would have any great confidence.

Representative WIDNALL. What effect does the thought that there will be inflation—I shouldn't say the thought, but the expectation of inflation—2 or 3 percent every year, which is now being recognized as something we should deal with, what effect does that have on the level of the long-term interest rate?

Mr. BURNS. I think it is bound to impart an upward tendency to long-term interest rates. You can't escape it.

Representative WIDNALL. The Federal budget in 1967 came under some very severe criticism, largely because of poor expenditure estimates, and this was particularly true with respect to Vietnam, as has been pointed out by our able chairman a number of times, and the use of a number of devices which tend to obscure the high level of Federal spending.

Do you feel that the Federal budget, as a tool of economic analysis was seriously compromised last year?

Mr. BURNS. I felt unhappy, as many of us did, on account of the poor estimating that was done by the Federal Government. I think

I would have to criticize the budget as it was presented last year. But I would criticize still more the failure of the administration to inform the Congress by midyear of the tremendous upsurge in expenditures, of the failure to stay within the budget that by then had become entirely clear.

I think the Nation as a whole, and certainly the Congress, should have been better informed, and that is a reason for the recommendation that I made at the end of my statement.

Representative WIDNALL. You strongly recommend that quarterly estimates of receipts and expenditures?

Mr. BURNS. It is high time that we move toward it. I think that the management of Federal finances would improve, but whether it does or not, the Congress would be better informed.

Business people, economists, would also be better informed. The task of evolving a sensible economic policy would therefore become a little easier. There are too many uncertainties that we face under the best of circumstances. We should have an up-to-date budget before us; this can be done, and should be done.

Representative WIDNALL. Beyond that, Mr. Burns, do you think of any other improvements that you would recommend for the Federal budget that would help restore public confidence?

Mr. BURNS. Well, I think the President has made a very useful statement in his budget message. I don't recall the precise language, but I believe that the President indicated that he would appoint a group of competent citizens, who would review our present budget accounting, and recommend changes.

The budget has become an extremely complicated document. To some degree that is unavoidable. But when the Federal Government shifts in its emphasis from the administrative budget to the cash budget and then to the national income accounts budget, that is frightfully confusing to everyone, including technically trained economists. I assure you of that.

A review of accounting procedures is long overdue. The President intends to appoint a group, as I understand it, to look into this, and I think it is a very healthy thing to do.

Representative WIDNALL. Dr. Burns, I would just like to make this comment. I don't have any other questions to ask you. But I find that in the area that I represent—that is, northern New Jersey—there is a very deep concern with taxes, and particularly today with real estate taxes. Many people who have poured their life savings into their homes, and they have them free and clear today, and many of these people are wealthy, are being forced to sell them because they cannot afford to stay in them any more because of the real estate taxes that have to be paid.

We are running into a situation, and I don't think people really recognize it, where it is not just Federal taxes or State taxes or city taxes, real estate taxes, or excise taxes. It is a combination of the whole, that people never really add up to find out how much is being poured into taxes for governmental services. I think we are going into a dead end on this pretty soon unless we start to hold the line on spending and cut out some of the frills, or postpone for awhile some of the programs that seem urgent but actually have no priority at this time.

I am thoroughly convinced it is the mood of the people of the United States now to really take just a good hard look at what is going on to see where we are going, and I think also the economic community is starting to realize, too, that we just haven't got an inexhaustible barrel of funds in order to take care of all these programs.

I just throw this out as my own opinion, as one person representing a lot of people in Congress. I think possibly you agree to some extent on that yourself.

Mr. BURNS. Yes, I do.

Representative WIDNALL. Thank you very much.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman. Thank you, Dr. Burns.

We couldn't do without your testimony and help. I appreciate your coming here.

Many of us on the committee who share your views with respect to the 6 percent proposed July 1 tax surcharge—that Congress would do well to have a policy of watchful waiting—feel that a way of doing that, and still keep our anti-inflationary powder dry, would be to have the tax-writing committees of the House and Senate and the Congress itself address themselves very promptly to the general outlines of a proposed tax increase, should one become necessary, and make such amendments as they care to in the President's proposal, and then have the Congress act on that, with the proviso that the tax increase would not go into effect, if at all, unless and until the President requests it, and that Congress by a joint resolution, which could be passed in a couple of days, approves.

Does that seem to you a possibly useful device in the situation of cross-currents which you have so well pointed out in your statement?

Mr. BURNS. Well, this would put the problem into the President's lap. I don't see why Congress cannot deal with this issue quite competently. It may take the Congress a little longer, but I am not entirely sure, even, of that. When the President has discretionary power, he may or may not use it.

Representative REUSS. Perhaps I didn't state the proposition clearly enough. I said the Congress, by a joint resolution, could activate the tax proposal which it had already legislated on but had put into deep freeze. The President might request it, but the Congress could also, by joint resolution, act, if it wanted to.

Mr. BURNS. I am a little afraid that, if Congress passed a joint resolution to this effect, there would be a good deal of confusion over the country. Some people are concerned now about taxes. This may be having an influence on consumer spending at present.

Representative REUSS. I am concerned about just that, and that is one of the reasons I am somewhat unhappy about the firm administration request that as of July 1 we should have a 6 percent surcharge. I would seek to avoid that overhang on the economy now by having a national judgment that we just don't know, but we want to be prepared and not have to consume months of lengthy congressional hearings, if inflationary pressures should develop.

Mr. BURNS. Congressman Reuss, I hope you will not misunderstand me. I certainly would not argue for a tax cut under present conditions. But it seems a little odd to me to pass a resolution in favor of a tax

increase, then freeze the measure, and hope thereby to make it easier for the Congress to put that increase into effect later, if needed. If you do anything in the legislative area along these lines, I think the measure should be symmetrical, but I don't believe I would travel this road at the present time.

The Congress is in the early stages of this session. By and large, the Congress is able to act when it needs to. If economic conditions became very clear, one way or another, I would have confidence in the Congress acting with reasonable promptness. If economic conditions are cloudy, the Congress may well take its time in debating the issue, and perhaps it is just as well. I don't believe I would be in favor of legislation along the lines you suggested at the present time.

Representative REUSS. Thank you.

Now, let me turn to one point concerning social security. Your testimony is that you think about an 8-percent increase is all we should have. The President—and I happen to agree with him—thinks it should be 20 percent. What we are talking about, then, is whether a person or a family now making an $80-a-month social security pension should have $86 a month or $96 a month, and please don't think that I am trying to paint you as an ogre for being for only $86, because I would be a $96 ogre then, too, and that is almost as bad.

However, is it not a fact that most of the things that social security annuitants would buy with that extra $8 or $16 a month would be things that are not subject to great inflationary pressures?

You point out in your excellent paper that where the boom is is in the aerospace industry, and machinery, and you point out, courageously, I think, that one of the ways to cool off that boom is to cut down on the space program. That means not landing a man on the moon by 1970. I take it that you are prepared to swallow that.

However, when you get to what social security recipients buy, this is largely food, and as you point out, wholesale prices of farm products have weakened, clothing, and as you point out, the textile-apparel-leather sector is noticeably weak. You point out that appliances are weak. Well, one of the things that I think some nice old people with their $96 a month would do, would be to pool together and maybe buy themselves a washing machine.

It is also true that social security receipts do not enter into the wage picture, and thus do not directly act on the cost-push side. In the light of what I have been saying, couldn't a more generous treatment of our social security annuitants, who you and I agree have lagged badly behind in recent years, be accorded without spelling any real inflationary dangers?

Mr. BURNS. This is a very difficult question of judgment, Congressman. I am afraid, as I tried to point out in my testimony, that a 20-percent boost in social security benefits would have a psychological impact on wage negotiations. I don't see how you can very well escape that.

Representative REUSS. If I may comment at that point, you state: "It would not be unreasonable for working people to feel that if retired folks are entitled to a 20-percent increase in income put at their disposal"—and then you go on to say that working people would not unreasonably feel that they are entitled to it also.

I would, I think, differ from you there. I think it would be unreasonable for an auto worker or a steel worker, who is making $400

a month, plus, to begrudge the widow's mite being raised from $80 to $96, and I hope that in labor negotiations to come, particularly if the Congress does pass the President's social security program, labor negotiators won't be naming Burns as a hero and Reuss as their villian, for what I have just said, because I think that this contention would be properly resisted by employers, and I would hope by the Council of Economic Advisers, to the extent that there is anything left of the wage guidepost.

Mr. BURNS. You and I may differ as to what is or is not reasonable or unreasonable. But the kind of reaction that I described, whether reasonable or not, is a human reaction. Not everything about human nature is fine or noble, Congressman Reuss, as you well know.

Representative REUSS. I want to, in conclusion, endorse very heartily your constructive suggestion for better and more frequent quarterly forecasting by the budgetary authorities. I think there is a very real feeling on the part of this committee that our jagged performance last year was in part due to insufficient reporting. I want to thank you again.

Chairman PROXMIRE. Senator Percy?

Senator PERCY. Dr. Burns, I wonder if you could comment on what you see to be the attitude of foreign monetary authorities on the dollar, what confidence they have in it? If they looked impassionately at our economy as we have looked impassionately at theirs, and were free with their advice as we have been free with ours, what would some of these authorities say we should do to continue to maintain confidence in the dollar?

Mr. BURNS. I am inclined to think foreign monetary authorities would place a heavy emphasis on better control of Federal spending. I think also that they would say that if we cannot curb Federal expenditures, we should raise taxes. That is my understanding of foreign financial opinion at the present time.

Senator PERCY. It may be an unfair question to ask you, but I have had some comment abroad about the Federal Reserve System here and its independence from political pressure. Because Chairman Martin's appointment is coming up soon would you care to comment at all on how he is viewed by international monetary authorities and by those who are in responsible positions in this country, as the person who does maintain freedom from political pressures, and who tries to exert an independent stance on the Fed's part with respect to monetary policy? How important is that appointment as a symbol of having a Fed that is maintained independently as to policy?

Mr. BURNS. Mr. Martin is held in the highest esteem in financial circles abroad, and also in this country. I have heard men say that Bill Martin is worth more than a billion dollars in gold. In fact, I have heard that sentiment attributed to a very high administration official whom I will not name.

Senator PERCY. Those are my sentiments. I did not know what yours were, but I am glad to have them. Mr. Martin is of tremendous value to this Government and the integrity of our fiscal policy.

We have had much discussion about balance of payments. We have talked about it a great deal, and yet the condition continues to deteriorate. Would you care to make some recommendations with respect to some of those things that this country should do to restore equilibrium in these payments, if you feel that is a worthy objective.

Mr. BURNS. I feel it is an objective of the very highest importance, not only for economic reasons, but also for international political reasons. Our political prestige might suffer and the world at large might suffer irreparable damage, if we were ever forced to devalue the dollar.

Our strongest defense of the balance of payments lies in pursuing a financial policy that will tend to keep the internal purchasing power of the dollar stable.

There are also other things that we ought to do. I think that at a time when we are so hard pressed in Vietnam, we should finally face up to the question whether we need to maintain a large army in Europe. There is great doubt about that in political circles.

We cannot continue involving ourselves with everything over the world. We have to make choices. I am inclined to think that we have delayed too long in handling the problem or our military forces in Europe. We can also save some money in our foreign aid program, and that will help our balance of payments a little. But the main defense of the dollar will have to come from the pursuit of an overall monetary and fiscal policy designed to keep the price level reasonably stable.

Fortunately, from our viewpoint, we are not the only culprits. Inflation has become a worldwide habit, and that has helped us to limp along with our balance-of-payments disequilibrium.

It may help us in the future. And the chances are that it will. But I do not think that we can prudently make the assumption that other countries will solve the balance-of-payments problem for us by practicing inflation in their own nations.

Senator PERCY. Dr. Burns, we talked with Dr. Heller this morning a little about the investment tax credit. It is my feeling that the investment tax credit was aimed at several objectives.

First, to increase the productivity of the worker and to increase his wages.

Second, to help industry to reduce costs, lower selling prices, and broaden the market for its product.

Third, improve our product with respect to world markets, so that we can increase our share of world trade, and thereby improve our balance of payments to offset some of the military and foreign aid expenditures.

Do you feel that the investment tax credit should become a permanent part of our tax structure, or do you prefer to see it something like a spigot that is turned on and off as you wish to accelerate or depress the economy?

Mr. BURNS. I am inclined to think that the investment tax credit carries with it the possibility of helping to stabilize the economy. Therefore, I should like to experiment with that piece of legislation for a time, permitting the investment tax credit to fluctuate, depending on economic conditions.

Now, I am not sure of the outcome, but I think that something may be gained in the difficult art of managing prosperity, if we carry out this experiment over the next few years. In the end, we may want to abandon it, but it is too soon to abandon the flexible aspect of the investment tax credit.

Senator PERCY. Dr. Burns, investors are always talking about, and looking for, new glamour industries, growth industries. I saw one

yesterday that is not generally looked upon as a glamour industry—rehabilitation of existing housing. Yesterday during the recess I saw houses in Philadelphia that were purchased by the interfaith-interracial group, at an average cost of $1,500, with $6,000 put into rehabilitation and put on the market privately at $7,500, completely refurbished. The people taking ownership of those homes pay $53 a month, which is about what they were paying for rent in units that were in utter disrepair and without any chance of owning them.

It seems to me that if we are looking for places to put large sums of private capital, if we could find a way to rebuild existing structures, rather than bulldozing down structures and building these high rises, all municipally or publicly owned and only rented, not sold, we might have a tremendous new growth industry for the future. Would you care to comment on whether the impact on the economy would come at the right place and in the right way, if somehow we could find a way to stimulate this movement in the cities across the country?

Mr. BURNS. There is nothing that I would like better than to see housing become a growth industry and a glamour industry. Whether financial incentives are adequate to bring that about at the present, I am quite doubtful.

But, as I say, it would cheer me up about the future of our country if this industry, rather than a dozen others I might name, would become the glamour industry over the next decade or two, because then we would have an activity that stimulates the economy, truly enhances the welfare of the people, and which also promotes better citizenship.

Your striving in the direction of expanding home ownership, Senator Percy, if I may says so, I find most encouraging, and I want to wish you every success in the exploration that you have underway in this area.

Senator PERCY. Thank you, sir.

Chairman PROXMIRE. Mrs. Griffiths?

Representative GRIFFITHS. Thank you very much, Mr Chairman.

First, I would like to say to you, Mr. Burns, that I certainly do agree with your theory of the investment credit. I think it is unfortunate that it wasn't put on in the beginning as a countercyclical device.

I would like to ask you this. Supposing that Congress does as it did last year—and I assume that there is every reason to feel that it possibly will do as it did last year—add additional money to programs, and create programs of its own, and then what if we did not pass the tax bill? What do you think the result would be?

Mr. BURNS. I believe if the expenditure curve rises rapidly, that if we do not pass the tax bill this year, we will the year after, or the year after that. The puritanical tradition in this country is still strong, and I think that it is a good thing. True, we are willing to live with deficits, even willing to live with defects year in and year out, but they must stay within a relatively narrow range.

I am entirely convinced, or to put it differently, I have enough faith in the American people and in the Congress to feel, that if the expenditure curve rises rapidly, it is just a matter of time before taxes will rise rapidly. If we move in that direction, I am fearful that our economy will be weakened.

Taxes are already taking a very large part of the income of the American people. I presented some figures previously. If I had used as my yardstick not the gross national product, but the net national product, which is a better measure, the tax burden would appear even larger than is indicated by the figures in my initial statement.

I think we have to watch the tax burden, if this country is to remain strong economically. Therefore, we must also watch our expenditure curve.

Representative GRIFFITHS. I would like to ask you in connection with the welfare program, what, in your judgment, is the difference in a welfare program supported by a payroll tax and one supported from general revenues, and do you have any preference for one over the other?

Mr. BURNS. I have a little preference for a program that is supported by an employment tax such as we have. My preference is based on the consideration that since this is a tax that affects working people across the country, they will be concerned about the magnitude of this tax, and, therefore, also about the growth of expenditures.

I think we are likely to have better control over expenditures through this kind of a tax, although there are arguments against it, from the viewpoint of equity. From the viewpoint of the longrun interests of the Nation, there is much to be said for the kind of legislation that we have now, and I would be reluctant, I think, to change it.

Representative GRIFFITHS. You mean the social security program is for all intents and purposes really a welfare program?

Mr. BURNS. Oh, yes.

Representative GRIFFITHS. That is not really as it started out to be in the beginning, the replacement of earned income?

Mr. BURNS. It is a welfare program, basically.

Representative GRIFFITHS. Now, I regret to say that I don't agree with you. I think that the moment you put an earmarked tax on in place of watching the expenditures, you guarantee that you will make them, and I think this is true even in social security.

I think many of the programs that have been added to social security never should have been added. But the money was available, and the program was added. Somebody spoke up and wanted the money, and it was added. Let me give you an example.

The cost of continuing children on the social security program from 18 through 22, if they continue in school, costs $250 million a year. In the first place, of course, the children don't get the money. The mother gets the money.

There is plenty of money available for kids to go to school on today, if they really want to go. What we have now done is, since the mother didn't work until she was 50, she is now writing in that social security should begin when a widow is 50. We have added $250 million a year to this program, when there were only 700,000 possibilities of any kids going to school.

Mr. BURNS. Then you feel that we have made this addition merely because there was money in the social security fund?

Representative GRIFFITHS. There was money available. Somebody wrote in and wanted some money, and so this program was added. I am very much opposed to that type of program.

I personally feel that the social security program should be what it set out to be. It should be to replace earned income, and it should pay

back in relation to what people have paid in. If we want to add anything else to the welfare, I think it should come out of the general funds, and I really feel this, because I think that a payroll tax is the least conservative tax there is.

What you are really guaranteeing is that every cent of it is spent. This has been true in any type of earmarked tax that has ever been levied. There are many people in this country devoting days and nights to figuring out what to do with the highway tax money. Anything that you earmark is gone. So that I feel that is a terrible mistake, and I personally am going to do everything I possibly can to see to it that we change that social security back to pay the people that paid into it.

Mr. BURNS. The thinking of the world is changing; also our own, we are moving gradually toward a welfare state along European lines. In many ways I feel that that is a good thing. What causes me concern is the speed with which we move.

Certainly, under present conditions, if we stay within the revenues made available by the employment tax, we will not increase social security benefits by anything like 20 percent.

Representative GRIFFITHS. But may I break in? The problem is that that won't be what will happen. You won't just give them the money that is available. You will look at the tremendous need, and part of the need has been created by the people who have been placed on the program that shouldn't have been placed there in the first place.

Therefore, you will satisfy first the need and then you will raise the tax sufficiently to pay for it, and a lot more women will go to work who are not going to be paid, and we will have more money available, and so we will spend that the next time.

Mr. BURNS. All that I can say is that, while you may be right, my own feeling is that the present scheme of taxation acts as a modest restraint on the growth of welfare programs.

Representative GRIFFITHS. I think that it has been proved that in the places where the welfare program comes out of the general tax fund, since it is competing for other tax revenues, that the welfare program is a more modest program.

Now, may I ask you what would your opinion be on an assured income, a negative income tax?

Mr. BURNS. That is a very difficult question. The negative income tax is one proposal among others for guaranteeing income to people.

If we had a guaranteed income through one device or another, and didn't keep changing the size of that guaranteed income, I am inclined to think that I would go along with it. What I fear is that once we begin guaranteeing incomes at one level, we will keep raising the level, so that the burden on the Nation may become insupportable before too long.

Representative GRIFFITHS. That is, if you could start, here is so much money and here is a possibility of a job or a training program, and any children you have you are going to support, don't come back and ask for more money. You might really save money.

Mr. BURNS. You might.

Representative GRIFFITHS. And, certainly, you would at least cut out the administrative costs, a large part of the administrative costs of the welfare program.

Mr. BURNS. Under the negative income tax?

Representative GRIFFITHS. Yes. Would you not?

Mr. BURNS. Oh, I feel quite concerned about that. I am afraid you would need an army of investigators to administer a negative income tax. In fact, I think that this may become a very great burden.

This whole question has to be studied very carefully. In some ways, a family allowance plan, which is a very different route entirely, but which does not involve complicated administrative machinery, could be preferable. I think all this should be studied carefully and objectively.

Representative GRIFFITHS. Thank you. We are going to study it later this year, and I invite you now to come and help us.

Mr. BURNS. I am very glad to hear that.

Chairman PROXMIRE. Congressman Curtis?

Representative CURTIS. I am glad to see Dr. Burns here again. I was very interested in your recital of some of our fiscal history.

In your statement, where you point out that the preamble of the 1963 revenue bill, which became the tax-cutting bill of 1964, explicitly assigned top priority to tax reduction, with debt reduction next, I should like to read the first sentence. You say:

> In the revenue bill passed by the House in the fall of 1963, Congress took the unusual step of spelling out its fiscal philosophy.

Then you go on:

> The preamble to this bill explicitly assigned top priority to tax reduction, with debt reduction next. Congressman Mills described the preamble as a firm, positive assertion that the Nation is using tax reduction and rejecting larger spending as its road to a bigger, more progressive economy.

Then you go on to point out:

> The history in line with the new fiscal policy enunciated in the tax reduction bill, Federal spending actually stopped rising for a time. From the third quarter of 1963 to the first quarter of 1965 cash expenditures moved along a horizontal trend.

I want to underline this, because this has been ignored, in my judgment. The new economists have claimed that the tax cut of 1964, which I think proved productive, followed their philosophy and not this enunciated fiscal philosophy that you referred to.

However, you don't say here, whether you thought that that was wise economic philosophy at the time, and whether you think it still might be wise.

Mr. BURNS. I thought it was wise at the time, and I said so in testimony before this committee, I believe this is still a sound philosophy for our country. I hope we will return to it.

Representative CURTIS. I hope so, too, and I hope personally that a few of our writers and others will refer to this basic fact that expenditures were restored from the third quarter of 1963 to about September 1965, when we reverted to the new philosophy which we have been pursuing since then.

You also point out, "When the administration urged a massive tax reduction, it rightly put great emphasis on the fiscal drag of our tax system."

Then you go on to say, "Yet in 1963 Federal revenues absorbed only 27 cents of every additional dollar of the gross national product in contrast to 30 cents in 1966," which leads me to this point.

I think the point that you are making is that if there was a fiscal drag in 1963, even with the tax cut of 1964, and what has transpired since then, it has become an ever greater fiscal drag. Am I correct in drawing that further conclusion?

Mr. BURNS. I think that our tax system is now a greater drag on the economy than it was in 1963, definitely.

Representative CURTIS. This is what worries me.

Mr. BURNS. And there is now much more of a fiscal drag than in 1962, when President Kennedy first announced his intention in the late summer of that year, to propose a massive tax reduction bill to the Congress.

Representative CURTIS. This is what deeply concerns me, because I also adhere to the philosophy that tax reduction should move ahead of debt reduction. And yet we have got a very difficult problem in the field of debt management, particularly, since almost 50 percent of the Federal debt today, the marketable debt, is in the securities of 1 year and less of maturity. I think that this has had a very serious impact on interest rates, as well as increasing the amount of money in our society.

Will you comment on that?

Mr. BURNS. Well, I think it is high time the Congress got rid of the ceiling of 4¼ percent on long-term Federal bonds. It serves no good purpose.

Representative CURTIS. But even if we did that, haven't we got the great problem of the mere management of a debt that size, granted it is a lesser percentage of the GNP, as we are always told, than in 1946? But it is also a tremendously greater percentage of the GNP than has occurred throughout most of this Nation's history.

Certainly, in peacetime—taking the figures back to 1860—the ratio in peacetime was never as high as 15 percent of GNP, and here we are still around 45 or 46 percent.

Mr. BURNS. The Treasury would have much greater freedom in managing the public debt, if the interest rate ceiling on long-term bonds were removed. That provision serves no constructive purpose at all.

Representative CURTIS. In light of forecasting difficulties which have been under discussion, and lags in economic impact, do you believe that frequent tax changes for ironing out wrinkles in the business cycle might be unsettling and unstablizing to the economy, by creating constant uncertainty as to the direction of Government policy?

Mr. BURNS. Well, I would like to see—once Vietnam makes it possible—the Congress adopt a policy of reducing taxes year in and year out, sometimes a little faster, sometimes a little more slowly.

Unhappily, international developments may make this kind of policy very difficult to carry out. But I think we should strive for it. A continuous policy of tax reduction, such as the Japanese have followed since about 1950, is better designed to promote economic growth than any other single measure that the Congress can take.

Representative CURTIS. Of course, we have high enough tax rates to start with, and we will probably continue that policy for some time to come. I think we could actually wind up with greater revenues at lower tax rates because if the process works as you say, we will be broadening the economic base on which the rate will apply.

Mr. BURNS. To the extent that that happens, we will have additional opportunities in the future to cut tax rates.

Representative CURTIS. Now, I notice that the Secretary of the Treasury has been saying that if it weren't for Vietnam, we would have a $10 billion surplus in our budget. I think he meant the administrative budget.

I have suggested that this is not a complete economic model, because part of our increased revenues, of course, are derived from the Vietnam expenditures. Would you comment on that? And also, what would be the difficulties involved in trying to separate the Vietnam war expenditures from our present economic situation to see where we might be?

Mr. BURNS. I would find fault with the reasoning of the Secretary of the Treasury on this point, just as you have. Certainly, the massive expenditures on Vietnam gave a boost to our economy, more so on the monetary side than on the physical side, but to a degree on the physical side as well.

I look forward to the day when we will be spending our Federal funds on more useful things than gunpowder. There are many opportunities for doing it. And our economy will gain in strength, once the conflict in Vietnam is over.

Representative CURTIS. We have a subcommittee concerned with Government procurement. I hope it enlarges its scope. But one of the things I am hopeful we will get into is trying to consider the difference between an economy based on these heavy war expenditures, and the problems that would then arise in shifting from those expenditures to peace. This is an oversimplification, but let me repeat in part the question I asked before.

Do you think this would be a difficult study to undertake, to try to get guidelines on shifting the economy more in this fashion in a rational way, than the way we shifted it after World War II or after the Korean war?

Mr. BURNS. Actually, we did extremely well after World War II, and we also did reasonably well after the end of the Korean war.

I should like to think that we will do better in the future, and the study that you will be undertaking may help us to achieve that result. Such a study is eminently worthwhile, and I do not believe that it is surrounded by very great difficulties.

Representative CURTIS. My time is up, but just one question. Was there much rational planning that you know of in shifting to peace after World War II and after the Korean war?

Mr. BURNS. No, there was not, and that is why I am heartily in favor of some systematic planning. My only point was that even in the absence of systematic planning, we did remarkably well, but I would like to see us do better.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

Senator JAVITS. Senator, would you mind yielding to me just for about 30 seconds, because I have a TV show? I am not going to ask questions.

Senator SYMINGTON. I will always yield to a TV star.

Senator JAVITS. I thank the Senator, and I can say the same about him.

I just wanted to express my pleasure at the presence here of Dr. Burns, my fellow townsman, my economic mentor, and, in my judgment, one of the most educated and distinguished public servants that ever served our Nation.

May I ask, Mr. Chairman, unanimous consent to give Dr. Burns a couple of written questions?

Chairman PROXMIRE. Without objection.

Senator JAVITS. I thank my colleague.

Mr. BURNS. Thank you so much, Senator Javits.

Senator SYMINGTON. Mr. Chairman, if my friend, the Senator from New York, would like to ask his question now, I would be glad to yield.

Senator JAVITS. In that case, may I ask one question? I think all of us, Dr. Burns, were very struck with the difference in thrust between your testimony and that of this morning's witness, Dr. Heller, and I have his testimony before me. Rather than read it to you I ask unanimous consent that that be reprinted here——

Chairman PROXMIRE. Without objection it is so ordered.

(The excerpted material from Dr. Heller's statement referred to follows:)

* * * * * * *

So the choice, almost inexorably, boils down to restraint in private spending versus restraint in public spending on programs that benefit the poor and disadvantaged, that attack the urgent, but unfortunately accustomed, problems of ugliness and urban blight. Before the Congress concludes that the war in Vietnam requires cuts in the War on Poverty, on slums, on crime, on air, water, and land pollution, it should consider these facts on public spending and private affluence:

Defense spending in fiscal 1968 will take 9 percent of a GNP of some eight hundred billion dollars, virtually the same ratio as in 1960, when GNP was about 500 billion dollars. This is below the near 10 per cent figure of the mid-1950's and far below the 13.4 per cent of 1953.

Total Federal purchases are only 11.0 percent of GNP this fiscal year and are expected to be 11.3 percent next year. Total Federal expenditures for the NIA budget, including trust fund activities, grants, transfer and interest payments, are 20.1 percent of GNP this fiscal year and 20.8 percent in FY 1968. Despite the enormous advances in the largely self-financed trust fund programs, this is only modestly above the 19.0 percent of the 1958–60 period.

Real disposable income per capita, the single best measure of our growing affluence as private consumers, has risen by 24% over the past six years.

Financial asset holdings of American families have grown by $470 billion in the last six years, while their debts have grown by only $150 billion. Their net financial position is $320 billion stronger than six years ago.

A quick perusal of the budget for fiscal 1968 shows requests of about $1¼ billion of additional spending for the Economic Opportunity programs, education, pollution control, urban problems, the Model Cities program, and water and sewer facilities. It may be that these requested increases are held to such modest levels by considerations of administrative efficiency—by the speed limits that prudence puts on expansion of new programs. I cannot imagine that our national priorities are such as to lead us to cut or abandon these modest increases in order to facilitate more rapid increases in general private spending. Indeed, I should think that the reverse would be true.

What I am saying, in sum, is that the President's tax increase proposal fits well into the Nation's need not only for flexibility in the face of economic uncertainty and for restoration or economic balance in the economy through a decisive easing of money, but also for a fairer distribution of the economic burdens of war.

Senator JAVITS. In essence, he says, "Look, you have a $800-billion economy. We don't have to hold back really on basic spending, war on poverty, slums, crime, air, water, and land pollution. You probably do have to do a little holding back on public works."

He says a quick perusal of the budget shows only one and three-quarters of additional spending for all these programs I have just mentioned over the last fiscal year; you can well afford to do it. Do it. And the tax increase fits in with that very well.

Now you come along and you say don't do it. Cut the budget and don't go for the tax increase, at least right away. Now, can you give us any observation on these conflicting views?

Thank you, Senator Symington. That is the only question I have.

Mr. BURNS. I can only speak for myself. Let me say, first of all, that the rapid increase in Federal spending that is now underway has already led to tax increases, and it is bound, no matter what the Congress does about taxes this year, to do so in the future.

Point two, the tax burden on the American people is very heavy now.

Point three, we must be very careful indeed not to make it any higher, because if we do, there is a real danger that the strong economy that we now have, and which is not only an asset to us, but to the entire world, may be weakened.

Therefore, I would say that at a time when military expenditures are going up so rapidly, we should seek ways of cutting back here and there. This is a very difficult task for the Congress, but I think the Congress will serve the long future of this country well, if it dedicates itself to that task.

Senator JAVITS. Thank you very much, Senator Symington.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Your time will run from right now, Senator.

Senator SYMINGTON. Thank you, Mr. Chairman.

Dr. Burns, I am impressed with your testimony.

One of your figures I hadn't realized were those on the Vietnam war. Everybody hedges "provided the Vietnamese war." Nevertheless, it is only $22 billion out of a $51-billion increase between 1965 and 1968. I think your figure of $22 billion is low, but the fact more of the increase is being spent outside of Vietnam than in the Vietnamese operation is impressive.

You speak of our gross national product, about $58 billion larger than in 1965, but that the Government absorbed 30 percent, through additional taxation.

Mr. BURNS. The Federal Government.

Senator SYMINGTON. The Federal Government?

Mr. BURNS. Yes.

Senator SYMINGTON. I have been to many hearings in the last 2 years, where effort was made to justify increases in expenditures on the ground it was still a no greater percentage of the gross national product.

I asked one high in the Government, How long do you think we can continue this in effect, guns-and-butter approach? More specifically, How long do you think the economy of the United States can stand the figure the Senate Appropriations staff, in conjunction with the armed services staff, has estimated, which is $2.5 billion a month, $30 billion a year? The answer was, "First, we think it is nearer $20 billion a year than $30 billion; but in any case, we think we could afford it forever."

Now, forever is a long time. Do you think we can continue these expenditures on this basis forever?

Mr. BURNS. I think we can continue——

Senator SYMINGTON. What is your analysis of the problem?

Mr. BURNS. Yes. I think we can continue expenditures on this scale in the indefinite future. I hesitate to say forever. That is a little bit too long a period for me to think about. But I am afraid that if we actually do so, the growth of our economy will suffer, and with it, the welfare of our people. Our international economic prestige, which is very high, in contrast to our political prestige at present, will also suffer. Therefore, I would say that while we can afford it financially, while we can afford it in terms of our physical resources, we cannot afford it if we want to remain the great economic power that we are, both for our own sake and for the sake of the rest of mankind.

Senator SYMINGTON. It would be difficult for me to segregate, as definitely as you do, the economic position from the political position, but you are an expert in this field and I am not.

I presented a statement, made by Dr. Stevens, this morning, in which he said that your gross national product, your economic capacity, was only one of many things to be considered when in turn one considered financial strength, your fiscal and monetary position.

What has worried me over the years is that the Treasury Department and other Government officials have consistently said our loss of gold was a serious matter, but that they were going to correct it the very next year. Years have gone by. In 17 years out of the last 18 we have had an unfavorable balance, which you know better than I.

It seems to me that pretty soon we have to decide whether it is important to retain gold or whether it is not. Would you comment?

Mr. BURNS. Gold is a great symbol. People have faith in gold. They don't always understand it, but they do have great faith in it.

If financial arrangements for this country and for the world at large were being made afresh, we might want to construct a monetary system that did not depend upon gold. But we have it.

And if we are ever forced—as we may be if the disequilibrium in the balance of payments persists—off the gold standard, the political consequences for this country would be very serious, and I fear that even more than the economic consequences.

Senator SYMINGTON. If you follow through to its logical conclusion this justification of expenditures on the basis of percentage of gross national product, then it is never important to balance your payments, is it?

Mr. BURNS. If you restrict yourself to the relation between governmental spending and the magnitude of our gross national product, you leave out of account entirely the balance of payments, and if you do that, you are leaving out of account a factor of the utmost importance to the future of this country.

Senator SYMINGTON. You talk about the political prestige we have as against a greater economic prestige that we have. I find our economic prestige is beginning to suffer also because of our failure to handle this balance of payments in accordance with the way we say each year we should handle it.

With that premise, and with respect to those interested in social security and pensions, as are most union-working people today, also those interested in retirement plans and those interested in life insurance; in those four categories you have most of the people of the United

States. There is a chance, is there not, that unless we face up to what this balance of payments could do to the integrity of the dollar, we might find ourselves in a difficult situation with respect to that integrity and if that happened, it could be very serious, indeed, for the people who could least afford to suffer the devaluation.

Would you comment on that?

Mr. BURNS. The case of England is very pertinent. The British people elected a Labor government. The Labor government was opposed to a stop-and-go policy, as they called it. And yet the Labor government has put through restrictive measures more drastic than any conservative that I know of had recommended in England. Why? Because the Labor government now in power is afraid of the international position of the pound sterling.

Now, unless we are very careful, we may be in a similar difficulty before very long. Time is running out.

Senator SYMINGTON. Thank you, Mr. Chairman.

Chairman PROXMIRE. Dr. Burns, in view of the economic uncertainty, and the fact that you think we ought to stop, look and listen, before we impose a tax increase, if economic conditions remain about the same, don't improve a great deal between now and May or June, why not wait until September or October before Congress acts?

We will still be in session in all likelihood, on the basis of previous experience. Wouldn't it be wiser to wait until then, and perhaps have an October 1 date for a tax increase, if we have one at all?

Mr. BURNS. I would say so, yes.

Chairman PROXMIRE. Dr. Burns, you have a fine reputation as an expert on economic growth. We have had an estimate from the Labor Department—Projection 70, they call it—indicating that in their judgment, if we are going to even maintain the present rate of unemployment, maintain it at 4 percent, you would have to have a 4.3-percent rate of growth between 1965 and 1970.

I understood you to reply to an earlier question that you anticipate that if the present 1-year projection of the Council of Economic Advisers for a 4-percent growth, not 4.3 but 4 percent growth, that if that is maintained, that we won't have increased unemployment. How do you reconcile that—seems to be a conflict here?

Mr. BURNS. If I understood you correctly, I don't see the conflict.

Chairman PROXMIRE. The conflict is that the Labor Department says you have to have a 4.3-percent rate of growth, and you and the Council of Economic Advisers say only a 4-percent growth is adequate to maintain present unemployment.

Mr. BURNS. Well, I think the difference between these two figures is well within the margin of error in any estimating of this character. I would not regard that difference as significant.

Chairman PROXMIRE. Do you think we should settle for a 4-percent annual physical growth rate?

Mr. BURNS. I would be happy if we had a 4-percent rate of growth in physical terms over the next decade. As for settling for it, that is another question. I would like to see this country grow rapidly, more rapidly, if we can.

Chairman PROXMIRE. Well, what I am getting at may be a technical difference, but I think 0.5 percent could be considered a substantial difference, the difference between 4- and 4½-percent growth rate.

They say that in order to maintain utilization of our resources with 4-percent unemployment, with roughly 85- to 90-percent utilization of our plant and equipment, we need a 4½-percent growth rate. Are they too high in your judgment?

Mr. BURNS. I haven't examined their estimates, and I can't say, but I would merely express an opinion.

In projections of this character, you make assumptions first about the increase in the size of the labor force, then of potential man-hours. It is easy to go wrong in projections of this kind.

Second, you make assumptions about the rate of improvement in output per man-hour, and you can even more easily go wrong in assumptions concerning this magnitude.

The difference between a 4-percent rate of growth and a 4½-percent rate of growth in actual experience over a term of years will be significant, but I don't believe that the art of estimation as now practiced by economists is sufficiently refined to justify a quarrel between you and me about this one-half of 1 percent.

Chairman PROXMIRE. I am certainly not quarreling with you. I simply want to get your opinion.

Mr. BURNS. I understand. From my viewpoint, these are roughly equivalent estimates, the art of economic estimation being what it is.

Chairman PROXMIRE. Then what we should do, I take it, is keep our eye on price stability. If we can maintain price stability, press for the highest growth we can get consistent with price stability.

As I understand it, one of the best ways, perhaps the best way, to break through the structural unemployment, the so-called unemployables, is to have a constant situation of pressure against our manpower resources.

This will persuade private industry to hire and train people who are in minority groups, who are teenagers, who are inexperienced, and in doing this, won't this have a salutory effect in diminishing the rate, the unemployment rate, which we have consistent with price stability?

Mr. BURNS. Definitely. We talk a great deal about antipoverty programs, but this is the basic way of reducing poverty. That is the way in which we have reduced poverty in the past, and it is the basic path to the reduction of poverty in the future.

Let's strive for full employment. Let's strive for a high rate of improvement in output per man-hour. This means that we must have a good business climate. We will not have full employment and a rapidly improving productivity in the absence of a good business climate. Beyond that, yes, let's do what we can, within the limits of prudence and of our resources, to look after poor people.

Chairman PROXMIRE. Now, on the investment credit, doesn't it have a great weakness if it is used as a stabilizing instrument instead of an instrument to persuade American business to renovate their equipment in this sense, and this was the point raised by the Secretary of the Treasury himself and well-documented by him.

There is an enormous lag between the reaction of business to a change in the investment credit, and the effect that it has on employment and business investment, and so forth.

I think he estimated that it took on the average 12 months or more between the time an order was placed and the equipment was de-

livered. For this reason, it seems to me that this is an imperfect, a very imperfect instrument, to be used for economic stability.

We would be much better served, if we either put it on or took it off and eliminated this uncertainty that business has to suffer from with these fluctuations, especially with the gap that you have at the end before it is put into effect again.

That is in the last 3 months of this year. We are going to be lucky to get any investment in plant and equipment, because people will just be inclined to wait. The margin of difference will be very considerable then.

If somebody is going to buy $100 million of jet planes, for example, on October 1, they wait until January 1, they would pick up $7 million in net profit. They would be awfully foolish not to wait. A lot of people will wait, and we will have a most unfortunate situation in machine tools and in a lot of other industries.

Mr. BURNS. As I indicated before, I would like to see the Congress experiment a little longer with a flexible investment tax credit. I would say, however, that a flexible investment tax credit has no chance of success, unless the period for which the credit is suspended is kept quite short.

You may recall that last year the Congress——

Chairman PROXMIRE. Let me interrupt for a minute to say Dr. Heller this morning suggested we might consider eliminating the gap by extending it for an extra year. This would mean we would have more than 2 years, 2 years and about 3 months of suspension, and I take it that you would disagree with that.

Mr. BURNS. I would disagree with legislation which suspended the investment tax credit for a period that is longer than a year.

When the Congress considered this legislation last year, I was in favor of suspending the investment tax credit, but I wanted the suspension to end this June, and then have the Congress take another look, and continue it or not, depending on circumstances.

I don't think there should be any suspension of it for a period that is longer than a year, and preferably for a period that is somewhat shorter.

I must add that I bring to this question something of the attitude of a student who wants to learn more. By that I do not mean that I want the economy to become my guinea pig. But I have been eager to learn more about countercyclical policy and a little experimentation, I think, is needed.

Now that we have done it, I would like to see the Congress live with a flexible investment tax credit for awhile, and see how it works out. In the end, I may want the flexibility withdrawn, and I will then not hesitate to say so, Senator, as you know.

Chairman PROXMIRE. Back on August 5, 1963, I was then chairman of the Subcommittee on Economic Statistics of this committee, and we submitted a unanimous report, Republicans and Democrats unanimously, to the full committee, which in turn unanimously submitted it as an official report of this committee, specifying that we wanted quarterly budget estimates, and in saying why, that the budget for each year should be presented in the context of a broader, longer run set of budgetary projections of 5 years.

Then we also said that periodic revisions of budgetary estimates should be provided at least on a quarterly basis. This was unanimous and as I say, that was more than 4 years ago.

Under the circumstances of what happened in the Congress last year, with the gross underestimate of the Vietnam war, isn't it clear to you that if we had gotten quarterly estimates last year, that we undoubtedly could have had a wiser fiscal policy? I think we would have cut spending. I really do.

The President wanted to cut spending in many respects. Senator Symington and some of the rest of us in the Senate—I am sure Congressman Curtis and others in the House—wanted to do it. This would have given us the kind of ammunition which would have been extremely helpful.

Can you see any technical reason, and you are an authority in this area, why the budget can't do this, at least give us quarterly estimates in the area of something as important as Vietnam? The Defense Department must be getting it on a quarterly basis, at least.

Mr. BURNS. I see no technical reason whatsoever. This would be inconvenient for the executive establishment, but their life must not be made too easy for them.

I do think that legislation to this effect would be desirable, and I emphasized that in my statement. I do not recall—I am glad you called this to my attention, that this committee made a recommendation to the effect that we should have quarterly budget estimates.

That recommendation has not been adopted. It is inconvenient for the executive establishment, but I wouldn't worry about that. They can do it technically. They will complain that they can't do it accurately. Very well, they will learn to do the job better.

Incidentally, they now expect estimates of this sort from the private community. They should also do it for themselves. And I recommend that you pass legislation along these lines.

Chairman PROXMIRE. Thank you very much. My time is up.

Congressman Curtis.

Representative CURTIS. I have no further questions.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Thank you, Mr. Chairman.

Dr. Burns, as I see it you might say the platform of our security and well-being as a country has three legs—the diplomatic, the military, and the economic. There is no secret about my growing apprehension over recent years about the size of the budget, the degree of the spending.

When we attempt to point that out, the answer is, "We can afford it because of the gross national product increase." They say, in effect, we can afford it forever.

If it is important to preserve the economy, with which in a country of this character, we might have more trouble than in a more homogenous country like Great Britain, how can we afford it for the indefinite future?

Let me put it this way. It seems to me that a country, as well as an individual, can only increase the standard of living of its citizens through borrowing, so long as it is trusted by its lenders. The degree of the fiscal and monetary control of this economy by Europe today, for example, I don't think is fully understood by the American people.

I say control of the financial picture, not the productive picture at all. So it worries me that you think we could continue with it indefinitely, and still preserve a viable economy. Would you comment?

Mr. BURNS. I am afraid I must stick with the answer that I gave previously, Senator, and my reasoning is very simple.

Suppose that our gross national product does not increase any more rapidly than our Nation's population. Then our output per capita will remain constant. We still could, as a people, divert even an increasing fraction of our resources to a military use. We could do it.

Senator SYMINGTON. How many Vietnams do you think we could handle at the same time?

Mr. BURNS. I think one is too many.

Senator SYMINGTON. You are talking politically and militarily. I am talking economically. Now, what is the limit of military expenditures in percentage of gross national product, if you think the current situation is satisfactory?

Mr. BURNS. I don't think it is satisfactory.

Senator SYMINGTON. Well, if you think it is viable, how far above can we go?

Mr. BURNS. I could not give you a figure.

Senator SYMINGTON. It is about 10 percent.

Mr. BURNS. The only honest answer I can give you is that I think we can go above the present figure. I very much hope that we do not, first, because we should be capable enough as a people to put our resources to better use, and second, because if we devote a large portion of our resources to gunpowder, we will not be investing sufficiently to assure rapid growth of our country, but I can't give you a figure.

Senator SYMINGTON. Then you do think—I don't want to labor it, all I want is to understand it, and I have great respect for your thinking—you do think we can continue to afford this amount of spending in operations like Vietnam, the German operation, the Korean operation, the Chinese operation—we have some 84,000 people in Japan, although most people think we are out. You think we can continue all this, provided at the same time it does not increase, say, beyond 10 percent of the gross national product?

Mr. BURNS. I think we can afford many things as a people. We are a rich and a powerful Nation. But I hope that we will be wise enough to use our resources in a manner that helps to build our Nation's economic strength. I hope we will do that for our own sake and also because of the example we set for the rest of the world.

One of the things that impresses me more than anything else at the present time is that the prestige of our private enterprise system is very great the world over. Communism is a failure. This is now known by the economists and the informed people in the Communist nations.

They are seeking inspiration from us. They no longer look to Karl Marx. They look to us for intellectual guidance. Why? Because we have proved that our economic policies work.

Therefore let us be very careful and not increase too rapidly the scale of our governmental expenditures, and particularly the scale of governmental expenditures in directions that do not build our Nation's strength for the future.

Senator SYMINGTON. Thank you. You stimulate me to ask one further question. The degree of our investments abroad has now become a political matter in France.

Without getting into the discussion of investment as against return, do you think it is going to become a political matter, based on your knowledge of Europe? Do you think our ownership of corporations and interest in corporations in other countries in Europe is going to become a political matter as it is today in France?

Mr. BURNS. I think it will become more of a political problem abroad, and it may become a dangerous political problem abroad if recession strikes.

Senator SYMINGTON. If what?

Mr. BURNS. If recession strikes, in the event of hard times. Our expanding businesses abroad is something that European nations will put up with, and even here and there be cheerful about, in a period of good times. But in a period of economic difficulty the political repercussions may be serious.

Senator SYMINGTON. Thank you, Mr. Chairman.

Chairman PROXMIRE. Congressman Curtis?

Representative CURTIS. Senator Symington inspired me to ask you this. If you think that industrial production is flat, do you think that we may already be in a recession?

Mr. BURNS. No, I do not think so.

Representative CURTIS. How do you interpret this industrial production, the flatness of it?

Mr. BURNS. We are passing through a phase of inventory adjustment. That will continue for a while. Sales in recent weeks have not come up to expectations. Also, not too long ago, deliveries were slow and prices were rising rapidly, so that businessmen sought to protect themselves by building inventories.

Now an effort is underway to adjust inventories, and as long as this adjustment process is underway, it is bound to be a drag on industrial production. I am hopeful that this phase will not continue for very long, but there are soft spots in the economy. In the year ahead there will be industrial slack here and there, and unemployment will rise a little. But I do not anticipate, as of today, a business recession.

Chairman PROXMIRE. I would just like to ask you finally, Dr. Burns—and this will just take a minute, you can file it for the record if you wish—to describe for us the Japanese tax reduction and how it has worked for price stability and how it has worked for budget balance. You said they have had a policy of regularly reducing taxes which you think has been excellent, and from which we can learn.

Mr. BURNS. Well, let me tell you a story. I got to know Prime Minister Ikeda. One day he put this question to me:

"What do you think the functions of a minister of finance are?"

And I said, "Well, Mr. Prime Minister, I can give you an answer to that but I think you can give me a more instructive answer. What is the answer to your own question?"

And he said, "Well, I will give you my answer. A minister of finance has one function and one function only: To cut taxes."

Of course he said that with a twinkle in his eye, but he had great experience in financial matters. Tax reduction has been carried out

over a longer period, more consistently, more successfully in Japan than any country that I know of.

What happened in Japan was that they cut tax rates, sometimes for corporations, sometimes for individuals, sometimes for both, and they found that the economy grew and that the tax revenue was larger than ever. In fact, tax revenue grew faster than expenditures. That made it possible to raise expenditures and cut tax rates at the same time. They kept repeating this cycle. It worked beautifully there.

Chairman PROXMIRE. How about prices?

Mr. BURNS. Well, that was a very cheerful story for a number of years. But Japan had a recession in 1965, between October 1964, and October 1965, roughly. In spite of that recession, the consumer price level rose approximately 7½ percent.

Chairman PROXMIRE. In 1 year?

Mr. BURNS. That is right. The wholesale price level, however, remained stable. This year the Japanese economy is moving forward rapidly once again, but the wholesale price level, which has remained stable so long, is now rising. The Japanese may soon be facing a balance-of-payments problem once again.

They did very well in keeping prices stable for a time. We did, too, for a while. For us, it was a remarkable period, from about 1958 to mid-1964, or roughly until the beginning of 1965. Now we no longer have a stable price level, unhappily.

Chairman PROXMIRE. It has been suggested that I ask you just one more question, and I want to apologize, but this has to do with your view of the so-called Heller-Pechman plan for redistributing Federal revenues to the States. What is your reaction to that plan?

Mr. BURNS. I like the plan.

Chairman PROXMIRE. How do you keep it from just being more spending? Do you prefer the plan to tax reduction?

Mr. BURNS. We are going to have more spending at the State and local level inevitably because we need it. On the other hand, I would like to see Federal spending curbed, and not merely for economic reasons.

I must tell you, Senator, that I am a little fearful of the future of the country. Too many people now have a stake in large governmental expenditures, too many businessmen, too many universities, too many university professors, and so on.

The spirit of dissent in our country, which is basic to democracy, is not as strong as it was in my youth. Too many businessmen are fearful of criticizing the Government. Why? They have contracts with the Government or they hope to have contracts with the Government. That is a major reason.

University presidents no longer speak out forcefully, in forthright fashion, on national issues as they did in the days when you and I were at college. Even university professors much too frequently practice a studied reticence.

A rising trend of governmental expenditures in our country I am afraid is inevitable, but I would like to see it take place on the State and local levels primarily. Therefore, I am sympathetic to the basic idea of the Heller-Pechman plan.

However, there is a time for everything, and this year is not the time for the Congress to pass legislation of this sort, unless you seek to put it into effect at a future date.

Chairman PROXMIRE. Senator Symington?

Senator SYMINGTON. Doctor, in humor I ask you this question. A bright person in my State said he thought the State could distribute the money we collected more efficiently than the Federal Government. When I say we, I mean the Congress, which levies the taxes. He thought they could distribute it in the State more efficiently than the Federal Government could.

I said, "Then why don't you let us work with you to increase the State income tax and reduce the Federal income tax?" But, he said, "You down there collect the money more efficiently than we can." He should make up his mind.

This morning there was another suggestion that we allow the President to raise and lower taxes. If we give the money to the States to distribute and the President takes over the tax decisions, what would you recommend we of the Senate and House do? Maybe we could get work in the post office.

Mr. BURNS. Well, this is one reason why I have become skeptical in recent years about the wisdom of giving this authority to the President.

Years ago I thought it was a very good idea, and favored it in my lectures and also in some writing that I did. But I have come to believe that if the President were given the authority to raise or lower taxes, the Congress would become a less effective body not only in this one sphere of government, but in the entirety of its actions.

Moreover, there was once a time when I thought the executive establishment was concerned with the permanent good of the Nation, and that Senators and Congressmen were politicians concerned with votes. I no longer think that, Senator.

We are all human at the executive end and at the legislative end. I think that the Congress is just as concerned about the permanent good of the Nation as is the executive. My feeling at present is that the revenue power should remain with the Congress.

Senator SYMINGTON. Thank you.

Chairman PROXMIRE. Congressman Curtis?

Representative CURTIS. I hate to prolong this, but I mustn't let the record rest on this Heller plan without registering a grave doubt about it. The point I want to make is I think your assumption is that the real estate tax is incapable of further response, and this to me is something that just hasn't been studied.

It seems to me what studies are now coming to the fore reveal that this has been Cinderella, neglected it is true, but productive and responsive since World War II. With just a little bit of cleaning up and modernization, it could well meet what I do recognize and agree with you is going to be continued increase on the part of spending for education, community facilities, and so forth, which is really the area I think we are discussing. I simply want to register that on the record, if you care to comment.

Mr. BURNS. I have not studied this question sufficiently to be sure of an answer to your question, Congressman Curtis. What I see happening now is a move toward local income taxes.

This worries me. The individual communities may be making serious trouble for themselves by imposing taxes of this type. Now, what you say about the real estate tax I am not able to comment on usefully.

Chairman PROXMIRE. Thank you very, very much, Dr. Burns. You have been a superb witness. You certainly have been most enlightening before us here. We thank you very, very much.

The committee will reconvene tomorrow morning at 10 o'clock in room 1202 of the New Senate Office Building to hear Dr. James Tobin, of Yale, and Dr. John Culbertson, of the University of California.

(Whereupon, at 4:40 p.m. the committee adjourned, to reconvene tomorrow, Thursday, February 16, 1967, at 10 a.m.)

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

THURSDAY, FEBRUARY 16, 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 1202, New Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, and Sparkman; and Representatives Reuss, Griffiths; Widnall, and Rumsfeld.

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.

We continue our hearings today with two outstanding economists, neither of whom is a stranger to this committee. I should say both are friends of this committee. Professor James Tobin, professor of economics at Yale University, a former member of the President's Council of Economic Advisers in the Kennedy administration and now an eminent member of the department of economics at Yale.

And John Culbertson, who is a professor of economics at the University of Wisconsin, but who is temporarily on leave to teach at the University of California. Unfortunately, yesterday I made the error of saying Professor Culbertson was a Californian, but he is only temporarily. Our State is proud of Professor Culbertson. He is a definite Badger and a Wisconsinite.

We owe him a particular debt of gratitude inasmuch as he has traveled a long distance from California to be with us today. Professor Culbertson has previously given this committee some very incisive insights into the monetary aspects of the economy.

Both of you gentlemen are recognized experts in monetary policy as well as in many other economic areas. We are very pleased to have you both here. Professor Tobin, you go right ahead.

STATEMENT OF JAMES TOBIN, PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Mr. TOBIN. Mr. Chairman, members of the committee, the main purpose of the Economic Reports of the President and his Council of Economic Advisers is to set forth the stabilization policy of the administration for the year ahead. By "stabilization policy" I mean the management of the aggregate demand for goods and services in the economy by fiscal and monetary measures. Under the Employment Act the President with the Council's aid, is supposed to outline a pro-

gram for achieving the objectives of the Employment Act—maximum employment and production. I shall confine my comments to this central aspect of the reports, although they contain many other interesting analyses and some important proposals that deserve the serious attention of the Congress and the public.

Employment Act policy for the year can be analyzed in terms of three decisions or calculations: (1) The target unemployment rate, (2) the rise in total demand necessary to achieve it, and (3) the fiscal and monetary program designed to accomplish the needed rise in demand.

On these three things the objective of the administration's stabilization policy for 1967 is to keep the unemployment rate at about 4 percent. On the second point the Council anticipates that this can be achieved by a growth of total demand of 6½ percent, of which 2½ percent will go into price increase—as measured by the overall index, the "GNP deflator"—and 4 percent into a rise in real production. On the third point, the fiscal and monetary program of the administration is designed—given the Council's appraisal of the strengths of private demands—to bring about this 6½-percent increase of aggregate demand.

As an alumnus of the Council I would want to say that the reports reflect high technical competence and great devotion to the principles of the Employment Act. My differences with the administration's program and forecast are small—I want to say that because I don't want to overemphasize the points of difference that I will be spending most of the time on later—and they concern matters on which there is inevitable uncertainty. The Council has correctly stressed that the uncertainties of the outlook in this year in particular are very great and require an extraordinary degree of openminded flexibility in the making of economic policy.

I fear that the administration has shaded its three major decisions and calculations for 1967 all in the same direction, that is, in the direction of accepting the risk of a rise in unemployment. I am going to discuss this in terms of the three major constituents of the policy that I outlined earlier.

First, on the unemployment target itself, it is disappointing, to me anyway, that the Council and the administration have not found it possible to aim at an unemployment rate lower than 4 percent. This is the same target that was set in 1961, and carefully described then as an interim target. At that time it was hoped that the various manpower programs which were being started would diminish friction and structural unemployment, making it possible for stabilization policy to aim at a lower unemployment rate.

A year ago the Council argued that the time had indeed come. They said:

> There is strong evidence that the conditions originally set for lowering the target are in fact being met, and that the economy can operate efficiently at lower unemployment rates.

The Council listed a number of reasons for what they called "The improved ability of the economy to sustain lower unemployment without inflation." Among those reasons were the improved quality of the labor force, and the absorption of less employable workers in various manpower programs of Government and in the Armed Forces.

And so last year the Council was looking forward with some pride to reduction in unemployment to 3¾ percent by the end of 1966.

Now the Council has retreated to 4 percent unemployment, expressing like the 1962 Council Report the hope and faith that manpower programs will someday clear the way for further progress. Obviously, the Council was chastened by the 1966 inflation. They say now:

> The experience of 1966 clearly suggests that expanding demand cannot lower the unemployment rate much below the present level without bringing an unacceptable rate of price increase.

The language of the report indicates a greater willingness to accept the risks of a rise in unemployment above 4 percent than those of a rise in prices above 2½ percent yearly. The President said, for example, in his report:

> We *need* no further slow-down; we can *tolerate* no new spurt of demand. [Emphasis added.]

The difference between "need" and "tolerate" is what I was calling attention to. I find this position difficult to reconcile with the Council's own convincing argument that the 1966 inflation was not due so much to the low level of unemployment as to the rapidity with which unemployment was reduced last winter. That is, it wasn't so much that we had unemployment around 4 percent as that we got the 4 percent very, very fast in the winter of 1965–66. They concluded, and I would be inclined to agree, that maintenance and gradual reduction of low unemployment rates need not cause continuing inflation at the rates which were experienced in 1966. Indeed, price pressures did ease in the second half of 1966, even though the unemployment rate remained low, as soon as the pace of the expansion of demand diminished.

I believe quite strongly that further tightening of the labor market can bring considerable economic and social gain, especially in the reduction of Negro unemployment, the expansion of job opportunities for youth, and further reduction of long-term unemployment.

Tightening of the labor market enlists the powerful forces of private enterprise and free markets, and on the side of the war on poverty. But if unemployment rates are allowed to rise, these forces will be working at cross-purposes with the Government's manpower and anti-poverty programs.

The main risk on the other side, that is the risk of aiming at too low a rate of unemployment, is the balance of payments. The Council says that our international competitive position was not damaged by our 1966 inflation, but they fear that it might be damaged in the future. Balance-of-payments problems and policies are too large and complex a subject for me to take up now. But I would say that I don't think that the last 10 years entitle us to be optimistic that differential rates of inflation among different countries will easily correct imbalances in international payments.

If they would, our problem would have been solved long since by improvement in our competitive positions that we have gained over these 10 years by having less inflation than our European friends. But anyway, the balance-of-payments gain from a cautious employment policy seems to me too elusive and too speculative to be a decisive consideration.

I turn then to the second point, and that is the question: How much expansion of demand is needed to hold unemployment at current levels, assuming that that is what the administration wants to do?

In 1966 the advance in production exceeded the Council's expectations by 5½ percent instead of the 5 percent which they had expected. But the decline in unemployment fell short of their expectations. The main reason for this was the extraordinary elasticity or responsiveness of labor supply with respect to new job openings. That is, as new jobs became available, they weren't filled just by reduction in the ranks of the unemployed. They were filled by entry of new people into the labor forces.

The labor force grew by 2.3 percent, if you look at the average for 1966 as compared to 1965, and from December 1965 compared to December 1966, it grew by 2.9 percent. These figures are to be compared with an increase in the population of working age of only 1.6 percent per year. What is called the "labor force participation rate" rose.

This experience vindicated the previous claims which had been made throughout the sixties that the low participation rate of the early 1960's reflected lack of job opportunities rather than genuine withdrawals from the potential work force.

We don't really know whether this phenomenon is over or not, I mean the phenomenon of increasing labor force participation in response to more abundant job opportunities. We don't know, in other words, whether further gains in labor force participation are still ahead of us if jobs remain abundant. But as the figures above suggest, the ones that I just gave, the rise in labor force participation was still continuing unabated at the end of 1966. The same is indicated, I think, by the January 1967 Labor Force Survey. Participation rates are still below the peaks that were reached in the mid-1950's boom.

It is also possible that the fruits of the investment boom of the last 2 years will begin to show up in a somewhat improved rate of increase of labor productivity. With these two things together; that is, larger increases in available manpower and in productivity, the economy could be capable of more than a 4-percent increase in production this year, at a constant rate of unemployment.

Accepting the Council's 2½ percent estimated price increase, I wonder whether a 6½ percent increase in total spending would be enough to keep unemployment from rising.

Third, taking their estimate that a 6½-percent growth of demand is needed, we have the question whether the fiscal and monetary program of the administration is designed to bring it about. While there is a good deal of uncertainty about this, I have a feeling that the program is more likely to fall short of the 6½ percent growth of demand than to exceed it.

I take as given the budget estimates of Federal expenditures, which of course are to rise, largely for defense reasons. The main potential weaknesses then in the Council's account of their projected $47 billion increase in demand seem to me to be these:

First, even after they assume the proposed 6-percent tax surcharge to be in effect after July 1, the Council is counting on consumer spending for $30 billion of the $47 billion, or 64 percent. That is a somewhat higher share of consumption in an increase in the gross national product than we normally have. Evidently, the Council is banking

heavily on increases in social security benefits and other transfer payments, and on some squeeze in profits to raise personal and disposable incomes, and also on a continuation of the rather low saving ratios of 1966, in spite of observed weaknesses in consumer durable goods markets and possible delayed effects of tight money on consumer credit.

Second, the Council expects the rate of inventory accumulation to fall by half, or from $11 billion increase in inventories in 1966 to about $5½ billion this year. The excessive accumulation of inventories in late 1966 is perhaps the major threat to prosperity in 1967. Selling from inventory instead of from new production is the classic mechanism by which slowdowns are converted into recessions.

The Council's figure on the reduction of inventory investment is a guess, and it might be overoptimistic.

Third, on the basis of equipment investment anticipations surveys for the first half of the year, the Council is forecasting a $3 billion, or 4 percent, rise in business fixed investment. This could prove overoptimistic if the scheduled restoration of the tax credit next January 1 causes postponement of projects as 1967 wears on.

Moreover, the cost of capital for business investment was sharply increased in 1966, as evidenced both in interest rates and in stock values. This may have delayed effects on investment in 1967, not fully registered in surveys of intentions last fall.

I concluded that in spite of the anticipated growth of Federal expenditures, including the proposed improvements of social security benefits, the restraints of current taxes and monetary policies taken together, are likely to be too severe. Therefore, I do not now see a case for the proposed 6-percent surcharge. Indeed, I can well imagine that in the course of the year it will prove desirable to restore the investment tax credit ahead of schedule.

If Federal expenditures are cut below the budget, or if social security benefits are increased less or later than proposed, then stabilization considerations suggest that taxes should be reduced. Let me emphasize that it does not make sense to argue that since the economy is too weak to stand a tax increase, Government expenditures must be cut instead. If the economy can't stand a tax increase, neither can it stand the same degree of fiscal restraint applied via a reduction of expenditures.

Expenditure programs should be considered on their intrinsic merits, and cut or added to as Congress judges the merits of the programs. Then, by flexibility in tax and in monetary measures, stabilization policy can be adapted to whatever decisions the Congress makes about national priorities.

During 1967 the monetary authorities should, I think, try to reverse most, if not all, of the increases in interest rates that occurred in 1966. Such a policy cannot be expected to produce early miracles, because both financial institutions and other businesses and individuals will be rebuilding their liquidity positions. The main obstacle to monetary ease is that omnipresent bogey, the balance of payments. Last year the extraordinary tightness of credit conditions in the United States provided a windfall for balance of payments by making it possible to borrow short-term money abroad—the balance of payments on the official settlements basis, that is.

As our interest rates decline this year, the incentives may turn the other way. That is why efforts to bring about a concerted interna-

tional reduction of interest rates are important. But however they turn out, I do not think that the United States can stick with an interest rate structure which was adapted only to critical and extraordinary inflationary conditions last year, just because one of its unintended byproducts was an inflow of funds borrowed abroad.

Chairman PROXMIRE. Thank you very much, Professor Tobin.

Professor Culbertson, your statement is somewhat more detailed than Professor Tobin's, and I would appreciate it very much if you could telescope it to 20 minutes or so and the entire statement will be printed as it is in the record and undoubtedly on questioning you can bring out some of the other points, or you can bring them out.

Mr. CULBERTSON. Thank you, Mr. Chairman.

TESTIMONY OF JOHN M. CULBERTSON, PROFESSOR OF ECONOMICS, UNIVERSITY OF CALIFORNIA, ON LEAVE FROM THE UNIVERSITY OF WISCONSIN

I have an abbreviated version of my statement which I would like to give. I appreciate the opportunity to appear before the committee.

Chairman PROXMIRE. I might say it is a delightfully iconoclastic statement. It's very helpful. We have been listening to administration witnesses say, as you indicate, that their policies are the best of all possible policies, of course, and it's good to get both of your criticisms this morning. Go right ahead.

Mr. CULBERTSON. One of the functions of the academic community is to assume an independent position and I have tried to do so.

The issues that I should like to raise are basic ones relating not only to serious questions about current policy but also to the general performance of the institutions now existing to effectuate the Employment Act of 1946.

The administration programs for monetary and fiscal policy depends upon a certain interpretation of the past roles of these policies presented in the annual report of the Council of Economic Advisers. That seems to me difficult to sustain on a factual basis. When we take fiscal policy as measured by the high employment Government surplus—a concept developed by the Council a few years ago but laid aside by it recently—we reach these conclusions.

1. Past fiscal policy has varied erratically in recent times, and in recent times has contributed to economic stability, being unusually restrictive in 1960–62 when the economy was slack and becoming extraordinarily expansive by 1965–67 when this was no longer appropriate.

2. Fiscal policy must not be a crucial determinant of economic developments, since the takeoff that brought the economy to full employment began in 1963 when fiscal policy was unusually restrictive and the choking off of an inflationary expansion in 1966 occurred when fiscal policy was extraordinarily expansive.

3. Fiscal policy currently is in the most expansive position in modern times. With budgeted expenditures, it will go further in that direction later this year unless taxes are increased or expenditures cut back.

In summary, we might say that we seemingly were saved from the inappropriateness of fiscal policy in recent years only by its ineffectiveness.

The most used measure of monetary policy in economic theory is the money supply, defined in the medium-of-exchange sense as private demand deposits and currency. An interpretation of monetary policy in terms of this measure also is at variance with that underlying the administration's economic program. Monetary policy also has been erratic and sometimes mischievous in the past. However, on the face of things it seems to have been a major determinant of economic developments. Unlike the case of fiscal policy, there are no major changes in the rate of growth of the money supply not followed by consistent changes in GNP.

What is the recent role of monetary policy thus measured? For a year beginning in the late spring of 1965, monetary policy was extraordinarily expansive, providing an annual rate of growth of the money supply of over 6 percent. This presumably contributes to explaining the excessive rate of growth of total demand during this period. Then in April 1966 monetary policy changed with characteristic abruptness and began reducing the money supply slightly, in comparison with an earlier average performance of growth in money supply at an annual rate of 3 or 4 percent. This can be interpreted as the factor that halted the inflationary boom, despite expansive fiscal policy, and brought the economy currently to the brink of recession.

A crucially important practical implication of this interpretation is that monetary policy remains severely restrictive. The money supply recently has shown no increase, remaining smaller than in April 1966. The monetary policy that brought the economy to the brink of recession remains in effect. It seems reasonable to believe that if continued, it will suffice to push us over the brink, to cause a recession by summer.

The Council's interpretation is that an easing of monetary policy is evidenced by recent declines in interest rates. But an obvious alternative explanation of these reductions in interest rates is that they reflect a reduction in the demand for credit associated with slackened growth of total demand and speculation on an imminent recession. The decline in interest rates, thus, may reflect the indirect effects of restrictive monetary policy rather than the direct effects of an expansive monetary policy. To settle this factual question, we must refer to a direct measure of monetary policy. Since the money supply has not increased, the reductions in interest rates cannot be attributed to monetary policy.

The Council makes its prescription for interest rates the centerpiece of its policy planning. It wants lower interest rates. But if its interpretation of the relation between interest rates and monetary policy is fundamentally inadequate, this may be a hazardous program. Doubtless, the Federal Reserve can get further reduction in interest rates by failing to provide normal growth in the money supply and causing a recession, which will cut demand for credit. But on the other hand, if the Federal Reserve jumps back in the other direction and begins providing bank reserves rapidly in an effort to give the administration the interest rates it wants, this may lead to accelerated growth in total demand and cause a rise in interest rates, which is what resulted from the rapid money growth beginning in the spring of 1965. But continued pumping of money into the economy in an effort to meet the Council's interest rate target in this environment could

lead to cumulative inflation, which we simply cannot afford at this juncture.

The argument is well established in economic theory that an attempt to maintain a politically determined interest rate by increases or decreases in the money supply can lead to cumulative inflation or deflation.

In addition to its implications for current policy planning, this interpretation of the past role of policy has important implications for the planning of the stabilization policy and for evaluation of the present policy-planning machinery. This interpretation argues that the Council's reliance on fiscal policy may be unjustified. It is difficult to believe that the past lack of correspondence between fiscal policy and economic developments can be reconciled with the proposition that fiscal policy is the main governor of total demand. Recent experience seems more consistent with the view that the crucial marginal constraint upon spending has been the availability of finance than with the Keynesian view that it is the will to spend. The presumed effectiveness of fiscal policy and measures such as the investment credit are associated with the latter view. If, as surely seems to have been true in 1966, the effective constraint upon spending was the availability of finance, a major effect of the large Government deficit and the investment credit may have been to drive up interest rates and cause spending constraint to be concentrated in the most credit-sensitive sector of the economy—housebuilding.

In my view, we presently lack firm knowledge on the timing and amounts of effects of changing fiscal and monetary policies. Recent developments in economic theory and research, as compared with earlier work, have emphasized the importance of financial variables and of shortrun dynamic interaction in the economy—in these respects being at variance with the thinking underlying the Council reports. But the Council report does not seem to hedge against the possibility that these ideas may prove to be correct. If they are correct, the Council's program of using monetary policy to achieve a politically determined interest rate with the expectation that this will have little effect upon total demand, which can be controlled by fiscal policy—this may prove to have very serious consequences. The present unsettled state of knowledge seems to call for a policy program the justification of which does not depend so crucially upon a particular economic theory.

The other broad issue raised relates to the effectiveness of present institutions for implementing the Employment Act. Our objective appraisal, in this respect confirming some detailed studies, represents postwar monetary and fiscal policy as erratic and sometimes destabilizing. That such is the case has not been widely recognized, presumably, because the most influential characterizations of past policy have been those developed by the policymakers, the Council and the Federal Reserve. In these characterizations, one finds both a lack of diagnosis of past error and a disposition to use measures of policy in such a way is to preclude such a diagnosis. This points to a general problem.

The policymaking agencies are in an obvious conflict-of-interest situation when they interpret past economic developments and their own past policies, choose concepts and measures of policy that affect its evaluation, and even influence the construction and release of the

relevant data. Where the influence of these agencies upon thought is great, this may prevent our learning from the past and developing the better defined guides required to bring policy under effective control.

One basic problem, then, is that of knowledge, of objective information, and of possible undesirable effects of excessive influence of the policymaking agencies. Even in the prosaic task of continuous provision of policy-related data, our present position seems inadequate. Current data on the high-employment surplus are not widely available. Perhaps this committee could assume a larger role in that connection.

Beyond the problem of knowledge is the problem of implementation. It appears that to achieve a better controlled monetary and fiscal policy will require institutional reform. In the case of the Federal Reserve, the necessary powers seem to exist to achieve a controlled behavior of the money supply, but without some change in institutional arrangements, there seems to be no reason to expect that the Federal Reserve will behave differently than it has in the past.

In the case of fiscal policy, there seems to be not only the problem of knowledge and guidance but a problem of machinery needed to achieve any close control over fiscal policy in an environment in which expenditures change erratically. To do so would seem to require much closer control over either tax receipts or certain marginal expenditure programs than presently exists. In other words, in order to bring fiscal policy under effective control so that the high employment surplus could be made to behave in a defined way would seem to require modification of the existing machinery.

I would like to conclude with some specific suggestions as to the present position of policy. I take it that our goal for our gross national product during the coming year, which conforms to the Council's interpretation, would involve continued growth in total demand at a rate less than that of last year, but the avoidance of a recession. In terms of our international position and the balance-of-payments problem, I am generally sympathetic to the posture adopted in the Council report. Drastic action does not seem called for. But it does seem quite important to get total demand under control.

But the particular suggestions that I would make are that we should push ahead for rapid development of a new international monetary system, an arrangement through the IMF to create international reserves.

Second, I suggest that it would be helpful in this connection if we could at this time abolish the gold reserve requirement behind Federal Reserve obligations, thereby making our gold holdings available for international use, and strengthening the dollar and any new international monetary unit in relation to the position of gold.

While the proposed measures to limit capital outflow and changed interest equalization tax are far from ideal, under the circumstances, they seem to me perhaps appropriate.

It seems important also to have some sort of a program in relation to the problem of cost push. I am not happy with the idea of resumption of the guideposts and making them a longrun policy. I would hope that in tackling the shortrun policy problem, we could move in a direction that would be more constructive for the longer run by attempting to act against those barriers to particular markets that are associated with excessive wage and price increases.

In relation to stabilization policy, the interpretation that I have suggested to you for your consideration would argue that monetary policy ought to be altered immediately, and moderate increases in the money supply again resumed. Perhaps it would be appropriate to forestall a cumulative recession to have a brief period of substantial monetary growth followed by moderate growth presumably in the 2- to 4-percent-a-year range.

In relation to fiscal policy, I would not propose a sharp tightening of fiscal policy. Large discontinuous movements of policies are inappropriate in the present uncertain state of our knowledge. But I take it present budget plans imply movement to a substantially larger high employment deficit in the near future if taxes are not increased or offsetting expenditure reductions are not made elsewhere.

This would seem to me inappropriate. I would prefer to keep the fiscal position as measured by the high employment surplus where it is or move it from its deficit in a surplus direction, and in the longer run to move it back to a more normal position than the present one.

In closing, I should like to emphasize how great the gap is between the Council's picture of a situation well in hand and the disturbing picture of the state of knowledge and policy that I have drawn. The hazard seems to me to be a real one and I commend to your consideration this alternative to the Council's interpretation of where we are, and how we got there. I also suggest the desirability of basic reconsideration of our existing arrangements for achieving the objectives of the Employment Act.

(The prepared statement of Professor Culbertson follows:)

PREPARED STATEMENT OF JOHN M. CULBERTSON

The major points that I should like to explore with you today can be summarized in this way: The interpretation of the past and present use of monetary and fiscal policies given in the Annual Report of the Council of Economic Advisers does not seem to be a realistic one. When the record is straightforwardly appraised in terms of the measures of policy that perhaps would command widest assent among economists, these conclusions emerge. (1) Fiscal and monetary policies during the postwar period have been highly erratic, presumably a major source of economic instability in this country. (2) During this period, fiscal policy does not seem to have been a major determinant of the behavior of total demand. (3) Achievement of the objectives of the Employment Act of 1946 seems to require establishment of more effective procedures for controlling monetary, fiscal, and debt management policies. (4) The Annual Report of the Council of Economic Advisers in its present form has some negative effects upon knowledge regarding stabilization policy since existing institutions require that the Report be a defense of and rationalization of the Administration's past and planned policies rather than an objective statement, and thus it tends to propagate what might be termed an official economic mythology. (5) Finally, a more specific point, monetary policy in early 1967 continues to be economically contractive. Unless this policy is changed very soon, it is not unreasonable to expect that it may cause a recession by summer. Preventing such a recession while avoiding renewal of excessively rapid growth of total demand is the immediate problem facing stabilization policy.

I should like first briefly to review international factors affecting stabilization policy. Evaluation of United States policy in relation to its responsibilities to the international economic system is made difficult by uncertainty as to just how this system is supposed to work. To determine whether we are following the rules of the game, we should have to know just what the game is. If the international monetary game were still the gold-exchange system, it would appear that the U. S balance of payments deficit is too small rather than too large. The main problem, then, would be that France is violating the rules

of the game by pulling the monetary system's reserves out of the bank and hoarding them. But it seems clear now that we are no longer playing this game but are in a phase of transition to a new game, the nature of which is not as yet determined. I suggest that it is important to define as quickly as possible the system towards which we are heading. Discussions with the IMF to develop and put into operation a new mechanism for creating international monetary reserves should be pressed forward urgently. Development of this new system must go forward even if France is not presently willing to join in the common effort.

A constructive action that can be taken in this connection is for this country as soon as possible to eliminate entirely the gold reserve requirement behind Federal Reserve obligations. The common belief that gold will hold a superior position in relation to any new international reserve unit is a major impediment to agreement on and secure operation of a new system. This belief rests largely upon the conviction that the United States lacks the wit to let off hoarding the bulk of the world's gold stock. If it could be made clear—which we may hope is true—that the United States is going to view gold pragmatically rather than in terms of ancient superstitions, this would be a substantial step towards a more secure international monetary system.

The general position taken in the Council Report on the United States balance of payments seems to me a reasonable one. The situation does not seem to call for drastic action. I do not think that causing a recession in this country in deference to our balance of payments position is called for, and doubt that on balance it would be helpful. There is force, I think, in the Council's argument that tendencies towards wage-price push may be better controlled with a steadily growing than a fluctuating total demand. Fluctuations in profits and in rates of price increase make it difficult to formulate or enforce standards of restraint on business markups and wage demands and limit the effectiveness of competitive forces against inflation. The forced abandonment of the wage-price guideposts because of accelerated growth of total demand in 1965–66 and the resulting price increases is only a case in point. But while causing a recession does not seem constructive, limiting increase in total demand to moderate proportions does seem to be required both by domestic considerations and to demonstrate to the world that the United States has its economy under responsible control.

It is important also to make progress towards an effective program to limit wage-price push and the otherwise unnecessary unemployment that it entails. In this area, as elsewhere. we should try to solve immediate problems in ways that lead toward an improved and viable system, rather than into a blind alley. On this basis, I am not enthusiastic over reactivating the wage-price guideposts and making them a permanent feature of our economic and political system. In an effectively operating market economy the constraint upon unwarranted wage and price increases is not that one may receive a call from Washington and have the heat put on him in various ways. The constraint upon unwarranted wage and price increases is the fear that one will not be able to make them stick, will be undersold by others. Uneconomic wage and price increases always involve some exercise of market power, some means of keeping competing sellers out of the market. A sounder long-run direction in which to move in attacking wage-price push, then, is to revise our laws and institutions in such a way as to limit such destructive exercise of market power. Curbing artificial barriers to competition of professional associations and labor unions also seems to be the key to improving the relative position of the disadvantaged groups upon which the burden of such restrictions mainly falls.

To interpret the present position of the United States economy and appraise the policies proposed in the President's Economic Message requires some view of the process by which the economy arrived where it now is, including the role of past policies. The Annual Reports of the Council of Economic Advisers over the past several years have consistently developed an interpretation of the use of monetary and fiscal policies and the course of economic developments that seems to support great optimism. Thus, it is to the achievements of fiscal policy, assisted by monetary policy, that the accelerated growth of recent years and reduction in unemployment are credited. Despite a temporarily excessive rate of growth in 1965 and early 1966, the combination of tools is represented as having brought the growth of GNP since to just about the right rate. For the coming year, a complex and seemingly finely calculated set of policy actions is proposed to keep it that way. Monetary policy, in this interpretation, already

has eased and is working to combat recession along with a fiscal policy that is characterized as properly stimulative. However, the Council estimates that in response to these policies demands will strengthen by midyear, so that "a shift toward restraint in fiscal policy is appropriate at that time." A proposal for a tax increase is offered in anticipation of this need.

The picture that emerges is one of very closely controlled monetary and fiscal policies governed by a highly developed ability to predict just what will be needed and adjust policy actions accordingly. A part of this picture presumably is the Council's estimate that further reduction in interest rates is now appropriate, which is made a major preference point in discussion of both domestic and international economic affairs. Perhaps it would be fair to conclude from this representation of the state of aiffairs that in the twenty years of operation of the Employment Act we have learned to run a very tightly controlled stabilization policy, one offering assurance against serious errors and cumulating economic difficulties.

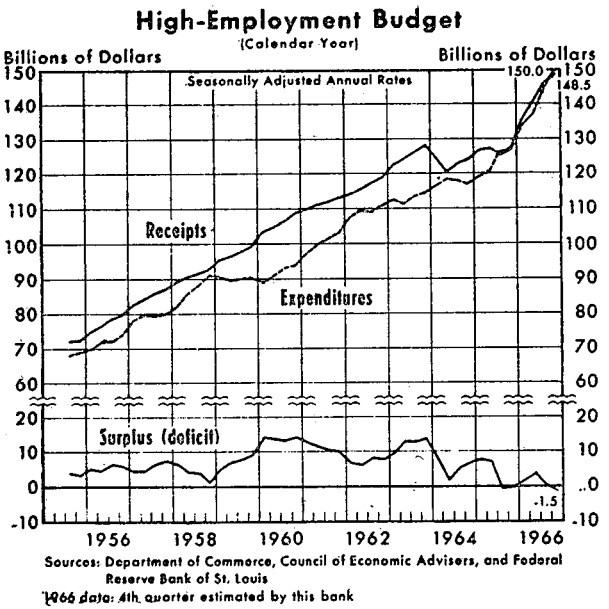
I think it very important for this Committee, and for the public, to be aware that this is not the only interpretation that can be made of the past record and present state of policy measures and of the economy. Indeed, so far as I can see, a straightforward application of the concepts that perhaps would command widest assent among economists leads to an interpretation that differs radically from this one. I should like to outline a version of this less favorable interpretation.

The principal issue between the competing interpretations is how monetary and fiscal policy are to be measured and thus what explanatory role is to be assigned to them in connection with past developments. With reference to measuring fiscal policy—determining when and by how much it has become more restrictive or expansive—perhaps wide agreement among economists exists in favor of the concept of the high-employment government surplus as the best single measure. This concept was developed and used by the Council in earlier years, but its recent Reports have not used it.

With reference to monetary policy, I take it that the measure commanding the widest support among economists is the rate of growth of the money supply, defined as demand deposits and currency. Use of this concept is not limited to those economists who are proponents of or enthusiasts for monetary policy. Rather, it is the basis of most current theoretical and empirical work, including econometric models. There are solid theoretical reasons why such models specify supply and demand equations for money, the latter taken to be partially determined by policy. To take interest rates or the total amount of credit as the policy-determined variable, as is implicitly done in the Council Report, involves a theoretical anomaly.

If one interprets the past role of monetary and fiscal policies on the basis of these measures, what story emerges? Straightforward reading of a chart on fiscal policy, thus measured, indicates that it was not closely responsive to the needs of economic stabilization. It also suggests that fiscal policy must not have been a major determinant of total demand, for if it were matters would have gone much worse than they did in recent years.

We note that the fiscal position moved sharply in a restrictive direction in 1959, with the high-employment surplus rising close to $15 billion. This change in fiscal policy seems to have contributed to causing the recession of 1960. But we also note that the recovery from that recession occurred despite the fact that fiscal policy remained unusually restrictive. Fiscal policy moved to a less restrictive position in 1962, which will be recalled as the year when the economy developed an increasingly slack position. Despite the condition of the economy, fiscal policy moved back to an unusually restrictive position in 1963. But despite *this* the economy in early 1963 began the upsurge in total demand that finally brought back full employment. This upsurge is difficult to attribute to the tax cut, which did not occur until a year later and which in any case moved the fiscal position to an average rather than extraordinarily expansive role.



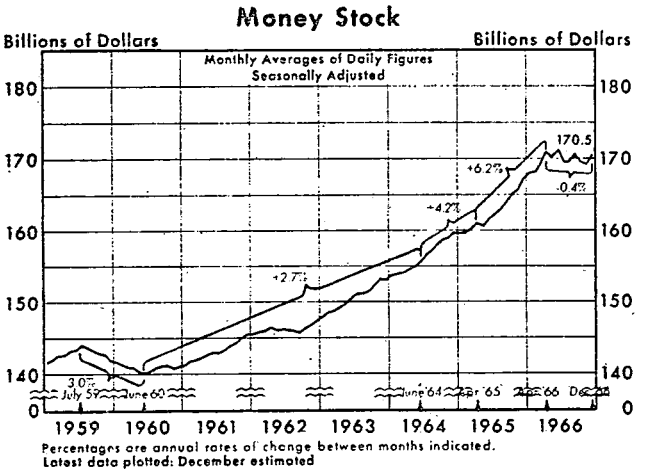
Fiscal policy finally did become unusually expansive, after mid-1965, by which time full employment had been substantially achieved and such a policy was no longer appropriate. In late 1966 and early 1967, fiscal policy moved to an even more expansive position—a position by a wide margin the most expansive within the past decade, the period for which these data are available. Yet during the reign of the most expansive fiscal policy of modern experience, the economy within the past year has been transformed from extreme expansion to the brink of recession.

With reference to its suitability, we observe that fiscal policy was generally restrictive in 1960–63, when expansive policies generally were needed, and thereafter became increasingly expansive the less appropriate this became. We note also that the timing of changes in fiscal policy bore little relation to the changing needs of the economy. With reference to its potency, we note that vigorous growth in total demand began in 1963 under an unusually restrictive fiscal policy (although accelerated depreciation and investment credit provisions make this measure of fiscal policy less than adequate during this period). During the past year, the most expansive fiscal policy in recent times did not prevent the choking off of a strong economic expansion. On the face of things, it appears that we were saved from fiscal policy's inappropriateness only by its ineffectiveness.

What of the past role of monetary policy as measured by the rate of growth of the money supply? We note that monetary policy can be credited with contributing to the recession of 1959–60, an unusual decline in the money supply having begun in mid-1959. Changes in money growth also can be assigned an explanatory role with reference to the recovery beginning in 1960 and the weakening of the economy during 1962, when the money supply about leveled off during most of the year. The abrupt beginning of money growth at a rate considerably above the earlier average rate in the fall of 1962 may explain the beginning of accelerated growth of total demand in early 1963. We note further that a sharp acceleration of money growth occurred in mid-1965 at a time, again, when the economy was near full employment and a tapering off of growth of total demand would have been appropriate. Money growth from the spring of 1965 through the spring of 1966 was by far the most rapid during any period of prosperity in recent times. If, as economic theory has it, this measures a causal force, evidently monetary policy must have been a major cause of the accelerated and excessive growth of total demand during this period.

Finally, with characteristic abruptness, the rate of growth of the money supply changed again in the spring of 1966, now becoming sharply restrictive by in-

volving a net decline in the money supply, compared with an average earlier performance of 3 or 4 per cent a year growth. Evidently this sharp departure in monetary policy can be interpreted as the factor causing the choking off of expansion since last summer. Indeed, it is difficult to find anything other than monetary policy to which to attribute this.



We observe that as measured by the behavior of the money supply monetary policy has remained severely restrictive down to the present. The latest data show the money supply still varying erratically at a level slightly below that of last June. Monetary policy, then, has not eased. The prevailing policy remains very restrictive. The monetary policy that transformed the economy from extreme buoyancy to its present ambiguous position remains in operation. It seems reasonable to believe that the monetary policy that brought the economy to the brink of recession will suffice to push it over the brink. If the Federal Reserve does not change course very soon, it seems reasonable to expect a recession by summer.

The declines in interest rates since late last year, then, obviously do not reflect the injection of new money into the economy at an accelerated rate, since this has not happened. Rather, they seem to reflect mainly the indirect effects of monetary policy on interest rates, which soon if not immediately generally overpower its direct effects. The lack of monetary growth after last spring caused a reduction in the rate of growth of total demand, which involved a reduction in demands for credit and thus led to reductions in interest rates. The decline in interest rates reflects not the direct effects of an expansive monetary policy but rather the indirect effects of a contractive monetary policy.

Measured in terms of the behavior of the money supply, monetary policy has been scarcely less erratic than fiscal policy, but on some crucial occasions it moved in the right direction. Thus, it contributed to both the acceleration of growth in total demand in 1963 and the deceleration in 1965, both of which were constructive and both of which were opposed by fiscal policy. This striking fact illustrates a more general conclusion, that in this interpretation monetary policy stands forth as a surprisingly powerful influence upon total demand. There does not seem to have been any substantial change in the rate of growth of the money supply that was not followed by a responsive change in total demand. If such is the case, the approach of using monetary policy in an effort to bring about a politically attractive interest rate with its effect upon total demand offset by fiscal policy may bring a result quite different from the one expected by its proponents.

A distinctive feature of the Council Report is its emphasis upon interest rates as an objective of policy, its prescription that interest rates should be reduced in this country and abroad. In the interpretation just reviewed, the Council's position on interest rates is basically erroneous. It interprets interest rates as determined by monetary policy, and therefore as a measure of monetary policy. The dependence of interest rates upon demands for credit, which in turn are

affected by economic conditions and thus by monetary and fiscal policies, is insufficiently taken into account.

With reference to the two recent big changes in monetary policy, the predominant response of interest rates was the opposite of the one envisioned in the Council's interpretation. Almost simultaneously with the acceleration of growth in the money supply in late spring of 1965, the interest rates began rising. Following the abrupt shift from rapid monetary expansion to slight monetary contraction in late spring of 1966, interest rates after a few months began declining. If interest rates thus are not simply the shadow of monetary policy but reflect changing economic conditions, it appears that our limited existing knowledge may not permit us to define in a mercurial economy what is the appropriate level of interest rates at any particular time. This, of course, is by no means a new idea. Discussions of the hazard of using monetary policy to try to set interest rates run far back in the literature of economics.

This literature warns us that if an attempt is made to bring about through monetary policy any interest rate other than the unknowable one that is consistent with economic stability, the likely result is a self-feeding instability. Suppose, for example, that in responding to the Administration's call for lower interest rates the Federal Reserve now began providing bank reserves at a rapid rate, leading to a sharp increase in the money supply as in the spring of 1965. And suppose that, as seems to have happened that time, this rather quickly altered the economic situation, leading to increased demand for funds and *rising* interest rates. But so long as the Federal Reserve persisted, the more inflationary the situation became and the more interest rates rose the more rapidly it would feed in bank reserves in an effort to hold them down. Evidently such a program could lead to another period of seriously excessive growth of total demand, which in the present situation would be dangerous.

But, on the other hand, suppose that the Federal Reserve chose to maintain an interest rate that was too high for the economy rather than too low. An effort to hold up interest rates in order to limit capital outflow and protect the balance of payments could lead to this, especially if a recession is permitted to get under way. Then in an effort to hold up interest rates the Federal Reserve fails to provide normal growth in bank reserves, which weakens the economic situation and demand for funds, tending to reduce interest rates further and cause the Federal Reserve to pull out bank reserves. Evidently this process also can go on and on, and presents no happier a prospect than its opposite.

It is appropriate to emphasize these possible cases. For the erratic nature of past monetary policy, which seems to have been a major cause of economic instability, evidently arises from the Federal Reserve's attempt to bring about credit conditions, or bank reserve positions, or interest rates—these all being closely related—that it adjudges to be the proper ones. This has led to abrupt changes in the behavior of the money supply and to persistence in destabilizing actions. At present, these illustrative cases are all too relevant. Although I follow its actions rather closely, I cannot pretend to know which way the Federal Reserve will jump next. It seems to me possible either that it will continue to defend interest rates that are too high and persist in its contractive monetary policy or that it will abruptly swing back to the opposite extreme and again cause excessive monetary expansion.

A critic of this line of argument may protest that other nations seem to have a politically determined interest-rate policy without this resulting in cumulatively destabilizing policies such as we have described. If they can do it, why cannot we? The explanation seems to be that in most other countries total demand and credit conditions are more heavily influenced by international transactions than is true of the United States and that they do not have the free and integrated network of credit markets that presently characterize our economy. More compartmentalized credit markets and extensive limitations on access to credit related to government policy are common elsewhere. Interest-rate policy in such an environment can be limited to certain markets and can be largely effectuated by variations in access to credit markets rather than variations in the rate of money creation. If, for example, interest rates can be reduced by denying access to the market of some potential borrowers, this does not lead to economic expansion as would pumping newly created money into the systems. Such regulated credit markets may have serious disadvantages as a means of allocating credit, but they do permit a politically determined interest rate to be achieved without cumulative instability.

One possible implication of this line of thought, of course, is that if we want to have a politically determined interest rate—or interest rates manipulated in

response to balance of payments considerations—we should begin to set up similar controls over credit markets. Indeed, some recent Federal Reserve actions can be interpreted as moves in that direction. For myself, I fear that the long-run costs of this approach in loss of flexibility and dynamism of the economy may involve a very high price to pay for the doubtful privilege of having an "interest-rate policy." When other nations in recognition of the superior performance record of the United States economy are trying to move from closed towards open systems, it seems that we should think searchingly about the matter before moving in the opposite direction.

So far as large variations in interest rates such as the recent period of restricted credit availability involve social costs, evidently one approach to limiting these is simply not to cause the economic fluctuations that give rise to them. In this case, the extreme credit tightness reflected the period of extremely expansive monetary policy that created a very bullish economic climate coupled with the unusually large Treasury borrowing needs associated with the extremely expansive fiscal policy, aggravated by the abrupt shift to restrictive monetary policy. If stabilization policies were more closely controlled and less erratic, it is not clear that there would be any problem of instability of interest rates.

The principal conclusions of this interpretation in terms of immediate policy problems seem to be two: (1) Monetary policy has not eased but remains restrictive, and if persisted in seems likely to cause a recession. (2) The proposed orientation of policy towards maintenance through Federal Reserve action of a politically determined interest rate is most hazardous.

The policy actions that in my judgment are most appropriate in the present situation are prompt resumption of moderate monetary expansion at a rate of 2 to 4 per cent a year—perhaps with a faster rate very briefly to assure against onset of recession—and a tax increase if required to offset further increases in government expenditures and keep the fiscal position from shifting to an even more extraordinarily large high-employment deficit. As the economic situation becomes more normal, it would seem appropriate to move the fiscal position of the government back to a more usual one, which may be taken care of sufficiently quickly by revenue growth if government expenditures level off.

This Committee also must be concerned in broader terms with the performance of the machinery that was set up to effectuate the Employment Act. The straightforward application made here of conventional measures of fiscal and monetary policy argues that the use of these policies in the postwar period has been very erratic and that they have been a major contributor to economic instability. Presumably the reason why this has not been recognized is that great influence has attached to the descriptions of policy and the interpretations of economic events by the agencies that made the policy, as reflected in the Annual Report of the Council of Economic Advisers and the publications of the Federal Reserve System. These seem to have chosen their measures of policy and their time comparisons in such a way as to hide the defects of past policy.

Of course, it is only to be expected that the makers of policy will present it in the most favorable possible light. The question to be raised is not one of men but of systems. In its early days, questions were raised as to the desirability of the Council being at once an integral part of the Administration team and a major public interpreter of economic developments. If it is unduly influential, the biased interpretation to which this system necessarily gives rise may create an unrealistic optimism, prevent our learning the true lessons of experience, and make us vulnerable to a cumulating difficulty if our illusory world is challenged and begins to collapse. The point is one fully recognized in other areas. We should immediately see the hazard of letting thought on our international relations be dominated by a current history written by the State Department with a view to supporting and justifying Administration policies. Illusions regarding economic policy are no less hazardous than other kinds of illusions. I suggest that this general issue merits some thought in the light of recent experience.

A basic lesson to be learned from recent experience, I suggest, is that monetary and fiscal policies under existing institutional arrangements are simply not under effective control. A basic reason for this is the lack of established measures of what these policies are, which would permit them to be objectively appraised and challenges issued when they contribute to economic instability. It appeared for a time that the Council had made a contribution in this connection in proposing that fiscal policy be measured by the high-employment surplus and making this concept the center of its discussion in some years. But in other years this concept dropped out of the picture. It is difficult to avoid inferring that this happens when the concept is embarrassing to the story that the Administration wishes to tell, as surely is the case this year.

In relation to monetary policy, the Federal Reserve has always resisted the idea of objective measures of policy in terms of which it can be interpreted and criticized. The thought has occurred to many Federal Reserve critics that one consideration leading the System to profess the immeasurability of monetary policy is that this implies its noncriticisability. In other words, doubling back in our argument, if we do not have effectively disciplined policy in part because we do not have agreed objective measures of policy, it seems true that we do not have objective measures of policy in part because discussion is dominated by the makers of policy, who consistently resist the establishment of standards that would constrain their actions and subject them to criticism.

Bringing policy under control is, in a sense, simpler in the case of monetary policy than in the case of fiscal policy. The Federal Reserve has the powers necessary to prevent erratic behavior of the money supply and cause it to behave consistently in accord with some defined operating rule. However, there does not seen to be any reason to expect the Federal Reserve System as presently constituted to do this in the future any more than it has in the past.

Fiscal policy involves an additional set of problems. Given the erratic and somewhat unpredicitable behavior of government expenditures, especially during an era of large and varying defense expenditures, and secular growth of receipts from given tax rates, a controlled fiscal position could be attained only if tax rates could be changed frequently in response to fiscal targets. For close control, the system would require some quickly adjustable element in receipts or expenditures.

Obviously, the present machinery cannot pretend to come anywhere near doing such things. Thus, until there is created a machinery to control government receipts and expenditures much more closely than is now possible, an erratic and sometimes destabilizing fiscal policy must be expected to continue to exist. Considering the important allocative implications and the difficult political implications of continual changes in tax and expenditure programs, such controllability in the fiscal system will not be at all easy to bring about, nor without its real costs. Given this, to discover that after all the effects of government deficits and surpluses are substantially offset by the government borrowing operations associated with them so that fiscal policy does not have much effect upon total demand—this might be more of a blessing than a curse.

In this interpretation, two decades of experience under the Employment Act leave us in a true situation much less favorable than our apparant situation. Our true situation seems to be one of some fragile successes, rather parallel to that of the 1920's. Again, we have a tolerable past record, hold to a partially mythological interpretation of that brought this about, and face a resultingly uncertain future. If this Committee could make any contribution to propagating objective information on the nature and effects of monetary and fiscal policy and bringing them under effective control, this would be an important service to the nation.

Chairman PROXMIRE. We thank both of you gentlemen very much for a most enlightening and critical analysis of our policies. I take it, Professor Culbertson, that you are contending that perhaps in the coming year—and this would seem to dovetail with what Professor Tobin has told us—more or less restrictive fiscal policies with a tax increase and with a monetary policy that doesn't expand the money supply could drive interest rates down, because we will move into a period of relative economic slack, and because the Council has settled for a 4-percent unemployment level, no great growth, a retarding in our rate of growth, dropping from 5½ percent in real terms to 4 percent, that we may get lower interest rates anyway, but we will be paying the price of higher unemployment than we should have and lesser growth than we ought to have. Is this your conclusion?

Mr. CULBERTSON. Well, Senator, my interpretation is that the interest rate depends very heavily upon economic conditions.

Chairman PROXMIRE. That is exactly right. That is what I am trying to say, that it depends on economic conditions and economic con-

ditions in turn depend to some or to a considerable extent on fiscal policy, on the targets set by our economic powers that be, in the executive branch especially, as they influence Congress, too, and if these targets are very low, as Professor Tobin has emphasized, you are likely to get some stagnation which will mean lower interest rates, but not with the results that most of us really want.

Mr. CULBERTSON. I may not go quite that far, Senator. If it keeps increasing at something like a 6-percent rate that should be interpreted as stagnation.

Chairman PROXMIRE. What is increasing at a 6-percent rate?

Mr. CULBERTSON. GNP.

Chairman PROXMIRE. You are talking about the total increase, the money increase plus——

Mr. CULBERTSON. Yes; total increase. As I say, I don't visualize that the coming year will necessarily be one of stagnation, and if it isn't, it is not clear that interest rates would decline much further, if any further, than they have. The context in which they would decline in that we have a recession.

Chairman PROXMIRE. At any rate, what you say is so startling that at first I thought you may have made a mistake, but you haven't made a mistake. I say this because we have accepted here the assertions by the Chairman of the Federal Reserve Board that he is adopting an easier money policy.

He points to increased bank reserves. He points to a drop in short-term interest rates. We all know these are statistical facts we can't deny, and you point to the money supply, which after all is the best index, and as you have indicated so well in your statement here, these other things are a reflection really of economic conditions.

The money supply in the third quarter of the year dropped 0.47, dropped about a half a percent. It was about neutral—0.01 percent in the fourth quarter—and it is about neutral—0.01 percent minus in this quarter.

So that with a growing economy and with a growing need for money obviously, this kind of policy is still restrictive. You are right. And this is a most helpful correction.

Mr. TOBIN. Senator, may I comment?

Chairman PROXMIRE. Yes; I wish you would, Professor Tobin. I might say we are very fortunate to have two outstanding monetary experts here. Professor Tobin is certainly one of the most gifted men in this area in our country.

Mr. TOBIN. Neither money supply nor interest rates is an unambiguous indicator of policy, because both of them reflect a mixture of forces: on the one hand, the things that are happening in the private economy to the demand for credit, and on the other hand the things that are happening in the Federal Reserve System.

So that it is a great mistake, in my opinion, to say that one of them, either one, is reflecting what is happening in the economy and the other one is the measure of policy.

Chairman PROXMIRE. I understand that, but what I am trying to say, Professor Tobin, is that the Federal Reserve Board can increase, decrease, or maintain the same money supply.

Mr. TOBIN. They can. They can also do that with interest rates if they want to.

Chairman PROXMIRE. I understand that, but what they have done is not to increase the money supply. They have decreased it in the third quarter and maintained a stable money supply in the fourth quarter and the first quarter of this year.

Mr. TOBIN. I don't think that is what they have chosen to do.

Chairman PROXMIRE. This is what has happened. This is the result of their policy.

Mr. TOBIN. That is what has happened, but the tapering off of credit demands, which is responsible for some of the decline in interest rates, is also responsible for the failure of the money supply to expand.

Chairman PROXMIRE. Yes, indeed, but as Professor Culbertson points out, the tapering off of the demand for money—the credit demand—is because interest rates are the highest they have been in 40 years up until recently and they are still very high on a long-term basis.

Mr. CULBERTSON. Could I make a clarifying comment in reply to his clarifying comment?

Chairman PROXMIRE. Yes. These debates are very enlightening.

Mr. CULBERTSON. I would differ from Professor Tobin in this way. It certainly is true that the change in the economic situation tends to cause a change in the behavior of the money supply, other things equal. My presumption is that if there is a change in the banks' desired reserve positions or a change in the demand for credit, the Federal Reserve offsets that through its provision of reserves. In the absence of such a presumption, it seems to me that our monetary system is fundamentally anomalous. If the economic situation weakens, the money supply goes down. That is a very inappropriate sort of monetary system.

You would be better off going back to gold, since this sort of monetary system is in general terms destabilizing. So my assumption is that the Federal Reserve ought to be offsetting factors affecting the money supply in such a way as to cause it to behave in an economically desirable way. It has the power to do this.

Mr. TOBIN. Of course, it has the power to do so, but that doesn't mean it has been using this power so as to fix any particular statistical aggregate such as the so-called money supply, or that it should do so.

The purpose of monetary policy, in my view, is essentially to try to stabilize, or to make moves in the proper directions, spending for investment, for housing, for inventory accumulation and so on.

Now, spending on these things depends largely on a comparison between the profitability which businessmen, consumers, and others see in acquiring new physical assets and the cost of credit or the yield of alternative uses of their own funds.

There just isn't any simple statistical relationship which tells you what is the proper monetary policy at any moment of time.

Chairman PROXMIRE. Yes, but wouldn't you agree at the present time, in view of the fact that industrial production has not grown in the last month or, two, that housing has been in the doldrums for several years, and is only beginning to recover somewhat in the last 2 or 3 months.

As you say so well, unemployment has not moved very much. It didn't decline at all last year to speak of. It has been the same. Automobiles, so many other things that depend to some extent on credit financing have been either stagnating or moving downward.

Under these circumstances, doesn't it seem logical that it would achieve a better economic situation if we had a positive increase in the money supply by the Federal Reserve Board, or does it not?

Mr. TOBIN. I think it very sensible right now for the Federal Reserve Board to engage in an easier monetary policy, that is to make bank reserves somewhat, perhaps even considerably, more plentiful than they have been. The result of that will be that there will be reductions in interest rates. Some have already occurred. It may be that such a policy would also bring about expansion in the statistical magnitude that you are talking about, the money supply.

But my point was that it is not fair to say that they haven't eased money simply because the money supply hasn't increased.

Chairman PROXMIRE. Let me ask, if I can get from you, Mr. Tobin, this will be very helpful; we have gotten from Mr. Culbertson an estimate of a 2- to 4-percent increase in the money supply in the coming year that would be desirable. Would you care to indicate any specific figure or do you think it would not be helpful to indicate how rapid an increase in the money supply we should have under present circumstances, assuming that things will remain more or less as they are in the coming year.

Mr. TOBIN. No, I don't think that is the way to look at monetary policy at all. Let me remind you that the bank reserves which the Federal Reserve controls relate not only to demand deposits, which are included in the money supply, but also to a whole category of bank liabilities called time deposits. These are larger in quantity than demand deposits, but are not counted as the money supply. The Federal Reserve properly worries about what is happening to time deposits as well as to demand deposits. To say that we should ignore time deposits because they don't count in money supply just doesn't make any sense to me.

Chairman PROXMIRE. Let's get away from this money supply figure. I think that you have made some very helpful refinements in my understanding of them. Let me ask you one other thing because my time is just about up.

In your statement you say—and you quote the Council's statement:

> The experience of 1966 clearly suggests that expanding demand cannot lower the unemployment rate much below the present level without bringing an unacceptable rate of a price increase.

You obviously quote that and disagree with it, which I would be inclined to do, too. You give one reason and that is that we haven't had a change in unemployment in the last year.

A second modification might be that the impact of tight money on prices, specific commodity prices, has not been as effective in keeping the price level down and is unlikely to be in a cost-push situation as effective in keeping the cost of living down as many people have assumed, particularly since food is a big element in the increase in the cost of living, and mortgage interest rate accounted for one-third of the increase in prices last year. Of course, this had a perverse price effect because of the tight money policy.

Mr. TOBIN. Senator, regarding the statistical effect of rises in interest rates on the cost-of-living indexes, I think there is a kind of statistical illusion that we shouldn't pay too much attention to. The way the indexes are constructed, we don't give the people who are sav-

ing money credit for the fact that they get more interest. We just count the fact that people who are borrowing have to pay more interest as an increase in cost of living.

But, if you look at the situation of a representative person, he is also able to gain from higher interest as well as having to pay more.

Chairman PROXMIRE. I am not saying that the effect of tight money wasn't to restrain inflation. I think it was in the aggregate. But I say we haven't had a very close or careful or thoughtful analysis, commodity by commodity, to show what the effect really was and how decisive it was, and I think we need that.

Mr. TOBIN. I think in general that the effect of monetary policy on the price level isn't very different from the effect of fiscal policy on the price level. They both influence the price level in the main by the manner in which they affect the overall level of aggregate demand relative to the capacity of the economy to produce, as measured say by the unemployment rate. So that I don't think you can change the terms of trade between unemployment and inflation by changing the mix of policy between monetary and fiscal policy. There is the statistical exception that interest rates are going to affect the cost of living index directly, but then some taxes go into the cost of living index too.

The main thing is that the effects of policy or other events on the general pace of expansion of demand relative to the growth of productive capacity of the economy also determines their effects on the price level.

What I was trying to suggest was that we shouldn't think that because we had a rapid run up of prices last year, in the early part of the year, we are doomed to have a similar run up every time we have 4 percent or lower unemployment.

That was more the result of the speed with which unemployment was reduced than of the level which was achieved.

Chairman PROXMIRE. I'm sorry, but my time is up. Congressman Rumsfeld?

Representative RUMSFELD. Thank you, Mr. Chairman.

Dr. Tobin, you make the statement that:

> If the economy can't stand a tax increase, neither can it stand the same degree of fiscal restraint applied via reduction in Federal spending.

I take it from this that you feel the net effect of either tool being used is roughly the same on the economy.

Mr. TOBIN. Well, it is roughly the same. There is some possibility of greater effect of changes in spending than in taxes. Changes in taxes affect the spending of the private taxpayers and they may not affect the spending of private citizens 100 percent, dollar for dollar, whereas if you cut spending by the Government directly, you cut it 100 percent for sure.

Representative RUMSFELD. Next you say, "Expenditure programs should be considered on their intrinsic merits." This statement has been made by other witnesses before this committee. Yet, yesterday Dr. Burns brought in a subject that relates to this that had not been commented on by individuals who had made that statement.

I would like to read it. Dr. Burns said:

> The Federal Government absorbed 30 cents out of every additional dollar of the gross national product. The States and localities took another 10 percent.

Thus, taxes siphoned off 40 percent of the increment of the gross national product last year. During the past dozen or so years this figure was exceeded only in 1956 and 1960. It may not be entirely an accident that these years were followed by a recession.

He goes on to say:

In 1963 the Administration urged a massive tax reduction. It rightly put great emphasis on the fiscal drag of our tax system. The argument was that the tax system draws off so large a portion of rising national income that it tends to choke off the process of expansion. Yet in 1963 Federal revenues absorbed only 27 cents of every additional dollar of gross national product in contrast to 30 cents in 1966.

I take it when you say expenditure programs should be considered on their intrinsic merits, that you are talking about within a narrow range. My question would be: Do you share the concern about fiscal drag that could result, if programs were in fact considered only on their individual merit and we kept adding on more, and as a result did increase taxes to compensate for the additional Federal spending?

Mr. TOBIN. When I say the programs should be considered on their merits I don't mean that——

Representative RUMSFELD. You say intrinsic merit.

Mr. TOBIN. Intrinsic merits. I don't mean that the Congress and the Federal Government should adopt every program which is meritorious.

Representative RUMSFELD. That is what it sounded like to me.

Mr. TOBIN. Then let me elaborate. What I mean is that the Congress and the Executive should consider the importance of any Federal program relative to other possible uses of the same economic resources. Those possible uses are either other Government uses by Federal or State and local or private uses. So what I mean is that you should consider programs of the Federal Government as against the importance of letting private citizens use the same resources by having to pay less taxes, as well as by considering whether the program is as important as some other Government programs.

So intrinsic merit means a judgment about social priorities, Government sector versus private sector, and within the Government sector both. What I meant to convey was that as far as stabilizing the economy and keeping its momentum going, whatever decisions are made about the size of the Government within fairly broad limits, we can still make the economy operate with full employment and grow properly if we take the appropriate tax measures and monetary measures.

Representative RUMSFELD. I am glad to have that elaboration then. Would it be corect to say that you see some possible dangers of fiscal drag as stated yesterday, in the event that there isn't a good balance between public and private? Do you worry about incentive?

Mr. TOBIN. The fiscal drag is a little different problem from the question of the general size of the public sector relative to the private sector. Now I think that the fiscal drag problem in the tax structure can be offset by expenditures by the Government or by transfer payments as well as by tax reduction.

A good bit of those tax yields that you are quoting Dr. Burns about comes from trust fund activities, of which social security is the main example. The money is also paid out, and the net effect is a transfer through the Government rather than a use of resources by the Government.

Now there is certainly the incentive problem that you refer to if you have taxes too high, but our tax rates I think are generally more favorable to incentives now than they were in 1963 before the Revenue Act of 1964.

Representative RUMSFELD. If the social security trust fund is affected as you just described, why in your statement did you say "If social security benefits are increased less or later than proposed" when your last comment indicated it was just a transfer, taxes for benefits?

Mr. TOBIN. Yes.

Representative RUMSFELD. Why would it have any effect at all the way you suggest?

Mr. TOBIN. The reason it would this year as I understand it——

Representative RUMSFELD. The lag?

Mr. TOBIN. The President has proposed that the benefits start July 1 but that the accompanying taxes start next January, so that there would be a period in which the benefits which were being paid out from current surpluses of the trust fund wouldn't be offset by additional taxes.

Representative RUMSFELD. Dr. Culbertson, even if monetary policy changed now, could we avoid the recession you foresee by summer, since monetary policy operates with a lag? Won't the restrictive policies of last year have its impact this year, and what is done now have only a limited effect during this danger period you see?

Mr. CULBERTSON. Our knowledge of lags as well as effects is very limited and none of us can speak with great confidence on such a question. In my own view of the matter, though, in a situation in which the economy is rather poised to go one way or the other, the lags may be very short. That is, plans are being kept flexible. People, businessmen, are ready to move one way or the other, and it seems to me that in such a situation the lags may be, as I say, extremely short. Depending on what action the Federal Reserve takes, in one direction or the other, we may have the beginning effects within a matter of weeks or a month or so. The full lag, of course, works out over a longer period and is very difficult to define.

Representative RUMSFELD. I would be interested in knowing what the reactions of either of you might be to this question about the unsettling effect of a so-called yo-yo tax policy. Chairman Mills of the Ways and Means Committee has voiced doubts about the wisdom of making frequent tax changes for economic stabilization purposes. Do you see any unsettling or destabilizing effects from this discussion about raising or lowering taxes during the relatively short periods of time? Does it cause uncertainty in the business planning, Dr. Tobin?

Mr. TOBIN. Business planners and other planners are subject to all kinds of uncertainties about their markets, their costs and everything, and I have never quite understood why they regard the uncertainties about taxes and other aspects of Government policy as of a different and more difficult order of magnitude than the general uncertainties of the markets which they face. I should think that if flexibility in tax and monetary policy were well done it would actually make things easier for them by making the general outlook under which they make their plans more reliable.

I should think that the modest and tentative conquest of the business cycle that has occurred in the last 6 years has made business plan-

ning a lot easier than the kind of cyclical atmosphere we had in the 1950's. This couldn't have been accomplished without some fiddling with the instruments of policy, tax and monetary policy. Although there is undoubtedly going to be a lot of attention to the possible unsettling effects of discussions of policy, I think the gains from the more reliable, assured outlook for the general markets the businessmen face is a much greater advantage.

Representative RUMSFELD. Of course, your response suggests—and I can appreciate the difficulty of my interpreting your remarks—but it suggests a degree of accuracy that will in fact result in a favorable situation.

I have been concerned with the wide disagreement among experts on these subjects. You here say you do not see a case for the proposed 6 percent surtax, in your statement. We have had both sides of this. We have also repeatedly had individuals comment on the difficulty of accurate forecasting in this area, and while I recognize that you have got to take the best information you have and go with it, this is certainly true, there have been others who have suggested that the time it takes for the mechanism of Government, the executive and the legislative together, to work in this area might be advantageous in terms of not making the errors that could be made when, for example, additional authority discretion is given to the executive, and there is a frequent change in the tax rates. Do you have any comment on that?

Mr. TOBIN. Well, I can well imagine that bad policymaking—like a housewife who doesn't understand the lag between changing the thermostat and the operation of the furnace, jiggles it up and down, and then doesn't understand why things are alternately too hot and too cold.

But I don't think that that is a fair description of the way Government policy has been operating in the economic sphere since the Second World War, especially in the last 6 years.

Representative RUMSFELD. True, but you can't say we have had a yo-yo tax policy during that period either.

Mr. TOBIN. We have used taxes as well as monetary policy in a flexible manner. It has been a kind of opportunistically flexible policy. For example, the occasion has been taken to accelerate or defer social security tax increases, as we discussed before, when more expansion or less expansion is desired. One way or another, a good bit of flexibility in timing of policy has been achieved, and I think the results are pretty good.

Representative RUMSFELD. Thank you.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman.

Would both you gentlemen agree that one of the things that was wrong with our total policy mix last year, and particularly our monetary policy, was that it did squeeze unduly the whole building industry, and that this was regrettable. Is there any dissent from that?

Mr. CULBERTSON. I wouldn't attribute that mainly to monetary policy, Congressman Reuss. I think the objection to monetary policy was its on-and-off character, a very rapid increase in the money supply during a period and then the abrupt reversal to no increase.

I think the high interest rates were caused by the excessive expansion to which the monetary policy contributed. But, to an important extent, high interest rates also arose from the fiscal policy. If you had more normal fiscal position, the Government would have been taking, I suppose, something close to $10 billion less out of the credit market. Also, the investment credit, of course, so far as it had an effect in buoying business investment financed in the credit market meant that credit was diverted in that direction. So, credit was directed both to financing Government and to financing business that otherwise to a considerable extent would have gone into housing.

Representative REUSS. Whatever the cause, I take it both you gentlemen agree that it was not satisfactory to have our homebuilding industry as flat on its back as it was for much of last year. That is not the ideal.

Mr. CULBERTSON. It was not ideal, but I want to know the alternative before I would buy it. I think there are things that would have been worse.

Representative REUSS. I now want to put something to both of you, because when I was in Mexico a couple of months ago, talking with the Mexican Central Bank people, I pointed out what they already knew, the fact that our housing industry at a time when Americans needed more homes was simply not producing, ostensibly because of tight money. And I pointed out that this, too, was at a time when banks in the United States were making large-scale and frequently inflationary loans to businesses to overbuild up inventories, and very marginal business activities and investments.

The Mexicans interrupted me to say that they had solved all of that south of the border. The Central Bank of Mexico, by regulation, has long since provided that a percentage, say 30 percent, of bank credits shall be made available to the housing industry, either to private industry or the public or cooperative housing industry, and thus in a tight money, close-to-full employment situation, they manage to channel necessary credits to housing, and by so doing, they avoid overchanneling of credits to sectors of the economy where in a given situation there may be inflationary pressures. What do you think of the Mexican solution and its possible applicability here?

I should add that the Mexican central bankers agreed to come up and instruct Chairman Martin if there was any disposition for that to happen.

Mr. TOBIN. I don't think that would be a good idea, because on the whole, I think we ought to have credit markets in which the importance of different uses of credit are measured by the prices that borrowers are willing to pay. There should be shifts in the composition of credit from time to time, depending on which things are more postponable. I wouldn't like to see a quota of that kind.

I do think that the concentration on the effects of tight money, especially the degree of tightness we had last year, on the homebuilding industry is unfortunate. But this could be remedied by some structural reforms in our financial system, which wouldn't subject it to quotas of the kind you are talking about.

Representative REUSS. What the Mexicans have, in effect, is a structural reform in their credit system. What they are saying is that since banks are the creators of money in Mexico as in the United States,

and since housing is an important objective of Mexican policy, therefore they don't want to let the creators of money escape entirely or almost entirely from the job of providing credit for housing. How would you suggest reforming our financial institution structure so that something which most Americans think is very worthy; namely, homebuilding, doesn't get socked on the head every time, for good and sufficient reasons, we have a high-interest-rate structure?

Mr. TOBIN. Well, in the worthiness of homebuilding is something that has been recognized by numerous other actions of public policy, subsidies, insurance of mortgages, and so on. And I don't think you can argue for special treatment for homebuilding ad infinitum just because owning homes is a desirable thing.

Lots of things are desirable; but once you have decided that they are worth a certain degree of subsidy, then they have to compete with other uses of resources, just like everything else.

Now the structural problem last year, it seems to me, is related to the fact that we have created this one set of institutions, the savings and loan associations which play such a strategic role in the mortgage market. They were permitted to, and they did, expand both their extremely short term, almost demand type liabilities and their mortgage assets parallel at a very rapid rate. They ran into a situation where the only way they could keep their deposits, or so-called shares, was by raising the interest rates they paid to a point where their portfolio of old mortgages with lower rates wouldn't yield enough to keep them from dipping into their reserves. It seems to me that it was wrong that they had a structure of assets and liabilities that made them so vulnerable to this kind of situation. They should have had a more diversified set of assets, including secondary reserves, so that they would not have been quite so vulnerable to sudden changes in the attractiveness of their deposits relative to those of banks and other institutions and to market securities.

They should have developed over the years—and the regulatory authorities should have encouraged them to develop—liability instruments of a more diverse and varied kind, so that not all of their liabilities were demand obligations.

Representative REUSS. Like long-term certificates of deposit?

Mr. TOBIN. Long-term certificates of deposits.

Representative REUSS. Anything else? You said "secondary reserves." What do you mean by that?

Mr. TOBIN. Well, reserves of Government bills or bonds which would give them some leeway so that they wouldn't be completely loaned up in mortgages at all times but would have some room for maneuver.

Furthermore, I don't think it would be a bad idea if the savings and loan associations and other institutions offered to borrowers the option, not an exclusive option but one option, of a mortgage loan with an escalated interest rate related to their deposit rates or to some index of market interest rates.

This would mean that they wouldn't be stuck with 5-percent mortgages when all of a sudden they found they had to pay more than 5 percent to keep their money. On at least some part of their portfolio they would be able to raise the charges along with the general tightness of money.

Now any of these things, or these things in combination, would have put the mortgage market and the housing industry in a better de-

fensive position against the general tightness of money markets that occurred last year.

Representative REUSS. On the interesting dialog between you two gentlemen a moment ago when Chairman Proxmire was examining, Mr. Tobin, you, I believe, rejected Mr. Culbertson's reaching out toward the money supply as the proper determinant of Federal Reserve monetary policy, and I think I heard you say that the Fed can't really control the money supply. You said, I thought, that it could control bank reserves, but not the money supply.

I would like to examine that, if I am reporting right what you said, with you, because I am not sure I follow you. The Fed, of course, can control the amount of bank reserves by its open-market policy, its reserve-requirement policy, and to a degree by its rediscount policy. That you concede; do you not?

Mr. TOBIN. That is what the Fed, in fact, does. It can control the quantity of bank reserves.

Representative REUSS. Yes.

Mr. TOBIN. It can set the discount rate, and so on.

Representative REUSS. Well now, when a bank gets a reserve, doesn't it almost immediately and inevitably transfer that into an increase in the money supply?

It either lends it to somebody, or it invests it in a security. In either case, unless I need, as I probably do, some educating on this, adding to the money supply.

Just let me finish and then I would like to have you clear this up. It is true, of course, that nonmoney substitutes for time deposits, as you mention, have to be considered, but the Fed can do something about their amount, too.

It, after all, controls reserve requirements on time deposits. Would you lead me out of this thicket?

Mr. TOBIN. Well, I think we have to distinguish between what the Federal Reserve controls absolutely and immediately, which is as you said, the quanitity of reserves and discount rates, and so on, and what they can control more indirectly by moving their immediate and available instruments in response to what they see is happening.

It is true, in a sense, that you can say that the Federal Reserve can control the money supply if they want to, because whenever they see the money supply being different from what they would like it to be, they can push their levers around until they get what they want.

There are other things, too, they could control if they wanted to. They could keep the bill rate at any level they want, if they intervened in the market every time the bill rate diverged from some target level they wanted. But that is quite different from saying that they do, in fact, act that way or that they should, in fact, act that way.

Now as for your point about the tight relationship between the quantity of reserves and the money supply, that is just not true. Although the Federal Reserve supplies a certain quantity of reserves to the banks, and determines the quantity that the banks can have without borrowing, it is the banks which determine how much of those reserves they use, how much they keep as excess reserves, or how much they supplement them by borrowing from the Federal Reserve at the prevailing discount rate.

The swing of required reserves, the reserves they actually are using, from the supply of unborrowed reserves by the Federal Reserve to them is from, oh, five or six hundred million dollars excess reserves some years ago to four or five hundred million dollars net borrowed reserves in recent periods of tight money.

So, there is a good deal of slack between the supply of reserves to the banks and the quantity that they use.

Now the second point is that the money supply, as defined, is currency plus demand deposits. The reserve base is the reserve base for the deposit liabilities of the commercial banks, including both time deposits and demand deposits.

Time deposits are not conventionally counted in the money supply. When the Federal Reserve supplies reserves to the banks and when the banks make loans and receive deposits, it is not determined by the Fed or by the banks in advance whether the deposits will arrive in the form of time deposits or demand deposits.

But the statistical magnitude that so entrances everybody will be different, depending upon which way it happens. I am not saying that the Federal Reserve is impotent to affect what happens in all these respects, because they can, by their discount rate, by the ceiling rate that they allow on time deposits, affect the choices that the banks make and the choices that the public makes.

But the point I want to make is that it is a travesty of what is happening to talk as if the Federal Reserve has a lever at its command marked "money supply" and you just push it where you want it.

They can do things which will affect the money supply and they can move the levers that they do have sufficiently so as to keep the money supply on some target, if that is what they want to do. But this is not necessarily what they have been doing, or what they should do.

Representative REUSS. I am over my time, but when I next have a go-around, I will start there and ask you what they should do.

Chairman PROXMIRE. Senator Sparkman?

Senator SPARKMAN. Thank you, Mr. Chairman. My questions will be quite brief. In your paper, Dr. Tobin, I believe there was a statement with reference to disappointment over not reducing the unemployment rate below the 4-percent level. Is that correct?

Mr. TOBIN. Yes, sir.

Senator SPARKMAN. Dr. Tobin, to what level do you think it is practical to reduce it?

Mr. TOBIN. Well, we have experienced unemployment rates as low as 2.9 percent.

Senator SPARKMAN. When was that?

Mr. TOBIN. In 1951 I believe.

Senator SPARKMAN. In 1951?

Mr. TOBIN. Yes; I believe so.

Chairman PROXMIRE. I think it was in 1953.

Mr. TOBIN. I am not even speaking about the low unemployment rates we had in World War II, which were almost as low as 1 percent. So it is feasible to reduce the unemployment rate at least as far as 3 percent, and perhaps farther. Doing so may have consequences that we wouldn't like; namely, that we would have a faster rate of inflation, wage and price inflation, with very low unemployment rates, than we would wish to accept. What I was suggesting is that I don't think we

should be satisfied with the 4-percent target indefinitely. We should try to move to a lower target, but not to move there all of a sudden. I think moving the unemployment rate down too fast is a source of inflationary pressure that can be avoided if it is moved down gradually.

I wouldn't like to set an ultimate rate. I would like to try to get it down below what it is now, by trial and error, seeing what kind of price and wage pressures develop.

Senator SPARKMAN. In other words, the exact figure is not so important. The important thing is just to try to press it down as much as may be practicable.

Mr. TOBIN. Yes, sir.

Senator SPARKMAN. Now one other thing. That has to do with the increase in the money supply, Dr. Culbertson. I note that you say in your paper that monetary expansion at a rate of 2 to 4 percent per year, perhaps with a faster rate very briefly to assure against the onset of a recession, would be appropriate. How would that compare with the expansion of money say over 1966?

Mr. CULBERTSON. The recent behavior has been quite erratic. From the spring of 1965 to the spring of 1966, the money supply was going up at a rate of over 6 percent. In the subsequent period of almost a year, it has not gone up at all.

My point is—maybe putting it this way—with our present state of limited knowledge, the effects of such erratic behavior in the money supply are quite difficult to predict. In this case, at least the first one went in the wrong direction. So less abruptness in the present state of knowledge would be appropriate. The pattern I propose is something that would be fairly close to the recent past average, and something that can be justified as not inconsistent with a moderate rate of growth in GNP.

Senator SPARKMAN. Is there a relationship, or should there be a relationship, between the increase in the supply of money and the increase in population, or better still perhaps, an increase in the gross national product?

Mr. CULBERTSON. Well, our knowledge does not permit us to define any fixed formula. There is some presumption that other things equal, if there isn't a shift in the desire of people to hold money in relation to their expenditures, the presumption is that the money supply would have to grow at about the same rate as GNP. You can't guarantee that there won't be such shifts, but recently they have been only of modest proportions. We are looking for some sort of a benchmark, not a fixed rule but some sort of benchmark. The usual expectation is that growth in the money supply will be somewhere near or at the same rate as growth in GNP.

Senator SPARKMAN. Now you bring up another matter there. That is the question of a tax increase. That is something with which the Congress is going to be confronted with before too long.

You say that there should be a tax increase if it is required to offset further increases in Government expenditures. How are we going to determine when the time comes whether or not such a tax increase is needed?

Mr. CULBERTSON. Well, Senator, my general point is that controlling fiscal policy represents a very difficult problem, and one that we have not mastered. From some of our earlier discussion here, one might

take it that the benchmark or the usual thing to do is not to change taxes, but, of course, if expenditures are changed, not to change taxes doesn't constitute standing still. It constitutes changing fiscal policy inadvertently.

It seems to me an inadvertent change in fiscal policy in an expansive position now would be inappropriate. The benchmark ought to be something roughly measured by this high employment surplus. I think we ought to try to keep that from shifting in a direction in which we don't want it to shift. Of course, we are depending upon our expenditure estimates which have an element of error in them.

I think we must recognize that we can't control fiscal policy closely in the present state of knowledge and technique, but that we have a responsibility to try, and we can't simply sit with the tax rate unchanged, letting expenditures go where they will.

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

Chairman PROXMIRE. Mrs. Griffiths?

Representative GRIFFITHS. Thank you, Mr. Chairman. May I ask either or both of you to what extent do you think welfare laws of this country (a) mask the unemployment rate, and (b) actually contribute to a tight labor market?

Mr. TOBIN. I don't quite understand, Congresswoman Griffiths. What do you mean by "masking the unemployment"?

Representative GRIFFITHS. The unemployment rate is those who are seeking work. There must be many people receiving welfare who are not seeking work, and they are not seeking work because once they get it, they lose the welfare, and work may be temporary; but the truth is, they are unemployed.

Mr. TOBIN. I am glad you asked that question. I think our present system of public assistance does discourage people from seeking work or from seeking training for work, and ought to be changed, because what we do in public assistance is essentially to charge a 100-percent-tax rate on earnings. That is if a family is on public assistance, and subject to a means test, anything earned by the family is deducted dollar for dollar from the welfare benefits received.

This seems designed to me to be a tremendous disincentive for seeking work. I think you are right, that there is a potential labor force there that is discouraged from being in the labor market and from sticking in the labor market by this medieval means test.

Representative GRIFFITHS. Would you support a negative income tax as opposed to the public welfare system that we now have?

Mr. TOBIN. I certainly would, yes, definitely—some kind of device under which the benefits, call them negative taxes if you like—paid to poor families and individuals will not be reduced dollar for dollar by their earnings, but where they will have an incentive to work and to obtain training by being allowed to keep, say, one-half or two-thirds of what they earn.

I am glad to see the President has suggested a modest beginning toward this, by suggesting that under present public assistance, a certain amount of earnings should be allowed without deduction of benefits.

Representative GRIFFITHS. Of course there are 25 States, I believe, that will not permit you to earn anything, and in some of those States the top payment is $44 a month for a single person, and you aren't

permitted to earn a cent. You are effectively removed from the labor market, where you possibly could be employed for just a couple of hours somewhere where needed.

May I suggest that we have a really very good test case that I think will be available immediately. I haven't really checked into the Indian policy of this country, but I understand it is pretty bad. Indians seem to be dying off, and they are all in poverty or most of them, and yet we have more people at the Bureau of Indian Affairs almost than we have Indians.

Suppose we suspended the Bureau of Indian Affairs for a year, and sent the money to the Indians? You could at least check it out. I mean maybe at the end of that time they wouldn't be poor.

Mr. TOBIN. I certainly support the spirit of your suggestion, without knowing enough about Indian affairs.

Representative GRIFFITHS. At least it would be a good test case. Who really is against Indians having some money? The policies that we have been following have done nothing to help. They are starving to death.

Now may I ask you, Mr. Culbertson, what monetary policy do you think would be consistent with a full employment rate and a stable economy?

Mr. CULBERTSON. Well, the presumptive policy in the present state of our knowledge I think is a fairly steady rate of growth in the money supply, adjusted with departures in one direction or the other to offset tendencies toward excess or deficient growth in total demand. We have to play this by ear as it were, in that we can't write a magic formula, but this I think should be played by ear with smaller adjustments and some defined presumptive benchmarks rather than with the erratic hopping about that we have had in the past.

Let me say that there is a well-developed rationale for referring to the money supply as a measure of monetary policy. It goes far back in economic theory, and I think underlies a great deal of recent work. This is not, of course, because the Federal Reserve has a lever labeled "money supply." It is a question of what is the most useful guide to Federal Reserve actions in the present state of knowledge.

There is a difficult interpretive issue in using criteria relating to interest rates in that interest rates are closely affected by economic conditions and demand for credit. The interpretive problem involves distinguishing the independent influence of the Federal Reserve on the economy from feedbacks operating in the economy as a part of its dynamic processes.

In the present state of knowledge, we simply may not know what the interest rate ought to be. Of course, that would be the problem. Does the administration have the knowledge required to know what the interest rate ought to be now? And since the interest rate is very closely sensitive to changes in economic conditions and even in the state of psychology, will they know what it ought to be 2 months from now?

The problem is one of designing a strategy for operations in the face of limited knowledge. The rationale for referring to the money supply is that this is what the Federal Reserve controls fairly immediately, and therefore it is a reasonable measure of its direct influence, of its independent influence upon the economy.

Professor Tobin is quite right that most immediately, of course, the Federal Reserve only controls bank reserves, the discount rate, and so on. But I suggest that it is impossible to formulate criteria for Federal Reserve open-market operations, say, in themselves. The presumption of the system is that there are certain kinds of changes in bank reserves that the Federal Reserve offsets. One makes the necessary consolidations and the index that emerges, I think, is the behavior of the money supply.

Representative GRIFFITHS. You have suggested that we have had a restrictive fiscal policy, a buoyant economy, and an expansionary fiscal policy and a less buoyant economy. Maybe the fiscal policy—you suggest that the fiscal policy was really ineffective. Maybe the truth is that it works in reverse.

Mr. CULBERTSON. Well, I am afraid we can't prove anything at all very definitely. But it does seem difficult to sustain the proposition that GNP is very closely governed by fiscal policy, in view of the past lack of correspondence.

Representative GRIFFITHS. You are saying really that it is ineffective?

Mr. CULBERTSON. No. I am saying really that we have limited knowledge, and that it may be. It may have very much less effectiveness than it has been credited with. Therefore we have to design a policy strategy that is reasonable in the face of limited knowledge. It seems to me that cannot be said of the administration's program.

Representative GRIFFITHS. May I ask your opinion also as to an assured income policy?

Mr. CULBERTSON. Well, that is not one of my major areas of study, and so I would rather not comment on it.

Representative GRIFFITHS. Thank you very much. Thank you, Mr. Chairman.

Chairman PROXMIRE. Dr. Tobin, your statement is one of the most refreshing and forthright pleas that we begin to have a more optimistic and progressive attitude toward growth of our economy that we have had, and I would like to question you a little further.

You told Senator Sparkman you didn't want to recommend a definite number, that you rejected the 4 percent notion of unemployment as being hard to accept, but you didn't want to reduce the target to a specific number.

What would be wrong, would you object very much if we just arbitrarily said 3 percent? What would be wrong with that? Is there anything that would suggest that that would necessarily be an inflationary target?

Mr. TOBIN. Well, we don't know what the price and wage behavior of the economy would be at 3 percent, and when we talk about target for the unemployment rate in this context, we are talking about the target of stabilization policy, monetary and fiscal policy.

If we talk about all the programs, all the policies of the Government, we certainly should have 3 percent and lower figures of unemployment as our target. But that would depend on improvements in labor markets achieved by manpower policies.

But if we just talk about what target we set for monetary and fiscal policy, I wouldn't like to say right now that it should be 3 percent, without seeing what happens as we gradually move it down.

Chairman PROXMIRE. You pointed this out, and you are right. In

1952 we had 3.1 percent unemployment. In 1953 it was 2.9 percent unemployment. And in April 1953 price controls expired—April of 1953. So we had a full year, no rise in prices to speak of.

Well, there was a rise but it was very small, seven-tenths of 1 percent in 1953. The next year it was four-tenths of one percent, much better than we have had lately. A very, very low level of unemployment.

We had that experience then before we had manpower training programs on the scale we have now, and it would seem to me that we ought to really press this a lot harder than we have, and since you are the man who has come up with by far the most forthright questioning of the Council's goal, I would feel much better if you could give us a little more assurance on this count; be a little more specific on how we can press it. As I say, we have had this experience.

Mr. TOBIN. The 1951, 1952, and 1953 experience is a bit misleading, because the happy experience of the price level in those years was to some extent due to a decline in agricultural prices. Industrial prices were rising during those years, but they were offset by a decline in agricultural prices.

Chairman PROXMIRE. Well that is true, but they couldn't have been rising very sharply if you had near stability.

Mr. TOBIN. I think it would be nice if we had that kind of circumstance again.

Chairman PROXMIRE. The situation now is somewhat similar. We have a war going on. We have a lot of our production going into that war.

Mr. TOBIN. Well, all I can say is that I think that we ought gradually to lower the target rate. We ought to be sure we don't have these abrupt kind of changes in the use of capacity and of manpower that we had last winter.

Chairman PROXMIRE. Let me just say look at what the Council projects. They say that they expect unemployment to rise. It is now 3.7. They expect it to go to 4 percent. That is not much of a rise, but it is a rise.

Also, they expect the percentage of utilization of plant to fall down to 88 percent, and they expect this with the growth of 4 percent.

Now the projections of the Labor Department—projections of 1970—suggest that even this is conservative. They say that we should have a 4.3-percent growth, not a 4-percent growth, a 4.3-percent growth to maintain unemployment at 4 percent.

So that it looks as if the Council is wrong in its growth rate, that it ought to be not 4 percent but about 4.5 percent, maybe even more, and on the basis of our past experience, and the fact we have had stable unemployment for a year or so, it looks as if they are being too pessimistic on their unemployment rate.

The thing that really concerns me more than anything else is that if we are going to break through this relatively high level of unemployment, higher than almost any other country anywhere, a situation in which we have 3 million people out of work, if we are going to break through it, the way to do it is to press demand. This is what gets the private sector of our economy bringing people in, whether they are minority groups or women or inexperienced teenagers, and training them. Isn't this correct?

Mr. TOBIN. That is certainly correct. I think we should do it on both sides. We should be helping on the supply side by training.

Chairman PROXMIRE. That is right. When you look at the budget, the cost of this kind of a program, manpower training is an infinitesimal part of the budget. For a fraction of the saving we could make in the space program alone, we could vastly step up that manpower training program.

Mr. TOBIN. But on the whole I think it is better to have the training done by employers than by the Government.

Chairman PROXMIRE. Yes, indeed.

Mr. TOBIN. And to the extent that we can arrange a tight enough labor market to give them incentives to do so, I think that that is very desirable.

But we do have to worry about what the price and wage consequences of tighter labor markets are, and although I think we overdo our concern about creeping inflation, nevertheless I don't think we can ignore that, and so that is why I would be cautious in pushing our target rate of unemployment down. But I think we ought to keep doing it.

Chairman PROXMIRE. Here is why I come back constantly to challenge you expert economists to come up with any indication that an increase in demand now under present circumstances, with the kind of slack we have in so many segments of our economy would necessarily push up prices very much.

There is no question in my mind that increase in demand will not push up food prices. There are other elements that contribute to that. We certainly don't have pressure on demand for automobiles. We don't have pressure on demand for houses. We don't have pressure on demand for appliances. We don't have pressure on demand in so many of these areas.

Our industrial plant has been growing at a tremendous rate. Our work force is not only going to increase but it is a flexible work force that can expand to meet demands.

I just think that we have approached this macroeconomics in such a way that we are frozen with the notion because we had some inflation last year, which on the basis of every analysis I have seen is not very closely related to demand, there were other factors which were more significant in explaining it, somehow if we get below 4 percent unemployment this year, we are going to have more inflation.

Mr. TOBIN. For this year I think we are going to have more inflation pretty much regardless of what happens on the demand side.

Chairman PROXMIRE. Cost-push inflation.

Mr. TOBIN. Well, in a sense, cost-push, but in a sense the inheritance of the demand inflation of last winter, too, because some prices follow other prices, and wages follow prices, and so on. But I think that the actual degree of inflation we have in 1967 may not be very sensitive to alternative degrees of demand pressure. But I do think that the general tightness of demand on capacity and on the labor force has something to do with the rate of inflation. Now whether you call it cost-push or demand-pull, that is an overrated distinction.

Chairman PROXMIRE. You can call it cost-push for another reason. You can call it cost-push because we have 3.1 million workers whose contracts come up for renewal, including militant groups in the auto

industry and the teamsters, and so forth, who are likely to push for substantial increases in pay.

You add on top of that a tax increase which has some cost-push elements in it; well, you are opposed to the tax increase, so I presume that you would agree that, (a), we should not have a tax increase, (b), we shouldn't in your judgment, have much of a change in expenditure policy, and that this would give us approximately the right kind of a fiscal policy together with a somewhat easier monetary policy that would secure greater growth than 4 percent, and lower unemployment than 4 percent.

Mr. TOBIN. On the tax increase my present feeling would be that it wouldn't be desirable; but I would like to stress the part of my statement which emphasizes uncertainties in the situation. I think this is a more than usual uncertain situation in which the range of possible happenings——

Chairman PROXMIRE. I understand. I think that is an accurate position.

Mr. TOBIN. And I think that you should be alert to the possibility that you will want that tax increase in the second half of the year.

Chairman PROXMIRE. Let me swing over, because my time is just about up, to Professor Culbertson and ask him this.

You, I understand, would say that if the Federal Reserve Board would increase the money supply at the rate of 2 to 4 percent, then you would favor probably the 6 percent surtax that the President has proposed.

Then you go on to say you are not very optimistic about the Federal Reserve Board doing this on the basis of their past performance. Now, on the assumption that they perform according to the style they have set in the past and what they have been doing so far, on which I think you are dead right, they haven't been having a very easy money policy, and I pointed out to Mr. Tobin at that time that they actually contracted reserves in the most recent period on which we have information available, they have reduced reserves.

The last time they did that they went through a recession and they have done it again. Under these circumstances would you still say we should have a tax increase, Mr. Culbertson?

Mr. CULBERTSON. I feel their policy is pretty unpredictable. I don't know what they are going to do, Senator.

Chairman PROXMIRE. Not knowing what they are going to do, but knowing what they have done in the past, do you still think we ought to have a tax increase?

Mr. CULBERTSON. I don't think that not having a tax increase would bring us out of this matter safely, if we don't get a change in monetary policy, I don't think it is that substitutable. It may be; but I would be quite confident in my own mind that if we don't get increases in the money supply, we will have a recession, tax increase or no tax increase. So I would not be willing to settle for that package. Changes in monetary policy should be pushed for very vigorously.

Chairman PROXMIRE. Thank you. Congressman Reuss?

Representative REUSS. I want to return to where I was. I guess I am sort of acting as Dr. Culbertson's lawyer on this matter.

The Culbertson thesis is that the Fed hasn't really known what it is doing; that it has failed to increase the money supply at various

periods and brought on recession, and increased it at a too rapid rate at other times and brought on inflation, and that if it regulated the money supply, it would be better off than if it concentrates on either the level of interest rates or on various other factors.

This seems to be a thesis with which you don't agree, Dr. Tobin, and in order to get it through my head as to just what the dialog is here, let me call your attention to the 1962 Economic Report of the President by the three advisers, Heller, Gordon, and yourself.

In this report, on page 92, the Council suggested that for the year 1962, in order to secure the projected increase in the gross national product, there ought to be an increase in the money supply of 3½ to 4 percent, and of liquid assets of about 5½ percent.

In fact, the Fed paid no attention whatever to this wholesome recommendation. Throughout 1962, as Dr. Culbertson's chart titled "Money Stock," which appears in his prepared statement (p. 590) shows, the Fed increased the money supply practically not at all; and as a result we had a distressing shortfall in 1962, and we didn't come anywhere near meeting our 1962 GNP hopes.

My question is, Weren't you and your colleagues right in 1962? Wasn't the Fed wrong? And isn't the present Economic Report rather sadly lacking, in that it not only doesn't tell us what kind of a money supply target we ought to have for this year, but hardly mentions money supply at all?

Mr. TOBIN. In 1961 and 1962 my colleagues and I were advocating more expansionary policy of all kinds, more expansionary fiscal policy, more expansionary monetary policy, because our diagnosis of the situation was that the economy was so far from full employment and had so much slack in it that we needed anything we could get in the way of expansionary policy, and we ran into some resistance on getting more expansionary fiscal policy, and we ran into some resistance on getting more expansionary monetary policy.

I wish we had had more expansionary both kinds of policy at that time, and we would I think have had more rapid return to full employment than we have had.

Representative REUSS. Right. I do, too, and your record is a most imposing one, both in 1962 and by hindsight.

My question is, Weren't you on the right track, and isn't the making of some projections of how the money supply ought to increase, a meaningful exercise for the Council of Economic Advisers, and shouldn't its advice be honored in the observance rather than in the breach by the Fed?

To put it another way, was the more than 6-percent increase in the money supply in the short period from February 1965 to February 1966 a sensible increase? Wasn't it too much?

And equally, was the nonincrease in the money supply back in 1962 sensible or not? And, of the most importance today, is the failure of the Fed to increase the money supply in the last 9 months sensible, and should we be beguiled by the fact that interest rates are now down?

As Professor Culbertson says, they are down because we are undergoing the first pains of a recession. In short, address yourself, as you have been, to the thesis that the money supply is a good polestar to guide by; that we shouldn't have the same projection in every year, but maybe in a good year 2 percent is enough; in a bad year 4 percent is needed. But should we have years in which there is a decline in the

money supply, and should we have years in which there is a 6.2 percent increase in the money supply? Both of those occurred in the 1960's.

Mr. TOBIN. The trouble with the general way of thinking about the situation that I find in Mr. Culbertson's presentation, and in your able service as his attorney, is that it seems to assume that the sources of instability in the economy are due entirely to what the Government does—to unstable variations in Government policy, or unstable variations in Government fiscal policy.

Now those may cause instability in the economy, but there is also probably a much greater source of instability in the economy in things that happen in the private sector; changes in the demand for capital, changes in the demand for money itself, changes in the ability and willingness of people to spend money, technological changes and so on. These changes occur more or less autonomously in the private sector or are the result of long past policies or of the past history of the economy.

Now those are much more important sources of instability in the economy than are the changes in Government policies, and the purpose of Government policies is to try to offset them.

If you look at the record of the instability of the economy before there was Government stabilization policy, when nobody was trying to offset them, and compare it with what has happened since people have been trying to offset them, I think you can conclude that on the whole Government policy has done more offsetting than accentuating of these basic sources of instability.

Representative REUSS. I thoroughly agree that monetary policy is merely one element, and that the big sources of instability are in the private sector.

Mr. TOBIN. Yes. Let me draw the conclusion that I want to draw from that, which is that the appropriate stance of Government policy in any particular year depends on what is happening in the private sector, and there may be years in which you want to have the money supply grow by 10 percent and there may be years in which you want to have it decline by 2 percent, and similarly with fiscal policy, because the basic factors that you are dealing with in the private sector are very different in those years.

You are not necessarily going to stabilize the economy by just putting your feet on the accelerator at the same level all the time, or on the brakes at the same level all the time.

Representative REUSS. What you have done, it seems to me, is to—so to speak—widen the goal points of the Culbertson thesis. You said 2 to 4 percent isn't enough. It should be a negative 2 to 10 percent, and for purposes of argument I will accept that change. But my specific question is this.

Having regard for the total variables, public and private, of the economy, was it sound and wise of the Federal Reserve System, in the year 1962, to fail to increase the money supply, and was it sound and wise of the Federal Reserve System, in the year from February 1965 to February 1966, to increase the money supply by 6.2 percent?

I think they were wrong both times, and that the Tobin 1962-Culbertson 1967 thesis was right.

Mr. TOBIN. You are doing two things to me at once, Congressman. One is to ask me to comment on past Federal Reserve policy, and the

other is to ask me to comment on it in the particular terms in which you and Mr. Culbertson choose to define the policy.

Representative REUSS. Take them one at a time.

Mr. TOBIN. I will take them one at a time. Now as for the policy of the Federal Reserve in 1962, as I said earlier, I wish it had been more expansionary. I wish it had. That probably would have meant both a faster rate of expansion of the money supply and lower interest rates at the same time.

And if it had resulted in a 6-percent increase in the money supply, and nothing had happened to interest rates, and to investment and the use of credit and so on, then I wouldn't have been satisfied with what had happened to the money supply.

Actually the reason for the failure of the money supply to expand in 1962 was the Federal Reserve's attachment to a particular target of the bill rate, which they had adopted for international balance-of-payments reasons.

Once they had adopted that target, then the money supply expanded as fast as the banks and the economy wanted more money at a 2½-percent bill rate. They weren't controlling the money supply. They were controlling the bill rate.

If they wanted the money supply to expand faster, they would have had to accept a lower bill rate, to have pushed a lower bill rate, and they didn't want to do that for international reasons.

Now I thought then, and I think now, they were putting too much emphasis on the international reasons relative to the needs of the domestic economy. But this is a matter of whether their policy was appropriate in 1962, not whether some particular figure for the money supply was being achieved in 1962.

Now February 1965 to February 1966: We still had unemployed resources at the beginning of 1965. Subsequently we were having a rapid increase in activity, which accelerated toward the end of the year. The needs for money, therefore, expanded quite rapidly as well. Unemployment was still around 4 percent at the end of that time.

I think it would have been a mistake to take any arithmetical target for the money supply and to say regardless of the extent of the expansion of activity, and that we shouldn't provide deposits in excess of some predetermined notion of what the rate of increase in the money supply should be.

There is in fact no close statistical relationship between money supply and economic activity. If you look at the series for the money supply and for money value of GNP over the last few years, you will find that the velocity of money, the ratio of money to GNP to the quantity of money has not been constant. You would think, to hear these money supply people, that it was a simple thing.

You put in a dollar of money and you get a certain amount of GNP out of it. It is not true. The velocity of money has changed during the past few years. Moreover, it has changed in a predictable direction; namely, it has risen. That is understandable in view of the increase in interest rates which has occurred.

Neither is there any simple, close relationship between the increase in the money supply and the rate of increase in GNP. If you plot one against the other, you get a jumble of noise.

I can't understand why this idea that there is a simple close relationship between expansion of money supply and expansion of GNP has

achieved so much currency, because there is no simple striking statistical evidence which stares you in the face which would lead you to this conclusion.

Professor Culbertson said quite rightly that neither is there any evidence that there is a simple obvious statistical relationship of a measure of fiscal policy; namely, the high employment surplus or a deficit, and the level of economic activity. That is true; there isn't.

There isn't a simple relationship in either case, and the fact is that the world is just a lot more complex than that. Therefore, I think that neither the managers of fiscal policy nor the managers of monetary policy can dedicate their policy to any simple single indicator of what they ought to be doing. They have to take into account a much wider range of measures of the situation and of the markets in which they are dealing.

The demand for money can change as well as the supply, and if you don't satisfy an increasing demand for money, you are tightening the situation, even though the quantity of money may be expanding very rapidly.

You wouldn't say that a market for wheat had gotten easy just because the wheat crop expanded by 10 percent, if at the same time the demand for wheat had expanded by 15 percent and its price had risen.

Both sides of these markets have to be considered. It is certainly not true that there is a stable demand for money, so that the things would be very stable, if you just kept the supply stable.

Representative REUSS. One can agree, as I did, with what you say about money depending on both supply and demand, and what you say about monetary policy being merely one small element in the myriad of public and private things that we have to worry about.

I certainly don't accept any simplistic or mechanical notion of putting an educated horse in charge of the Federal Reserve, and having him turn out 3-percent money a year in season and out of season. But having said all that, I think we make mistakes in our monetary policy by paying little or no attention to the rate of increase of the money supply, and I cite two horrible examples—in 1962, where the Fed, contrary to your advice, didn't increase the money supply; and though you apparently don't agree with this example, the February 1965 to February 1966 period, when the Fed increased the money supply at an exorbitant 6.2-percent rate. You say that people wanted money in this period. Sure they did, and that was precisely the reason why they shouldn't have been given so much money. So I am going to think about this a good deal more, and I have gotten a great deal out of what both you gentlemen have said.

Chairman PROXMIRE. I might add that this afternoon our witnesses are two more eminent economists. We will hear my old professor at Harvard, Professor Hansen, and Professor McCracken of the University of Michigan.

I notice in their prepared statements, which I have examined Professor McCracken's statement especially, there is an extensive discussion of the same issue so we can carry on there. I want to thank you gentlemen. I do have one final question, and I don't mean to take too much time, but I have asked each economist to comment on this because we have some conflicting opinions from Mr. Martin.

Would each of you tell me whether or not you think that as Congress looks at a tax increase in May or June or in October, we should

primarily be concerned with the state of the economy, or we should be influenced to a large extent by the budgetary considerations.

Frankly, I will tell you what we have heard from economists so far. Without exception the economic witnesses have said that the status of the economy should be the determining factor. That was Dr. Burns' position and Dr. Heller's position.

But I would like to have yours, too, because I think it would be important to the Congress to know how the most competent economists in the country feel about how we should approach this tax increase. Do I make myself clear?

Mr. TOBIN. Yes. I have no hesitation in my saying that it should be decided in relationship to the state of the economy without regard for the budgetary consequences.

Chairman PROXMIRE. Professor Culbertson?

Mr. CULBERTSON. I wonder whether the proposition might be put in a more meaningful way. In a sense these are not alternatives.

Chairman PROXMIRE. I am not talking about alternatives. I am not talking about monetary policy. I am talking about a tax increase.

Mr. CULBERTSON. I mean that worrying about the budget or worrying about the economic situation are not alternatives. I think, in a sense, in order to worry about the economic situation you have to worry about the budget. That is to say, the significance of the tax increase depends also on what is happening to expenditures.

If expenditures are rising, a tax increase is something different than it would be if expenditures weren't rising. So I guess my formulation would be, look at the budget in the sense of asking what the tax increase will do to the fiscal position, and then decide what is an appropriate fiscal position in the economic circumstances.

Chairman PROXMIRE. You see what concerns me is if we look at the budgetary situation, not simply from the standpoint of the expenditure rising or falling, say we have a given assumption that we will adopt something like the President has proposed on the expenditure side, now if we anticipate that the economy is going to be moving ahead quite rapidly, we might have a surplus, even without a tax increase.

If we anticipate, on the other hand, the economy is going to be moving downhill, we might have a defict even with a tax increase.

So that under these circumstances I am concerned if we try to anticipate too much on the budget balance aspect of this, we might act preversely.

At the same time, I think that I don't want to miss anything. I don't want to miss the opinion of competent economists. I have gotten one from Mr. Tobin. Mr. Culbertson, do you see my view now on this thing?

On the assumption that we have the present level of spending that the President has proposed, many of us disagree with it but assume we kept that, and assuming that the economic outlook is bad, under these circumstances would you still persist on a tax increase? On the assumption that it is good or about the same, I presume you would.

Mr. CULBERTSON. Yes. Well, if the economic situation is really bad, I wouldn't. But I think that insufficient attention is directed to the net fiscal position, and that we use too much an implicit benchmark of "no tax change, no change in fiscal policy."

If expenditures are rising, not to increase taxes, because it isn't crystal clear that the economy will be extremely strong into the indefinite future, it seems to me puts one in an untenable position. To control the fiscal position we do have to make changes in taxes that offset changes in expenditures, and we are often too neglectful of the necessity of using taxes to offset expenditure changes.

Chairman PROXMIRE. Thank you very much. I thank both of you gentlemen very much. It has been a mighty stimulating morning. As I said, this afternoon we have two more economists coming up, Dr. Hansen and Dr. McCracken. The committee will stand in recess until 2 o'clock.

(Whereupon, at 12:25 p.m., the joint committee recessed until 2 p.m., the same day.)

AFTERNOON SESSION

Chairman PROXMIRE. We continue our hearings this afternoon with two highly distinguished economists. Alvin Hansen, Littauer professor of political economy emeritus, Harvard University, needs no introduction to this committee or this audience. He is one of our great economists and has probably done more to make known the principles of modern economics than any other single person, and I might say he was also a professor of mine at Harvard, and I am afraid that was one of the, probably one of the, few challenges in his life he was never able to overcome, because while I learned a great deal from him, I am afraid I didn't absorb nearly as much as he imparted.

Paul McCracken, professor of economics at the School of Business Administration at the University of Michigan, former member of the Council of Economic Advisers in President Eisenhower's regime, likewise needs no introduction to this committee. His incisive mind and lucid vision have benefited us on many occasions in the past.

I was honored to appear at a meeting with Professor McCracken and listened to his words of wisdom not long ago. We are mighty happy to have both of you gentlemen.

Professor Hansen, you may proceed.

STATEMENT OF ALVIN HANSEN, LITTAUER PROFESSOR OF POLITICAL ECONOMY EMERITUS, HARVARD UNIVERSITY

Mr. HANSEN. Senator Proxmire, thank you very much for those generous remarks. I am glad to appear before you and your committee and discuss the economic problems that confront us.

I shall not attempt to appraise the overall survey of economic developments and foreseeable trends contained in the January 1967 Economic Report. I shall limit myself to brief statements on two points, both related to the problem of price stability and the control of inflation.

The first point has to do with the wage-price guidelines—an extremely complicated and I may say confusing subject. I believe that the Council, in its 1962 report, wisely opened nationwide discussions of the productivity guideposts, and I am convinced that this discussion has brought into the open some of the basic principles that cannot be ignored if collective bargaining is to be conducted on lines that promote a balanced economy. But there remain some dark spots that need to be explored.

I ought perhaps to apologize for speaking on this subject at all. It is an area in which I have no special competence. It is perhaps a case of fools rushing in where angels fear to tread. I have puzzled a good deal about this matter and probably the best I can do is to raise some questions in the hope that others will dig into it a bit deeper than has been done so far.

Let me try first to put the jigsaw puzzle together. The 3.2-percent productivity guidepost was derived from the total private GNP. This is very important. This includes services as well as commodities. It implies concern about the Consumer Price Index which includes both services and commodities. It implies that if overall worker compensation—wages, supplements, and fringe benefits—rose by 3.2 percent a year and if overall income distribution—wage versus nonwage groups—remains reasonably undisturbed, then the Consumer Price Index should remain stable, given these assumptions this conclusion is, of course, correct.

But this is not what happened in 1960–65. Market forces and collective bargaining in the overall picture did not follow the guidelines. Instead per worker compensation increased by 4.25 percent per year and the Consumer Price Index rose by 1.2 percent per annum—incidentally, all my data are drawn from the 1966 and 1967 Economic Reports. In the meantime, the all commodities Wholesale Price Index displayed remarkable stability. Unit labor costs in the commodity producing industries remained stable. This implies that the percentage increases in employee compensation were offset by corresponding increases in per employee productivity in these industries.

Why did the Consumer Price Index rise by 1.2 percent while the all commodity index remained stable? The answer is, of course, as we all know, that productivity increases in the services area are meager compared with the remarkable advances made in the commodities area. Forty percent of personal consumption expenditures now go for services. This has been growing. If we apply a weight of 0.60 to commodities and 0.40 to services and if we assign a productivity increase of 4.25 percent to commodities and 1.5 percent to services, we arrive at a weighted average increase in productivity of 3.2 percent. These figures are intended only to be illustrative but they are possibly not too far from the facts, and they conform to the guidelines productivity increase of 3.2 percent for the total private economy, services included.

On balance the country appeared to be reasonably happy over the price developments in 1960 to 1965, despite the fact that the compensation did not correspond to the guidelines. Consumers, of course, grumbled and some journalists fumed about so-called inflation. But in general there was much talk about "reasonable price stability." And about one thing we can be certain: had there been a fall in the all commodities index, which we should have had if the Consumer Price Index had been stable, we should have heard a storm of protest. Falling commodity prices have always been associated with the depression and unemployment. The events of 1960–65 have shown, I believe, that the degree of restraint suggested by the 3.2 figure to some extent was unrealistic. Guidelines based so heavily on productivity increases in the services are bound to be set too low. There is, I believe, general agreement that the appropriate goal to work for is price stability in the all commodity index. This means that we must expect a rise in the consumer index of about 1.2 or 1.5 percent per annum.

Now where does this leave us with respect to the guidelines? I suggest that the implied conclusion is that we should shift our guidelines away from the productivity trend in the total private GNP, which includes both commodities and services, and turn our attention to the commodity producing industries thereby emphasizing stable unit labor costs in this area and a stable all commodities Wholesale Price Index. Alternatively we could use the Council's guidepost and add an escalator clause.

Precisely what the productivity figure in the commodities area is I am not prepared to say, but it is clearly substantially higher than the well-known 3.2 percent in the total private GNP. The figure is probably somewhat around 4 to 4.25 percent, or was at any rate in 1960 to 1965, but, of course, there will be changes in productivity increases over time, which have to be taken account of. These figures at least seem to fit reasonably well into the general picture, and are to some extent supported by admittedly inconclusive statistical data.

The guidelines are intended to help prevent cost-push inflation. They are not a substitute for monetary and fiscal policy. Monetary and fiscal policy are designed to prevent demand inflation, not cost-push inflation.

I suppose it is generally agreed by now that the guidelines approach can play a role only at critical points in the wage-and-pricemaking process, including both management and labor. A democratic society in the interest of otherwise unorganized consumers will increasingly be compelled to exercise a price and wage surveillance over economic power blocs. Government must more and more sit in at the bargaining table equipped with full information about costs, profits, and productivity.

All this becomes even more important under conditions of full employment and high-level prosperity. And it applies to all advanced countries. Western European countries have enjoyed in the last 15 years a degree of growth, prosperity, and full employment unequalled in all history. With higher employment and growth rates than ours, European price increases have also exceeded ours. In fact the consumer index has been about twice ours for 15 years. No one will deny that full employment tends to create upward pressures on prices.

At that point I might mention the fact that in the history of 75 years, prices in the prosperity phase of the cycle have on the average gone up about 3.5 percent per year, in the long history of prices in this country.

It follows that the goal of reasonable price stability must all the more remain an important objectvie of public policy. But we cannot afford to buy price stability at the cost of the 5.7 unemployment rate of 1958 to 1965. With fuller employment it will become much harder to maintain a price stability record equal to that of 1960–65.

Experience all over the industrial world seems, however, to indicate that cost-push inflation such as Europe has had does not tend to accelerate into galloping inflation. In a perfectly fluid free market we could expect a rapid escalation of creeping inflation under the impact of rising expectations. But the market is not a fluid market. Countervailing power enters into the picture. Lags play an important role. The system is a network of contracts, partly legal and

partly behavioristic. The result is a lagging adjustment to change. Fiscal and monetary restraints, imperfect though they be, play their role.

The result has on balance in most advanced countries turned out to be a moderate inflation without serious disruption of a reasonably balanced income distribution. The continued maintenance of a balanced income distribution may be even more important, possibly, than price stability itself. Instead of our term "wage-price guidelines" Western European countries use the phrase "income policy." This term seems to stress the concept of a balanced income distribution and puts less emphasis on price stability per se. An "income policy" seems to say that the question is not so much the relation of money wages to productivity changes, but rather the question of real wages to productivity increases.

Without taking a dogmatic position, I raise the question whether an escalator clause in labor contracts might not contribute to a more stable development of income distribution, especially the relation of wages to profits. If money wages and prices get out of line, profits and wages are certain to get out of balance. Would not an escalator clause help to keep wages and prices in line with each other and so contribute to a balanced income distribution?

Wage bargains influenced by apprehensions about possible excessive future consumer price increases are likely to lead to results similar to that we experienced during the past year in the case of the abortive contract—the one turned down by the union membership—between the airlines and the machinists' union. Aware of the upward trend in consumer prices, the union demanded a cost-of-living escalator clause. The airlines stood firm against this. The agreement broke down. In the new contract that was finally accepted the union demanded, and was granted, not only wage increases to offset future price increases but in addition an escalator clause as well. Had the escalator clause been accepted by the management in the first place, the outcome might have been very different.

Be it noted that an escalator by itself alone tends to restore the balance which has been thrown out of line by the excessive price. The escalator corrects the imbalance. It does not correct a new imbalance. A further imbalancing price rise may, of course, emerge either from market or administrative price forces, but the fault does not lie in the escalator.

No wage bargaining, whether or not based on guidelines however defined, can hope to command confidence in a world of uncertain price stability, unless there is some assurance that the nominal money-wage increases will have meaning in real terms.

In the 1960–65 period, for example, a wage contract based on the 3.2 guidelines was in fact eroded by the price rise to a 2.0 increase in real wages.

An escalator clause limits the buildup of explosives discrepancies in the relation of wages to profits. It tends to keep real wage movements in line with productivity changes. It acts automatically as a safety valve. It prevents the erosion of the real wages contracted for at the bargaining table. It prevents long-term contracts from getting out of date, and surely successful long-term contracts can have a stabilizing effect upon the economy.

There is, I believe, growing agreement in the Congress, if I am not mistaken, both among Republicans and Democrats that an escalator clause should be applied to the social security benefit payments and perhaps also to Government savings bonds.

There is one special matter I would like to insert here. The Council's report considers the problem whether the 1966 increase in consumer prices, which is about 3 percent, should not be added to the productivity increases in the 1967 wage bargaining contracts as retroactive pay, so to speak. Some economists have so argued.

The Council takes a different view, I think quite rightly. They argue that the 1966 consumer price increase should not be added. I agree with this conclusion, but for a different reason than that stated in their report.

I feel it should not be added because the 1966 pay hike has already offset and indeed more than offset the 1966 consumer price increase. Money wages including supplements and fringes rose by about 7 percent in 1966, a record figure.

The consumer price increase of 1966 of about 3 percent has therefore already been taken care of and more. The problem of anticipated future increases in consumer prices is, of course, rightly a matter of concern.

My second point relates to the stabilization role of fiscal policy. In general I agree very much with the Council's statement on the need for fiscal flexibility, in particular the following:

> In any over-all stabilization program, fiscal policy must play a major role. Fiscal policy is generally more even in its impact than monetary policy. Its effects tend to be more readily predictable and less subject to time lags.

It is by now, I believe, widely agreed that fiscal policy can effectively be employed to promote growth and full employment. But the machinery needed to cope adequately with short run, cyclical fluctuations is sadly missing. A continuously pursued and active fiscal policy requires something more than tax and expenditure programs designed to achieve long-term growth and full employment.

The current economic report of the President does indeed suggest one important forward-looking step. Quite apart from any change in tax structure—which is quite a separate problem—the President suggests a quick action measure to cope with possible impending inflationary pressures. He proposes, as well all know, a surcharge on the regular tax liabilities of corporations and individuals beginning July of this year and applicable for a limited period. Passage of a bill of this character is obviously relatively easy compared with a formal tax revision bill. Moreover, as conditions change, the President may alter his proposal.

Some of my best friends believe that a procedure of this sort provides adequate flexibility. I cannot agree. It fails to meet the test of a continuously active and flexible fiscal policy. That this is true becomes alarmingly apparent when we compare it with monetary policy. Imagine the Federal Reserve Board going to Congress in January asking for approval to put into effect rediscount policy and open market operations 6 months hence. This is, of course, too ridiculous even to contemplate. Indeed the Board reviews the changing economic scene day by day and week by week, and is prepared to change the discount rate and open market operations as circumstances demand.

This is flexible monetary policy. And precisely similar flexibility is needed for fiscal policy.

To achieve true flexibility the President should be granted discretionary power to impose, reduce, or rescind, as the case may require, surcharges supplementing the regular tax liabilities of corporations and individuals. Recommendations along this line have been made by your own Subcommittee on Fiscal Policy, by the Commission on Money and Credit of some years ago, by President Kennedy in his state of the Union message of 1962, and by economists representing both conservative and liberal schools of thinking.

To safeguard congressional control of taxation I should be prepared to agree that the Congress should retain the power, by majority vote in both Houses, to veto any presidentially ordered surtax rate changes.

The procedure proposed by the President in the current report will not give us the flexibility we need. Consider the situation that may well confront us this year. The Congress by late spring will be holding hearings on the proposed surcharges. There will be sharply divided opinion. Even though events may strongly indicate the need of a surcharge, action may be delayed until late in this calendar year or perhaps entirely rejected. Obviously, timing is of the essence.

If someone objects to the flexible procedure which I have suggested above on the ground that no one can be trusted with such powers, my answer is that the Federal Reserve exercises exactly such powers. It is my conviction that such powers should in a democratic society rest in the final analysis in the office of the Chief Executive—the office which alone is responsible to all the people. Once this reform has been instituted, I have no doubt that the country will quickly come to expect, as routine performance, small but reversible changes in surcharges just as changes in discount rates and open market operations are now accepted as a matter of course.

Will a flexible fiscal policy create uncertainties and destroy confidence? The Council in the current Economic Report has stated the case very well as follows:

> The flexible and continued use of stabilization policies should enable both business firms and individuals to make their economic decisions in a climate of greater confidence. A knowledge that policies are alert to changing developments should help to reduce the important uncertainties about possible fluctuations in sales, profits and employment opportunities.

Mr. Chairman, I would like to add a few comments which may possibly anticipate some questions that some of you may wish to raise later. In particular the criticism that has been directed by many against the Council with respect to the much-discussed tax increase of February last year. There was much discussion about whether or not we should have a tax increase. I would like to say a little bit about that along lines that I think have not been adequately discussed in the financial papers and elsewhere.

If you look at the price development, the wholesale price development from October 1965 to February 1966, that is a 4-month period, you will find that the Wholesale Price Index increased by 2.3 percent in 4 months. On an annually calculated basis that would be an increase of 6.9 percent.

Now that was pretty shocking, and I think was probably a very important factor in inducing a lot of people to become frightened about the situation, and to demand a tax increase.

However, when we analyze the components of that price index, we learn a rather startling thing. Prices of farm products in those 4 months increased 8 percent, or on an annually calculated basis, the fantastic figure of 24 percent, a 24-percent increase in prices of farm products in that 4-month period calculated on an annual basis. Well, this is enough to scare anybody.

But actually the Wholesale Price Index, omitting farm products and foods, rose by a very moderate amount. If these facts had been clearly in the minds of everybody discussing this situation at that time, I think it might have had quite an influence on opinion as it became apparent around February or so of 1966. Farm prices flattened out after February and then fell abruptly to normal levels by the end of the year. It was a temporary scarcity situation, not a case of an overheated economy.

Now there were restraints already present, both monetary and fiscal at that time, quite apart from any possible new tax increase. There was the very severe decline of housing, owing to the monetary policy that was pursued, and there was the increase in social security taxes and the return to excise taxes, which together made a tax increase of $7 billion, which is not inconsiderable.

I must say that I am not very happy about the kind of restraints that were imposed on the monetary side in this period, which weighed so terrifically on housing, whereas on the other side bank loans were allowed to continue to rise for the first half of the year at the same very high rate as prevailed the year before, namely, on an annually calculated basis of about $20 billion. This is the kind of discriminatory result that can follow from monetary policy, but fell peculiarly upon one part of the economy, namely, housing, in this period.

If we had had a really coordinated monetary and fiscal policy in 1965 and 1966, I should have favored relatively easy monetary policies and a tax increase in February. But this was not the situation that confronted us.

It was very interesting to note how many of the people who favored a tax increase in February in 1, 2, or 3 months began to climb off the bandwagon. If now we ask the question, "Wouldn't we be better off today if we had imposed a tax in February?" my answer would be "No."

I think the degree of restraint, though I wasn't particularly happy about the manner of the restraint, the degree of restraint, monetary and fiscal, for the year, was about right.

When you approach the peak of a long period of expansion, the degree of price increase that we had in 1966 over 1965, I would regard as moderate, indeed, it is less than the average increase per year that Western European countries have experienced in the last 15 years.

The degree of restraint imposed was not sufficiently severe, I think wisely, to prevent a tremendous increase in employment. Employment increased in 1966 by 1.9 million. Think of the impact that has upon the standard of living of 5 million people, when you include the dependents of the worker who became employed.

So far as the general mass of employees were concerned, their real wages rose at the very high figure of 4 percent. Obviously they did not suffer. The aged group is always cited. That could have been easily corrected, and we are in process of correcting it now.

During the second half of the year, we did acquire a far better balance in the mix between monetary and fiscal policy, and it seems to me that on balance we can say that despite many mistakes that were made in 1966, on the whole it has been a good year, and we are in a reasonably good position now to go forward, and whether we should have the surcharge that the President has proposed or not remains to be seen.

I don't think we ought to decide that now. This is something to be considered as time goes along and as we learn more about how the economy is going to move throughout the rest of this first half year, and how it seems likely to move by the time we get to July.

That is all, Mr. Chairman.

Chairman PROXMIRE. Thank you very much, Professor Hansen. Professor McCracken, you have a very interesting and detailed statement. You may begin.

Mr. MCCRACKEN. Mr. Chairman, I want to express my appreciation for the opportunity to appear here before this committee again today, and particularly to appear with my favorite former professor. He is not, of course, to be held liable for any of the views that I now hold. At the same time, I would certainly want to register here my own great intellectual debt of gratitude to him. Certainly you are correct that, in a very real sense, he and the fiscal policy seminar which he fathered are almost the beginning of modern economic policy.

STATEMENT OF PAUL W. McCRACKEN, EDMUND EZRA DAY UNIVERSITY PROFESSOR OF BUSINESS ADMINISTRATION, THE UNIVERSITY OF MICHIGAN

Mr. MCCRACKEN. The origins of economic instability can all too often be found in the public sector and in the operation of fiscal and monetary policies themselves. The nature of the problem of the mix or blend of monetary and fiscal policies is also not quite what is often envisaged. These two lessons of experience become particularly pertinent this year as we review economic and financial prospects and their policy implications for the year ahead.

ECONOMIC POLICY AS A SOURCE OF INSTABILITY

Our image of the business cycle has too often been that of an unruly and unstable private sector seemingly determined to pursue its erratic course, but kept more or less to an orderly path by the instruments of economic policy in the public sector.

While there is a good deal of truth to this view of the problem, the fact is that a far larger part of our problem of economic instability has come from erratic and inappropriate fiscal and monetary policy than we may like to admit. Illustrations of this abound, but two recent episodes may serve to remind us of this point. I have been very careful to choose one from a Republican administration and one from a Democratic era. Certainly the reason for the failure of the economy to regain reasonably full employment after the 1958 recession is to be found in the extent to which both monetary and fiscal policies strayed off course during those years. Clearly we should have had a substantial tax reduction in 1958 or 1959 to avoid the fiscal drag from a

rapidly widening full-employment surplus—which reached the $14 billion zone by 1960. And the 2.9 percent per year rate of growth of the money supply—defined to include time deposits—from 1955 to 1960 was obviously inadequate. Since the basic capacity of the economy in real terms was growing at the rate of at least 3½ percent per year during that period, rising unemployment was the inevitable result of this sluggish monetary expansion.

Again in recent months we have seen the economy pursue an unnecessarily erratic course because of the operations of fiscal and monetary policy—a story that, by now, needs no detailed elaboration. The rate of monetary expansion should, of course, have decelerated during 1965 as the economy regained reasonably full employment, but it was allowed to pick up speed from an 8-percent annual rate in the first half of that year to a 10.6-percent rate in the second half. Since the ongoing ratio of the money supply to GNP is fairly stable, though the visible effect on business activity of monetary changes often shows up with a lag, this accelerating pace of monetary expansion was appropriate only if we were wanting the economy to be on a 10- or 11-percent growth path well into 1966. With the economy already at reasonably full employment as we moved into last year, these accelerating monetary pressures for expansion increasingly took the form of price pressures. The 3.5 percent per year rate of rise in the Consumer Price Index during the first half of 1966 was, therefore, an almost inevitable consequence of the policies we pursued. Moreover, inflation is a process which unfolds through time. It begins with rising prices and then moves on to become rising labor costs as these higher prices become the basis for subsequent wage demands. This is the part of the process that we shall see a good deal of in 1967.

The whole problem was, of course, vastly exacerbated by the January 1966, budget message, laying out the President's program for fiscal year 1967. The underestimate of defense estimates is by now a well-explored chapter in fiscal history. The January 1966, budget message implied that purchases of goods and services for national defense by the end of fiscal year 1967 would be at the rate of not over $57 billion per year, compared with the $69 billion rate that seems probable now. With this projected slow rise to an early plateau the case could not be made for the tax increases warranted by the actual path of these outlays through the fiscal year 1967.

(Table 1 follows:)

TABLE 1.—*Purchases of goods and services for national defense*

[Seasonally adjusted annual rates in billions]

Fiscal year (1)	Implied in January 1966 budget message (2)	Actual (3)
1965	$48.8	$48.8
1966	53.0	53.7
1967	56.5	66.0
Calendar year and quarter:		
1965:		
3d quarter	49.8	50.7
4th quarter	52.0	52.5
1966:		
1st quarter	54.0	54.6
2d quarter	56.2	57.1
3d quarter	56.4	62.0
4th quarter	56.5	65.5
1967:		
1st quarter	56.6	68.0
2d quarter	56.7	69.0

Source:
Col. 2: Data for fiscal years 1965–67 are from Economic Report, January 1966, p. 59. Data for the 3d and 4th quarters of 1965 are the "actuals" as then estimated by the Department of Commerce. Quarterly data for 1966–67 represent a rough scheduling out of figures consistent with estimates for fiscal years 1966 and 1967.
Col. 3: Department of Commerce data through 1966. Data for 1967 are a scheduling that seems to be generally consistent with budget estimates for fiscal years 1967 and 1968.

The moment of truth soon arrived. Monetary policy had to regain control of an economic situation initially made hyperactive by its own excessively expansionist pace in the latter part of 1965. And it had to accomplish this at a time when credit markets were being further activated by a Federal cash budget requiring $6 billion in fiscal year 1966 and an estimated $10 billion in fiscal 1967. (In estimating the Treasury's requirements for funds from the money and capital markets, sales of loans and participation certificates must, of course, be added to the stated deficit.)

The Federal Reserve did, however, face up to the problem, reducing sharply the rate of monetary expansion—though the shift of monetary policy then inaugurated was probably too abrupt. The annual rate of monetary expansion dropped to 3.4 percent in the third quarter of 1966 and to 1.2 percent in the fourth. There was, of course, an easing of policy in December which apparently has carried through January. And we now find ourselves inevitably looking at a configuration of evidence about prospects that sometimes emerges before a real recedence in business activity.

The point of alluding to these historical episodes is not to make any partisan score here. It is simply to remind ourselves of the nature of the problem that we face. One is drawn from a Republican era and one from a Democratic administration. Moreover, we do need to remember that these were both periods when the management of economic policy was exceptionally difficult. In the earlier period there was an emergent inflation-mindedness that was beginning to have a disturbing effect on the economy and the balance of payments on current account was deteriorating sharply to a negative position in 1959. Again a year ago the problems of laying out a budget for fiscal year 1967 were formidable. We were engaged in a controversial military conflict of uncertain magnitude. And the pace of the econ-

omy in the second quarter of 1966 decelerated just when some of these basic decisions might well have been reviewed. It is understandable that the Secretary of the Treasury would use the phrase "Monday-morning quarterbacking" to describe some of the criticisms of fiscal policy last year.

Even so we must, if we are to make progress, review the lessons of experience. And one lesson we have been reminded of once again is the extent to which public policies themselves are often the source of the very instability for which they are presumed to be the solution. And this has particular implications for the strategy of policy as we look down the 1967 road.

Integrating Monetary and Fiscal Policy

Another basic point that we need to see more sharply has to do with the nature of this "mix" problem in the integrated use of monetary and fiscal policy. Too often, discussion of this matter seems to imply that these are two quite separate and self-contained instruments of policy. Like the dermatologist who can do a job with his electric needle or with his knife, so the managers of policy can make an adjustment by turning the knob of fiscal policy or the knob of monetary policy. Or they can have a neutral effect on the level of economic activity by turning one a little in one direction and the other at little the opposite way. Now, what do we mean by easing or tightening monetary policy? Often we seem to calibrate this by the incidence of unsatisfied borrowers, or simply by the level of interest rates. At this point, however, we confront an interesting fact. The ongoing ratio of the money supply to GNP displays surprisingly little variation. If we look at the last decade, except for the recession year of 1958 this ratio ranges within the comparatively narrow limits of 0.436 in 1964 and 0.420 in 1960. And the average ratio of 0.431 for the first 5 years is virtually identical with the 0.435 for the latter half of the decade. The data, therefore, strongly suggest that the economy will not stray far from the course being traced out by monetary expansion. There can, however, be a fairly wide range of budget positions consistent with a given level of GNP. Indeed, even with an expansion budget in an overheated economy, a reduced rate of monetary expansion can cool off the boom. This is almost precisely a description of events during the latter half of last year. If the ease or tightness of monetary policy is to have an ambiguous calibration, therefore, it must be in terms of the rate of growth of the money supply.

(Table 2 follows:)

TABLE 2.—*The money supply, GNP, and the Federal budget surplus*

[Dollar amounts in billions]

Calendar year	GNP	Money supply [1]		Federal budget surplus	
		Amount	Percent of GNP	Cash	National accounts
1957	441.1	191.1	43.4	$1.1	$2.1
1958	447.3	199.9	44.6	−7.2	−10.2
1959	483.7	207.9	42.9	−8.0	−1.2
1960	503.7	211.7	42.0	3.6	3.5
1961	520.1	221.1	42.4	−6.8	−3.8
1962	560.3	236.8	42.2	−5.7	−3.8
1963	590.5	255.3	43.2	−4.6	.7
1964	631.7	275.8	43.6	−5.2	−3.0
1965	681.2	300.2	44.0	−4.5	1.6
1966 [2]	739.5	321.2	43.5	−5.7	.2

[1] Time deposits are included in the money supply.
[2] Preliminary.

Source: Federal Reserve, Department of Commerce, and Bureau of the Budget.

A little easing of fiscal policy and a modest tightening of monetary policy, therefore, will not, in the end, have a neutral effect on the course of business activity. After some lag the pace of the economic advance is quite apt to settle to a lower rate consistent with the reduced rate which credit and the money supply are rising.

Fiscal policy, of course, still has a role in stabilization. For one thing, it can activate the economy to expand more promptly and more vigorously. The 1964 tax reduction, for example, certainly produced a more vigorous and prompt expansion than we could have achieved even if our external payments problem had permitted a more aggressive use of easy money. On the other hand an easier fiscal policy not validated by a more rapid monetary expansion is not apt to have more than a transient effect.

A second role for fiscal policy is essentially monetary in character. While the pace of monetary expansion may set the basic course that the economy will tend to follow, the state of the budget has a powerful effect on capital markets and the level of interest rates. And this market for credit—like other markets—cannot perform its allocative functions smoothly if subject to large displacement influences—in this case from the fiscal operations of Government. Moreover, if the pressure of swollen demand against limited supply gets too intense, political pressures to expand credit more rapidly begin to mount.

This is the transmission process by which excessive budget deficits tend to produce inflation. Thus, a major responsibility of fiscal policy is highly monetary in character. And, in a world of fixed exchange rates and convertible currencies, this is particularly important. We must not only achieve full employment but we must do so with a level of interest rates consistent with those prevailing throughout the industrial world. Only with the right fiscal policy can we hope to achieve both the rate of monetary expansion and orderly credit markets consistent with the full-employment growth path for the domestic economy and the level of interest rates consistent with equilibrium in our external payments.

Thus, in a sense, we now see it as the task of monetary policy to set the growth path for the domestic economy, and it is the task of fiscal policy to achieve the money and capital market conditions that will validate this course.

Operational Implications for Policy

What are the implications of these general comments for policy in 1967? The most urgent requirement is that we remove some of the economic uncertainty and instability that emanate from the public sector itself. Here we are on the firm ground of section 2 of the Employment Act of 1946. This section really calls for decisions about fiscal, monetary, and other Government economic policies to be consistent with the characteristics of an economy operating at reasonably full employment.

Obviously this does not mean that monetary policy can be automated. At the same time we should be able to sail this channel within narrower tolerances than recently, when monetary expansion varied from a 10.9 percent annual rate in the fourth quarter of 1965 to a negligible 1.2 percent rate a year later.

The major problems here, however, are to be found in budget policy. Suppose that we use the so-called high-employment budget surplus—the difference between expenditures and the receipts the tax structure would have produced at reasonably full employment—to calibrate the operation of fiscal policy. During the last decade fiscal policy was, by my count, being operated perversely in 4½ years of that 10-year span. From late 1956 to the end of 1960, the high-employment surplus rose sharply to the $14 billion zone, this during a period of sustained unemployment. From late 1962 to the end of 1963 it again moved up to the $14 billion zone even though business conditions were deteriorating—the unemployment rate was higher at the end of 1963 than in mid-1962. And the sharp decline in this high-employment surplus in the second half of 1965 was clearly inappropriate for an economy reentering the zone of full employment. In only 5½ of the 10 years could the operation of fiscal policy be said to be reasonably consistent with the needs of the economy. This is a score of 55, which, in academe, is pretty close to a failing grade. Moreover, the fact that uncertainties about the budget constitute one of the greatest imponderables in appraising business and economic prospects exacerbates further this perverse influence for the orderly course of the economy.

What can or should be done?

First, the whole budget information system needs to be overhauled. No present concept of the budget deficit measures the draft of the Federal fiscal operations on the money and capital markets. The budget on a national income and product basis is given favorable billing in the budget message, but estimates of purchases of goods and services for national defense on this basis are not to be found in the 478 pages of this document. The President is to be commended for recommending a much-needed, thorough, high-level conceptual review of these matters.

Second, the paucity of information about where the budget itself is going is almost a disgrace in our economic information system. The Federal Establishment must begin to provide more frequent estimates of budget prospects for the year or so ahead. The Federal Government during the year calls regularly upon businesses to estimate their future capital expenditures, their expected sales, and their planned inventories. It asks households about their income

expectations and their plans to purchase new cars, used cars, new homes, used houses, washing machines, refrigerators, dishwashers, and a wide array of other items. And this exceedingly useful information is regularly made available through Federal Government publications. About its own fiscal plans and expectations, however, we have only the January budget messages and occasionally a midyear review—even though those transactions are rapidly approaching $200 billion annually.

As a regular part of our economic information system the Bureau of the Budget at the end of each quarter should give a quarterly projection of receipts and revenues through the fiscal year covered by the latest Budget message. Thus the shortest horizon for this report would be three-quarters for the one issued in October. These projections at all times will be difficult to make, and at times they will be off target, as is true occasionally of Government surveys about buying plans or inventories, but this fundamentally is merely asking the Federal fiscal establishment to begin to report for its own operations what it has long requested from households and businesses.

In addition to this short-run projection, the President should also be called upon to present in each Budget message something like a 5-year budget projection. This has been shown to be technically feasible. Naturally the arithmetic for any year will undergo modification over the 5-year span, but this is also true of long-range business projections. Even so, the quality of budgetry will itself improve by the administration's thus having to work out and to articulate its views about where where the budget ought to be going in the several years ahead. And, the public is entitled to more information than it is now getting about the administration's present thinking about budget strategy for the long run.

The Year Ahead

A few quick comments now on policies for the year ahead. First, monetary expansion must move along a roughly 6 percent per year growth path if our economy, whose productive capability is rising by close 4½ percent annually, is to have the credit requirements for reasonably full employment. While specific problems will require the Federal Reserve to sail a little toward one side or the other of this channel during the year, we should be able to avoid the extremes of 1965 and 1966.

It should also be a year of somewhat lower interest rates and easier money and capital market conditions. The decelerating rate of increase in capital outlays here, together with the certainty that the rate of inventory accumulation is going to be considerably less at least than it was in the latter half of last year, and also the economic slowdown in Europe (particularly in such countries as the United Kingdom, Germany, the Netherlands, and Belgium) gives us some more scope for lower rates than perhaps seemed probable even in the latter part of last year.

The major policy question, of course, has to do with a tax increase. This fiscal year disbursements are projected to exceed revenues by $10 billion assuming the tax increase, and with no tax increase this would rise to $14 or $15 billion in fiscal year 1968. In each case 35 to 40 percent of this would be covered by sales of financial assets.

Federal budget cash deficit

[In billions of dollars]

Item	Fiscal year—		
	1966	1967	1968
Stated deficit plus no tax increase	$3.3	$6.2	$9.5
Plus sales of financial assets	3.0	3.9	5.3
Equals budget financing requirements	6.3	10.1	14.8

Source: Budget message, January 1967, pp. 448 and 467.

This would be too large a deficit for the probable state of the economy. The first question is the extent to which therapeutic action ought to be taken on the expenditure side of the budget. It is useful here to put the proposed budget in terms of the annual rate of increases proposed. If we schedule out proposed expenditures for fiscal year 1968 on a quarterly basis, by the final quarter of that fiscal year total outlays would be at about a $174 billion annual rate (on the national income basis). They would thus be rising at the rate of 9.3 percent per year from the level of the last quarter of last year, in other words, the last quarter of 1966. And the proposed annual rate of increase for nondefense outlays is almost 11 percent—considerably more than double an essentially noninflationary rate of growth for GNP.

(The table referred to follows:)

Federal outlays on a national income basis

[Seasonally adjusted annual rate in billions]

Item	1966, 4th quarter [1]	1968, 2d quarter		Annual rate of increase (percent)	
		Budget message [1]	Suggested	Budget message [1]	Suggested
National defense [2]	$65.5	$73	73	7.5	7.5
Others	86.7	101	96	10.7	7.0
Total	152.2	174	169	9.3	7.2

[1] Projections that on a quarterly basis seem roughly consistent with fiscal year estimates in the budget message.

[2] National defense purchases of goods and services.

Source: Department of Commerce for 3d quarter 1966 data.

What, therefore, would the budget look like if the $5 billion or so of fiscal restraint were applied to nondefense expenditures instead of to taxes? The fact is that these outlays for services supplied by the private sector could still rise at the annual rate of 7 percent—still 50 percent higher than the noninflationary growth rate for GNP.

Thus limiting the rise in these nondefense outlays is a reasonable budget target. While expenditures trends cannot be sharply deflected in the short run, the end of fiscal year 1968 is over 16 months away. And present economic uncertainties give us time to achieve this somewhat more moderate growth in these nondefense outlays.

Would this more moderate rise be consistent with how people want to divide their incomes between the public and private sectors? This is really the fundamental expenditure question. In one survey-study,

for example, people strongly supported increased Government spending on a wide array of programs. When, however, they were asked if the Government should spend more even if taxes had to be increased, no program then received support from as many as 50 percent of the respondents. And the really meaningful cost-benefit calculus comes only when the inevitable tax costs are coupled with the expanded programs—as the administration's need for recommending tax increases again this year makes clear. The evidence does not support the view that people prefer a substantial reallocation of their incomes to the public sector—much as some of us in the public sector would find it attractive to have an enlarged share of the national income come our way. And I might add that a professor in a State university is, of course, in the public sector. Thus an increase in nondefense spending at the rate of 7 percent per year, the evidence suggests, is more in accord with the preferences of people about the division of their incomes between public and private uses than the 11-percent rate proposed by the administration.

(The table above referred to follows:)

U.S. attitudes toward Government programs

[Percent of spending units]

Program	Should spend—	
	More	More, even if taxes are raised
Help for older people	70	34
Help for needy people	60	26
Education	60	41
Hospital, medical care	54	25
Defense	47	30

Source: Eva Mueller, "Public Attitudes Toward Fiscal Programs," Quarterly Journal of Economics May 1963, p. 215.

Conclusions

This is a time when there is real need to make progress on operational aspects of economic policy, and there is receptivity to change. The single most important requirement at this juncture is to take some of the uncertainty and instability out of monetary and fiscal policies. First, monetary authorities must guide the monetary expansion somewhat more steadily along the full employment growth channel.

Second, the budget, and absence of regular information about the budget, has itself been a major problem for economic stability. We should initiate some steps to correct this. The Federal Government should begin to provide the regular and continuing projections of its own fiscal activities for several quarters ahead that it has long requested from key elements of the private sector. And each budget message should contain a 5-year projection showing the administration's present thinking about where the budget is going in the longer run.

Third, with a rise in nondefense spending at the rate of 7 to 8 percent per year through mid-1968 (instead of the 10–11 percent annual rate proposed by the administration), a tax increase can be avoided, or in any case, that issue is not one of immediate importance to economic policy.

(The attachment follows:)

APPENDIX

Quarterly scheduling out of Federal receipts and expenditures on a national income and product basis

[Seasonally adjusted annual rates in billions]

Fiscal year	Expenditures			Receipts	Surplus
	National defense [1]	Other	Total		
1966	$53 7	$78. 6	$132 3	$132. 6	$0. 3
1967	66. 0	87. 6	153. 6	149. 8	−3. 8
1968	71. 5	97 1	169 2	167. 1	−2. 1
Calendar year and quarters:					
1966:					
3d quarter	62 0	83 8	145 8	145 3	−. 5
4th quarter	65. 5	86. 7	152. 2	148 3	−3. 9
1967					
1st quarter	68 0	89. 0	157. 0	151. 3	−5. 7
2d quarter	69 0	92. 0	161. 0	154. 3	−6. 7
3d quarter	70 0	94. 5	164. 5	162. 5	−2. 0
4th quarter	71 0	97. 0	168. 0	165. 5	−2. 5
1968:					
1st quarter	72 0	99. 0	171. 0	168. 5	−2. 5
2d quarter	73. 0	101. 0	174. 0	171. 5	−2. 5

[1] Estimated purchases of goods and services only.

Source: Budget message, January 1967 for fiscal year data. Calendar year 3d and 4th quarters data are from U.S. Department of Commerce. Quarterly data represent a pattern roughly consistent with preliminary estimates for the 3d and 4th quarters of 1966 and data for fiscal years 1967 and 1968 in the budget message.

Chairman PROXMIRE. Thank you very, very much, both of you distinguished gentlemen. This is mighty enlightening. Professor Hansen, did you say whether you were for a tax increase this year, or do you care to say?

Mr. HANSEN. At the present time I wouldn't like to say. I would like to wait.

Chairman PROXMIRE. At any rate you will not say that you are for one, so you are presumably of the wait and see school?

Mr. HANSEN. Right.

Chairman PROXMIRE. Let me ask you this, and as long as I am asking you this, I would like to ask both of you gentlemen to comment on it.

What should be the factors that Congress should pay attention to in determining whether or not there should be a tax increase? Should the decision be entirely on the state of the economy or should we consider the budgetary situation, that is whether or not we may have a deficit in the budget?

Mr. HANSEN. My answer unreservedly is on the state of the economy.

Chairman PROXMIRE. Thank you very much. Professor McCracken?

Mr. MCCRACKEN. If we had the capability for flexibility in fiscal policy which Professor Hansen outlined in his statement, and with which I would agree, then the question of a tax increase centers entirely around the state of the economy.

We don't have this degree of flexibility at the present time, and I suspect probably we shall not have it this year. Therefore we probably can't entirely ignore the state of the budget. But the important thing there I think is more nearly what is happening to the full em-

ployment surplus and whether the projections one is able to make between probable revenues and probable expenditures show a gap.

Chairman PROXMIRE. Full employment surplus is a function of the state of the economy, is it not?

Mr. MCCRACKEN. Precisely.

Chairman PROXMIRE. Presumably it is conceivable certainly that the tax increase could be counterproductive even from a strictly budgetary standpoint. In other words, you could increase taxes and have a lower revenue result, if it tended to depress business conditions.

I would like to come back to you, Professor Hansen, and say hail to you. I am just delighted to see somebody come in with something other than orthodox views that we have heard over and over again, which I disputed but ineffectively that wage-price guidelines are dead because you cannot put a cost-of-living escalator into wage-price guidelines without having an engine of inflation.

Even the staff of this committee keeps telling me I am wrong on this, and they are right on almost everything, so maybe I am wrong. And the Council of Economic Advisers—every economist that has come up has insisted that you cannot take a wage-price guideline of 3.2, tack onto that any significant part of the cost of living without ending up with an inflationary situation.

You flatly refute this. You say as I understand it that you can have the 3.2 or whatever the productivity increase is, and add on that a cost-of-living escalator, and that that simply takes account of what has happened before. It should not result in an increase in the cost of living in the future, is that correct?

Mr. HANSEN. Right.

Chairman PROXMIRE. How do you answer the argument that they make over and over again, whether this should be the situation, it is likely to be the situation, because if you have the expected increase in the cost of living this year of 2.5 percent, and add on, say, a 3.2-productivity increase, you would then permit a 5.7-percent-wage-price guideline, and isn't this likely to have some effect in pushing up prices?

Mr. HANSEN. As I understand the argument, those who believe that it starts a wage-price spiral, it is this: The escalator brings the wages up in line with profits broadly speaking, in line with a stable income distribution.

Then the argument of my opponents is well, when that happens, when they have got back to a balance, then here comes along administered prices, and they shoot the price up to maintain the higher profits they had so long as the lag prevailed. And if the administered price is increased in that manner, it then creates an imbalance which again calls upon the escalator to come into action to create a balance again. If now, then administered prices come in, this creates a new imbalance and up goes the spiral.

But I say the trouble there is that when the balance is reestablished by the escalator, administered prices come in and create a new imbalance, and that is the thing that should be opposed rather than the escalator.

Chairman PROXMIRE. We wish there were no administered prices. We wish we had some way of eliminating them.

Mr. HANSEN. Yes.

Chairman PROXMIRE. But in a reasonably short run, it is pretty hard to see how we are going to do that.

Mr. HANSEN. Yes. Of course you are then in the situation in which there is no solution except price controls, and so on.

If the economic power blocks step in, and all the time create an imbalance by boosting their side of the income, why you can of course restrain their activities through monetary and fiscal policy, but are likely under those circumstances to create undue unemployment, because already your administered prices and your wages have been shot out of line, and if now monetary and fiscal policy refuses to go along with that and to validate those increases, then you are going to create unemployment. This is the problem that confronts all countries.

Chairman PROXMIRE. The thing to keep our eye on in your view is the real, keeping real income in line with productivity increases?

Mr. HANSEN. In line.

Chairman PROXMIRE. Unless you do, in a way you are cheating labor. In other words, it was most transparent last year. If we have a 3.3-percent increase in the cost of living and a 3.2-percent increase in wages because of productivity, you have a decline, an actual decline in real income.

Mr. HANSEN. Right.

Chairman PROXMIRE. And under these circumstances the only way you can have a fair productivity increase is to make allowance with an escalator.

Mr. HANSEN. Right. My point is that the escalator is simply reestablishing a balanced income distribution. It does not itself add to aggregate income. It only redistributes income.

But now when the administered price comes along and creates a new imbalance, and your escalator again tries to correct that, then you are on the spiral all right, and it is the administered price increase which causes the imbalance. It is the culprit, not the escalator.

Chairman PROXMIRE. Congressman Reuss and I have been working on something, trying to get some kind of a practical solution here. The administration, as you know, just walked away from the wage-price guidepost, the specific post this year, and they are supported by Walter Heller and other distinguished economists.

We have been wondering whether or not we could get some compromise, some practical acceptance of maybe a 5 percent or maybe a 5½ percent, which would be close to what you suggest, guideline, which in my judgment at least would be better than nothing.

Mr. HANSEN. Yes.

Chairman PROXMIRE. If you have nothing, then you have a situation where you are likely to get more cost-push it seems to me than if you have something, especially when you can justify it as you do so well, by saying let's put it squarely on a recognition of real income matching productivity increases.

Mr. HANSEN. Right.

Chairman PROXMIRE. Do you agree with that, as a practical matter, not as a matter of theory now, but as a practical way of achieving greater price stability?

Mr. HANSEN. Yes, I agree. Mr. Chairman, my analysis is based on theory, and I think we should switch from the productivity of the total private GNP to productivity of the commodity-producing industries. That makes a higher figure than the 3.2 percent, and I think it is more realistic, because I think all we really expect to do, and I

think all we ought to do, is to try to stabilize the wholesale price index, not to stabilize the consumer index.

If you stabilize the consumer index, the all commodities wholesale price index would fall, and I think all experience shows that when entrepreneurs, producers are up against a proposition of falling commodity prices, then you are in trouble.

The proper goal of price stability is stabilization of the all commodities wholesale price index, and that is what we got in 1960–65, by accident, not because of the guideposts, because the employee compensation exceeded by a good deal the guideposts in those years, and gave us stability in the wholesale price index, and with an increase in consumer prices of 1.2 percent a year a real wage increase equal to the overall productivity of 3.2 percent in the total private GNP, exactly as in 1960–65. In the event that the consumer price index should rise more than 1.2 percent, the escalator would come into play.

Chairman PROXMIRE. Yes, but didn't we have a situation, too—the staff points this out to me—that the guideposts only really applied to workers in the manufacturing section, and the production workers, and their average hourly increase was only 3.6 percent, not four and a fraction percent.

Mr. HANSEN. What year is that?

Chairman PROXMIRE. This was last year. Therefore the contention that they don't have a little catching up to do wouldn't hold, because they would have in that particular area.

Now it is true that the overall compensation is increasing at 6½ percent, much of this because people were moving from low-paid, low-income work, especially on the farms, into higher incomes.

Mr. HANSEN. Right. That is involved in the rise in productivity. I think for the period 1960–65 the productivity figure is more nearly 4 percent and possibly a little bit more than 4 percent.

Your figure is quite right for last year, but for the whole of the period 1960–65, it was—I don't have the figure here, but as I remember it—it was 4 percent or a little bit more than 4 percent.

Chairman PROXMIRE. I would like to ask you, and perhaps Dr. McCracken would like to get into this too, because I noticed, Dr. McCracken, in the course of your presentation you criticized our policies in late 1965 and early 1966 as being inflationary. I thought that Professor Hansen indicated that he thought that maybe those policies at least in 1966 weren't quite so bad.

I would like to ask you, Dr. McCracken, in answer to the point that I thought Professor Hansen raised very, very well, much of the rise in prices in late 1965 and throughout much of 1966 were in food prices, which are not really sensitive or are not so sensitive to demand pressure.

Mr. HANSEN. Right.

Chairman PROXMIRE. With the results in production policies and various other factors. What is your answer to that?

Mr. MCCRACKEN. My concern with what happened in 1966 is really not so much the magnitude of the rise in the price level. I suppose we would like to have had it a little smaller, but I wouldn't consider this my major concern about the performance.

It was merely that we did generate the kind of accelerating pace of the economy which then required a reversal of policy which has brought us at least pretty close to the brink of a recession here in 1967.

Now so far as the price level is concerned, there were certain aspects of the inflationary picture there that were, of course, disturbing. There was an emergence of concern on the part of consumers about the prospects for the price level. Perhaps this was reflecting the general discussion about it more than any substantial concern.

This was undoubtedly part of the deterioration in sentiment about whether this was a good time to buy, the kind of things picked up by surveys at the Survey Research Center at the University of Michigan. This in turn was perhaps part of the more sluggish demand evident now in durables and in automobiles. But my concern there is more with the uneven course of the economy that was created than simply the magnitude of the price rise.

Chairman PROXMIRE. Unfortunately my time is up. I will be coming back.

Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman. I enjoy being here this afternoon and hearing you two gentlemen who are appearing as the afternoon panel before the Joint Economic Committee. I wish there were more of the press here because you have both made thoughtful and excellent statements. Incidentally, I didn't realize that you were professor and pupil. It is a rather interesting relationship.

Chairman PROXMIRE. If the Congressman will yield for just a minute to observe the distinguished Frank Porter of the Washington Post is here, giving complete coverage to this hearing this afternoon. I am delighted to have him here.

Representative WIDNALL. I am glad, too. We just have some remarks as to the recent contest in Illinois. There was some talk that you should elect the professor and not the pupil. I don't think we have to choose here between the professor and the pupil.

Mr. MCCRACKEN. I will let him run.

Representative WIDNALL. We appreciate your remarks very much, and I know they add a great deal to the fund of knowledge we are gaining through these hearings.

The question of inflation, the question of cost increases and tax increases certainly has been gone into by many people, and I still can't get in my mind how our cost index or price index is accurately reflecting some of the changes that have taken place in the economy with respect to everyday expenditures.

A cigarette tax will go up by 1 cent, and you go to buy a package of cigarettes and the package will have gone up by 5 cents. Now this is a tremendous change in costs. The same thing happens with automobile repairs. It happens with respect to going into a service establishment, such as a barbershop, a beauty shop, places like that.

I just don't see the things that are normally used by the average individual as being reflected in the index that is shown to the people that says, well, it only went up 0.05 percent or it went up 0.07 percent.

This may apply to some big items across the board, and it may average out, but in the everyday cost of living, I think we ought to have some kind of reflection of that, and I am sure it would show a far greater increase than has been shown in the past. Do you think there is any validity to what I am talking about?

Mr. HANSEN. I am not sure that I see that there is. How about that, Professor McCracken? How would you answer it?

Mr. McCracken. This question about whether the indexes appropriately measure what is really happening to the cost of what people buy is one which has been examined periodically. I think there is a general agreement that the indexes over time overstate the rise in the price level, but that is a long-run matter, not the shorter run thing.

The BLS tries to obtain actual prices that people are paying. If the cigarette tax goes up 1 cent and the price of cigarettes goes up 5 cents, it would be the 5 cents and not the 1 cent that would be factored into the index. But I am really not an expert on these price indexes.

Representative Widnall. How much reflection is there in that of the local real estate taxes? I think in New Jersey particularly now they are almost becoming confiscatory with respect to many, many homes that have been owned for years, where the people have paid off their mortgages and they can't afford to live there any more because of the tremendous increases in real estate taxes, and these are not 1 percent, 2 percent or anything like that. It is hundreds of dollars, in some cases thousands of dollars.

Are they reflected? And this is the ordinary cost of living for many, many millions of our citizens.

Mr. Hansen. One point Professor McCracken mentioned, the cost of living in one respect overstates the actual cost properly considered.

If a sales tax is imposed, that is included in the cost of living index. Suppose that sales tax, however, has been imposed in order to furnish a new public service. That ought not to be included in the cost of living. Yet it is.

Now this overstates the cost of living. If I buy two suits of clothes, two suits instead of one, that doesn't mean an increase in the cost of living. If you give new services, additional services, and you finance it by sales taxes, the cost of living has not gone up. Yet we count it as having gone up. There our figures overstate the fact.

Representative Widnall. Are these figures related to real wages?

Mr. Hansen. No. I am now here merely measuring the money costs. That is what they do measure, the money costs of what consumers buy, and it overstates it in the respect, that it includes all sales taxes.

Now if a sales tax is increased in order to finance this same old service which now costs more money, because wages have gone up, salaries have gone up, then it should be included. But if it finances, as it very often does, new additional services, it should not be included.

Now there is the offset that if an increase in the income tax finances new services, that increase is not counted in the cost of living index. Increases in income taxes, are not counted in the cost-of-living indexes. Increases in sales taxes are counted. So there is something of a balance there.

Nevertheless I don't know exactly how the balance comes out, but certainly so far as sales taxes are concerned, which is becoming very important in the country, I think by and large those sales taxes are financing new services, and ought not to be included in the cost of living, and yet they are. The figures overstate the cost-of-living increase.

Representative Widnall. Do you have any comment on that, Professor McCracken?

Mr. McCracken. Not particularly except I believe in the Economic Report this year the Council on Economic Advisers does allude to certain aspects of what you are talking about.

Mr. HANSEN. The figure was smaller than I had anticipated, 0.02.

Mr. MCCRACKEN. Two-tenths of a point I think.

Mr. HANSEN. Much smaller than I had thought.

Mr. MCCRACKEN. But how to handle such things as interest rates or mortgages, taxes and that sort of thing are difficult matters in the construction.

Representative WIDNALL. When you go into a restaurant, you see the price of particular dinners raised from, say, $3.50 to $3.75, or from $3.75 to $3.85, these seem to reflect much more than 0.1 percent or 0.05 cost-of-living increase.

This may be just unusual with respect to my own particular case in the restaurants I patronize, but I'm sure it happens in restaurants of all kinds throughout the whole United States, and I know they just don't seem to be on any 3.5 percent guideline.

The increases that are taking place are far more than that. I just can't square what I see in the papers with what I see in my own bills, what I see in the bills of other people, including low-income people, very low-income people.

Mr. HANSEN. I appreciate that. I sometimes feel the same way myself.

Representative WIDNALL. What can we do to encourage more people to get into the services areas, to help stabilize prices in those areas?

Mr. HANSEN. Spend more money on educating doctors and nurses than we do.

Representative WIDNALL. How about servicemen such as television repairmen and the like? You have got the same problem there. It is not just in a specialized profession where you have to have a 4-year education or a college education.

It seems to me that you don't have the element of control over those prices that you do have reflected in trying to handle major wage or management and labor agreements, such as the things that are coming up right now.

Mr. HANSEN. I think scarcity is the main thing. We don't have an ample supply of people in the service industries, and we have to create an additional supply. It costs money to do it.

Representative WIDNALL. But you do have certain things, too, with respect to some of these other areas that are not the big major industries, where the restrictive labor practices that prevent people from getting into it, or discouraging people from getting into it, take place.

Mr. HANSEN. Right.

Representative WIDNALL. Shouldn't we take a look at that, too?

Mr. MCCRACKEN. This whole area of restriction on mobility of of labor is certainly one that needs to be explored. Of course, I think we have to recognize that one of the restrictions on mobility has to do with prestige.

We may be moving into an economy where the blue-collar worker will have to be paid more than the white-collar worker, because the latter takes part of his income in prestige as it were. We certainly see this at the educational level, with the enormous pressure to get into college and on into a white-collar occupation. But there are a lot of viscosities in mobility here, a lot of restrictions of various kinds, some formal and some informal.

Representative WIDNALL. In closing I would just like to make this comment. We are now having on Capitol Hill a great deal of effort to get truth in lending and truth in packaging and truth in this and the other, truth in green stamps and other things as far as the American people are concerned.

I think one of the most urgent things we need is truth in government, and this has to do with our budget, our fiscal policy, our monetary policy, coordination and correlation of the two together, so that we do know where we are going and we don't get some of the legerdemain that has taken place over the last few years.

Now all of us are concerned with the estimates as to the spending in Vietnam, and I think there are some things right now in the budget, and I hope that all of you who have the expertise outside of government will continue to make the great contributions you have been making, by an honest appraisal of where we are going and what we have been doing and where we ought to go, in order to try to do a better job than we have been doing.

Thank you.

Chairman PROXMIRE. Congressman Reuss?

Representative REUSS. Thank you, Mr. Chairman. Mr. McCracken, you set forth the philosophy you presented today in one sentence of your statement where you say:

> Thus in a sense we now see it as the task of monetary policy to set the growth path for the domestic economy, and it is the task of fiscal policy to achieve the money and capital market conditions that will validate this cause.

You have made an extremely cogent case for that. I take it that you would not want to overplay this point. Let me tell you what I mean.

You would not want to make fiscal policy exclusively the task of arranging the Government surplus or deficit in such a way as to not vitiate your monetary policy.

That is certainly an important task, and you make that case extremely well. But a wrongheaded fiscal policy could, in the future. as it has in the past, make us depart from our maximum production, purchasing power, and employment goals.

For example, if you overtaxed people at a particular point, you could reduce the demand and thus, despite a good sensible monetary policy, produce a result one didn't want.

Mr. MCCRACKEN. Oh, yes.

Representative REUSS. You do therefore include this little emendation to your statement?

Mr. MCCRACKEN. Yes. When I used that term "thus in a sense," I put this in advisedly. In other words, what I was trying to do is emphasize there that fiscal policy has a greater monetary dimension than perhaps we have always realized.

Representative REUSS. I think you are absolutely right.

Mr. MCCRACKEN. That was the only point.

Representative REUSS. Let me now apply that as you do to the situation confronting us. It seems to me that what you are saying is that we need a monetary policy of moderate ease in the year ahead. You talk about something like a 6-percent increase in the money supply, defining money supply as ordinary money supply plus time deposit.

Mr. MCCRACKEN. Plus time deposits, yes.

Representative REUSS. Which would work out at something like three and three or four and two.

Mr. MCCRACKEN. Something like that.

Representative REUSS. Give or take a percentage point. Then you talk about the projected deficit in the months ahead, and you give as your judgment that it is about $5 billion more than you would like to see from the standpoint of not vitiating that monetary policy.

I won't at this time comment on the sociological value judgment which you make, and which we want you to make, as to whether this $5 billion in deficit should be saved by taxing that much more or spending that much less. Put it to one side for the moment.

Whichever way we elect to apply your $5 billion thesis, isn't it going to have an effect over and beyond the wholesome effect that you want; namely, not to vitiate monetary policy. Isn't it going to have an effect on the demand side, and whether we adopt the President's 6-percent surcharge and keep spending where he wants it, or whether we cut spending $5 billion as you would prefer, isn't this likely to have a possibly untoward effect on total demand which might produce the worst of both worlds; namely, tight money and some inflation, and also a deficiency of demand which would increase unemployment?

I will now come to my point before asking you to respond, and that is this. Wouldn't we be better off agreeing, as I tentatively do with your, "We must decrease our deficit by $5 billion," wouldn't we be better off, and there still is time, by making an all-out gung ho effort to close tax loopholes, and thus accomplish your preferred fiscal role, without at the same time investing that fiscal role with a counterproductive byproduct role of overreducing demands?

There is, I should think, $5 billion to be found in plugging tax loopholes, such as oil depletion allowance, capital gains abuses, abuses in the income tax exempt privileges of States and localities, estate tax loopholes, et cetera. Why therefore, not find your $5 billion first by an all-out attempt to close loopholes and repair the revenues in that way?

If you fell short of the $5 billion by a billion or two, then my quarrel with you about should it be in spending or an across-the-board tax increase would be markedly less, and at that point I might quite well agree that in space, in certain less essential nondefense programs, and I should think in defense too, we could readily find that $1 or $2 shortfall. Do you see what I am driving at?

Mr. MCCRACKEN. Yes, I do. Well, let me just make two or three points. I am not sure that they will be well organized here.

My first point would be that in looking through the tops of our bifocals at the whole budget picture, a key question in any budget is what budget will accurately reflect the preferences of people about how they want to allocate their income and their resources between the public and private sector.

As I look at what fragmentary evidence we can bring to bear on this, I don't interpret this evidence to suggest that, say, a 7-percent-per-year rate of growth in nondefense spending would be out of line with this.

Now point No. 2 is that for technical reasons it is true that a reduction in spending, or a reduced rate of increase, is probably apt to have a somewhat more restrictive effect on the level of business activity than

an increase, a corresponding increase in taxes. At least this would be my own expectation.

Representative REUSS. Some of our witnesses have said that they think it is "even-Stephen," either way.

Mr. MCCRACKEN. I don't think this is a major—I don't think this question as to whether you go the tax route or the expenditure route is apt to hinge on that difference. But if I had to array them, I would put the reduction in expenditures first.

Now on the question of taking the route of closing loopholes and achieving the total fiscal result in that way, there is always a strong case for this sort of thing.

As a matter of fact, if I remember correctly, I think the estimates are that about 50 percent of the national income now in one way or another is not subject to the income tax.

There would be a good deal to say for having a simple arrangement by which you don't have any deductions at all. In other words, the whole national income is going to be the base for the income tax. But we are getting deep into equity questions, which of course must be raised in any kind of tax change.

At the same time, I think it is operationally useful to make a distinction between an effort where you were trying to reform the tax structure in the interests of equity, and this issue of how we can make the operation of fiscal policy more fluid, more flexible, more responsive to changing economic circumstances.

Representative REUSS. Could I interrupt at that point? I raised the question of plugging tax loopholes, not solely from the standpoint of equity, although that is important, but particularly, from the following standpoint.

If you find your $5 billion that you want to take off the deficit, because you don't want to have fiscal policy vitiate your new sound monetary policy, you might very well achieve an untoward effect that you do not want on reducing effective demand. Specifically, if one takes the tax increase route, the consumer whose tax goes up is going to buy less, and the businessman whose tax goes up is going to invest less.

If you look, however, at the air pockets in the system, which are represented by the loopholes, you do achieve your revenue-repairing objective, but you don't, except in a minimal way, chill off demand. You don't chill off consumer demand in any meaningful way at all, and as far as investor demand, there is an awfully vague relationship between these loopholes and the propensity for investors to invest.

I thank you for allowing this interruption, but I wanted to indicate that I wasn't thinking primarily of equity here. I was thinking of how we get and keep full employment without inflation.

Mr. MCCRACKEN. Yes. Well, the question about the extent to which taxation to achieve equity and tax actions simply in response to changing economic circumstances is one that is very difficult to give an unequivocal answer to.

In a sense, one can say that the only time you can move toward closing loopholes and whatever things you want in the tax structure for their own right is when you are changing taxes. Therefore, if you were going to changes taxes for any reason, you ought to try to do what you can to move in that direction.

At the same time, these tend to be fairly slow going affairs. For that reason I guess for stabilization purposes I would tend to think more in terms of some relatively simple change, such as the surtax route.

The current state of the economy, as I indicated at the outset, is such that I don't think we need to be in any hurry to move in either direction, for that matter.

Representative REUSS. One thing we could do would be to stretch out the expenditures so as to save on the expenditure side. If we get going now on an administration tax loophole plugging program, we might have some political things working for us.

Those whose expenditures were being stretched out would then suddenly be quite eager to have the loopholes plugged, and the loophole pluggers might hear about it.

Chairman PROXMIRE. First—I would like to, before I ask a few more questions—I would like to reassure both of our guests, and I am sure you knew this, but I want to emphasize it, that your statements have been given to the House and Senate Press Galleries, the Associated Press, and the United Press, and all the media of communications, so that the country will be able to get the benefit of your words of wisdom this afternoon, although we have only one live correspondent present, so far as we know.

I would like to say to you, Dr. McCracken, we are just delighted as to the emphasis on quarterly reports from the Executive on the budget quarterly reestimates. It seems to me that if we are going to have intelligent, effective economic policy, we can only do it if we have the facts; if we have the statistics available.

Mr. MCCRACKEN. Exactly.

Chairman PROXMIRE. And if the estimates are wrong, and we know how very wrong they were on Vietnam, 100 percent off, obviously, our economic policy can't be any good. If it is good, it is just a matter of luck and not based on a sound analysis.

I call your attention to the fact that this committee unanimously, Republican and Democratic, recommended in 1963, and I quote:

> Regular periodic revisions of budgetary estimates should be provided on at least a quarter basis.

I know how strongly some of the members of the committee feel on this, and I am delighted to see you reinforce it. The reason I bring it up again is that I would like to have you tell me, as a former member of the Council, and one who understands Government finances very well, if there is any technical reason why this administration or any administration can't make these budgetary estimates. What is wrong with it? Is there any objection that is legitimate?

Mr. MCCRACKEN. Well, I think if I were to argue the other side, or if I were to put myself in the position of the Budget Director, for example, or the President, I suppose there are two or three points that one would make.

In the first place there is just the general observation that this would all be very difficult, and if the trend were unexpected, projections might jar confidence.

These arguments I would pay very little attention to. One of my early jobs after leaving graduate school was in the Department of Commerce, which was in the early stages of giving consideration to whether or not we should try to ask businesses for their capital budgets. It seems to me most of the arguments that I have heard in regard to the mechanical problems here are practically carbon copies of the reasons advanced against these surveys.

Well, the fact of the matter is that we went ahead. We have now regular reports on plant and equipment expenditures. They haven't always been exactly on target, but I think it would be agreed that they have been quite useful.

Chairman PROXMIRE. There is no question that the more recent they are, the more active they are likely to be, is there?

Mr. MCCRACKEN. That is exactly right.

Chairman PROXMIRE. There is no question that the situation that we have, we do have a very hard situation in estimating the Vietnamese war, but if we get up-to-date estimates from the most authoritative source, the Pentagon, they are better than just the vague statement that we are going to have to have a supplemental of some indefinite size.

Mr. MCCRACKEN. That is right. Now, I suspect that one of the difficult questions has to do with this problem. What is going to be the framework of these estimates while the administration is still in the process of defending its program and its request for appropriations in the legislative session? Are they supposed to make their guesses as to which of their proposals will be casualties, and which ones will be given appropriations in excess of what was requested? Or does this mean that those quarterly estimates are just about inevitably then going to reflect precisely what is in the budget? In other words, they couldn't concede at that point that things are going to be different.

I don't consider that a conclusive argument, however, against this. I think we ought to give this thing a run for a few years. My guess is that most of these problems would turn out to be less important than they seem in advance. A lot of these things here can be done, if people will just set their minds to doing them.

Mr. HANSEN. Could I make a point, Mr. Chairman?

Chairman PROXMIRE. Yes, indeed; I wish you would, Professor Hansen.

Mr. HANSEN. I have a feeling that the feasibility of quarterly reports would be very much improved if we had long-range plans.

It is, of course, true—the military is a good example—that changes may be so great that long-range plans don't mean anything, but there is a large area where long-range plans can be very significant. If you have long-range plans, it is much easier to make quarterly reports than if you are just going along from year to year.

Chairman PROXMIRE. I welcome that. Incidentally, may I just read the other part of our recommendation. This was in three categories:

A. The budget for each year should be presented in the context of a broader, longer run set of budgetary projections. These projections should probably cover a five-year period.

Mr. HANSEN. Right.

Chairman PROXMIRE (reading):

B. A quarterly basis.

C. Budget accounts should be broken down by calendar quarters, rather than simply being shown as annual totals.

Mr. MCCRACKEN. Mr. Chairman, there are times, you know, when an issue seems more urgent, seems more relevant, perhaps, to the current situation than at others. It seems to me that in the light of the background of our fiscal history of the last 12 to 15 months, that this

may well be as good a time as we have had for several years in really pressing this issue.

The wheel is squeaking more. We are more aware, in other words, that we have got this budget deficiency in our information system.

Chairman PROXMIRE. And, also, I think that we are getting—it is hard for us to realize, I know you two gentlemen do, but it is hard for those of us who aren't professors and economists to realize how vastly our economic policy has improved, and how rapidly it has improved because of the economic information.

The statistics themselves are relatively very new, and they have been broadened greatly and refined greatly. Now, this would seem to be one of the easiest things to accomplish.

It is true it is not easy because, of course, the budget is a huge, complex document, but it certainly would improve policy, it seems to me, quicker than almost anything else.

Let me ask you this. Professor McCracken, I would like to join Congressman Reuss most emphatically in his plea for us to close loopholes. That would certainly be the most welcome and wisest way, it seems to me, that we would have in raising revenue, but I would agree that it is going to be hard to get that through very promptly. It means a long, tough, hard dragged out fight.

We can do it in the Senate more easily than in the House, because we can amend more easily. We have tried in the past, heaven knows how many times, to do something about the oil depreciation giveaway, but we haven't gotten a great deal of success, and that, it seems to me, is one of the keys to the whole thing.

At any rate, let me ask you, isn't it true, just as a matter of economic policy, that a cut in Government expenditures does not increase cost in any way, and therefore, has an unmitigated anti-inflationary effect, while the tax increase also diminishes demand, but does increase cost in some respects.

The President asks for an increased corporation income tax. That is going to mean some of that will be passed on to the consumer in higher prices.

He has also asked for an across-the-board surtax on income. Labor is going to fight to maintain their take-home pay. There will be translated to some extent higher costs and higher prices.

The income tax itself, as Professor Hansen has rightly said, is not considered to be an increase in the cost of living, but nine taxpayers out of 10 would say that it might as well be, because they have to pay it if they are going to stay out of jail. So that, wouldn't it be sensible to recognize that between these two alternatives that a reduction in spending does have that advantage?

Mr. MCCRACKEN. Oh, yes. As between these two actions, the effect on cost I think is very definitely in favor of a lesser rate of rise in expenditures. We have seen this in the last year.

I think the Economic Report estimates what happened, in fact, a year ago. There is an estimate of what happened to the cost-of-living index as a result of having taken off the excise taxes, and of course we gave it another one- or two-tenths of a point increase by virtue of putting the excise taxes back on.

Chairman PROXMIRE. This is especially true when you have a cost-push situation.

Mr. McCracken. Or formal escalation. That is if you tie wage rates to the cost-of-living index and excise taxes are in the cost-of-living index, it practically eliminates a rise in excise taxes as a major means of exercising restraint in the economy or financing expenditures because it is at least one step further toward tripping off the wage escalator.

But even income taxes have somewhat the same effects. As you say, there is the pressure to maintain take-home pay even when income taxes rise.

Chairman Proxmire. Professor Hansen, I would like to ask one final question. It is my understanding that the Council has projected a growth rate of 4 percent with present fiscal policy, and an unemployment level of 4 percent.

In view of your long experience with these problems, do you consider this to be an adequate target, or do you think that they should work toward a lower unemployment rate, and if so, would you care to indicate what you think would be an appropriate target, and is our growth rate as projected by them adequate in your judgment?

Mr. Hansen. I think a reasonable target for the United States would be 3 percent.

Chairman Proxmire. 3 percent?

Mr. Hansen. 3 percent unemployment; yes. It has been estimated that the way the British calculate unemployment rates and the way we calculate them, a 3-percent rate in the United States would be equivalent to a 2-percent rate as the British calculate unemployment.

Now, 2 percent is regarded in European countries, as I am sure we all know, as a very high rate of unemployment. The rates have been way below that in many countries, down to 1 percent, and sometimes even below 1 percent. So that it seems to me a perfectly reasonable goal now, an intermediate goal maybe, would be 3-percent unemployment.

We have been going down a little bit below 4 percent in some of the months in recent years, and I wouldn't suggest that we immediately aim at 3 percent, but it should be a near-term goal in my judgment, 3 percent unemployment.

Chairman Proxmire. This is very encouraging. I want to call on Professor McCracken. Before I do, I want to say there is a rollcall vote that started about 3 minutes ago, and I have to get to the floor to vote on it, so I am going to ask Congressman Reuss to take the chair. Unfortunately, I will have to depart.

I want to thank both of you gentlemen for an excellent job. I think Professor McCracken wanted to respond to that last question.

Mr. McCracken. A 4-percent rate of growth will not enable the economy to keep unemployment even as low as 4 percent in this decade.

In a study with which I was associated some 2 years ago, published by the National Industrial Conference Board, we concluded that for the period ahead, the growth rate would have to be about 4.35 percent. That doesn't sound perhaps as if it is far away from 4 percent, but small differences compounded are fairly important.

I don't think a 4-percent growth rate, even if you start off with 4 percent unemployment, will enable you to hold at 4 percent unemployment. I think the unemployment rate would tend to rise.

Representative Reuss (presiding). Congressman Widnall?

Representative WIDNALL. Thank you, Mr. Chairman. Professor Hansen, what is the main difference between the computation of unemployment in Great Britain and over here? You say there it is 2 percent compared to our 3 percent.

Mr. HANSEN. Well, there is one difference. We include for youths anybody who is seeking work and is not employed. In England, it is not counted until a young person has already held a job.

Now, you might think that that makes a terrific difference, but it doesn't make as much as you might suppose, because in England it has been so easy for youths to get a job that very soon they do get on the payroll and are counted, if they are unemployed, so that the difference is not as great as you might suppose. But that is one difference that I happen to think of right now. Can you add to that, Paul?

Mr. MCCRACKEN. Well, there are several factors, though I am not an expert in this field. At least in some of the countries I think unemployment is measured according to the number of people registered at the employment offices, rather than being based on surveys.

There are several definitional differences, but even after you allow as best you can for these, there is no question but what unemployment rates in the United States have been substantially higher than in Europe.

Representative WIDNALL. I would like to ask you both several questions. The first one is, What is your attitude toward the plans such as the negative income tax, which would guarantee a minimum income for all Americans?

Mr. HANSEN. My position would be this. I would not object to a negative income tax for employed workers. I underline "employed." It amounts to kind of a subsidy to their private employers, to employ people that are not very efficient, and so I would start with that. I would not be opposed to a negative income tax for employed workers.

Then we have all the unemployed, who are really to a certain extent, unemployable. They don't have the training that the market demands. So that my second point would be a big program of training and retraining.

Take a country like Sweden. They have full employment all the time. Yet they engage continuously in a big program of training and retraining all the time to keep the supply of labor in line with the demand for labor, I mean now, structurally in terms of the kind of labor that is needed. I think we need a much bigger program of training.

Then, No. 3, I would make the Government the employer of last resort, for example, the CCC and whatnot, so that you would have instead of a guaranteed annual wage without work, which I would be opposed to, you would have a retraining which would get more people into employment, and finally, employment by the Government as the employer of last resort for people that can't fit into the market.

Now then, those people should, as much as possible, be shifted as rapidly as possible into retraining programs. On this point, let me add a word to what we were discussing a moment ago.

If we have an adequate retraining program, we can achieve a much lower rate of unemployment without inflationary pressures.

A major reason why the United States is up against inflationary pressures, at even an unemployment rate of 4 percent, and European

countries are not confronted with severe pressures at so high an unemployment rate, is that we have an amazing lot of people whose education does not fit them for the jobs required in modern industry.

In Western Europe, the percent of illiterates is practically invisible. It is very high in the United States, and this is the reason why we reach inflationary pressures at even high rates of unemployment.

Representative WIDNALL. Professor McCracken, will you comment, please?

Mr. MCCRACKEN. I think I would be perfectly willing to sign my name to what Professor Hansen has said. There is a good deal to say for the negative tax income. I suspect it has important sociological values as well as economic.

There are these collateral considerations which certainly would have to be a part of the plan—manpower training, the importance of making sure that this was not impeding the flow of workers into regular work, and that sort of thing.

Representative WIDNALL. Have you looked into the proposal made by minority Members of the House, and some in the Senate, in what is called the Human Investment Act, which would give credits?

Mr. MCCRACKEN. No.

Representative WIDNALL. Tax credits to employers who go about with these retraining programs and try to keep a constant flow of people under training.

We have given this serious thought and hope this will be a possibility in the future, using resources that are available, rather than setting up vast new training centers. These people are in business already.

Mr. HANSEN. If we could get over being quite so jittery as we are about moderate rates of inflation, and push demand higher than we seem to have been willing to do, this would be a tremendous factor in getting more people into private employment where they can be trained, and this would automatically not only lower the unemployment rate, but also help to solve this problem of the unemployables whose education doesn't fit the demands of modern requirements.

So I think if we were prepared to accept something like the moderate inflation that the Western European countries have been familiar with, we would find that we would be curing this whole matter very much more rapidly than we are if we insist on having rigid price stability.

Representative WIDNALL. Do you feel that the investment tax credit is an appropriate device to use for evening out wrinkles in the business cycle?

Mr. HANSEN. Well, I have not been too sympathetic with that view, I must say. I don't think it is a very good tax to use for cyclical fluctuations.

I say this, despite the fact that it does hit at exactly the area that tends to rise and fall the most rapidly; namely, the capital goods area, and one would think therefore it would logically follow that this is the thing to hit.

But the difficulty is that there comes a time when you take it off, and a time you put it back on, and expectations arise before, and in the period in between, which seems to me makes it not a very dependable or a very flexible method of controlling the cycle. I must say, I am not very enthusiastic about it as a cyclical device.

Representative WIDNALL. It certainly seems to have a great effect on the economy within the last couple of years.

Mr. HANSEN. Oh, yes. It was intended as a longrun——

Representative WIDNALL. It heated up the economy too much in some areas, I think.

Mr. HANSEN. Yes. From the longrun standpoint, it surely is a factor in helping to promote growth, and it can be used countercyclically but it doesn't seem to me it is a very flexible countercyclical device, and I am not very enthusiastic about it.

Mr. MCCRACKEN. I would agree 100 percent. I think our current awkward situation that we confront here at present is good evidence of this.

We do have this very difficult question of how to avoid an air pocket now at the latter part of this year. In the first place, the investment boom that we had a year ago was primarily caused simply by the inevitable response of investment activity to rising levels of business, and situations where increasingly companies were hitting the ceiling of their existing capacity. The investment boom there was simply a symptom of the generally rapid increase in business activity.

But as a cyclical instrument, I think it is an extremely awkward one. In most cases its use would tend to be another chapter in this history of the extent to which the operation of economic policy that starts out to stabilize winds up destabilizing the economy.

Representative WIDNALL. Just one other question. Dr. Heller, when he appeared before the committee, said that increases in social security in the benefits and the payroll taxes might be timed for their economic impact. Do you think that social security benefits and taxes should be used as an economic stabilization tool?

Mr. HANSEN. That was advocated a good many years ago in England, and there has been very much discussion about it. It was discussed again relatively recently 2 or 3 years ago in Britain.

No, again, I would say that I would not be very enthusiastic about using it as an countercyclical device. I feel that the surcharge is an excellent countercyclical device. Its impacts spread uniformly throughout the entire country.

The reason why I don't like any large use of monetary policy is exactly that its impact is not even over the entire economy. It hits certain parts of the economy much harder than others, and from that standpoint, therefore, I favor pretty continuously low-interest rates.

I have in mind monetary policy moving a little against the wind as my colleague, and Professor McCracken's former teacher, John Williams would say, "Monetary policy moving against the wind, but making only a modest contribution," the phrase he used. I think the surcharge is an excellent countercyclical device, and the President should be empowered to use it.

On these other matters, they disturb things that ought to be settled policy.

Representative WIDNALL. Thank you, Professor Hansen.

Professor McCracken, will you comment on that also?

Mr. MCCRACKEN. Well, I seem merely to be in the position of the obedient pupil here, because once again I agree on this issue of social security.

The viscosities incident to the expenditure process are such that I don't see any real possibility of operating on that side in a very countercyclical way or shortrun adjustments.

If we manage economic policy reasonably well, the adjustments that we are going to make are not those incident to a 1933, or even a 1938, or even a 1958. They are going to be pretty modest adjustments of an economy that may be straying a little bit above or below the growth paths, but not very much. And under those circumstances, variations in expenditures, I think, just cannot be operated to be helpful. The expenditure process is too slow.

Those decisions ought to be made on the other grounds. In principle, it should be possible to operate on the tax side by variations in tax rates. There is prose in some of my papers where I have supported this, and I still would support it. I am however, less optimistic about whether in fact in the foreseeable future this is going to be an available instrument of policy.

Therefore, I come to the conclusion that we must keep the basic budget position reasonably in balance. By "reasonably in balance," I mean we should keep the relationship between full-employment revenues and expenditures in line. If so, the kind of adjustments that we are going to need to keep the economy on course can probably largely be done by monetary policy. But it won't require the kind of recent zigs and zags in monetary policy, where we went from an 11-percent to a 1-percent annualized rate of growth within a year's time. This is not necessary or desirable for good stabilization policy even in the monetary area.

Representative WIDNALL. Thank you. May I close my questioning in a light vein.

I saw your testimony:

> In only 5½ of the 10 years could the operation of fiscal policy be said to be not clearly perverse in its effect on the economy. This is a score of 55, which in academy is pretty close to a failing grade.

I want to congratulate you on your courage, because I understand today you may cause psychiatric troubles somewhere, if you criticize anybody or hurt their feelings about grading them. I understand that you are not supposed to tell anybody whether they got zero or 100 percent, or anywhere along the line, or you will have a very severe problem in handling people.

Mr. MCCRACKEN. Confession is also useful psychiatry. One of those perverse periods was 1958, when I was a member of the Council of Economic Advisers.

Representative REUSS. I noticed the timing in that. Things went worse after you got off, I must say.

Mr. MCCRACKEN. I think I will just leave it at that.

Representative REUSS. Both of you gentlemen have been very patient, and I won't keep you longer except to spend a minute or two with Dr. Hansen on the wage-price guidepost matter.

Do I gather correctly from what I believe you said that you would favor this year, 1967, something like a 5-percent wage guidepost, that being constructed by a combination of the productivity increase and the anticipated cost of living increase this year, or a considerable part of it, and that you would recommend a price guidepost such as we have had in the past, productivity increase with the above-average and

below-average variation, and that for services, which aren't ordinarily included in the guidepost, you would continue to honor them in the breach and not say much about them. Is that a fair statement of what you think would be a useful wage-price policy for 1967?

Mr. HANSEN. Congressman Reuss, not quite.

Let me try to state briefly what my proposal was. I am afraid it is more applicable to a longer term trend than one single year.

It is a little difficult to apply these things to the next year, because productivity changes considerably from one year to another, and you have to take, as the Council has done, a rather long-run period to obtain your guidepost.

My guidepost that I am suggesting is not the productivity increases in the entire total private economy, which includes both commodities and services, but excludes the Government, and that is what the Council has used. They base their guideposts on productivity increases in the private, total private, economy.

I would base it on a more generous scale, and therefore, what I am proposing is somewhat in line with what you have suggested, Congressman Reuss. I would base it on the productivity increases in all commodities industries. It happens that that is not very high this past year, but over the long run, over the period 1960–65, it was about 4¼ percent, and I think that makes a more realistic guidepost, because it would then aim at stabilizing the commodities Wholesale Price Index, not the Consumer Price Index.

Representative REUSS. By the commodity-producing industries, you mean everything but services?

Mr. HANSEN. Yes, everything except services, that is right, and Government. That gives you a higher figure. Your figure is five. My figure would be lower than that, based at least on the experience that 1962 to 1965. That is the guidepost.

This ought to give you stability in the wholesale price index, but maybe it won't turn out that way, perhaps because of the power of economic blocs, administered prices, and wage unions pushing up their wages.

We may not succeed in holding it where we would theoretically hold it on those guideposts. So then, attached to the wage bargain is an escalator clause. The net effect of that is that you can keep the wages that you immediately now propose in the wage bargain lower because you are not taking account of excessive future increases. That is taken account of in the escalator. You are basing it on facts of productivity now, now on speculations about excessive price increases in the future. Those are taken care of by your escalator.

Representative REUSS. Where you say something like 4.1 percent.

Mr. HANSEN. That might be the guideline, 4¼ or 4½ percent as in the period 1960–65.

Representative REUSS. Plus the cost of living.

Mr. HANSEN. No, not plus. Plus an escalator, but not plus a fixed amount. Some people have advocated that next year they should take the guidepost and add on the cost-of-living increase of the past year. I am opposed to that for the reason that the wage increases in 1966 already took care of the price increases of that year, and yielded an extraordinarily high real income of 4 percent in 1966. We don't need, to go back and add that on, and I don't want to add on a speculative increase for the future, because I don't know what that would be. I

just want to base it on the facts of productivity and then add the escalator clause.

Representative REUSS. Then on prices you would leave the guideposts the same as they are?

Mr. HANSEN. I would make them higher than the Council has had them, because I think that theirs is based on the assumption that you can properly hold the Consumer Price Index stable. I think that is unwise, because that would really mean a falling Wholesale Price Index, which I think is not desirable for the economy.

I think the price development of 1960–65 was a good one, stable wholesale prices, subsequently rising consumer prices. That was good reasonable price stability. That is the kind of thing I would like to aim at.

Representative REUSS. Let me see if I can formulate that. Then you would get rid of the productivity gage for prices?

Mr. HANSEN. For the private industry. My guidepost is based on productivity in the all commodity producing industry.

Representative REUSS. Why not use as a price guidepost your commodity industry productivity?

Mr. HANSEN. Yes.

Representative REUSS. Which is 4¼.

Mr. HANSEN. Pardon?

Representative REUSS. Which you say is about 4¼ percent?

Mr. HANSEN. Yes, it was that in the period 1960–65.

Representative REUSS. So you would recommend that as the——

Mr. HANSEN. As a guidepost.

Representative REUSS. As a price guidepost. How do we arrange that between the Wholesale Price Index and the Consumer Price Index?

Mr. HANSEN. Automatically that would take care of itself. If wages are increased on the basis of this formula of 4¼ percent, that would make the demand in the economy as a whole—everybody is getting that increase, presumably, everybody, service industries, they are all getting that increase.

Of course, we know that that is not exactly true. We are talking about an average here. Everybody all around is getting 4¼-percent increase in money wages.

That means that the demand coming from individuals, personal income, is rising 4¼ percent a year. And since productivity in the service industries is very low, it means that the monetary demand will exceed the supply of goods and services, so that consumer prices will rise at about 1.2 percent a year, as it did in 1960–65.

Representative REUSS. In order to preserve the same income shares as between labor and industry——

Mr. HANSEN. Use the escalator.

Representative REUSS. You would need to use the same 4¼-percent commodity for prices as you have suggested for wages; is that right?

Mr. HANSEN. That is right, for wages all around the whole economy, so far as average wage increases are concerned.

Representative REUSS. And this cost of living escalator which you would add to the wage guideposts, although only on an if-as-and-when basis——

Mr. HANSEN. Right.

Representative REUSS. How would you handle the absorption or pass-on-ability of that in the price?

Mr. HANSEN. That would not cause an increase. The price increase is an administered price increase in excess of the normal differential increase of consumer prices over the Wholesale Price Index. The fact that the excessive price increase has occurred means that the wage earner has been gypped of the real wages he was supposed to get.

There is a lag there. This means that the employer has been getting excessively large profits. It means that the balance, the income distribution balance, has been disturbed. The escalator corrects that.

If now correcting it only means that profits are brought back to where they ought to be, to be in line with the normal income distribution balance, if now, however, the employer arbritrarily says, "I have been enjoying these extraordinarily high profits so much I want to keep these extraordinarily high profits, and so now I must raise prices in order to keep them at that level," then you do get the spiral.

What I am saying is that the escalator is not the cause of this spiral. It only brings back the proper balance. But if now in the administered price area they step in now and say "We want these extravagant prices we have been getting, so we must now raise the price," then you are getting into the wage-price spiral, and this is a problem that we can't solve by guideposts, and so on.

It is a problem of the power of economic blocs and how do you manage that? Well, you can bring pressure to bear upon the whole economy by increasing unemployment. But it is a bad way to handle it.

Apart from that, you can only handle it by getting right over into price and wage controls, which we don't want. So that therefore the importance of the kind of educational projects that the Council of Economic Advisers has been engaged in. In this last report they tell about scores of conferences they have had with employers and trade unions trying to persuade them of the general overall picture, and how it defeats even the individual industries in the long run, if you violate the precepts that you learn from the general overall economy.

After all, in the long run you can't get blood out of a turnip, and the educational process is, therefore, certainly an important one. I don't know, many people, of course, are inclined to laugh it off and say that it doesn't mean anything. I think it has meant something.

It has played some role, especially if it is limited pretty much to the key industries, the key agreements. You can't manage everything, but the Government could insist that in the key industries it must sit in at the bargaining table and all facts must be disclosed to the public. The Government could insist on that.

It doesn't do so, so far. They do something of it, but more or less to the extent that industries are prepared to invite Government in and listen to them for a while, but there should be a more orderly and systematic machinery by which governments sit in at the key wage bargains.

I see no other solution for this matter of economic power blocs stepping in and just running away with the thing. These guideposts won't help us and the escalator won't, either. Nothing helps you if the economic blocs are going to step in and run it.

Representative REUSS. Thank you very much, Dr. Hansen and Dr. McCracken. You have contributed greatly to our deliberations.

We will now stand adjourned until 10 o'clock tomorrow morning when we will convene in room 318, Old Senate Office Building.

(Whereupon, at 4:15 p.m., the hearing adjourned, to reconvene at 10 a.m., Friday, February 17, 1967.)

THE 1967 ECONOMIC REPORT OF THE PRESIDENT

FRIDAY, FEBRUARY 17, 1967

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

The joint committee met at 10:10 a.m., pursuant to recess, in room 318, Senate Office Building, Hon. William Proxmire (chairman of the joint committee) presiding.

Present: Senators Proxmire, Jordan, and Percy; and Representatives Reuss, Griffiths, and Rumsfeld.

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

Chairman PROXMIRE. The committee will come to order. Today the committee is pleased to hear from three more highly competent economists who are well known to this committee for their valuable judgments on matters of economic policy. They are Mr. Beryl Sprinkel, vice president of the Harris Trust & Savings Bank of Chicago; Mr. Nathaniel Goldfinger, director of the research department of the AFL–CIO, and Mr. Carl Madden, chief economist of the Chamber of Commerce of the United States.

I might say all three of these men are known nationally in the academic community as well as throughout the country as very able economists. Obviously, both Mr. Goldfinger and Mr. Madden are closely associated with particular groups, but we should recognize that they are men of objectivity and scholarly achievement, and I am sure on the basis of their past testimony that they will be able to help this committee in arriving at a public-interest conclusion.

I am going to ask you gentlemen—and this is asking a lot, especially for a Senator—to limit your oral statement to 15 minutes or so, and you can place a longer statement in the record if you wish. By limiting your oral remarks, it will provide more time for colloquy which will permit members of the committee to ask you questions that particularly concern them. Mr. Sprinkel, you may begin.

TESTIMONY OF BERYL W. SPRINKEL, VICE PRESIDENT AND ECONOMIST, HARRIS TRUST & SAVINGS BANK, CHICAGO, ILL.

Mr. SPRINKEL. Gentlemen, I am honored to have the opportunity to testify before this committee on economic affairs. My basic thesis will undoubtedly be an unpopular one in the current environment, but I believe it is correct and deserves a hearing.

I argue in essence that despite the best of intentions, the results of monetary fiscal policy in the last 1¾ years has been to destabilize our inherently stable economy rather than provide the stability desired. I plan to develop the relevant evidence.

My assignment is to focus on the monetary situation, and I will do so in the context of the total policy mix as well as the prevailing economic trend. Certainly we know more about monetary fiscal policies than we did in the great depression, when poor policies certainly contributed to the depth and duration of that catastrophe.

We know how to prevent extremes, either depression on the one hand or hyperinflation on the other. But political tolerance has narrowed significantly since those days, and in my opinion there is very little evidence that we have the increased knowledge and the political will to finely tune the economy, particularly once full employment of resources has been achieved.

In my opinion the policies from 1961 to 1965 were unprecedently favorable, but from mid-1965 up to the present, I think they have been consistently destabilizing. The hallmark of the new economics as I understand it is that Government officials can prescribe the proper public policies.

When the margin for error is small, once we have achieved full employment, in my opinion, these acts are likely to be destabilizing. The reasons for the failure are not the marketplace, but improper analysis and execution.

It is tempting to characterize the private economy as unstable. According to this view policymakers must be constantly alert, ready to change, to counterbalance the destabilizing forces inherent in the economy. In my opinion the opposite is true, that we really have a very stable economy, and if we were not constantly tinkering and upsetting, we would not have as much instability as is actually observed.

Now this view is not held because I think monetary fiscal policies are unimportant. In fact, exactly the opposite. I think their effects are extremely pervasive, and sharp changes almost inevitably destabilize.

Certainly economic forecasting techniques have improved over what they were several years back, but they have not improved sufficiently to serve the needs of an activist economic policymaking group.

In addition to occasional lapses in political will, there of course are several lags that inevitably bring difficulty. There is what I would call the recognition lag. For example, in the fall of 1965, the administration clearly did not recognize the inflationary pressures that were developing. They pointed primarily to agricultural prices. There is the execution lag. It took about 1½ years to bring about the 1964 tax cut. And finally, the impact lag, and of course the private sector is now suffering from the lag of tight monetary policy of 1966.

Furthermore, we can't agree—when I say we, I mean professional economists, much less laymen—can't agree on how you should measure monetary fiscal policies. If you were to ask a group of monetary experts how they would measure a change in monetary policy, I would submit that you would find at least the following answers:

Changes in bank credit, changes in free reserves, changes in interest rate, changes in total bank reserves, changes in the money supply narrowly defined, changes in the money supply broadly defined, and fiscal policy fares no better.

We were told for many years that fiscal impact should be measured by changes in the administrative budget. Some of us thought that

the cash budget was the proper measure. The new economics taught us that we should forget all of these and concentrate on the full-employment budget. But now we are told by the Council of Economic Advisers that we should measure fiscal impact by the change in the national income budget.

Unfortunately these measures do not all yield the same answer. Even if we were agreed on how the change should be measured, we still would not know how much change is desired to bring about a given impact on the economy.

Let's look at the 1960–65 pattern and see why it was beneficial.

The policies were essentially beneficial because we had a lot of unemployment of labor and capital. Stimulatory policies were clearly needed. There was room for error. Additional stimulus was unlikely to bring inflation. It was only going to hasten the employment of resources.

Furthermore, monetary policy during this period was quite stable at about 3 percent growth in the money supply, which as you know is my preference for the measure, because I think we can demonstrate a relation to total spending.

The major exception occurred, I believe, in 1962 when I testified at that time before this committee; the money supply had declined for about 9 months. The economy shortly thereafter began to stall out, and there was a fear of recession, but the money supply turned back up, followed shortly by a rise in the economy.

One other, incidentally, major postulate of the new economics which I think is incorrect, is that we can substitute fiscal policy largely for monetary policy; that really monetary policy is of secondary interest. I think it is important to recognize that the pattern of economic trends over the last several years can be much better explained by what happened to money than what happened to fiscal policy.

We did have an upturn in 1963, following a rise in the money supply—we had a leveling in the economy prior to then. This upturn started way in advance of the tax cut; there was no noticeable acceleration in the economy after the tax cut. And again in 1966, when we had fiscal stimulus, and tight money, the economy in my opinion is beginning to stall out again.

Now let's look at the period mid-1965 up to now.

One could have hoped that as we approached full employment of resources that there would be less stimulus coming from a flexible monetary fiscal policy presumably attuned to the needs of the economy. But alas, in fact we received more stimulus. The budget shifted into sizable deficit and monetary policy became much more expansive, as measured by the money supply, total bank credit, total bank reserves.

From April 1965 to April 1966, for example, the money supply rose 6 percent, twice as much as the annual rate provided in the preceding years. In fact, in the month of December 1965, when the administration loudly opposed the rise in the discount rate, we actually had the largest 1-month increase in the money supply of any month in the preceding 19 years. It went up 1 full percent. That is at a 12-percent annual rate. Certainly, this added to the fuel of inflation, and destabilized the economy. I think it is important to ask why did we get more expensive policies at that point in time.

Part of it was because the administration clearly underestimated inflationary potentials as did many other people. They underestimated the defense needs by a sizable margin and as the chairman has pointed out on numerous occasions recently. Consequently, Congress did not insist on a tax increase, nor did they insist on a pruning of total expenditures.

The demand for credit rose and interest rates began to rise. And of course the Federal Reserve responded by adding additional credit to the system under what I think was the unfortunate assumption that monetary policy was tightening because interest rates were going up. This was due primarily to a rise in demand for money, and in fact monetary policy was easing.

There were several unfortunate consequences that followed this increased stimulus. GNP began to rise faster, and of course a larger component became inflation. Consumer prices in 1966 rose nearly 3 percent, and wholesale prices were up a little over 3 percent. Sales and order trends rose rapidly. There was discounting of inflation. The easy money policy in my opinion contributed to tight money, and it is very important to distinguish between the two.

The easy money policy which accelerated total spending, and demands for credit, certainly tended to increase the upward pressure on interest rates, and of course the Federal Reserve accommodated during much of this period by adding credit at a rapid pace.

In May of 1966, monetary policy abruptly changed gears, shifting from a 6-percent annual rate of expansion in the money supply to a rate of decline of about 1.7 percent rate for the following 7 months. In the short run this impact did mean higher interest rates. But there were several other compounding difficulties.

Private borrowers began to anticipate their needs. They feared that credit would not be available. You may remember the Federal Reserve refused to raise CD rates in line with the rising market trend. This meant that bankers were faced with sharp increases in demand for credit, and at the same time threatened with the liquidation of their liabilities and fewer assets.

Furthermore, numerous speeches by Federal Reserve officials placed the blame on banks for making too many loans to business; that this was the culprit causing the inflation. In fact, I think a near panic was caused by the activists and inept policies pursued in 1966, and it is a real tribute to a hobbled money market that one was avoided.

Since August, interest rates have receded. Monetary policy restraint of course, which in the short run tended to make for higher interest rates, ultimately brought easier money, because the demand for money is now declining.

The Federal Reserve rescinded its letter in December. Free reserves have improved and interest rates have declined, but the money supply has not increased, as you will note from the second chart in my prepared text.

The difficulties have been compounded in my opinion by a withdrawal of the investment credit. Of all the fiscal tools available, this one, in my opinion, was the most cumbersome for slowing up the economy, because it works with a considerable lag.

There is now talk about renewing it, and of course if we talk a long time about it, this will compound the difficulties. Already some prob-

lems have occurred, in some industries, and I would expect more as the date January 1, 1968, approaches.

For example, the American Railway Car Institute suggests that as a result of the survey of their membership, that orders of cars from independent car producers this year will be about 3,600, compared to 70,000 last year, and incidentally I want to take this opportunity to amend my prepared statement. I have stated 2,448 against 70,000. It should be 3,600 against 70,000.

Now the President has proposed a 6-percent surcharge, despite indications of either a recession or a leveling tendency in the economy. If we look at the evidence, I think it is clear that, at the moment, the early leading indicators are weak. The leading indicators have been weak for months. The money supply has been declining. It has not declined yet as long as it usually declines prior to a recession, but then we can't be sure that the decline is over.

Individual sectors are weak. Consumers are not disposed to spend. Housing has been weak, but recently has risen moderately. Plant and equipment spending may be peaking out. Profit margins are under squeeze. New orders are beginning to slip. Operating rates are declining, and of course the additional complications of the investment credit.

Furthermore, inventories are clearly a problem.

The Government sector seems to me to be the only one sector that is going to be rising sharply, if we can believe the budget. There is clearly a tug between the public and private sectors, and whether we have a recession or a leveling tendency is going to depend mightily on what happens to economic policies in the next few months.

While recognizing the stubborn and persistent monetary fiscal errors of the past 1¾ years for what they are, what should be done now?

In my opinion a prudent shortrun policy would consist of the following:

1. Promptly restore monetary growth to about 3 percent a year, so that a serious recession can be avoided and economic growth restored. We must not be misled into thinking that monetary policy is now easy, because interest rates have declined and free reserves have risen. Based on past experience, we cannot expect a resumption in the growth in private spending until monetary growth is restored.

2. Promptly rescind the investment-credit suspension. Considerable damage has been done, and more is in store as January 1, 1968, is approached. Extended discussion about the possibility of rescinding the suspension will compound difficulties by encouraging order deferrals.

3. Avoid a tax increase because of its adverse effects upon private expectations, but at the same time apply unusual restraint on Government expenditures. All men of good will share the objectives of the Great Society, of increasing opportunities and alleviating poverty, but there is ample room for objecting to methods. Greater reliance upon the initiative and resources of the private economy might well get better results at lower cost to the Government.

At a minimum, Government programs should be carefully evaluated in terms of results rather than objectives before additional funds are authorized. Higher taxes are neither a necessary nor a desirable means of getting an easier monetary policy. Under present circumstances, the economy needs moderate stimulus, not restraint.

4. Continue to deemphasize wage-price guidelines and permit the machinery of private collective bargaining to work. Income policies have been attempted in all major European countries, with notable failure, as is occurring in the United States at the present time.

Wage-price guidelines are no substitute, nor are they a useful supplement to stabilizing monetary fiscal policies. The arithmetic of the guidelines is impeccable, but the economics is fallacious. Not only do wage-price guidelines or income policies fail to achieve stated objectives, since they attack symptoms rather than causes, but they do positive harm by disrupting markets and misallocating resources.

An activist economic policy incorporating wage-price guidelines appears politically attractive, since it apparently places the administration on the side of prudence and points the finger of irresponsibility at private parties. But wide-ranging evidence indicates the policy is destined to failure, and will remain disruptive if continued. The recent move by the Council of Economic Advisers to disclaim a specific figure for wage increases was in the right direction, but not far enough, in my opinion.

Looking at the somewhat longer run, how can policymakers use their limited tested knowledge and demonstrated technical abilities to insure better economic performance? It is my view that policies should not be frequently adjusted for fine economic tuning.

Despite laudable objectives, the results of such actions are likely to be destabilizing. Continued empirical research may eventually expand our knowledge to the point where fine tuning of the economy, with flexible monetary fiscal policies, will be possible.

In the meantime let us play the more cautious and prudent role of avoiding destabilizing action by providing moderate increases in total spending, in line with the growth and the capacity of the economy to produce. A stable growth in the money supply of about 3 percent a year similar to the 1960–April 1965 period, accompanied by a Federal budget designed to obtain an approximate balance of full employment is probably the best we can do at present.

In conclusion, the gross mistakes in economic policymaking and execution of the recent past have convinced me that until our knowledge is substantially improved, an activist monetary fiscal policy is quite likely to destabilize an inherently stable economy, especially once full employment has been achieved.

In other words, a little knowledge can be a dangerous thing when ambitiously applied to economic affairs.

Chairman PROXMIRE. Thank you very much, Dr. Sprinkel.

(The prepared statement submitted by Dr. Sprinkel follows:)

PREPARED STATEMENT OF DR. BERYL W. SPRINKEL

DESTABILIZING POLICIES IN A STABLE ECONOMY[1]

I. INTRODUCTION

My assignment is to "focus on the monetary situation." I will concentrate on monetary policy developments since 1960 and will differentiate between performance from 1960 to mid-1965 and mid-1965 to the present. This discussion must be within the context of prevailing economic trends and the total mix of economic policy. In my view, policy was unprecedentedly good in the earlier period while consistently destabilizing in the latter.

[1] The views expressed are those of the author and not necessarily those of the Harris Trust and Savings Bank.

It is clear we have come a long way in our understanding and execution of both monetary and fiscal policy since the 1930's when poorly conceived and ill-timed policies contributed greatly to both the timing, magnitude and duration of the Great Depression. We now have the knowledge and political will to prevent malfunctioning of the economy at either the extreme of depression or hyper-inflation. But public and political tolerance for economic malperformance has narrowed since the decade of the 1930's. There is, however, little evidence to indicate that our knowledge and political will have improved sufficiently to formulate and execute the kinds of "flexible" monetary-fiscal policies that will achieve and maintain the generally accepted domestic goals of stable growth at full employment with stable prices, to say nothing of achieving our international objective of eliminating the deficit in the balance of payments.

II. INHERENT LIMITATIONS OF ACTIVIST ECONOMIC POLICIES

The hallmark of the new economics is that alert Government officials can consistently prescribe the proper public policies for maintaining economic stability. Despite the obvious political attraction of such a posture, there is little evidence that it can be successful. In fact, once the economy has achieved full employment of resources, thereby reducing the margin for error, an activist economic policy is very likely to be destabilizing.

There are many reasons for the shortcomings in economic policies and most are not due to imperfections in the marketplace but rather to imperfections in analysis and execution. There is a great temptation to characterize the private economy as a very unstable system constantly threatening to shift either into recession or depression on the one hand or into inflation on the other. According to this view, policymakers must be constantly alert and flexible, ready to fight either extreme by providing just the right amount of stimulus or restraint. A contrary view, which I believe is more nearly correct, is that the economy tends to be quite stable and frequent alteration in the degree of stimulus or restraint is more likely to destabilize the economy than achieve the avowed goal. The past one and one-half years yields but another illustration of the hazards of frequent change in policies. This view is held not because of a belief that monetary-fiscal tools are impotent and therefore inconsequential, but rather the reverse. Monetary-fiscal changes have pervasive economic effects and frequent alterations are often so illtimed that destabilization results. In addition to the obvious danger of insufficient political will, the lags in economic policymaking and execution almost assure us that serious mistakes will arise. The art of economic forecasting has improved but remains inadequate for the needs of activist policymakers.

There is first the recognition lag. This lag cost many months of time in late 1965 and early 1966 when the Administration refused to believe serious inflationary pressures were developing. There is the execution lag following recognition of the problem. Although for monetary policy this lag may be brief, it can be quite long for fiscal policy as witness the fact that it took over one and one-half years to pass the 1964 tax cut. Finally, there is the impact lag which for both fiscal and monetary policy may be one to two quarters or longer. The private sector of the economy is now being depressed by the impact lag of the very tight monetary policy of 1966.

There are other complications which make success difficult. Monetary-fiscal authorities are not agreed as to the proper measure of policy changes and even if they were, it is difficult to gauge how much change is necessary to bring about the desired change in the economy. For example, monetary policy measurements proposed by various leading authorities include such diverse series as the change in bank credit, change in free reserves, change in interest rates, change in total reserves, and change in the money supply both broadly and narrowly defined. Fiscal policy measurements fare no better. For many years we were assured by Congressional leaders and others that the fiscal impact should be measured by the Administrative budget. The new economics taught us that only the full employment budget mattered. Some of us thought that the cash budget was the best measure, but recently the Council of Economic Advisers insisted that the national income budget is the proper budget for measuring fiscal impact. Unfortunately, the above proposed measures of monetary policy do not all yield the same answers and neither do fiscal measures. The basic point of the above remarks is that 1) we know much more about monetary-fiscal policies than we did during the Great Depression, but 2) our ignorance of detail concerning monetary-fiscal impacts is still so large that an attempt to sharply vary policies in order to

"finely tune" the economy will almost certainly lead to serious errors, particularly when the margin for error is small.

III. THE RECORD—1960 TO MID-1965

It is my view that both monetary and fiscal policies were unprecedentedly beneficial from 1961 through mid-1965 partly because the margin for error was great. Monetary-fiscal stimulus was provided and was clearly in order from 1960 through mid-1965 when substantial amounts of capital and labor resources were underutilized. There was considerable room for error for increased stimulation was unlikely to bring inflation but would hasten the employment of idle resources. Furthermore, monetary policy was quite stable from 1960 through mid-1965. During that period the money supply, the measure of monetary policy I prefer because of demonstrable empirical relations to spending, increased at a fairly stable 3% annual rate. (See Chart I). The only exception occurred during the first nine months of 1962 when monetary growth dropped sharply. Although the rate of rise in the economy was remarkably stable during most of the early expansion years, the economy faltered in late 1962 and threatened to go into a recession. Following the resumption in monetary growth in late 1962 the economy resumed its upward thrust.

Another additional major but, in my opinion, incorrect postulate of the new economics is that fiscal policy can be used in large measure as a substitute for monetary policy. Although fiscal policy received most of the plaudits for the 1961–1965 economic expansion, it should be noted that economic performance can be better explained by trends in monetary growth. Despite the fact that the 1964 tax lagged the initial proposal over one and one-half years, the economy continued to record favorable growth records in response to an expansive monetary policy following the 1962 slowup. Furthermore, there was no demonstrable acceleration in the economy subsequent to the tax cut. Rather than looking on monetary-fiscal policies as substitutes, the evidence suggests they are more nearly complements with monetary policy providing the major spending motive force while the tax system establishes the structural incentives to encourage production, employment, saving, investment and growth. As pointed out later, the predominant influence of monetary policy as a spending inhibitor was again vividly illustrated during the past few months.

IV. DESTABILIZATION SINCE MID-1965

One could have dared hope that as the economy approached full employment of resources near mid-1965 a "flexible" monetary-fiscal policy would provide less stimulus. But alas, the stimulus increased! The Administration seriously underestimated the rising cost of the Vietnam War so that increased spending on defense and Great Society programs shifted the cash budget from a small surplus in the second quarter of 1965 to a sizable deficit. And, in fact, the cash budget probably underestimated the changing fiscal impact since the surge in Government orders, which initiated hiring and production, occurred well in advance of cash payments.

To compound the difficulty, monetary policy also became more expansive. In contrast to the approximate 3% annual growth in the money supply from 1960 to April 1965, monetary growth doubled to 6.1% from April 1965 to April 1966. Furthermore, measures of bank reserves and total bank credit reflected similar tendencies. In December 1965 when the Fed raised the discount rate amid great objections by the Administration, who argued that a tighter monetary policy was inappropriate, the money supply actually increased nearly 1%, the largest monthly gain in 19 years. As late as March 17, 1966, the majority report of this Committee condemned the discount rate increase because of lack of coordination with fiscal policy and also because it was apparently the Committee's view that a tighter monetary policy was inappropriate for the existing needs of the economy.[2] Even though interest rates were tending upward due to sharp increases in demands for funds, monetary policy continued to fuel the flames of inflation by sharply augmenting the money supply.

We can properly ask why policies became more expansive just as the economy approached full employment of resources and inflation became a threat. The Administration clearly underestimated the inflation potential. To a considerable extent this was due to the sizable underestimatioin of Government spending

[2] Report of the Joint Economic Committee, Congress of the United States on the January 1966 Economic Report of the President, March 17, 1966, pp. 6–10.

Congress consequently did not insist on a tax increase nor did it carefully prune nondefense spending. As the demand for credit accelerated, the Federal Reserve sharply augmented credit supplies, in the apparent but, in my opinion, mistaken belief that the rising trend in interest rates and declining free reserves meant monetary policy was becoming tighter. In fact, monetary policy became more expansive as the growth in total bank reserves, total bank credit and the money supply accelerated.

Several unfortunate consequences followed largely as a result of increased policy stimulus. Current GNP began to rise at a faster rate. Since resources were in tight supply, inflation became a serious problem for the first time during this economic expansion. For example, consumer prices rose 2.9% in 1966 while wholesale prices increased 3.3% compared to only 1.3% and 0.4% annual rate of increase from 1960 to mid-1965. As inflation anticipations accelerated and sales and order trends developed strength, there was increased impetus to borrow, and money and credit demands surged ahead. Despite the rapid infusion of reserves and new money, interest rates rose rapidly. The easy money policy in the year ending April 1966 engendered a tight money market by increasing inflationary fears and thereby stimulating credit demands. Although a change toward an easier monetary policy does in the short run tend to lower interest rates by increasing the supply of money relative to demand, a continued easy money policy tends to stimulate demand relative to supply, particularly when inflation develops. Therefore, an easier monetary policy resulted in higher rates. The truth of this concept is borne out not only by our recent history but also by modern history of most European countries which have had high rates of monetary growth accompanied by inflation and high and rising interest rates.

In early May of last year monetary policy abruptly changed gears and the money supply declined at a 1.7% annual rate for the following seven months. Not only was the long-run impact of an easy money policy continuing to stimulate demand for money, but the sharp shift toward a tighter policy in the short run compounded pressure toward higher interest rates which peaked in August.

Furthermore, during the spring and early summer anticipatory borrowing began to develop as private borrowers became concerned that if they delayed making loan arrangements, credit might not be available. Federal Reserve officials accelerated this trend by refusing to raise CD ceiling rates in line with rising market rates as had become the custom. In fact, the rate that commercial banks were allowed to pay on consumer-type deposits was cut from 5½% to 5%. Therefore, banks were threatened with deposit liquidation and the necessity to severely reduce asset expansion. To compound the difficulties Federal Reserve officials made clear that they regarded bank loans to business as the major inflationary culprit. It was repeatedly stressed by Federal Reserve officials that banks must restrict loans to business or run the danger of not being able to borrow at the discount window. The move by Federal Reserve officials to blame excessive bank loans to business as the cause of inflation was analagous to the tendency of the Council of Economic Advisers to blame labor and business leaders for the same difficulty as they broke the economically unsound wage-price guidelines. Both actions reflected increasing tendencies to substitute Administrative actions for market forces under the apparent but, in my opinion, mistaken conviction that the free market would not protect the public welfare. Although it is always tempting to blame nebulous private markets, excessively expansionary monetary-fiscal policies were clearly the cause of recent inflationary pressures.

Considering the unprecedented pressures placed on the money market last summer, brought about mainly by activist and inept financial policies, it should not be surprising that a near monetary crisis developed. It is a tribute to the efficiency of a hobbled money market that it was avoided.

Following the near monetary crisis in August interest rates receded significantly. Just as an excessively easy money policy stimulates the economy and the demand for funds, a policy of monetary restraint eventually has the opposite effect. Demand for credit began to abate by fall 1966 and finally in December the money supply rose slightly. In late December the Federal Reserve rescinded the September letter which requested banks to restrict business loans. Although free reserves continue to improve as interest rates decline, there has been little monetary expansion even up to the present despite the obvious weakness in the economy. (See Chart II) To compound the difficulty, on September 8, 1966 the President asked Congress to suspend until January 1, 1968 the 7%

investment credit. Of all fiscal tools available, this one was probably the most cumbersome since its major effect could not be felt until well into 1967 when it was not clear that restraint would be needed. This change in signals has, however, already been very upsetting to some industries. For example, the American Railway Car Institute recently surveyed its members and based upon replies received estimated that only 10,028 railroad cars would be ordered in 1967.[3] Since it is believed that 7,580 of these cars will be built in the railroads own shops, no more than 2,448 will be ordered from outside carbuilders. In the last three years orders of railroad cars from independent builders were 1966—70,168, 1965—60,600, and 1964—40,518. According to the American Railway Car Institute, "It has now become clear that the suspension of the investment credit has dealt a staggering blow to the railroad car-builders and their suppliers." The cost of this fiscal experiment will be measured in the loss of thousands of jobs and millions of dollars income.

Now the President asks for a 6% surcharge on corporate and individual income taxes. This despite indications that the economy is either headed into the fifth postwar recession or the rate of rise in economic activity will be substantially reduced.

V. CURRENT STATUS OF THE ECONOMY

Let us look at the evidence. The leading indicators of economic activity are weak. This is the pattern typically reflected prior to recessions, but also weakness frequently occurs prior to a slowup in the rate of rise in the economy. Secondly, the growth in the money supply has been severely retarded and this pattern is typical of a recession. In fact, the seven-month retardation in monetary growth from April through November 1966 was the most severe of any similar postwar period. The duration of monetary weakness has so far been somewhat less than typically precedes a recession, but we cannot be sure monetary contraction has ceased. Individual sectors of the economy have clearly lost much of their buoyancy. In fact, the only major area slated for significant advances in the next several months appears to be Government spending. Consumers are showing less willingness to spend and reflect concern about the declining value of the dollar. Housing construction is down sharply reflecting primarily the extremely tight money market of 1966. Tight money inevitably takes a serious toll in the housing industry, but the inability of banks and savings and loan associations to aggressively compete for funds increased the housing penalty. Plant and equipment expenditures in coming months will hold at best and, in fact, may shortly recede due to the anticipated restoration of the investment credit on January 1, 1968 plus slack product demands and narrowing profit margins. The recent slowup in business sales growth has led to considerable involuntary inventory accumulation and inventories now appear high relative to current sales. Inflation continues due to prior excess demand even though price pressures are abating.

Once again we observe the overwhelming impact of monetary policy which has been highly restrictive since April 1966. The economy is clearly stalling out yet fiscal stimulus continues unabated.

VI. APPROPRIATE POLICIES FOR THE PRESENT AND FUTURE

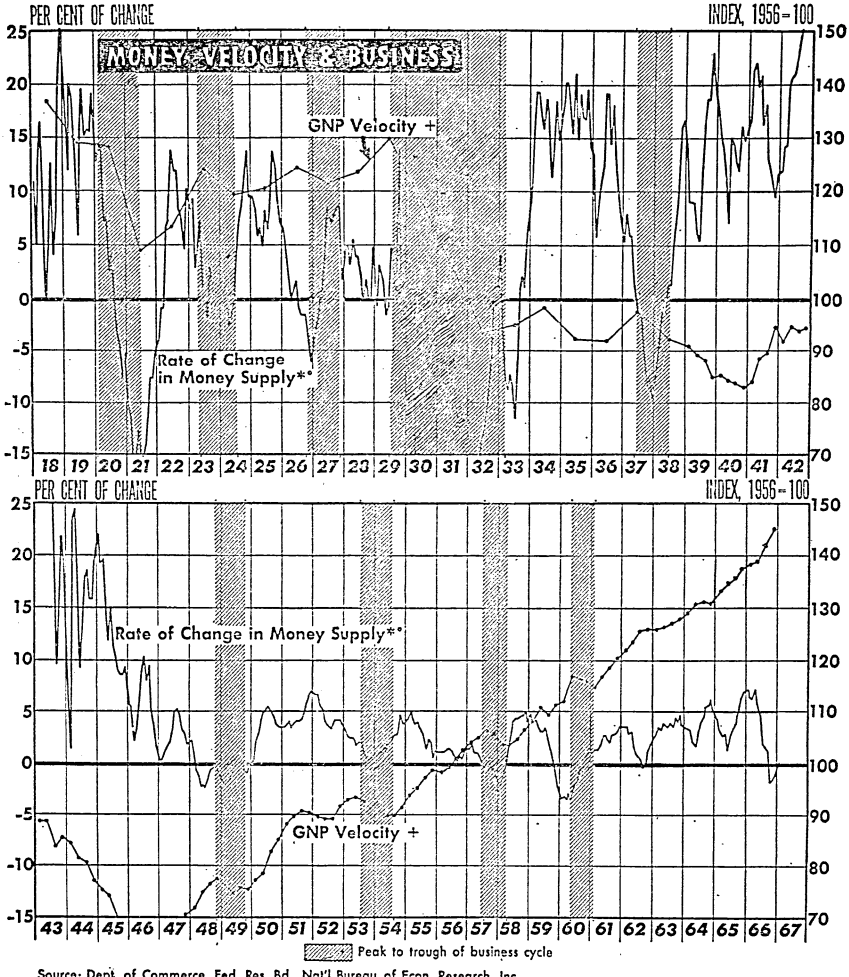
While recognizing the stubborn and persistent monetary-fiscal errors of the past one and one-half years for what they are, what should be done now? In my opinion, a prudent short-run policy would consist of the following: (1) Promptly restore monetary growth to about 3% per year so that a serious recession can be avoided and economic growth restored. We must not be mislead into thinking that monetary policy is now easy because interest rates have declined and free reserves have risen. Based on past experience, we cannot expect a resumption in the growth in private spending until monetary growth is restored. (2)

[3] Memorandum on the Effect of P.L. 89-800 on Railroad Carbuilding Industry, American Railway Car Institute, 11 East 44th Street, New York, New York 10017, February 6, 1967.

Promptly rescind the investment credit suspension. Considerable damage has been done and more is in store as January 1, 1968 is approached. Extended discussion about the possibility of rescinding the suspension will compound difficulties by encouraging more order deferrals. (3) Avoid a tax increase because of its adverse effects upon private expectations. But at the same time apply unusual restraint on Government expenditures. All men of good will share the objectives of the Great Society of increasing opportunity and alleviating poverty. But there is ample room for objection to methods. Greater reliance upon the initiative and resources of the private economy might well get better results at lower cost to Government. At a minimum Government programs should be carefully evaluated in terms of results rather than objectives before additional funds are authorized. Higher taxes are neither a necessary nor a desirable means of getting an easier monetary policy. Under present circumstances the economy needs moderate stimulus, not restraint. (4) Continue to de-emphasize the wage-price guidelines and permit the machinery of private collective bargaining to work. Income policies have been attempted in all major European countries with notable failure as is occurring in the U.S. at the present time. Wage-price guidelines are no substitute for stabilizing monetary-fiscal policies. The arithmetic of the guidelines is impeccable but the economics is fallacious. Not only do wage-price guidelines or income policies fail to achieve stated objectives since they attack symptoms rather than causes, but they do positive harm by disrupting markets and misallocating resources. An activist economic policy incorporating wage-price guidelines appears politically attractive since it apparently places the Administration on the side of prudence and points the finger of irresponsibility at private parties. But wide-ranging evidence indicates the policy is destined to failure and will remain disruptive if continued. The recent move by the Council of Economic Advisers to disclaim a specific figure for wage increases was in the right direction but not far enough.

Looking at the somewhat longer run, how can policymakers use their limited tested knowledge and demonstrated technical abilities to assure better economic performance? It is my view that policies should not be frequently adjusted for fine economic tuning. Despite laudable objectives, the results of such actions are likely to be destabilizing. Continued empirical research may eventually expand our knowledge to the point where "fine tuning" of the economy with flexible monetary-fiscal policies will be possible. In the meantime let us play the more cautious and prudent role of avoiding destabilizing action while providing moderate increases in total spending in line with the growth in the capacity of the economy to produce. A stable growth in the money supply of about 3% per year similar to the 1960–April 1965 period accompanied by a Federal budget designed to attain approximate balance at full employment is probably the best we can do at present. In conclusion, the gross mistakes in economic policymaking and execution of the recent past have convinced me that until our knowledge is substantially improved, an activist monetary-fiscal policy is quite likely to destabilize an inherently stable economy, especially once full employment has been achieved. In other words, a little knowledge can be a dangerous thing when ambitiously applied to economic affairs.

CHART I



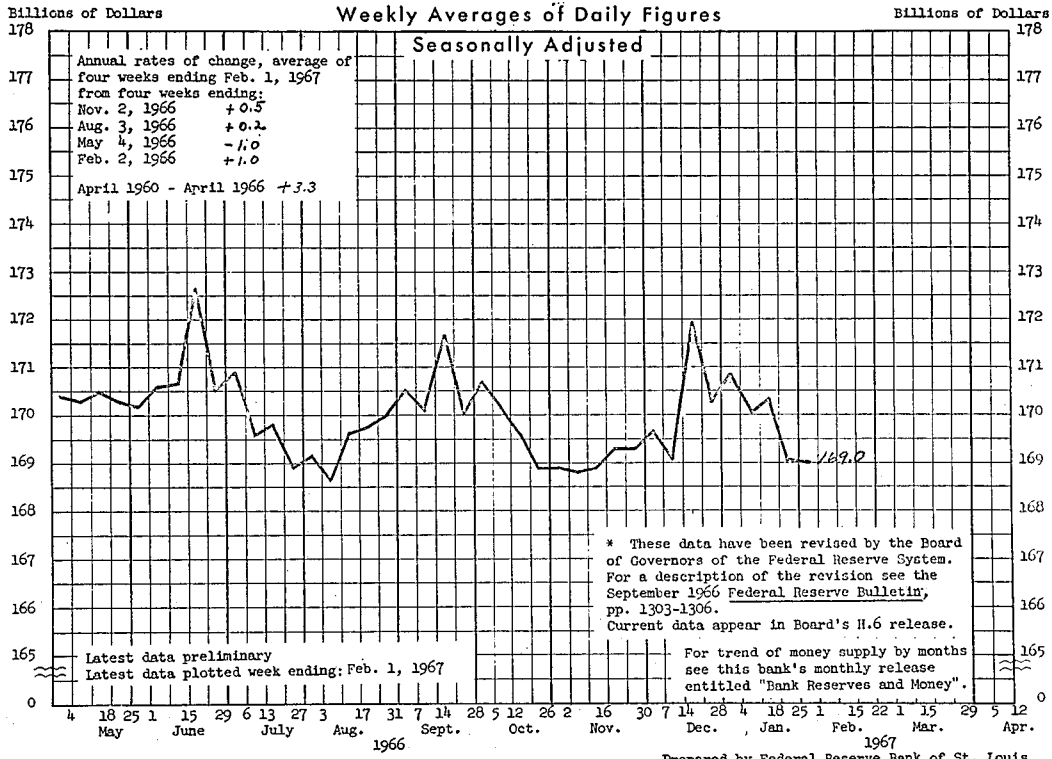
Source: Dept. of Commerce, Fed. Res. Bd., Nat'l Bureau of Econ. Research, Inc.
*All commercial banks demand deposits adj. + currency (seas. adj.)
•Annual rate of monthly change, 6-month moving average
†Annual data before 1939; quarterly since 1939

HARRIS BANK

CHART II

U.S. MONEY STOCK*

Weekly Averages of Daily Figures



Prepared by Federal Reserve Bank of St. Louis

Chairman PROXMIRE. Mr. Goldfinger?

STATEMENT OF NATHANIEL GOLDFINGER, DIRECTOR, RESEARCH DEPARTMENT, AFL–CIO

Mr. GOLDFINGER. Thank you, Senator Proxmire, I am grateful to the committee for this opportunity to discuss with you several major economic problems.

The economic outlook for 1967 is foremost in the minds of all of us. But there are other important issues, as well—including the lack of balance that has been developing between wages and profits; the excessive emphasis that has been placed on private savings and investment by comparison with consumer purchasing power and Government investment; the apparent acceptance by the Council of Economic Advisers of a 4-percent unemployment rate as full employment; the apparent insistence of the CEA that the potential growth rate of the American economy is 4 percent per year; and the dangerous focus of an aggregate monetary policy in selectively depressing one sector of the economy.

The overall growth of the American economy during the past 3 years has renewed confidence in its ability to meet the needs of the American people. The real volume of national output has increased by more than 5½ percent annually. Employment has risen about 2½ percent per year and the rate of unemployment has dropped by eight-tenths of 1 percent per year. These are significant achievements.

Imbalances have been developing, however, which threaten to undermine the potential for sustained economic growth. For the most part, these imbalances have been the result of excessive incentives for capital goods spending, a misguided wage-price policy, and years of previous neglect of public facility and manpower needs.

Basic policy changes are necessary in these areas to assure balanced growth and a fuller use of American resources in the future. To some extent such changes have already begun. Unfortunately, however—and this is a matter of the deepest concern to the labor movement—the Council of Economic Advisers appears bent upon correcting some of the symptoms of the imbalanced development of the recent past—particularly the rise in prices—by abandoning the goal of full employment, or at least putting it in cold storage, and slowing economic growth to a rate below what the Nation's resources probably will permit.

At present, the American economy is going through adjustments, which follow:

—Tight money and the highest interest rates in 40 years, which threw residential construction into a severe recession in 1966 and affected related industries such as lumber and appliances.

—The failure of the buying power of workers' take-home pay to rise last year, which has contributed to weaknesses in consumer durables.

—The renewed increase of idle productive capacity towards the end of 1966, as large-scale instalaltions of new plants and machines added to productive capacity at a faster pace than production.

—The build-up of excessive inventories in many businesses.

These soft and weakening spots in the private economy have been somewhat more than offset, thus far, by the much sharper than ex-

pected rise of Federal Government expenditures, essentially for defense, and the continued increase of state and local government expenditures. But the reduction of unemployment, which proceeded from 1963 to early last year, has come to a half at about 3.8 percent of the labor force.

A key to the trend of economic developments in 1967 is Government policy.

Administration actions in the past 2 months have halted at least temporarily the sharp drop in homebuilding. Moreover, the modest easing of monetary policy and interest rates is probably encouraging business expectations and should lift homebuilding and related activities in the coming months, if the recent trend in monetary policy continues. Already residential construction seems to be moving up slightly.

In addition, the increase in the Federal minimum were for nearly 5 million of American's lowest wage workers is adding about $1 billion of high multiplier buying power to the economy's spending stream in the next 12 months. Collective bargaining gains, hopefully, will also provide some additional strength to consumer markets.

The operations of medicare and medicaid are also adding strength to consumer markets.

The President's Budget proposes a continued, but slower, rise of military spending to meet commitments in Vietnam, as well as a modest increase of Government expenditures for domestic programs.

We of the AFL–CIO remain firmly convinced that the American economy has the resources for extending our social advances, while meeting the military requirements of the conflict in Vietnam. The cost of the war should not be absorbed by freezing or cutting expenditures for such essential domestic programs as housing and rebuilding of our cities, aid to education, the war on poverty, the achievement of clean air and water.

The administration's budget proposals appear to be moderately expansionary in 1967. In the first half of the year, with soft and weak spots in the private economy the Federal Government will add a yearly rate of about $5 billion more of the spending stream than it takes out—providing a moderate stimulus, in addition to the stimulus of a less stringent monetary policy to economic activities.

During the second half of the year, the administration's suggested tax boost would offset the administration's proposed increase in social security benefits. In anticipation of a substantial rise of economic activities, the administration's proposed budget would add a yearly rate of only about $3 billion more to the economy's spending stream than it takes out in the second half of 1967.

However, economic projections are not precise. Actual trends during the next 3 to 4 months may not develop as the Government's experts now foresee them. Whether the suggested tax increase will have a beneficial or depressing impact on the economy in the second half of the year should become clearer in the coming months than at present.

The question at the moment is whether economic activities, the demand for goods and services, will rise sufficiently in 1967 to prevent a rise of unemployment and make possible a continuing and gradual reduction of unemployment.

75-314—67—pt. 3——12

Actual trends in the next several months should provide better answers to these questions than are now available—whether the moderately expansionary fiscal policy and easing away from tight money and high interest rates will have the lifting effect on economic activities that the administration expects.

Lack of Balance in the Private Economy

A major underlying problem in the American economy is the continuing lack of balance between employee compensation, on the one hand, and profits and dividends, on the other. We are experiencing a wrong-way shift in income distribution. The record on this score is utterly clear.

Last year, much of the gain in wages and fringe benefits was washed out. The buying power of the average factory worker's weekly take-home pay was actually slightly less than it had been in 1965. And gains in the buying power of take-home pay in the previous 5 years were extremely modest, while profits soared and dividend payments to stockholders rose sharply.

Real compensation per hour for all employees in the private economy, including executives and supervisors, increased only 2.7 percent a year in the 6 years from 1960 through 1966. But real volume of output per man-hour in the entire private economy rose at a yearly rate of 3.5 percent. This is an indication, a measure, of the fact that the vast majority of wage and salary earners have not received a fair share of the benefits of the national economy's expansion.

The price level has been rising, in recent years, regardless of what happened to labor costs per unit of production. The price level advanced moderately when unit labor costs were steady or declining and it rose more sharply when unit labor costs increased.

In the manufacturing sector of the economy, unit labor costs actually fell 1.6 percent between 1960 and 1965, while the wholesale price level of manufactured goods increased 1.7 percent—about as much as the drop in the unit labor costs. In 1966, unit labor costs of industrial goods rose 1.7 percent, as a result of increased employer contributions to social security and the attempt of workers to catch up with rising living costs. But wholesale prices of manufactured goods jumped 2.8 percent.

In the 6 years, between 1960 and 1966:

Corporate profits skyrocketed 60 percent before taxes and 80 percent after payment of taxes.

Dividend payments to stockholders rose 56 percent.

Factory workers' weekly take-home pay increased merely 24 percent, and in terms of buying power, only 13 percent.

Total wages, salaries and fringe benefits of all employees in the entire economy increased only 45 percent, reflecting a substantial increase in employment as well as gains in wages and salaries.

At the peak of the last business cycle in the second quarter of 1960, corporate profits after taxes reached $27.8 billion—an increase of more than 75 percent. Although they declined to $46.8 billion in the fourth quarter of 1966, they were still 68.3 percent higher than at the previous business cycle peak.

Even these figures, however, understate the extent of the bonanza enjoyed by American business in recent years. They take no account of the changes in accounting for depreciation, which have depressed reported profits. When depreciation is added to profits after taxes, the bonanza appears even more phenomenal. The ratio of cash flow—depreciation plus profits after taxes—to net worth in 1966 not only exceeded the peak of the previous boom; it was higher than it had been even during the extremely abnormal Korean war year of 1950. This may be seen in the table herewith submitted for the record.

(The table referred to follows:)

Cash flow as percent of net worth—all manufacturing corporations

Year	Depreciation and depletion	Profits after taxes	Cash flow	Net worth	Cash flow as percent of net worth
	Billions	*Billions*	*Billions*	*Billions*	
1949	$3.6	$9.0	$12.6	$77.6	16.2
1950	3.9	12.9	16.8	83.3	20.2
1951	4.5	11.9	16.4	98.3	16.7
1952	5.5	10.7	16.2	103.7	15.6
1953	6.2	11.3	17.5	108.2	16.2
1954	6.8	11.2	18.0	113.1	15.9
1955	7.6	15.1	22.7	120.1	18.9
1956	8.6	16.2	24.8	131.6	18.8
1957	9.4	15.4	24.8	141.1	17.6
1958	9.8	12.7	22.5	147.4	15.3
1959	10.3	16.3	26.6	157.1	16.9
1960	10.9	15.2	26.1	165.4	15.8
1961	11.6	15.3	26.9	172.6	15.6
1962	12.8	17.7	30.5	181.4	16.8
1963	13.6	19.5	33.1	189.7	17.4
1964	14.5	23.2	37.7	199.8	18.9
1965	15.8	27.5	43.3	211.7	20.5
1966:					
I	4.1	7.2	11.3	222.4	20.3
II	4.4	8.4	12.8	228.6	22.4
III	4.4	7.4	11.8	233.4	20.2
3-quarter average 1966					21.0

Source: President's Economic Report, 1967.

Mr. GOLDFINGER. It is my judgment, on the basis of looking at this table, that the rates of return in 1965 and in 1966 adjusted for changes in depreciation rules, were equal to, and possibly even higher, than they were in the 1920's, an exceptionally lopsided period in terms of income distribution.

While profits soared even beyond the expectations of businessmen themselves during the current expansion, wage increases have been moderate. In a paper prepared for the meetings of the American Economic Association last December, Prof. Otto Eckstein declared:

> It is striking that every econometric wage equation devised by scholars so far—and this now includes at least half-a-dozen studies embodying different product and labor market variables—substantially over-predicts the rate of wage increase in the last several years . . . What is striking is not that the rate of wage increase was lower than in the mid- or early 1950's, but that the rate of wage increase was lower by over 2 per cent a year than the equations based on the postwar relationships would have predicted.

While employee compensation was rising modestly in this period, productivity was rising more rapidly. The result, as reflected in Government reports, was a rise in unit labor costs in the entire private economy of about 3 percent between 1960–1965—an average yearly rise of approximately one-half of 1 percent a year. In the key manufac-

turing sector of the economy, unit labor costs actually declined 1.6 percent during the same period.

Despite this remarkable stability of labor costs, prices moved upward. The Consumer Price Index rose 6.6 percent—more than twice as much as unit labor costs in the entire private economy, and wholesale prices of manufactured goods rose by about as much as the decline in manufacturing unit labor costs.

The result has been—in spite of a faster rise in employee compensation and unit labor costs in 1966—a redistribution in the share of national income in favor of profits, dividends, and capital gains.

Workers have not shared equitably in the gains made possible by increasing productivity in recent years—not even by the Council of Economic Advisers' guidepost standards. From 1960 to 1965 real hourly compensation of all employees in the private economy, including executives and supervisers, went up only 2.6 percent—not the 3.2 percent wage guidepost figure. And in 1966, real hourly compensation of all employees rose 2.9 percent.

In manufacturing, the real increases in hourly compensation were even less than in the total private economy. They were 2.2 percent annually during 1960 to 1965 and 1.9 percent last year.

Even more striking is the fact that in 1966, when the real gross national product rose by 5.4 percent, the buying power of the average factory worker's weekly take-home pay actually declined, and for construction workers and miners, it was hardly any greater.

Estimates of the AFL–CIO research department indicate that for the 6-year period, from 1960 to 1966, the cumulative total compensation of all employees in the private economy fell more than $50 billion short of the amount which they would have received if their incomes had risen sufficiently to provide them with real hourly increases of 3.2 percent a year—a short fall of about $8 billion a year.

The Council of Economic Advisers shows at least a partial recognition of the shortcomings on both equity and economic grounds of the current relationship between wages, prices, and profits. In a steadily expanding economy, it declares:

> The profit margins which were feasible only in the boom stage of a boom-bust economy . . . are inappropriate. In fact—

It continues—

> profit margins not only should be lower than in the boom phase of a cyclical economy, but should be reduced on the average because operations in such an environment carry lesser risk.

And, in keeping with this principle, the Council urges employers to absorb increased costs to the "maximum extent feasible" and to lower prices "at every opportunity."

The CEA also realistically dropped the specific-figure wage guideline—in recognition of the 3.3 percent rise in living costs between December 1965 and December 1966.

But the CEA in my opinion turns its back on the collective bargaining measures that can possibly begin to restore a better balance in the private economy. The Council rejects cost-of-living escalators and other collective-bargaining measures to offset the impact of an increased price level on workers' earnings.

However, as Prof. Alvin Hansen indicated in Challenge magazine a couple of months ago—and as I understand he indicated very clearly

to you gentlemen yesterday—escalator clauses do not initiate increases in the price level. They react to past increases in the cost of living and only after a lag.

Without a means for advancing their real earnings, how can workers ever gain a fair measure of equity by following the CEA's advice?

Restoration of balance between wages, prices, profits, and business investment, as I see it, is essential to provide a sound foundation for sustained economic growth, for sustained growth of consumer markets, as well as a more equitable distribution of income.

Both justice and economic good sense require substantial increases in the buying power of workers' wages. A continuing lag of real earnings behind the Nation's rising productive efficiency would leave workers with a continuing decline in their share of the value of national production. In addition, it would lead to a serious weakening of consumer markets.

It seems to me to be perfectly clear that American workers are justified in seeking wage increases to offset past price increases that have washed out part of the buying power of their earnings. And that they are justified in seeking to improve their living standards.

In the American economy, a major mechanism for achieving needed increases in real earnings is collective bargaining between unions and employers—within the framework of the different industries, occupations, and markets, as well as the national economy.

The extraordinary profits of recent years and the economy's rising productivity make possible substantial increases in workers' buying power without raising the general price level. The profits and increasing productivity of many companies are so high that they can increase the buying power of their employees and simultaneously cut the prices of their products, and many other companies can certainly afford to absorb the cost increases that may be coming this year.

The statement adopted by the President's Advisory Committee on Labor-Management Policy on August 18, 1966, points in the direction of a possibly more equitable and workable public policy than the CEA's wage-price guidelines—with their rigidities, inequity, and unworkability.

The statement declares that—

> It is impractical if not impossible to translate the goals reflected in the guideposts into formulae for application to every particular price or wage decision. 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 income.

The mechanism, recommended by the President's Labor-Management Committee, to seek the goals of rising real incomes and relative price stability, is along the following lines.

> "* * * 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 * * *" if the evaluation indicates that the over-all economy is falling short of the goals reflected in the guideposts, the following steps should 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 Advisors 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.

It is too early to know how this pragmatic approach will work out. But it is based on a recognition that there is a wide variety of different conditions among the thousands of industries, markets, and occupations.

In addition, the AFL-CIO has, on numerous occasions, requested the Congress and the Government agencies to focus public attention on the wage-price-profit-investment policies of the dominant corporations in key administered-price industries—to curb their price-raising ability.

If the President determines that there is a national emergency to warrant extraordinary stabilization measures—with even-handed restraints on all costs, prices, profits, dividends, corporate executive compensation, as well as employees' wages and salaries—he will have the support of the AFL-CIO. We, of organized labor, are prepared to sacrifice—as much as anyone else, for as long as anyone else—so long as there is equality of sacrifice.

In an economic and social order, such as ours, relatively steady economic growth is unlikely to be achieved, unless it is based on balanced relations in the private economy.

Restoration of an improved balance in the private economy is essential—to provide both equity for workers and a sound basis for sustained economic growth.

The Unsustainable Capital Goods Boom

Related to the shift in economic distribution, the profits explosion of the 1960's fed the fires of a dangerous and unsustainable capital goods superboom.

In its 1965 Economic Report, the Council of Economic Advisers noted that business fixed investment had exceeded 11 percent of gross national product (in constant dollars) in the early postwar period but had dropped to about 9 percent in the 1958—63 period. The Council then went on to observe "for the remainder of this decade investment is likely to contribute more to the economy than it did typically in the 1958–63 period. But it cannot be expected to match its early postwar performance when heavy backlogs added to demand."

In January 1966, the Council declared "that business fixed investment cannot continuously grow twice as fast as gross national product as it did in 1964–65, and that it cannot always be a propelling sector of demand."

Yet, last year, 1966, was the fifth year in succession in which business fixed investment rose more rapidly than GNP. It was the third consecutive year in which its rate of growth was twice the rate of growth in GNP. It was also a year in which investment once again exceed 11 percent of gross national product—in constant prices.

This superboom in capital goods created inflationary strains, added to the depression in the housing industry and thwarted the administration's efforts to bring about an improvement in the balance of payments. As the machinery order backlogs mounted, machinery prices began to rise. The prices of nonelectrical machinery prices rose 5 percent. In addition, as the funds raised by corporations through

sales of bonds and bank loans more than doubled between 1964 and 1966, the funds available for housing dried up. Housing starts dropped precipitously.

What is more, "as the increasing demand for capital goods began to strain domestic capacity * * * purchasers increasingly turned to foreign suppliers to get prompt delivery," this year's Council report observes. As a result, "imports of capital goods rose by about 50 percent and accounted for more than 20 percent of the increase in imports in 1966."

This upsurge of capital goods spending and the economic distortions which it has produced raise serious questions about the special incentives for business investment adopted in recent years—the overemphasis of the combined 7-percent tax credit for new investment in equipment, the speedup of depreciation and the reduction of the corporate tax rate from 52 to 48 percent.

It was and is the AFL–CIO view that these tax reductions for business have been dangerously overdone and have been contributing to imbalances between demand and productive capacity. The major incentive to sustained increases in business investment is rising demand for goods and services. The major barrier to a sustained high level of investment in the past has been idle productive capacity.

By 1965 and 1966, the capital goods superboom moved far beyond sustainability. It continues to rise about twice as fast as GNP—which cannot be sustained indefinitely. It moved to about 11 percent of GNP—which the postwar record indicates is clearly unsustainable.

Our convictions on this score have been strengthened by recent studies which indicate that America's economy cannot sustain the levels of investment which have been reached in recent years. Among the most recent of these is a study by the staff of this committee.

That study indicates that the projection of "past relationships, trends, and programs * * * into the future, without alteration" would result in a ratio of business fixed investment to real gross national product higher than any year of the postwar period and it concludes that such a level of investment is "completely unsustainable for any long period of time * * *."

The committee staff's report suggests that a balanced and sustainable full employment economy would require a level of business fixed investment that is 9.5 percent—9.8 of real GNP in 1970 and 1975—significantly below the unsustainable levels of recent years.

Return to a more sustainable level of investment may well cause serious adjustment problems. The history of the American economy is replete with depressions and deep recesisons that followed unsustainable capital goods booms.

Attempts to maintain the boom by artificial devices for another year or two will only postpone the inevitable adjustment and difficulty.

A sound policy would place emphasis, now, on increasing the demand for goods and services—to match the rapid increases in productive capacity. And a sound policy would attempt to restore balance to the basic relationships in the private economy among wages, prices, profits, and business investment.

The Full Employment Goal

Full employment is the top-priority goal of organized labor. As a result, we are disturbed by the CEA's apparent acceptance of a 4-percent unemployment rate as achievement of its objective.

In 1962, the Economic Report defined a 4-percent rate of unemployment as a temporary goal and set a specific date for its achievement. It declared:

> We cannot afford to settle for any prescribed level of unemployment. But for working purposes we view a 4 per cent unemployment rate as a temporary target. It can be achieved in 1963, if appropriate fiscal, monetary, and other policies are used. The achievable rate can be lowered still further by effective policies to help the labor force acquire the skills and mobility appropriate to a changing economy.

In 1963, the Council of Economic Advisers' Annual Report again defined a 4-percent rate as an interim target. This time, however, it dropped the target date. It said:

> Success in a combined policy of strengthening demand and adapting manpower supplies to evolving needs would enable us to achieve an interim objective of 4 per cent unemployment and permit us to push beyond it in a setting of reasonable price stability * * *. However, an unemployment rate of 4 per cent is an unacceptable target. Therefore, we must expand the various programs that would assist us in pushing below it.

In the next two reports, 4 percent was reaffirmed as an interim target, but its achievement was again left for some indefinite future. The following year, the Council grew even more restrained. It called for "prudent * * * reduction in the unemployment rate to a level below 4 percent" and "a cautious move toward lower unemployment * * *."

In this year's report, the evolution seems to have become virtually complete. With the exception of one reference to the undesirability of making 4 percent unemployment a "permanent objective of U.S. economic policy," the report contains frequent statements (including one in the opening paragraph) about the attainment of "essentially full employment" in 1966.

We regard this transformation as most disturbing. I concede that a plausible argument might have been made for the thesis that a 5½-percent rate of real growth, the average rate of the past 3 years, was undesirable in 1967, because it could lead to an excessive rise in prices; and that it would be wise to whittle away at unemployment, in 1967, at a somewhat slower pace. But, instead, the CEA seems to have given up—at least for the time being.

Full employment, in the context of American society, and the American labor market, is considerably less than a 4-percent unemployment rate—which in the past year has been accomplished by very high levels of joblessness for Negroes, youngsters, and unskilled workers.

In his report, President Johnson states:

> Nearly 3 million workers were without jobs at the end of 1966. Perhaps two-thirds of them were "frictionally" unemployed: new entrants to the labor force in the process of locating a job; persons who quit one job to seek another; workers in the "off" months of seasonal industries; those temporarity laid off but with instructions to return.

The President's comment indicates that full employment, in terms of American life, would be a jobless rate of about 2½ percent of the

labor force—and even that level could be reduced by efforts to reduce seasonal unemployment, for example, and to improve the U.S. Employment Service. The objective would be a continued effort to reduce joblessness to a bare minimum, to provide job opportunities, at decent wages, for all who are able to work and seek employment.

The definition of recent unemployment levels as full employment is also contrary to the findings of the President's Automation Commission. "We are not impressed," the Automation Commission observed, "with a 4-percent unemployment rate, or a 3-percent, or any other unemployment rate, as an ultimate goal of economic policy. We take seriously the commitment of the Employment Act of 1946 to provide 'useful employment opportunities for all those able, willing, and seeking to work.'"

Acceptance of a 4 percent rate of unemployment as full employment also contradicts our own experience. In its January issue of Employment and Earnings, the Bureau of Labor Statistics compares the labor market of 1952 with the current situation. It points out that—

> The jobless rate for skilled blue-collar workers, at 2.8 per cent in 1966, was nearly one-half of a percentage point higher than in 1952, and the rates for other blue-collar workers were also above those of 14 years earlier * * * The number of unemployed experienced wage and salary workers totaled 1.5 million in 1952, compared to 2.3 million in 1966.

And it concludes:

> It is apparent in 1966, that the Nation's labor force was not as fully employed as it was in 1952 and that the potential for further employment growth was far greater.

It cannot be repeated too often that the jobs that can be generated and the goods and services that can be produced by continued economic growth are too crucial to permit any slamming of the economic brakes when unemployment hovers around 4 percent—and more, if those not counted as unemployed in the official figures are included. Prof. Robert Solow has said:

> Those last few jobs matter particularly because they will go in large part to the people who need them most: The Negro, the teen-ager, the unskilled manual worker, the dropout or 55-year-old without a high-school diploma.
>
> It is precisely when the labor market tightens, when the skilled, the educated, the experienced all have jobs, that it becomes the turn of the disadvantaged. To relax now, to give up on the problem of full employment with inflation, is to condemn thousands of our citizens to more or less permanent unemployment.

In its study of U.S. economic growth in 1975, the staff of the Joint Economic Committee declares:

> In view of the increased level of economic literacy since the passage of the Employment Act over 20 years ago, it is a bit surprising to find economists still talking about the appropriate "tradeoff" between rising prices and unemployment.
>
> Policies should not be directed at determining how large a general rise to trade for so many jobs for the unemployed, nor at agreeing on the increase in unemployment to accept for added price stability. Rather, the task is to comply fully with section 2 of the Employment Act, by designing policies which will lead to realization simultaneously of a stable general price level and jobs for all those able, willing, and seeking work.

The AFL–CIO welcomes this reminder to the Council of Economic Advisers and others that the use of broad blunderbuss fiscal and monetary measures to restrain demand well before resources are fully utilized is not an acceptable answer to the problem of inflation.

It should be emphasized that an economy, which achieves full employment and growth steadily thereafter at a rate corresponding to its potential, generates certain anti-inflationary forces which are too often overlooked. Steady growth at full employment levels reduces the ratchet effect which occurs when prices shoot up during periods of recovery and remain rigid during periods of stagnation; it avoids the increase in unit costs which put pressure on prices at low levels of utilization; it encourages a sustained rise of investment in modern machinery; and it makes it possible, as the Council has implied, to devise policies which keep profits at more reasonable and sustained levels.

These and other factors—such as manpower training programs—make it unnecessary to rely upon the rate of unemployment to create a reservoir of jobless human beings as a means of combating inflation.

The objective of full employment is not yet achieved, despite the welcome improvements of the past 3 years. A continued effort is needed to achieve and sustain job opportunities, at decent wages, for all people who are willing and able to work.

The Economy's Growth Potential

Related to the CEA's apparent acceptance of a 4-percent unemployment rate, as full employment, is its apparent insistence in the 1967 report that the American economy's growth potential is 4 percent per year. I just question that, and personally I don't buy that estimate at all.

Despite the unquestioned need for all that we can possibly produce in the coming decade, the Council of Economic Advisers apparently has lost its enthusiasm for reducing unemployment below the 4 percent which it once regarded as an interim target. Moreover, it stubbornly insists upon confining its estimates of the Nation's potential capacity for growth to 4 percent—a view which appears to us and to many others as well to be unwarrantly pessimistic, timid, and self-defeating.

In addition to its restrictive definition of full employment, the Council has presented a limited conception of America's economic potential. Like the former, this conception can lead to policies which restrict the expansion of job opportunities and the production of goods and services.

The Council argues that given "a trend rate of increase in output per man-hour in the total economy of just over 2½ percent a year," and an increase in total man-hours of 1½ percent, the Nation can increase its output by only 4 percent a year once it reaches full employment. A number of studies, however, indicate that the Council is selling America short.

The projections recently prepared by the staff of this committee regard an annual growth rate of 4 percent a year as a realistic estimate of America's output potential in the next 10 years—with a 3-percent unemployment rate at 4½-percent real growth per year and a 4-percent unemployment rate at a 4-percent growth rate.

The National Planning Association "projections show a growth rate in real GNP averaging 4½ percent yearly between 1965–76 * * * This result emerges from our analysis of demographic factors, manpower developments, the productivity outlook, and from assumptions about the continued pursuit of Government fiscal policies and programs * * *"

Indeed, NPA also projects a target growth rate of 5 percent per year as feasible. The NPA study declares that while the 5 percent yearly expansion of real GNP is "entirely feasible, prospective shortfalls in public policy and private responses place these prospects near the outer limits of the probability range."

These estimates of the economy's growth potential range from 4 to 5 percent. In the light of these differences how can the CEA be so sure of its 4-percent growth potential figure? Moreover, why err at the low end of the range?

This is far more important than a difference in statistics. At the present level of GNP, a difference of one-half of 1 percent in the rate of economic growth represents a difference of $3.8 billion of goods and services in 1 year—no small bit of change. And such difference in output adds up to a significant difference in job opportunities—perhaps more than 300,000. Over a decade, such differences could add up to a very large cumulative loss of output and employment.

This issue and its policy implications are too important to be glided over. I suggest that this committee thoroughly examine this issue in its technical details, as well as its policy implications and consequences, including the impacts on levels of employment and unemployment.

The Need for Planned Expansion of Public Facilities and Services

President Johnson is to be commended for recommending the continuing expansion of Federal expenditures for major domestic programs, despite the sharp rise of military spending. However, the recommended expansion of these efforts is most modest by comparison with the present backlogs and increasing needs of a rapidly growing and increasing urban population for improved public facilities and services.

The recent report of this committee on State and local public facility needs is a most valuable compendium of the needed facilities and their costs in the 1965–75 decade, and is a most valuable contribution to what is possible in the near future.*

In 1965, State and local expenditures for public facilities came to $20 billion—with about one-fifth financed by Federal grants-in-aid. The committee study indicates that these expenditures will have to rise to over $40 billion by 1975 to meet the needs for public facilities. The cumulative total need over the decade is for expenditures of $328 billion. And if the Federal Government continues to finance about one-fifth of the total, the cumulative total of such Federal grants-in-aid would be more than $65 billion over the decade.

Moreover, as the committee study indicates, these costs do not include the additional costs of services—the costs of teachers, nurses, and other personnel to man the facilities. In addition, the committee study does not include the important area of housing.

A planned effort is needed to meet these requirements. I think we should move ahead by establishing comprehensive inventories of

*"State and Local Public Facility Needs and Financing," 2 vol. study prepared for the Subcommittee on Economic Progress of the Joint Economic Committee. December 1966. Available at U.S. Government Printing Office.

public service needs, both at a national level, which has already been accomplished by the Joint Economic Committee's staff report, and also at the State and metropolitan level.

In December 1965, the Sixth Convention of the AFL–CIO declared:

> A vast and planned national effort, under Federal leadership, is needed to apply as much of our resources as possible to meet these needs, within a reasonable period of years. Such effort should be based on a national inventory of needs in the various categories—such as, how many elementary and secondary school classrooms are required now and will be needed in the next ten to twenty years. Progress towards meeting specific objectives in each category, thereafter, would depend on the availability of resources and the political decisions of Federal, State and local governments, within the framework of the best available estimates of needs.
>
> The construction of the required facilities and provision of expanded public services would provide employment for large numbers of workers at many different kinds of jobs and skills—in the production and distribution of building materials, in construction and in the expanded services * * *.
>
> The AFL–CIO urges the Federal Government to develop, coordinate and maintain a national inventory of needs for housing, community facilities and public services, based on present backlogs and future population growth. Each State and metropolitan area should be encouraged to develop an inventory of needs within its geographical jurisdiction, in additon to the development of a coordinated national inventory prepared by the Federal Government.
>
> Such comprehensive inventory of needs should provide the foundation for nationwide programs in each category—based on Federal financial and technical assistance to the State and local governments, including Federal grants-in-aid and guaranteed loans, as well as direct Federal efforts.
>
> Target dates should be established for achieving specified objectives and the pace should be speeded up or slowed down, depending upon changes in defense requirements and the availability of manpower and productive capacity.
>
> We urge the Federal Government, the States and metropolitan government authorities to develop such inventories of needs in housing, community facilities and public services as soon as possible and to move ahead rapidly, with sufficient funds and resources, to meet the requirements of a rapidly growing, urban population.

Such planning should begin now. And expenditures for such purposes should be stepped up considerably, when military spending levels off or declines.

In this regard, the development of a Federal capital budget would be most helpful. I hope that the bipartisan committee, proposed by President Johnson for a "thorough and objective review of budgetary concepts" will recommend some form of capital budget for the Federal Government—the development of a modern, businesslike separate accounting of Government investments and reimbursable outlays from current expenditures for general operations and national security.

The longrun health of American society requires the improvement and expansion of public facilities and services, including housing, as well as achievement of sustained full employment.

Chairman PROXMIRE. Thank you, Mr. Goldfinger.

Dr. Madden?

STATEMENT OF CARL H. MADDEN, CHIEF ECONOMIST, CHAMBER OF COMMERCE OF THE UNITED STATES

Mr. MADDEN. I would like to express my appreciation at the opportunity to testify on behalf of the national chamber federation on the Economic Report of the President and the Annual Report of the President's Council of Economic Advisers.

The economic environment in early 1967 is markedly different from a year ago. The Economic Report of the President and the Council's 1967 annual report clearly reflect this fact. In the interval between the 1966 and 1967 reports consumer prices rose 3.3 percent and labor costs per unit of output rose to the highest level in almost 6 years, despite the optimistic hope expressed in last year's Economic Report that "overall stability of costs and prices will be preserved in the year ahead." The year 1966 was one in which the simple numerical wage-price guideposts were swept away before the onslaught of excessive aggregate demand, spurred by a faster escalation in Vietnam than predicted and a correspondingly sharp advance in business investment spending. It was a year in which too little and too late fiscal restraint forced monetary policy to excessive tightness that brought a precipitate decline in residential construction and close to disorderly conditions in the bond market last summer as banks unloaded securities to obtain loan funds. And 1966 was also a year when no further improvement in our payments deficit took place.

In fact, had it not been for the magnet of our high interest rates that pulled in short-term capital from abroad, our deficit would probably have worsened as our export surplus shrank.

Both the Economic Report and the Council's annual report recognize that the year ahead poses delicate problems for national economic policy on all fronts. This is especially true on the monetary-fiscal and wage-price fronts. Each report acknowledges some of the policy mistakes of 1966, particularly the failure to recognize the inflationary pressures built up by excessively easy monetary and fiscal policies and the impact of rising defense spending on a fully employed economy. The key question is, Have the reports properly identified and reasonably evaluated the probable stresses and strains in the economy this year? We believe they have not.

The Economic Outlook

The Economic Report has the advantage of appearing at the end of the annual economic-outlook derby that starts each fall. It is no surprise, therefore, that the Council's 1967 GNP estimate of $787 billion lies within the range of earlier private forecasts—although at the upper end.

But this year, knowledge of earlier private forecasts may have been a disadvantage, because these forecasts are currently being revised downward. The projected rise in "overall prices" of "slightly more than 2½ percent" is close to earlier forecasts, as is the view that "the Nation should continue to experience substantially full employment," although the assumed 3.9 percent unemployment rate is lower than most private estimates. But it is with respect to the size, trend, timing, and consistency of changes in the major categories of spending composing the GNP that the Council's forecast is most open to question. Let me elaborate on this point.

The Council expects the all-important GNP component—business fixed investment spending—to rise about $3 billion this year over last year's record. The Council cites the November 1966 survey of intentions for plant and equipment spending as basis for its statement that "investment should increase only slightly from its level in the fourth quarter of 1966."

But the real question is whether investment will continue to rise at all this year. The third-quarter 1966 NICB capital appropriations survey showed a 15-percent drop from the second quarter; and the 1,000 largest manufacturing corporations surveyed also indicated that they would make further sharp cuts in appropriations in the fourth quarter.

Because of the momentum in fixed investment expenditures, unfilled orders are still rising, which should keep the producer durable goods industry busy the first half.

But the combination of an expected slower rise in defense orders this year than last year, weakened automobile and other consumer durable sales, the virtual disappearance of mortgage financing as a source of consumer cash flow, the suspension of the investment tax credit, and the emerging squeeze on profits, all argue for a slowdown throughout the year rather than the pattern of slowdown in the first half and upturn in the second.

At best, a leveling off is indicated in the second half compared to the first, with rising consumer spending, construction, and Government spending only moderately exceeding declines in both investment spending and inventory accumulation. The Council's forecast, on the other hand, is based on an expectation that inventories will be run down in the first half while residential construction remains weak; but that in the second half both of these activities will turn upward, along with business fixed investment.

The Council's optimism regarding the second half of this year not only assumes substantial monetary ease and availability of financing early this year, and an extremely fast recovery in construction activity, but it also assumes that there will be no restraint on investment despite an appreciable squeeze on profits from the cost-push pressures that the Council anticipates and the lack of the investment tax credit which will also tend to depress second-half fixed investment spending, especially as projects are deferred into 1968. All of these assumptions are quite questionable.

It makes considerable difference in any economic forecast whether an expected price rise will reflect demand-pull or cost-push forces. In the first instance, continued advances in total real economic output are much more likely than in the latter case. This is because profits will rise if there is demand-pull but will be much less likely to rise if there is cost-push. It is difficult to see in the business sector the basis for the Council's optimism about the second half of 1967. The consumer sector of course, will continue to grow, but not by enough to warrant the Council's expectation of a real growth rate of 4 percent or more this year.

Because of weakness in the business sector, the administration's tax proposal could have the opposite effect of that intended. The impact of higher taxes on shrinking incomes might be such as to lose as much revenue as is gained, even though the proposed increase in social security benefits would, mathematically speaking, about offset the initial tax increase. We are, of course, aware that one reason for the suggested July 1 effective date of the proposed tax increase is to give Congress time to assess the state of the economy at midyear. In this connection we would like to request, respectfully, that this committee seriously consider recommending restoration of the investment tax credit and accelerated depreciation allowances if by midyear it be-

comes evident that the economy requires overall stimulus rather than restraint. In addition to its business cycle implications restoration of the credit, and accelerated depreciation allowances, is important for long-term economic growth and for improving our international competitiveness.

THE FEDERAL BUDGET AND THE ECONOMY

As we stated in our comment on last year's Economic Report, the timing of Federal budget expenditures, especially procurement of durable goods, as in the defense buildup, is quite important for evaluating the economic impact of the budget. Similarly, the manner in which revenues are raised has differing effects on the economy.

The most impressive budget-reference change in the Annual Report of the Council is the shift from the administrative budget to the national income accounts basis. While the latter is far preferable as an indicator of the economic effects of Government spending and taxing, it does have certain weaknesses in this respect. As just noted, the economic impact on the business sector of rising defense procurement occurs when the orders are placed, not when they are paid for (as in the consolidated cash budget) or when they are delivered (as in the NIA budget).

When defense orders are rising, as from mid-1965 to mid-1966, the economic impact is understated in both budgets. If, as the Economic Report indicates, there has been a turnaround and the rise in defense spending is moderating, both budgets will overstate the stimulus to the business sector, especially when the depressing influence of the accelerator effect is added to the delayed budget-response effect.

In addition to this timing defect, the NIA budget also fails to take into account the impact of Government financing on money markets and interest rates which, in turn, obviously influence business decisions. It is necessary to consider the consolidated cash budget to explore this relationship—in particular to discover whether fiscal policy is reinforcing or running counter to monetary policy. The national chamber in 1962 responded to a request from the President to look into the problems of Federal budget presentation by proposing eventual replacement of the administrative budget by a comprehensive cash budget. With your permission, Mr. Chairman, I would like to introduce into the record of these hearings a copy of the report of the ad hoc Committee for Improving the Federal Budget that was approved by the chamber's board of directors on October 19, 1962. This report is attached as appendix A.

Chairman PROXMIRE. That will be printed in the record at this point, Dr. Madden.

(The material referred to follows:)

APPENDIX A

CHAMBER OF COMMERCE OF THE UNITED STATES,
Washington, D.C., November 19, 1962.

THE PRESIDENT,
The White House,
Washington, D.C.

DEAR MR. PRESIDENT: In accordance with your request, I appointed a committee to look into problems of federal budget presentation and offer suggestions on

behalf of the Chamber of Commerce of the United States for dealing with them. I am pleased to enclose the committee report and a membership roster.

I believe the National Chamber has been fortunate in the caliber of committee members we were able to bring together. The experience of these men has permitted reviewing the problem from a variety of viewpoints in the time available.

The federal budget has many facets ranging from the first compilation of data within the agencies to executive action on Congressional appropriations. The Committee did not cover the entire budgetary area. Rather, it concentrated its attention on the area of budget presentation. The objective of our comments and proposals in this regard is the fullest possible understanding by the public and the Congress of the current and prospective financial status of the government at the time of budget presentation and of the financial implications of continuing and proposed federal programs.

The report does not concern itself with implementation. It is believed appropriate to leave that matter for resolution by you after first considering the recommendations and comments.

The Committee is grateful for the kind assistance of Mr. David E. Bell, Director, Bureau of the Budget, and his associates.

Sincerely,

H. LADD PLUMLEY, *President.*

CHAMBER OF COMMERCE OF THE UNITED STATES OF AMERICA, WASHINGTON, REPORT OF THE COMMITTEE FOR IMPROVING THE FEDERAL BUDGET, APPROVED BY THE NATIONAL CHAMBER BOARD OF DIRECTOR, OCTOBER 19, 1962

IMPROVING THE FEDERAL BUDGET

I. THE BUDGET AS A REFLECTION OF FEDERAL PROGRAMS

The annual budget presents the fiscal aspects of the President's program, and general understanding of it permits intelligent participation by the public in determination of government policies. Knowledge by the citizen of the fiscal facts of the federal budget is an essential to sound representative government. The objective of and the common thread linking our comments and proposals is the fullest possible understanding by the public and the Congress of the current and prospective financial status of the government at the time of budget presentation and of the financial implications of continuing and proposed federal programs.

The Committee recognizes that many improvements have been made over the years to provide Congress and the American people with an annual presentation of government programs, their estimated cost and the manner in which the costs will be financed.

The paramount objectives in budget improvement are set forth by the Bureau of the Budget; first, to be complete, informative analytical and accurate; and, second, to be simple, concise and understandable. However, the pursuit of one objective can interfere with the attainment of another. The quest for complete information can hamper attempts to be concise and understandable. Thus, an all-purpose budget must represent a compromise designed to meet different objectives.

With these considerations in mind, the Committee studied the forms of the existing administrative budget and of other proposals for changes in budget presentation.

The Committee concluded that a comprehensive cash budget should be the principal vehicle for the President to present his annual financial plans to the Congress and to the public. Shortcomings of other forms—the present administrative budget and the sometimes proposed capital budget—support this conclusion. The Committee also considered the appropriate role of the national income and product accounts and the so-called full employment budget.

II. VARIOUS BUDGET CONCEPTS

Administrative Budget

A budget which includes only 70 percent of federal receipts and expenditures is not an adequate vehicle for the President in submitting his financial plans to the Congress and the public. The present administrative budget totals omit trust fund receipts and payments and record public enterprise transactions on a net basis, because such funds are not available for general purposes. However, the significance in many areas of the omitted transactions is no less than that of receipts and expenditures shown in the administrative budget.

We conclude that the present administrative budget should be developed and refined into a well-devised comprehensive cash budget.

Comprehensive Cash Budget

The focal points in measuring the impact of government fiscal operations are the total of cash receipts from the public, the total of cash payments to the public and the resultant effect on the public debt.

So-called trust funds and public enterprise transactions on a gross receipts and gross disbursements basis are an integral part of the whole picture. In recent years trust fund receipts have grown proportionately faster than budget receipts. They should not be omitted from any comprehensive presentation of the government's fiscal program.

Important categories within such a cash budget should be clearly shown by columnar form or appropriate groupings, such as the amounts of trust fund income and trust fund outgo, loans and self-liquidating investments repayable in dollars, and public enterprise receipts and disbursements. The amount of the net trust fund accumulations or withdrawals should be clearly segregated from the surplus or deficit.

A comprehensive cash budget, carefully evolved and tested, should ultimately replace the present administrative budget.

Capital Budget

This Committee firmly opposes adoption of the capital budget.

The capital budget concept disguises rather than discloses the total impact of government expenditures. It proposes two budgets, one for current operating expenditures, and one for capital expenditures. The criteria for definition of capital items would be debatable at best and many marginal proposals would be lodged under the capital umbrella. These dual budgets would merely delay recording expenses currently incurred. The federal government—unlike private business—has no proper reason to capitalize expenditures.

We agree with the conclusion of a 1960 committee of certified public accountants which advised the Budget Bureau that the capital budget concept is not appropriate for the United States Government and that it would likely lead to unsound financing practices. In particular, the Committee was impressed by that group's comment that:

". . . the impact of revenues and all expenditures is inseparable so far as the financial management of the Government is concerned and . . . matching receipts and disbursements (cash flow) is most meaningful from the standpoint of the Federal Government."

Other Approaches

Recent discussions of federal fiscal policy have referred to the national income and product accounts and the full employment budget—two additional approaches in viewing the economic impact of federal government operations.

A statistical compilation based on the federal sector of national income and product accounts is not satisfactory as a primary budget document, though it may have worthwhile uses. It is misleading to refer to such a compilation as a budget because it is incomplete and it is based on statistical estimation of many components rather than on accepted accounting support as in the administrative or cash budgets. While interesting or helpful in measuring the impact of federal spending and taxing on national income and output, the national income accounts compilation should never be confused with the budget.

The so-called full employment budget is not a budgetary statement in the manner of the conventional or cash budget. The term designates a hypothetical computation of factors required to achieve a certain economic objective.

III. RECOMMENDED MODIFICATIONS IN BUDGET PRESENTATION

The Committee recommends the following modifications in existing presentation in order to achieve greater public understanding of the government's budget proposals:

1. As stated previously, a comprehensive cash budget, carefully evolved and tested, should ultimately replace the present administrative budget. Major emphasis in budget presentation should then be focused on this method of estimating receipts, expenditures, and surplus or deficit for a given year. The three alternatives used in the 1963 budget document and the *Budget in Brief* were very confusing.

2. The capital budget should be resisted as a completely inappropriate application of business practice to federal financial administration.

3. The lead-off tabulation in the budget document should be a one-page budget summary setting forth the major element comprising total gross expenditures classified by function and total gross revenues classified by source. The effect of the surplus or deficit on the public debt should be clearly brought out together with the total obligational authority proposed to be available for the year, including carry-over authority already available.

4. The budget document should clearly summarize the proposals for that portion of revenues projected in the budget which will require legislation. The estimated revenues under proposed legislation should also be shown.

5. The Administration should continue to seek agreement with the Congress to eliminate nonessential detail from the budget documents. Schedules such as those for personnel compensation could be submitted directly to the Appropriations Committees of the Congress, and this would significantly reduce the bulk of the budget document.

6. Graphic presentations in the budget should be improved by greater reliance on presentations showing comparable information over a period of five or more years. Bar charts would display trends in clearer fashion than the present "pie charts" which are limited to a single year.

7. The format of the budget should be more flexible. Small, relatively routine programs should receive less attention than large complex ones.

8. Every attempt should be made to reduce the size of the *Budget in Brief*, now 64 pages long. This document offers the best opportunity for wide dissemination of budgetary information. Public acceptance and understanding will improve in direct relation to reductions in its size and complexity.

IV. RECOMMENDATIONS FOR FURTHER STUDY

As was requested, our recommendations are limited to matters of budgetary presentation. It became apparent during the Committee's deliberations, however, that desirable changes in the form and presentation of necessary budgetary information depend on fundamental improvements in the budget process. Such improvements are particularly required in the techniques for preparing, reviewing, and authorizing individual government spending programs.

Areas for further study as well as potential accomplishments seems to be indicated in the following:

1. The detailed budget justifications should be strengthened by identification of meaningful workload data and the calculation of unit or program costs. The would provide an improved basis for determining and reviewing appropriation requests for desirable programs.

2. The frequent, almost annual, changes in the concept of what is "in" or "out" of the budget should be replaced by a comprehensive, consistent long-term concept of the budget totals, developed from a firm, logical framework (such as a comprehensive cash budget proposed in this report).

3. The present budget practice reflects only funds to be received and paid during the budget year; but the public should know also the amount of costs related to the current year but not to be expended until furture years, as well as the impact on future years of both existing programs and proposed new programs. Efforts to display the long-range consequences of budget policies and programs should be continued and enlarged.

4. A study should be made looking toward the development of a comprehensive concept and statement of federal debt, including holdings by the public, government trust funds, and other government agencies. This should include issues of all federal agencies whether or not they are technically designated as "full faith and credit" obligations

COMMITTEE FOR IMPROVING THE FEDERAL BUDGET

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Mr. MADDEN. The principal point to be made regarding Federal budgeting is that each of the four current concepts—the administrative; cash; national income accounts; and high employment budgets—performs a particular service.

Each is necessary to a better understanding of the effects and role of the Government's fiscal operations; but none is sufficient in this regard. Which of these concepts is the most important depends on the questions to be answered, as I have already suggested. An important corollary of this proposition is that the economic significance of a Federal deficit or surplus will be different depending on which budget concept is being used.

As a case in point, by emphasizing the NIA budget in its annual report, the Council is able to refer to a smaller fiscal year 1968 deficit than if it had emphasized the administrative budget. But what are the economic implications of this smaller deficit? As already indicated, the NIA budget suffers from a serious timelag in showing the influence on the economy of rising (or falling) Federal procurement, as for defense. For this reason, Mr. Chairman, we agree with your proposal that a quarterly review of budget estimates should be instituted, especially the estimates for defense spending.

Similarly, the administrative budget is badly in need of reform, as ex-Budget Director Maurice Stans has emphasized in a recent U.S. News & World Report article in the January 16, 1967, issue. We are pleased to find the administration thinking along the same lines as Mr. Stans in the President's announced intention to appoint a nonpartisan Commission on Budget Reform. This Commission should examine, among other things, the advisability of eliminating over-

*Served through September 24, 1962.

lapping and duplicative activities, removal of outmoded programs—such as farm price support—and the possibility of changing the Government's direct domestic credit programs, which many students of the question believe operate counter to monetary policy. Above all, the cost-effectiveness approach to setting priorities and measuring the benefits of programs as is done in the Department of Defense, should be broadened to include not only older programs but also those in the Great Society category which, so far, have been accepted largely on faith as to their social and economic benefits. For a fuller treatment of this question, may I respectfully refer this committee to the findings and recommendations of the national chamber's task force on economic growth and opportunity, whose third report, the "Disadvantaged Poor: Education and Employment," will be published this month.

But, important as it is, cost-benefit analysis and resource effectiveness is only one aspect of resource use. The other aspect is the level of employment. A striking change in this year's annual report is the playing down of the high employment growth side of the economy in favor of emphasizing the resource-allocation pattern. This is especially noticeable in the section of the report devoted to the wage-price guideposts.

The Wage-Price Guideposts

The Council again reminds us (p. 119)* that "business and unions can push prices up even when resoures are not fully utilized." This reflects its fear of cost-push in 1967. But, contrary to its reports since 1962, the Council has backed away from specifying a precise percentage figure for guideposts. Instead, we find the admonition that, (p. 133), "To assume steady movement toward price stability in 1967, the public interest requires that producers absorb cost increases to the maximum extent feasible, and take advantage of every opportunity to lower prices." But surely the public interest requires that there be moderation in wage demands in the light of the Council's own admission (p. 128) both that "the primary source of the rise in consumer prices lies in areas to which the guideposts have no applicability" and that "much of (the rise in corporate profits) would have occurred had the guideposts been precisely followed." In our estimation these statements come as close as possible to admitting what Secretary Wirtz conceded before your committee on February 7—that the precise percentage guidepost was a mistake.

The national chamber's position on the guidepost question has consistently been that as a general guide the proposition is unassailable that price and wage changes should reflect productivity gains if stable growth is to be achieved. But it does not follow that a rigid productivity formula and administrative coercion should be used as a guidepost policy. Our testimony against Mr. Reuss' H.R. 11916 last September, was based on three points that we believe are still valid: (1) That the Reuss proposal would have changed the nature and intent of the voluntary guidepost concept as first set forth in the Council's 1962 annual report; (2) it would have drastically altered the philosophy of the Employment Act and the unique and valuable role of the Joint Economic Committee under the act; and (3) by proposing an

*Economic Report of the President together with the annual report of the Council of Economic Advisers, 90th Cong., first sess, H. Doc. 28.

administrative instead of a general economic policy approach to controlling inflation, the bill mistook symtoms for causes of inflation and would, therefore, not have been effective.

In taking this position the national chamber federation is not blind to certain defects in general anti-inflationary or anti-deflationary economic policy measures in the monetary and fiscal spheres. For example, we have seen in the past year the uneven incidence of tight money, which strikes most heavily on industries that are hypersensitive to sharp changes in the cost and availability of credit. We are also aware of the lesser effectiveness of an easy-money policy in overcoming a recession than in curbing a superboom. And we appreciate the difficulty of using fiscal policy flexibility because of the political difficulties involved. But it would be a mistake to conclude that these defects and difficulties can be offset by more "banging on the economic machinery" of the coercive guidepost kind. Rather, I think we must conclude from the uneven impact of monetary policy that the structure of our financial system is the crux of the matter, given the changes in the magnitude and character of flows of funds in the past two decades or so. With respect to the political complications and implications of introducing more flexibility into fiscal policy, the lesson of last year clearly demonstrates the need to reevaluate the conditions under which a suitable fiscal-monetary policy "mix" is likely and not just theoretically desirable. It is questions of this kind that, in our opinion, the Joint Economic Committee should be considering.

Uses of the Growth Dividend

I have mentioned the lesser emphasis in the Economic Report on growth in favor of stressing resource allocation. The report does, however, raise the question of how best to use the expected "growth dividend" of $47 billion. This figure corresponds to a real growth rate of 4 percent, which is much lower than the average of nearly 5½ percent of the past 3 years. Paradoxically, a great expansion in the nondefense Federal budget has accompanied the slowing down in the growth rate, so that the budget has actually risen as a fraction of the GNP. But, aside from a concession on page 136 to the demands of the Vietnam war on our resources, chapter 4 of the Council's annual report on "Selected Uses of Economic Growth" appears to have been written with a peacetime economy in mind.

Perhaps the most significant statement in this chapter (p. 135) is that "Public policy cannot be neutral in its impact on the allocation of gains from economic growth. How these gains should be distributed must be squarely faced as an issue of public policy."

Such a statement could imply either more reliance on Federal programs to promote market solutions, or more reliance on Federal programs that directly affect resource allocation. The discussion that follows through little light on this all-important question. In fact, from the viewpoint of those who have studied the problems of poverty and urban problems, as has the national chamber's task force on economic growth and opportunity, the treatment of these and related questions in the report is extremely cursory.

Balance of Payments Policy

The recent dramatic drop in our short-term interest rates and the narrowing of the differential vis-a-vis Europe has exposed us, in the opinion of many experts, to the danger of a larger balance-of-payments deficit this year. Yet, this and last year's report relegate the question of our continuing payments deficit to the last chapter, unlike the 1965 report which featured our payments problem. Recent developments have also presented the Federal Reserve once again with the dilemma whether to moderate its domestically oriented credit-easing policy for balance-of-payments reasons or to run the risk of worsening our payments position by easing credit further. But there is little if any discussion by the Council of the appropriate monetary-fiscal mix that it considers necessary to minimize both domestic recessionary tendencies and the payments deficit this year.

Instead, there is a less helpful discussion of the responsibilities of other nations (p. 189) to "adopt measures to neutralize their 'windfall' foreign exchange gains," measures to achieve consensus on balance-of-payments adjustment policies, and measures to achieve international monetary reform.

To be sure, efforts to enhance international monetary balance-of-payments cooperation deserve support. But by the same token, in appraising our payments problem and devising courses of action to right the payments balance, particular effort should be made to avoid ad hoc measures resulting in undesirable restraints or controls on the free flow of trade and credit.

There is little dispute that many elements enter into determining the international flow of capital; that the flow is affected by factors other than a shortage of real capital; and that the flow does not occur "always and automatically in just the economically 'correct' amount" (p. 189). In refuting such contentions, however, the Council may well be knocking down strawmen.

The unpleasant fact is that since 1961 the Government has advanced only ad hoc measures to cope with our payments problem; it has lacked a clear policy regarding the range of responsibilities which have come to the United States in its role of international banker; it has resolved the growing burden of defense responsibilities by measures perpetuating so-called temporary and voluntary restrictions on export-earning private investment, and it has relied far too heavily on monetary measures and too little on fiscal measures to offset overheating of the U.S. economy.

As a result, this year, when facing the danger of a larger deficit despite many ad hoc measures with adverse effects on long-run prospects for free flow of capital, the Council also faces at home declining productivity, rising unit labor costs,, and labor unions bent on wage settlements beyond productivity gains.

The real issue is whether the Council gives full recognition to the dangers of unduly prolonging restraint upon the kind of investment, foreign or domestic, which is a major stimulus to exports. Guidelines, when perpetuated year by year, freeze old patterns of investment and export expansion that may be belied by dynamic growth patterns. Such guidelines likewise gain a status quo which it becomes easier to defend than to replace with long-term measures reflecting full recogni-

tion of changed responsibilities. And talk about international cooperation measures, prolonged in consultation and in esoteric official discussion during times of high employment and growth, can lull official thinking into ignoring that the current drift of policy merely hands surplus countries, through gains in official reserves and in short-term dollar claims, further bargaining power over future U.S. domestic economic policy. These vital long-run questions of economic policy are neglected in the Council's report.

Conclusion

In summary, the Economic Report of the President and the Council's 1967 Annual Report appear to have overstated the prospects for the economic outlook this year and to have understated the year's stresses and strains. This casts doubt on the policy proposals for economic stability. These policy proposals, such as the 6-percent surcharge, rest implicity on an estimate that the second half will be stronger, made in the face of a probable slower rise in defense orders this year than last, weakened auto and other durable sales, an emerging squeeze on profits from rising unit labor costs combined with slower sales, and the impact on investment of these developments and the continued suspension of the invention tax credit. Under these circumstances, the Congress should exercise great caution in evaluating the fiscal stability arguments for a tax increase in the light of current economic trends and forthcoming developments.

At the same time, the Federal budget for fiscal 1968 of $169 billion on national income account has risen from $91 billion in fiscal year 1960. "Its dominating feature," in the words of the London Economist (Jan. 28, 1967, p. 325), "is quite simply its tremendous growth and not only because of the war," a growth that in the past 3 years has amounted to $50 billion, "of which just under half is accounted for by the war in Vietnam," and that has resulted in a rise of Federal spending as a share of a rapidly growing GNP. This huge budgetary growth has led the Senate majority leader, Senator Mansfield, to call for a reexamination and reevaluation this year of major recent programs, in the hope that, quite apart from issues of aggregate employment and output, the effectiveness of resource allocation can be strengthened by consolidation and economy in the Federal Government.

The chamber of commerce federation respectfully recommends Senator Mansfield's views to this committee and the Congress.

Chairman Proxmire. I thank all of you gentlemen for a fine series of papers. Let me see if I can find out if we have universal agreement from these diverse groups on a few things.

As I understand it, all three of you agree that we should not, on the basis of the present economic situation, increase taxes in May or June of this year. We shouldn't have the 6-percent surtax increase the President has proposed to begin July 1; is that your view Mr. Sprinkel?

Mr. Sprinkel. That is correct.

Chairman Proxmire. Dr. Madden?

Mr. Madden. That is correct.

Mr. Goldfinger. That is not precisely my view, sir. I don't know what the economic situation will look like in May and June when you

gentlemen will be called on to examine this situation. I would take an open-minded view on this issue, watch the situation carefully between now and May and June, and make the decision on the basis of the actual trends in sales, production, employment, and unemployment.

Chairman PROXMIRE. A, you would not enact it now, and B, you—or you would enact it if the situation is about the way it is at the present time.

Mr. GOLDFINGER. I am not sure that I would enact it if the situation in May and June was as it is now, but I would like to think that we have several months—3, 4, or 5 months before deciding whether it is necessary.

Chairman PROXMIRE. On the basis of all your testimony, Mr. Goldfinger, I would assume you feel one of the real problems is we have a deficiency of purchasing power. Wouldn't you, therefore, discriminate, and on the basis of a tax increase, maybe I don't want to put words in your mouth, but I would assume that you would be more in favor at least of an increase in corporate income taxes and no increase in personal income taxes.

Mr. GOLDFINGER. We are on record along those lines, sir. Mr. Meany, President of the AFL–CIO issued a statement right after President Johnson's state of the Union message, stating that the issue of the tax increase would be examined later.

However, in terms of the composition, the incidence of the tax increase, if and when such a tax increase is imposed, it should obviously exempt the lower income taxpayers along the lines of the President's proposal, which in our judgment is only a partial recognition of the ability to pay principal.

Furthermore, if and when such a tax increase is imposed, depending on circumstances between now and the time when it is seriously considered later this year, the levy on corporate income should be much higher than on individual income.

Chairman PROXMIRE. You see the difficulty is that we have assumed that it is easier to save a so-called—and all these things are so-called—neutral tax, and if you start fooling around with discrimination between different tax groups, you are going to be tied up for a lot more than the few weeks that we would have to have if we are going to have a stabilizing tax; although I think Congressman Reuss and many of the rest of us would agree that there are all kinds of changes we ought to have in the Internal Revenue Code to make it more equitable.

Mr. GOLDFINGER. Frankly, Senator, I am kind of sick and tired of hearing my fellow economists talk of neutral tax changes. The neutral tax changes that they have been talking about, the neutral tax changes in quotes that have been put into effect have really been discriminatory. They have been discriminatory not only against low-income taxpayers but against moderate-income taxpayers.

There has been, as I indicated in the paper that I presented, a continuing shift of income distribution away from the low- and moderate-income people in this country into the hands of the wealthy families and into the hands of business, and this shows up in profits, it shows up in dividends; it shows up in capital gains; and it shows up also in interest payments.

We have allowed serious distortions to develop, and I think that any kind of tax change in the future must take these issues into consideration. Otherwise, we will perpetuate an imbalanced condition in the