1035-A

Y4
B85/2
In 3/2

GOVERNMENT
Storage

KSU LIBRARIES
A11900 560252

93Y4
B85/2
In 3/2

HE FEDERAL BUDGET AND INFLATION

UMENTS
AN 30 1975
RY
STATE UNIVERSITY

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET
UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

AUGUST 14, 15, 21, AND 22, 1974

Printed for the use of the Committee on the Budget

AUTHENTICATED
U.S. GOVERNMENT
INFORMATION
GPO

THE FEDERAL BUDGET AND INFLATION

HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

NINETY-THIRD CONGRESS

SECOND SESSION

AUGUST 14, 15, 21, AND 22, 1974

Printed for the use of the Committee on the Budget

U.S. GOVERNMENT PRINTING OFFICE
39-566 WASHINGTON : 1974

COMMITTEE ON THE BUDGET

EDMUND S. MUSKIE, Chairman, *Maine*

WARREN G. MAGNUSON, Washington
FRANK E. MOSS, Utah
WALTER F. MONDALE, Minnesota
ERNEST F. HOLLINGS, South Carolina
ALAN CRANSTON, California
LAWTON CHILES, Florida
JAMES ABOUREZK, South Dakota
JOSEPH R. BIDEN, JR., Delaware

PETER H. DOMINICK, Colorado
MILTON R. YOUNG, North Dakota
ROMAN L. HRUSKA, Nebraska
JACOB K. JAVITS, New York
PAUL J. FANNIN, Arizona
ROBERT DOLE, Kansas

DOUGLAS J. BENNET, JR., *Staff Director*
JOHN T. MCEVOY, *Chief Counsel*
ROBERT Z. BOHAN, *Minority Counsel*
MARIA P. DURELLI, *Chief Clerk*

CONTENTS

STATEMENTS BY COMMITTEE MEMBERS

	Page
Chairman Muskie	1
Senator Dominick	3
Senator Magnuson	4
Senator Young	6
Senator Moss	7
Senator Hruska	7
Senator Hollings	9
Senator Fannin	10
Senator Dole	12
Senator Biden	44

WITNESSES

AUGUST 14, 1974

Rush, Hon. Kenneth, Counselor to the President for Economic Policy	13
Ackley, Dr. Gardner, University of Michigan, and former Chief Economic Advisor to President Johnson	57

AUGUST 15, 1974

Ash, Hon. Roy, Director, Office of Management and Budget; accompanied by Dale McOmber, Assistant Director for Budget Review	91
Simon, Hon. William E., Secretary of the Treasury; accompanied by Edgar R. Fielder, Assistant Secretary for Economic Policy; and Frederick L. Webber, Assistant Secretary for Legislative Affairs	183

AUGUST 21, 1974

Burns, Dr. Arthur F., Chairman of the Federal Reserve Board	211
Heller, Dr. Walter W., regents' professor of economics, University of Minnesota	245

AUGUST 22, 1974

Adams, Prof. F. Gerard, Wharton School of Finance and Commerce, University of Pennsylvania	274
Warnke, Hon. Paul C., Assistant Secretary of Defense	297
Weidenbaum, Prof. Murray L., Washington University, former Assistant Secretary of the Treasury	304
Rivlin, Alice M., senior fellow, Brookings Institution and former Assistant Secretary of HEW	317

ADDITIONAL MATERIAL

Page

Article by Milton Friedman, Newsweek, 1974, "A New Holiday"------ 105
Speech by Senator Goldwater, August 13, 1974, "Inflation"---------- 106
"Big Government's Destruction of the American Economy," by Wesley H. Hillendahl, Committee for Monetary Research and Education, Inc---------- 106
"Estimates of Federal Tax Expenditures," prepared by the staffs of the Treasury Department and Joint Committee on Internal Revenue Taxation---------- 129
"Federal Research and Development Programs—Special Analysis O," Office of Management and Budget, January 1974---------- 151
"Federal Program Evaluation from the OMB Perspective," Frank L. Lewis and Frank G. Zarb, Office of Management and Budget, Public Administration Review, July 1974---------- 168
"Managing for Results in the Federal Government," Frederic V. Malek, Deputy Director, OMB, Business Horizons, April 1974---------- 177
"A Program for Controlling the Budget," by Murray L. Weidenbaum---- 306
U.S. losses resulting from Herstatt bank failure---------- 199, 361

LETTERS

Letter from Dr. Burns to Congressman Wilbur Mills, August 1, 1974, re desirability of raising the corporate income tax from 48 to 50 percent-- 237
An open letter to President Ford, by Walter W. Heller, regents' professor of economics, University of Minnesota, as published in the Wall Street Journal, August 12, 1974---------- 268
A letter to Senator Muskie from Frank Rodio, Jr., Pennsauken, N.J., August 16, 1974, enclosing his report entitled, "Inflation Alert: Blueprint for Action"---------- 343
Letter to Senator Muskie from Gardiner C. Means, Vienna, Va., August 13, 1974, with attachments---------- 344
Letter to Senator Muskie from William E. Simon in response to question regarding the amount of funds lost by U.S. banks in closing of I. D. Herstatt and Bass and Herz banks, September 16, 1974---------- 361

TABLES

Federal budget outlays in constant (fiscal year 1969) dollars---------- 100
Federal budget outlays in current dollars---------- 100
Government spending as percentage of national income---------- 106
Government spending related to personal income in the United States, 1950–73---------- 107
Government spending related to personal income in the United States, 1975–90---------- 111
Per capita debt and interest payment in the United States---------- 109
Money supply and price increases, 1965–68---------- 110
Money stock related to population in the United States---------- 111
Fiscal year 1975 budget—composition of outlays---------- 117
Proposed 1975 reductions requiring legislative action---------- 121
Budget receipts, 1973–75---------- 183
Unified budget receipts for fiscal year 1975 as estimated in May 1974---- 184
Federal outlays for the unified budget, off-budget Federal agencies, and Government-sponsored enterprises---------- 221

	Page
Macroeconomic effects of alternative budget scenarios (calendar year 1975)	275
Hypothetical governmentwide programs planning budget, fiscal year 1973	308
Controllable share of 1973 agency budgets	310
Estimated net outlays of off-budget Federal agencies, fiscal year 1975	312
The Strategic balance: United States and U.S.S.R., 1963–73	313

CHARTS

The budget and inflation	188
The budget and unemployment	192

THE FEDERAL BUDGET AND INFLATION

WEDNESDAY, AUGUST 14, 1974

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to notice, at 9:40 a.m., in room 4200, Dirksen Senate Office Building, Senator Edmund S. Muskie (chairman), presiding.

Present: Senators Muskie, Magnuson, Moss, Hollings, Cranston, Abourezk, Biden, Dominick, Young, Javits, Hruska, Fannin, and Dole.

Also present: Alvin From, Lee Lockwood, and Lucinda Dennis, staff of Senator Muskie.

Senator MUSKIE. The committee will be in order.

May I say this is the first official hearing to be conducted by the new Senate Budget Committee, and so I think it is appropriate for me to make a brief opening statement and some of my colleagues, I understand, may also have some opening statements. I do not think they can be described as filibusters. I think we can get to the witnesses reasonably quickly. But I think it is important to set the context of these hearings.

OPENING STATEMENT OF CHAIRMAN MUSKIE

This is an historic occasion this morning.

Frankly, during some of the long hours and months of work that went into the budget reform bill, I had my doubts as to whether this committee would ever become a reality.

But it did. And now to borrow a phrase from the President, we have our work cut out for us.

Two days ago we heard our new President describe inflation as public enemy No. 1. I am sure everyone in this room would agree with that assessment.

The question, of course, is where are we going to go from here?

In the 1960's, a President of the United States committed our Nation to placing a man on the Moon. If we were to do it today we might meet inflation there. There was no small commitment, to be sure. But primarily it entailed only a marshaling of national resources and a nurturing of the technology needed to realize a finite goal.

Inflation is a much more elusive target. It is subject to countless uncontrollable pressures, both domestic and international.

The tools for taming it are far from exact.

If we are to strike a blow at its seemingly boundless vitality, we are going to need a far steadier aim than we have had in the past.

That, of course, is one of the principal reasons that we now have a Budget Committee—to help provide a steadier aim for the Congress in putting its fiscal house in order.

As a committee, our formal legislative recommendations to the Congress are scheduled to begin next year.

But we believe we have a responsibility to become involved—in appropriate ways—in the budget debate of this year.

Congress has no higher priority, for the fall of 1974.

Here in the Senate, over the last few weeks, we have heatedly debated the question of whether cutting Federal expenditures will ease inflationary pressures.

Opinions are sharply divided.

As our first official act, this committee seeks to divert the energy of these divisions into the energy of constructive consensus, bearing in mind that the American people want action, not slogans—solutions, not panaceas.

We must ask the hard questions from the very beginning, for they will not get any easier if we wait.

And we must be prepared to let popular assumptions fade where they are not supported by the facts.

The most crucial question we must ask at the outset is how Federal spending affects the economy. Is Federal spending in fact a prime cause of today's double-digit inflation?

On this point we have heard a lot of talk. We need some hard analysis.

We must also ask how Congress can best control Federal spending—whether we reduce it, or simply hold the line—within a broad framework of agreed-upon priorities.

Before we suggest cutting the budget, we must ask first, what is in the budget?

If cuts are required, we must ask where they can best be taken, to avoid the pitfalls of false economy.

And, we must ask the price of the various policy options before we agree to buy. How much unemployment are we willing to allow as a possible price of tighter fiscal policy? How much slack in our productive capacity can we sustain as another possible cost of restraint?

Will any or all of these cures be worse than the disease itself?

These questions are serious business.

And many people in the Congress and throughout the Nation, are looking to this committee and its counterpart in the House, for serious answers.

Inflation is not a partisan issue. Each and every citizen has felt its stealthy touch.

And I believe that each and every citizen is willing to pay a price to leave it far behind.

But the lead must come from us.

We are here this morning because we are ready to take that lead.

And I know that I can speak for the entire committee when I say that we are looking forward to the challenge.

At this point may I express my appreciation to Mr. Rush for being willing to launch not only the administration's economic policy but this committee. We look forward to his testimony, but before we get to that, I would like to yield to the ranking Republican member of this committee, my good friend, Senator Dominick.

OPENING STATEMENT OF SENATOR DOMINICK

Senator DOMINICK. Thank you, Mr. Chairman.

I am delighted that we are as a committee starting these hearings. I believe that this committee, as I have said, has the potential to become one of the Congress' most important responses to the need for combatting inflation. Therefore, Mr. Rush's testimony, Mr. Ackley's testimony, and the others tomorrow and next week, are going to be extraordinarily important.

This year the proposed Federal budget for 1975 is more than $304 billion and that budget exceeds last year's by $20 billion. When one looks at the history of spending by the Federal Government, the need for timeliness for Congress to get control of its own spending apparatus is obvious, at least to me.

For example, it took this country 185 years to reach an annual Federal expenditure of $100 billion. Nine years later we were at $200 billion. And now, 4 more years have passed and we are at the $300 billion level.

Right now the rate of inflation in the country is projected to be 14 percent, a figure 10 percent higher than 10 years ago, and I believe it is here in this committee where the Congress can and should begin to provide a meaningful and thoughtful response in working to combat not only inflation today but also to meet and head off pressures of tomorrow.

It is my hope that this committee's work will be one way to respond to the call of President Ford Monday night when he said to Members of both Houses, "You and I have a lot of work to do. Let's get on with it."

I would ask, Mr. Chairman, if I could have unanimous consent to put my whole prepared statement in the record. It is not very long to begin with, but I think I have hit on some of the key points of it.

Senator MUSKIE. Of course. Without objection, that will be done.

PREPARED STATEMENT OF HON. PETER H. DOMINICK, U.S. SENATOR FROM THE STATE OF COLORADO

Senator DOMINICK. I am delighted that the Senate Budget Committee, a committee which I believe has the potential to become one of Congress most important responses to the need for combating "inflation", today opens hearings to review the fiscal year 1975 budget. Certainly as we move forward to respond to this country's No. 1 problem—inflation—it is important for us as members of this committee to receive and review the testimony of men who have been most involved in spending decisions at the Federal level.

It is clear to me that although each of us as well as the experts may differ on the precise means of slowing or reversing the inflationary spiral, more and more attention must be paid to control of the Federal budget and the wisdom of curtailing the Federal Government's overspending of the budget.

This year the proposed Federal budget for 1975 is more than $304 billion. That budget exceeds last year's by $20 billion. When one looks at the history of spending by the Federal Government, the need for the timeliness for Congress to get control of its own spending apparatus is obvious.

For example, it took this country 185 years to reach an annual Federal expenditure of $100 billion. Nine years later we were at $200 billion, and now, 4 more years have passed and we are at the $300 billion level.

Right now, the rate of inflation in this country is projected to be 14 percent, a figure 10 percent higher than 10 years ago. I believe that it is here in this committee where the Congress can and should begin to provide a meaningful and thoughtful response in working to combat not only inflation today, but also to meet and head off pressures of tomorrow. It is my hope that this committee's work will be one way to respond to the call of President Ford, Monday night last, when he said to Members of both Houses: "You and I have a lot of work to do. Let's get on with it."

I believe that one aspect of "getting on with it" will be the work of this committee in carrying out one of the declarations of purpose in the legislation creating us, namely, the need for Congress to assure effective congressional control over the budgetary process.

As Senator Muskie and I pointed out in our letter of August 13 to President Ford:

"The establishment of a new Congressional procedure for handling the budget and the assumption of power by your Administration offers a unique opportunity for cooperative action by the Congress and the President to fight inflation and control unemployment.

Mr. Chairman, I look forward to the testimony of these and other witnesses, and I pledge my support for our committee's efforts to bring more structure and control to congressional spending.

Senator MUSKIE. At this point I yield to my distinguished senior colleague, Senator Magnuson.

OPENING STATEMENT OF SENATOR MAGNUSON

Senator MAGNUSON. Mr. Chairman, I want to, of course, join with the chairman in his statement today and the Senator from Colorado. I have a short statement which I will place in the record in its entirety. We face a challenge in this committee to take a look at not only Federal expenditures but as importantly, how this fiscal policy affects the economy. This is what we have got to find out. Do Federal expenditures have the effect of firing the flames of inflation? Or, conversely, do limited expenditures have the other effect, to create unemployment?

Unemployment can cost us more if we are not judicious. First, unemployed people do not pay taxes, which causes a decline in tax revenues. And even more importantly, we would have to spend huge sums in welfare support for people who might otherwise be productive tax paying citizens.

The Appropriations Committee finished the big Defense Department appropriation bill yesterday and tomorrow I am starting on HEW. These are the two big bills, and so we cannot affect fiscal year 1975 bills very much. But, next year's budget is going to be another story. This committee will have surely a great deal of influence with whatever comes from downtown. What we decide must serve as a ceiling.

But I hope Mr. Rush and the witnesses down the line will point out that it is not so much the overall budget that Congress is worried about. We have never appropriated money over the budget. Congress

has appropriated $26 billion under the budget since Mr. Nixon and Mr. Ford came into office.

The problem has always been priorities. Where do you cut? And this is what has got to be sorted out by this committee. Do you take it from Defense or do you take it from health research? Do you close up community mental health centers? Do you have a budget in which there is no training program whatsoever for the health manpower of this country on one hand, while we are talking about a national health insurance bill on the other hand that will cause a demand for more doctors. We could have a good national health insurance bill but if you do not have the manpower to provide care, the promise will not amount to much, will it? And this is what bothers me.

I think our problem is not so much the overall amount of money. I think we will agree on substantial cuts overall of Federal spending. There are many places we can do it. But we are going to have some serious problems and we need serious advice from everyone, including the private sector, on what are the priorities. Whatever the Federal Government is going to spend, what are the priorities? It is a great challenge for us on this committee. We are going to have to end up cutting budgets but we are going to end up with a lot of controversy on where we cut them. This is our real problem.

Thank you. I ask to have my entire statement put in the record.

Senator MUSKIE. Without objection, of course.

PREPARED STATEMENT OF HON. WARREN G. MAGNUSON, U.S. SENATOR FROM THE STATE OF WASHINGTON

Senator MAGNUSON. Today the Senate Budget Committee holds its first public hearings. The occasion is appropriate to address a few remarks to my colleagues and to the new administration.

It is an accident of history that we, as members of a new congressional committee, should be here today with these witnesses, who are representatives of a new national administration, to discuss the condition of the Nation's economy.

I hail the announcement by President Ford that he will work with this committee because the Federal budget must be brought back under control. For a decade I have called for a more sensible budget process; the new Budget Committee finally offers us an alternative.

The Congress now has a unique opportunity to move on inflation before November. These, and following hearings, will indicate the depth and breadth of our economic problems. I hope the new administration comprehends the scope of the problem and its human dimensions.

The President detailed several specific actions Monday night. We should recreate the Cost of Living Council. We should convene a domestic summit on the economy. And we must insist on fiscal restraint in Federal spending. This is the year, not next, for international economic reform, trade reform, and enactment of the key remaining energy bills. I join in supporting all these matters.

But there are other equally urgent elements to the problems of inflation. I hope President Ford omitted them by oversight, not by choice. We must have tax reform, and we must have effective restraints placed on monopolistic economic power.

There is no quick fix for the national economy. Nor is there any simple dogma which will solve our problems. Let me explain why. We have key commodity shortages. We have capacity shortages in several basic industries. But we also have excess capacity and rampant, mounting unemployment in other basic industries. We have high profits and shrinking productivity. Inventories are mixed. Real wages have shrunk in the last 12 months. And the rate of saving in traditional financial institutions is dismally low. Any single policy to solve one of these problems, such as high interest rates, aggravates another problem. In other words, our national response must be sophisticated and adapted to the particular problems in a particular sector of the economy.

Frankly, the old time religion won't work when a highly concentrated auto industry raises prices 10 percent in response to a 25-percent reduction in sales.

There are significant, constructive actions we can take. We can reduce the overall rate of inflation by attacking the monopolistic industries and by stimulating the productive, competitive ones. We can reduce inflation by real Federal fiscal restraint. We can reduce inflation by taxing excess and inflationary profits from the oil industry. We can reduce inflation by stimulating productive capacity in basic industries and by reducing reliance on scarce commodities.

And throughout this struggle, we must keep our eye on the basic priorities and values of our Nation—equality, fairness and renewed opportunities for all who wish them.

That's our task Mr. Chairman. I look to these and later witnesses to help us on our way.

I think this committee should applaud the portion of President Ford's speech Monday night where he discussed dealing with Federal budgets as they affect inflation, setting up the Cost of Living Council, and many related suggestions. These are movements forward. I think the country feels greatly relieved that not only Congress but also the Executive seems to want to move with us on the matter of inflation.

Senator MUSKIE. Thank you, Senator Magnuson.

I would like to yield to Senator Young.

OPENING STATEMENT OF SENATOR YOUNG

Senator YOUNG. Thank you, Mr. Chairman. I would like to say just a few words.

I think this committee will be very instrumental in holding down Federal expenditures. It is always popular to advocate a cut in Federal expenditures but when you come to cutting expenditures, you always run into opposition at the word "cut." It seems when you actually make cuts you run into sizable opposition from many people.

Just one other thought. Nearly half of our Federal expenditures today do not come under the jurisdiction of the Appropriations Committees and I do not know whether they will come under the jurisdiction of this committee. I am referring to expenditures where legislative committees legislate and appropriate in the same bill.

The CHAIRMAN. Thank you, Senator Young.

Senator Moss.

OPENING STATEMENT OF SENATOR MOSS

Senator Moss. Thank you, Mr. Chairman. I have just a brief observation. This is a historic first because this committee launches now its first hearing and our problem will be, as has been said by my colleagues, very broad and certainly controversial, but in this beginning day this committee is going to come into the stream of helping to shape budgets to begin with rather than the traditional task that we have had of receiving a budget and then trying to work the Congress will on what has already been wired into that budget.

Hopefully, with the help of these fine witnesses we have today and many, many others we will hear, we can get ourselves in a position where in future years, we will have some input into shaping the budget in the first place, and as my colleague, Senator Magnuson, said, the real name of the game is priorities. Where do you put the money that we are going to spend?

We are all in favor of holding spending down but the ideas vary greatly as to where it shall be held down and where it shall be spent. So that is what we are facing in the life of this committee.

I have great hopes for this Budget Committee that has now been authorized and created by the Senate and its counterpart in the House, and I think this is the beginning of a new awareness of the responsibility of the Congress in shaping budgets in the first place.

Thank you, Mr. Chairman.

Senator MUSKIE. Thank you, Senator Moss.

Senator Hruska.

OPENING STATEMENT OF SENATOR HRUSKA

Senator HRUSKA. Thank you, Mr. Chairman. My share of the rhetoric of the morning, Mr. Chairman, will be in the form of a statement which I ask be placed in the record——

Senator MUSKIE. Without objection.

Senator HRUSKA [continuing]. To save the valuable time of many people, I would just like to make this observation: It is often said that the Congress has no input into the budget, that the process is one of more or less unilateral character in that the President sends a budget message to us in January and we work our will upon it and make no significant contribution to it. That, of course, is not true.

For example, in one of the bills pending before the Appropriations Committee there have been reductions of approximately 3½ percent below the President's budget request. Yes, we have on file and being urged upon the committee the addition of various items totalling $900 million over and above what we have already processed. We are going to have to wade into those and find out whether they have sufficient priority to be allowed and thus take away from that 3½ percent cut.

So there is an input. Unfortunately, sometimes, when an item fails in the committee, the majority of the votes in our chamber clears the atmosphere too frequently by the addition of huge sums of money which have already been considered by the President, considered by the committee, and then rejected. This may be followed by Senate action which is in a totally different direction. And it is to that consideration the Congress must address itself, a matter of restraint and self-discipline.

A development of this thought is in my prepared statement. I thank the chairman for allowing its inclusion in the record.

Senator MUSKIE. Thank you, Senator Hruska. Of course, your statement will be included in the record.

PREPARED STATEMENT OF HON. ROMAN L. HRUSKA, U.S. SENATOR FROM THE STATE OF NEBRASKA

Senator HRUSKA. Today is a historical day for the U.S. Congress. This special Senate Budget Committee, meeting for the first time today, signals both a renewal and a beginning. Today the Congress reaffirms the role it has always retained under our Constitution—that of appropriating Federal funds. But, today is a beginning. For the first time, the Congress is going to approach its budgetmaking responsibilities with greater initiative, efficiency, and dedication.

I think the tone of President Ford's address to the Congress this Monday should be particularly noted by this committee. He pledged to keep Government spending down as a key step in the fight against inflation that is plaguing this this country. We as members of this Budget Committee have as our obligation and duty to oversee Government spending and take steps to insure that it is kept to a minimum.

This new Budget Committee can set a worthy example, not only for Congress, but for the rest of the Nation, by its activities. If we are wise, careful and act in the best interests of the country, we will have achieved our goals.

A new administration is in the White House. An administration that has pledged its cooperation with the Congress. We must reciprocate. This Budget Committee can work hard to see that responsibility is exercised in the determination of spending priorities by the Senate.

I have been especially privileged to be a part of the legislative history which has resulted in the establishment of this committee. It was my privilege in company with 15 other Members of the Senate to serve on the Joint Study Committee on Budget Control, which filed its report and recommendations on April 18, 1973. Since that time, I have followed with close interest the labors of the Committee on Government Operations and the Committee on Rules and Administration to fashion reform proposals which could command the support of a majority of Senators and establish a sound basis for compromise with the House.

As I stated on the Senate floor when this bill was first considered: "It is no mean feat to labor in the long shadow of the Constitution and nearly 186 years of congressional practice and precedent and forge proposals as cogent as those presented in the pending bill and the reports of the two committees." Mr. Chairman, the efforts of those committees were likewise rewarded in conference, and we now have the framework to guide us in a new approach to congressional budgetmaking.

The law that brings us here today bears witness to a great cooperative effort in the Congress. It belies the claims of those who would believe that the Congress is unwilling to reform, or if disposed to reform, incapable of rising to the task. As the new Senate Budget Committee, we have an obligation to insure that by our words and deeds,

we can fulfill the hopes of all Members of Congress who gave so much to this bill.

Our purpose can be simply stated: to establish a congressional budget process which will interrelate all congressional spending decisions to each other and also to the receipts and revenues available for such spending. The new budget process will give Congress earlier and more accurate information as to how much money is needed and is available to finance Federal programs. Furthermore, it is intended to provide Congress with more complete information on the consequences of any decision to increase or decrease the funding of Federal programs or the size of the Federal surplus or deficit.

Make no mistake about it, Mr. Chairman, we have a great task ahead of us. We should operate under no illusions. Let us recognize that elaborate structures and procedures, no matter how painfully they may have been developed, cannot serve as solvents for the extremely sticky issues of substance which are the main concerns of Congress. The budget reform bill provides for long-needed reform procedures. But, it offers no magic automatic solutions for the tough issues of defense spending and welfare spending, income support and social service programs, subsidized housing and housing allowances and so on.

In conclusion, we have our work cut out for us. We have made a good start. Let us improve upon that start knowing full well that the dictates of experience and changing times might well cause us to mold the framework as we go along.

Senator MUSKIE. Senator Hollings.

OPENING STATEMENT OF SENATOR HOLLINGS

Senator HOLLINGS. Thank you, Mr. Chairman.

Mr. Rush, I will make a comment in the form of two questions and perhaps you are going to answer these in your formal statement. One is to the effect of trying to balance the budget this year. I notice the President in his address talking in terms of getting a good health bill now, and getting a good trade bill now, but when it came to actually balancing the budget he said he hoped to work with the Congress with respect to 1976 and not 1975.

Yesterday the Subcommittee on Appropriations agreed, on Defense, to cut some $5 billion and if we take 5 percent from some of these other budgets, we can approximate a $10 billion cut and there are many of us interested in doing that. In fact, the HUD-Space Science bill reached the floor, and has been sent back to the committee. The transportation bill out of the appropriations has reached the floor, and has been sent back to the committee. President Nixon vetoed the agricultural bill. So this is in the realm of the possible, as many of us see it.

My question would be why not now? Why can we not try to get that $10 billion? Why not try to balance that budget now?

And the second question would be to the effect having withstood individual income tax cuts, having taken Dr. Arthur Burns and the administration approach of tight money and cutting budgets and everything else like that, is it the administration's intent to come back after Labor Day and start giving business the tax cuts, start talking about investment credits and accelerated depreciation allowances and

all of a sudden breaking the dam? That worries me, that we are trying in this committee to effectuate a discipline and we are liable to get tackled from behind by the business leadership. They are running all over the Hill on some little silly consumer agency. They have got all kinds of lobbyists, but none up here to balance the budget and I have got a feeling they are sort of sitting in the offing ready to tackle us from behind. The administration is working along with them unknowingly either by giving investment credit or by delaying the balancing of this budget until next year.

Senator MUSKIE. Thank you, Senator Hollings.

Senator Fannin.

OPENING STATEMENT OF SENATOR FANNIN

Senator FANNIN. Thank you, Mr. Chairman, and may I commend the chairman and ranking member for immediately getting down to work on this problem that we have of trying to work out a budget program. In considering—I will have a statement, Mr. Chairman, for the record, but I will just take a moment to comment about the considerations we will have. I feel that we cannot consider any appropriation as uncontrollable. We have a habit of saying well, this cannot be touched or that cannot be touched. It says that every appropriation has a certain number of Senators that will support it and so we run into the problem continuously. I think unemployment is a very great factor that is involved in what we do in trying to balance the budget but unemployment is so interrelated with other programs that are taken and fostered by the Congress. So in considering unemployment we must consider in relation to fiscal and monetary policy, balance of payments, and balance of trade, these are important, and we have quite a number of other factors which I will try to cover in my statement, Mr. Chairman.

Senator MUSKIE. Thank you, Senator Fannin, very much.

PREPARED STATEMENT OF HON. PAUL J. FANNIN, A U.S. SENATOR FROM THE STATE OF ARIZONA

Senator FANNIN. When the Joint Study Committee on Budget Control was created, we wre mandated to establish a system that would give Congress the means to make fiscally sound decisions. Having participated in the deliberations which ultimately resulted in formation of the Senate Budget Committee, I am especially pleased to be present at this first hearing of the committee.

The creation of this committee is in itself an admission by the Congress that something has been terribly wrong in the budgetary policies—or nonpolicies—that we have followed in the past.

The most crucial problem facing our Nation today is inflation caused in part by the uncontrolled and seemingly uncontrollable Federal budget. The people of this Nation are tired of excessive Federal spending, the ever-increasing amount of taxes required because of this spending, and the inflationary effects of huge deficits. We simply have not had a system which involved sound fiscal planning to govern appropriations and expenditures. If we are to curb inflation and control the national debt, Congress must begin to control the appropriations and the expenditures of Government.

This, Mr. Chairman, is our reason for being as a committee. I pray that we will meet this responsibility.

It should be emphasized that if we are to slow the momentum in growth in Federal expenditures, we should begin by recommending immediate cuts, including cuts in the so-called uncontrollable expenditures.

Mr. Chairman, it is clear to me that this committee fully realizes the pressing need to eestablish order in our Federal finances. The question is not whether it must be done, but how. A solution requires a firm ceiling on expenditures or a tax increase, or some combination of the two. There are several reasons for choosing a curb on spending in preference to a tax increase.

First, Government expenditures—counting outlays by State and local governments as well as Federal—have been rising much faster than our national production, so that an increasingly large portion of the wealth that our citizens produce is being devoted to the support of Government. In 1929 total Government spending amounted to about 10 percent of the dollar value of our national output. Since then the figure has risen to 20 percent in 1940, 30 percent in 1965, and 35 percent in 1972. It is time to call a halt.

Second, the expansion in Government outlays has not produced the kind of benefits the public has a right to expect. As Government assumes wider responsibilities, it becomes increasingly apparent that we must have a better system of controls to screen out low-priority programs and to insure that high-priority programs operate efficiently. The best way to get effective controls of that kind is for Congress to decide that one-third of our national output is quite enough for the tax collector.

Third, I have the impression that the American people feel that they are already carrying a sufficiently heavy tax burden, and will strongly resist any increase. If that impression is correct, raising taxes may not be a realistic alternative to a ceiling on spending.

Mr. Chairman, for many years I have believed and recent events have reinforced that belief, that better congressional control of the budget is absolutely essential to control inflation and maintain the vitality of our economic system.

In the past decade we have seen a proliferation of Federal programs with scant regard for future costs. Programs which at the outset required only a few hundred thousand dollars suddenly balloon to multi-billion dollar programs. Clearly, we must begin analyzing—and admitting—what the future costs of programs will be. We must stop establishing open-end programs which become fiscally insatiable. We must plug some open-end programs, and in some cases cut back on programs, which are out of control.

Mr. Chairman, we must quickly dispense with the idea that there is any such thing as an uncontrollable expenditure. We should look at every program, regardless of how long it has been in existence, and judge whether it is justified and whether the American people should be required to continue paying for it.

We must concede that there is a bottom to the Federal fiscal well. We cannot possibly provide programs and expenditures to meet every need that comes to the mind of the aspiring politician. There are limits to our national ability to provide for the needs and desires of the people.

Mr. Chairman, this is a tough job. If we do it right, we will be making hard decisions that will not help win any popularity points. If we fail to do the job, the economic future of the Nation is indeed grim.

Senator MUSKIE. Senator Cranston.

Senator CRANSTON. I have no opening statement.

Senator MUSKIE. Well, you have set a historic record.

Senator Dole.

OPENING STATEMENT OF SENATOR DOLE

Senator DOLE. I have a very brief statement, Mr. Chairman, and will make it a part of the record.

I would only reiterate what both Senator Hollings and Senator Fannin have said that there are a great many things that need to be done. There is a willingness on the part of almost everyone in the Congress to share some of the responsibility and make some of the hard decisions, even those which may be politically painful insofar as spending cuts are concerned, and I am encouraged by the attitude of President Ford. It does give us an opportunity, I believe, to make a new start, to carry on in those areas that have been successful, discard those programs which have not worked, and perhaps really begin to come to grips with this before the end of this year.

Senator MUSKIE. Thank you, Senator Dole.

PREPARED STATEMENT OF HON. BOB DOLE, A U.S. SENATOR FROM THE STATE OF KANSAS

Senator DOLE. I appreciate this opportunity to participate in the first hearing of the Budget Committee.

The current rate of inflation is unacceptably high. The two-digit inflation rate we have seen in recent months is the most severe problem facing the people in Kansas and in other States.

Bringing inflation under control must be the highest priority economic objective of the Federal Government. It is good to see that the President has identified the reduction of inflation as his greatest concern. Hopefully, we can initiate action in this committee which will be beneficial in achieving that goal.

BROAD ACTION NEEDED

The program for combating inflation must be a comprehensive one touching all the bases: restraining the growth of money supply, holding down Federal spending, and urging spending restraint by others in order to slow down the growth in demand, on the one hand, and taking a series of actions designed to increase supply, on the other.

Our primary focus today is, of course, on controlling Federal spending. In the spirit of the Congressional Budget and Impoundment Control Act, which gives the Congress and the Executive shared responsibility for the budget totals, our focus should be on how we in the Congress can work with the President in achieving the restraint on spending that we know to be essential.

We have already begun to make some progress in holding down Federal spending, as witnessed in recent cuts made to appropriation bills. I am glad to have been able to take an early leading role in the efforts

to make these cuts. Hopefully, we can continue our efforts in a similar vein.

WORLD PICTURE DARKER

We can take some—but very small—comfort in knowing:

That inflation has been less severe in the United States than in most advanced nations;

That much of it has resulted from unusual factors, including simultaneous bad harvests in many parts of the world, the quadrupling of prices imposed by oil exporting countries, and a simultaneous economic boom in the industrial nations; and

That events are not likely to repeat themselves, certainly not all together.

I do not want to dwell on these points, however, because I do not want them to become an excuse for doing less than we must to bring inflation under control rather than an explanation of how we got to where we are.

In summary, we have a great amount of work ahead. I believe our efforts here will be productive and that we will be ultimately successful in controlling inflation.

Senator MUSKIE. Senator Abourezk.

Senator ABOUREZK. I have no opening statement.

Senator MUSKIE. Thank you, my colleagues. It is evident that this committee reflects a wide spectrum of views. I must say that presiding over it will be an interesting experience. But in any case, we are delighted to begin. We are going to be orphans in the storm for a while with respect to quarters. We never know what hearing room we will be occupying because we have not been assigned one but it is appropriate that we begin in the Public Works hearings room. The public does work to support this Government and to provide the revenues and the public is affected by the budgetary policies that we adopt.

I am delighted to welcome Mr. Rush who is the President's Counselor for Economic Policy. We have known him in other capacities and on a personal basis. I welcome his attendance here this morning and I particularly appreciate his willingness to testify at a point when the administration is clearly reviewing economic and budgetary policy, and probably leaving many questions unresolved in a final sense. And yet I suspect from what the President said, that the basic thrust of the policy of the previous administration may be continued in any case.

Mr. Rush and I discussed the question of the wisdom of his appearing today and we both agreed it would be a useful beginning, especially as a symbol of the willingness of both the President and the Congress to work together cooperatively in dealing with this problem. So I do welcome you, Mr. Rush, and invite you to present your testimony.

STATEMENT OF HON. KENNETH RUSH, COUNSELOR TO THE PRESIDENT FOR ECONOMIC POLICY

Mr. RUSH. Thank you very much, Mr. Chairman, distinguished members of the committee. It is a great honor for me to appear before this committee on a historic first meeting of a committee for which we all have great expectations.

I am also pleased to be able to review and explore with you the general economic issues and principles underlying our current problem of inflation and the policies necessary to promote and move our economic system toward stabilization once again.

The fact that this hearing marks the first official action of the newly formed Budget Committee carries a great deal of significance. This committee has the potential of lubricating the process of communication, conciliation, compromise, and cooperation that the President called for in his address to the Nation Monday night. Because past efforts at controlling Federal spending or budget cutting have proven to be one of the most difficult tests of the spirt of nonpartisan cooperation, I applaud, and support, the integral role this committee will play in the challenge of controlling inflationary Federal spending that immediately confronts us.

Today, I would like to present a general overview of our policies for moderating the unacceptable rate of inflation, beginning with some general observations on fiscal policy and, in particular, the important impact Federal spending has on our current inflation. Before I begin, however, I will not that while our policies must focus on the diverse and often competing goals of employment, efficiency, and balance in our international accounts, inflation is our No. 1 problem today.

Our policy recommendations of fiscal and monetary restraint are widely recognized as the most reasonable approach available. Perhaps even more important, it is our intention to pursue these policies until the desired results are obtained. Gradual progress will require cooperative efforts within the Government and awareness in the private sector that current price and wage decisions should reflect long-term realities. My appearance today will be followed by other administration officials who will discuss these economic issues in greater detail.

The Federal Budget

While the Federal budget is the most comprehensive single vehicle for determining national policies and the relative importance of all the competing Federal programs, not enough concern has been given in recent years to its overall impact on the economy. Large increases in Federal spending for stabilization purposes in past years have given the Government more influence over the allocation of scarce resources in our economy at the expense of personal choice. The size of the budget relative to GNP should reflect our current notion of a proper balance between public and private control over the economic processes that allocate our scarce resources.

In recent years, however, past commitments to programs already on the books and the expense of cost increases built into these programs have restricted our ability to limit spending, change priorities, or raise money to meet the needs of more current demands. Past budget outlays for new programs have created long-term claims against our current and future national output.

The demands of past and present programs have forced the Government to turn increasingly to deficit financing. While income taxes have been reduced three times since 1963, a Federal spending deficit has been recorded in 14 of the last 15 years. The incursion of these large deficits has made the Federal Government a large borrower in the financial

markets, thereby reducing the funds available for businesses to make the necessary capital investments that will increase our productive capacity. Because deficit spending on the part of the Federal Government is one of the major causes of our current inflation, we must emphasize a policy of fiscal responsibility that will restrain the growth of demand by controlling Federal spending, and set the stage for avoiding inflationary deficits in future years.

For several weeks we have been making difficult decisions about the fiscal 1976 budget and what must be done to prevent fiscal 1975 outlays from drifting out of control. Trying to slow down the upward momentum of the Federal budget is not easy because it is usually more popular to respond to demands for increased spending, lower taxes and easier credit. In fiscal 1965 Federal outlays totaled $118 billion; in fiscal 1975 outlays of $305 billion have been proposed and there are constant pressures to move that figure even higher. This constant expansion of spending programs has already eroded budget planning flexibility and legislative commitments have been established far into the future.

The recent enactment of the Congressional Budget Reform and Impoundment Control Act, that established this committee, is encouraging because it provides a rigorous framework for Congress to use in approaching Government spending decisions. One of the responsibilities of this committee is to see that our actions and the actions of Congress conform to our rhetoric.

I will now briefly outline the major elements of our current policies.

First, this is not the proper time to reduce tax receipts. The additional consumption demands would further aggravate inflation. Even more important, such action would repeat earlier signals that the Government is unwilling to face the difficult challenges of necessary fiscal restraint.

Nor is this the right time to increase taxes even though the announcement effect might be dramatic. New capital investments in plant and equipment are particularly sensitive to tax increases and to uncertainties about future cash flows which are directly influenced by tax and capital consumption allowance rules. Fundamental changes in the tax structure should occur only after long and careful analysis of the impact on investment incentives and the resulting fairness to all groups. Tax reform studies preceding new legislation can and will go forward and some significant adjustment may be necessary, but the basic tax structure should not be changed each time short-term economic distortions develop. That would be disruptive to consumers and business firms in making long-term savings and investment decisions.

Second, as to expenditures, decisions must now be made to require a balancing of receipts and outlays in fiscal 1976. Since there is a lead-time of 11 months, we can strive to slow down the rate of increase of outlays for existing programs, and specific legislative adjustments can be identified and acted upon. We can also work to increase the productivity of Government programs so that the same services can be provided at a lower cost.

Our flexibility in restraining fiscal 1975 spending is somewhat more limited because the programs are already in place. The latest official estimates include budget outlays of $305.4 billion and receipts of $294 billion, which would result in a deficit of $11.4 billion during the cur-

rent fiscal year. However, legislation currently pending before the Congress would rapidly escalate spending beyond the planned level. Our firm intent is not to allow the cumulative effects of pending legislation to push spending higher and to seek every possible way to reduce spending, using the figure of $300 billion as a target. We must continue to work diligently with the Congress to promote reasonable compromises that will reduce this figure even more. The important thing now is to move forward on the two-pronged budget goal of achieving at least a balance in fiscal 1976 while actively attempting to reduce fiscal 1975 spending to as far as practicable below the current estimate of $305 billion. We must not permit outlays to drift upward in response to current legislative increases.

Third, as for monetary policy, I reaffirm the importance of achieving the moderate restraint goals of the Federal Reserve System. Careful examination of various statistics indicates that the Federal Reserve has sustained a supportive level of growth in the supply of credit while attempting to gradually stabilize the turbulent financial markets. The necessity of adding large inflation premiums and the intensity of loan demand in recent weeks have pushed interest rates to historically high levels, but both lenders and borrowers should consider the future course of the economy, particularly the slow acceleration of business activity and the gradual moderation of inflation pressures. While monetary policy must remain flexible and responsive to the changing needs of the economy, the present Federal Reserve Board policy of moderate monetary restraint seems to be most appropriate for the current situation.

Fourth, the Government can and should make every effort to improve the productivity of the economic system so that output is increased without creating more inflationary cost pressures. The obvious beginning point is for the Government to eliminate, or at least reduce, the barriers to efficiency created by its own policies. We have underway at this time, a broad review of all Government regulatory activities, purchasing practices, and allocation and price support programs which may be disrupting the productivity of the economic system. Increased knowledge of the impact of Government activities on price and supply is an important complementary action that has the potential of removing a number of inflationary obstacles and inefficiencies. These specific actions can be important supplements to the basic fiscal and monetary policies in shaping the general economic environment. We are constantly seeking new ways whereby the Federal Government can improve productivity, both in its own activities and in the private sector. Various Cabinet officials have participated in the efforts of the National Commission on Productivity and we hope this group of labor, management, and Government leaders will continue to be active in the future development of incentives for productivity improvement.

Fifth, at this time, we retain our strong opposition to a return to mandatory wage and price controls. We have found that the delays and distortions introduced into the free market system by strict controls were responsible for many of the shortages, disincentives to invest, and other inefficiencies.

Under the circumstances anticipated in the year ahead, it is our considered judgment that the need for flexibility of decisionmaking in industry is of paramount importance to protect jobs and efficiency.

The problems created by a program of mandatory controls far outweight the contribution such controls might make to price stability under current conditions.

We do, however, support the reactivation of the Cost of Living Council that will let us monitor wages and prices to expose abusive increases. The recent General Motors example is indicative of the President's willingness to use his own persuasive powers to urge voluntary wage and price restraint.

In the reactivation of the Cost of Living Council, we are not requesting the statutory authority to impose mandatory wage and price controls or to delay wage and price increases. The mere existence of such authority has, in our opinion, an adverse impact on expectations. The name of the game becomes "raise prices and wages now before the Govenment intervenes." Statutory authority to delay wage and price increases would lead to the belief that the Government was on its way back to mandatory controls. This could result in anticipatory wage and price increases that would be highly inflationary. The Agency we are proposing would provide an institutional focal point in Government for increasing our knowledge about the causes and effects of inflation, for monitoring wage and price developments, and for reviewing the actions of Government agencies with the goal of improving efficiency.

Finally, there are a number of important policy issues pertaining to international economic developments which strongly affect our own economy and which are, therefore, receiving priority attention. We have taken the lead for many years in working for a more open and equitable world trading system, in the conviction that expanded exchange of goods and services among nations benefits all peoples. In the area of international trade, the most important immediate task before us is the passage of the Trade Reform Act so that international negotiations can begin to reduce trade barriers and make better arrangements for managing trade relations. As you know, the new round of GATT negotiations started in September of 1973 with a meeting of 105 nations in Tokyo. Other nations are anxious to proceed and are waiting for the United States to obtain authority for full participation in the negotiations. Passage of the pending trade legislation by the Senate before the end of this summer is a crucial part of our commitment to meaningful discussions.

In other areas, we will continue to play a major role in seeking a cooperative international solution to the world's food and energy problems.

Dramatic fluctuations in a world trade in agricultural commodities have had a disruptive impact all over the world. Our overall policy is to seek ways to ensure that food production is adequate to the world needs, and that reserves are accumulated to prevent severe shortages during years of poorer crop yields. The United States initiated and will play a major role in this November's World Food Conference in Rome, which will deal with the problems of world food reserves, high prices, food assistance for less-developed countries, and existing trade restrictions.

In seeking an international approach to the world energy problem, we have been talking with the other major consumer nations in the Energy Coordinating Group (ECG). The most important of the co-

operative efforts discussed is a program to deter any future supply disruption and to protect ourselves if supply disruptions return. Effort has also focused upon longer-term cooperative solutions to the energy problem, such as research and development, as well as conservation and the accelerated development of our own conventional resources. However, the crisis continues to be important and serious. While we are engaged in several efforts to adjust to this challenge, the fundamental problem is still the high price. The current level of oil prices is creating serious problems for every nation and is making more difficult our own domestic efforts to combat inflation. In this interdependent world we are also members of the World Bank and the International Monetary Fund, we are seeking a better international system to deal with the development problems of these countries, including the problems created by the major increases in oil prices and other commodities.

In the international monetary arena, we have made considerable progress toward the construction of a new international framework. we have initiated an intergovernmental effort to minimize the distortions caused by Government investment policies that can significantly alter the efficient use of resources and undermine world economic progress. We are also actively promoting policies to recycle the earnings of the oil exporting countries into needed, productive investments.

SUMMARY

I have attempted to summarize my view of the correct economic policy prescriptions required by the current rate of inflation. I believe the situation requires a sustained program of moderate fiscal and monetary restraint combined with specific Government actions to improve the productivity of our system. It is also important that immediate Senate attention be given to the pending trade legislation. If we sustain this set of policies, I believe that we will make steady progress against the unsatisfactory rate of inflation while minimizing the risks on the unemployment side.

A concerted, cooperative move toward fiscal responsibility now will have benefits that carry forward for many years to come.

Thank you very much, Mr. Chairman. I look forward to testifying before this committee again in the future, after the President and his economic advisers have had more time to review the situation in its entirety.

Senator MUSKIE. Thank you very much, Mr. Rush.

In view of the fact that we have excellent attendance this morning, which I hope will be a continuing habit of this committee, if there is no objection I will invoke the 10-minute rule so that we may all have an opportunity to question.

May I suggest to my colleagues that inasmuch as the Senate is not in session with respect to floor activity today, that we take as much time today to inquire into these matters as possible. I will ask the staff to monitor the timing so the time will not get out of control.

First of all, Mr. Rush, I know that the President, as I indicated earlier, is conducting a review of economic policy, but in order to put your statement this morning in some context, do you have any reason

to believe that the policies outlined in your statement this morning are being subjected to significant change by this administration?

Mr. RUSH. I think, Mr. Chairman, that the policies I have outlined this morning represent the policies that the President approves. The President is now engaged in a very thorough review of all economic policies, both macroeconomic problems and microeconomic problems. With regard to the macroeconomic outline that I have given I think this pretty well represents a consensus among his advisers and I think the President approves of this.

With regard to microeconomics there are many things we still can do in various fields.

The President has asked his advisers to submit to him, which we did yesterday, a review, an outline of our concepts of what should be our economic policy, and this was done by the members of the so-called quadriad headed by me, that is, Dr. Stein, Dr. Burns, Mr. Ash, Mr. Simon, and by me. And these are now in the hands of the President and we will be discussing them with him tomorrow.

I have discussed these problems and our policies with him up to this time and I find that he is in general accord with the views that pretty much represent a consensus of all of us as they went in to him yesterday.

Senator MUSKIE. So that as indicated in your statement, "We will continue the present emphasis on fiscal and monetary restraint as the administration's approach to the inflation problem."

Mr. RUSH. I think this will be the case, yes.

Senator MUSKIE. With respect to the 1976 budget, the President has said that his objective is a balanced budget. Does that indicate a decision to abandon the full employment budget concept which President Nixon introduced in his administration?

Mr. RUSH. The budget we talk about throughout is the actual budget, not a full employment budget. And all of my references are to actual dollars, not to full employment budgets.

Senator MUSKIE. My question really is addressed to this point. You, therefore, abandon the concept of full employment budget as reflecting the impact of the budget on the economy?

Mr. RUSH. I would say we still use the full employment budget for informational purposes but for purposes of budget making we use the actual budget's term of dollars.

Senator MUSKIE. Let me put it this way. If the full employment budget is in surplus, would you accept that fact as a description of the budget as either expansive or restrictive on the economy?

Mr. RUSH. No. I would say that the full employment budget in balance, but a budget in actual dollars showing the deficit is not what we are aiming for and not what we would accept. What we want is a budget that is actually balanced.

Senator MUSKIE. What I am trying to get at is whether a budget that is actually balanced in terms of outlays, which I assume is what you are talking about——

Mr. RUSH. Outlays and receipts.

Senator MUSKIE. And receipts.

Mr. RUSH. Yes.

Senator MUSKIE. A budget balanced in terms of outlays and receipts could be in surplus under the full employment concept.

Mr. RUSH. Yes, it could be.

Senator MUSKIE. Those who accept the full employment concept, as President Nixon did, tell us that a full employment budget in surplus is restrictive in its effect on the economy. Does this administration accept that conclusion?

Mr. RUSH. I would say, Mr. Chairman, that my view is a full employment budget showing a surplus is desirable and that if we will go on—basically only on a full employment basis we have an inflationary budget.

Senator MUSKIE. Well, you are saying that if the full employment budget is in surplus, then it is nevertheless inflationary.

Mr. RUSH. It can be if it is in deficit with regard to receipts and expenditures.

Senator MUSKIE. Well, then, you do not accept the full employment concept as an accurate indicator——

Mr. RUSH. I do not.

Senator MUSKIE [continuing]. Of the impact on inflation and jobs.

Mr. RUSH. I do not, no.

Senator MUSKIE. So that in regard, you are abandoning the full employment concept.

Mr. RUSH. As a test of inflationary impact, yes.

Senator MUSKIE. And as a test of budgetary decisions.

Mr. RUSH. Yes.

Senator MUSKIE. I think this is a significant change from policy explicitly adopted by President Nixon. Now we are abandoning it.

Now I want to get into some other matters here. With respect to the 1975 budget, as I understand your statement, your goal is to move toward a $5 billion reduction in the budget estimate while also working toward some unnamed figure beyond that. Will you have a specific figure beyond that to submit to the Congress?

Mr. RUSH. We are now engaged, Mr. Chairman, in preparing a series of meetings which will result in a summit meeting and as a result of the meeting with the legislative leaders, we would hope to have a cooperative approach by the Congress and by the administration to see to what degree legislative action might be possible to reduce the budget below the $300 billion. We cannot go below $300 billion without legislative action and we probably will not be able to reach it without legislative action.

Senator MUSKIE. Would it be accurate to say the administration at this point does not have a final goal for cutting the 1975 budget?

Mr. RUSH. That is correct.

Senator MUSKIE. Senator Magnuson questions my use of the word "budget" to describe the challenges before us. I am using it as a loose term to suggest what further cuts we make in Government spending.

At the end of this review process will there be submitted to us a division of the fiscal year 1975 budget?

Mr. RUSH. We have not focused on that as yet but basically the review of the budget process would consist of two things. There would be three items in it which Mr. Ash can go into in much more detail tomorrow. One of them, of course, would be possible additional receipts as a result

of accelerated offshore leases for oil exploration. A second would be a delay in putting programs into effect and a stretching out of programs that might result in material savings. A third would be actual savings as a result of personnel cuts, as a result of increased efficiencies or as a result of cutting back programs within the legislative mandate.

Now, the fourth way of cutting, of course, would be to ask for legislation to cut back on programs to discontinue certain programs and this, of course, is what we would want to discuss fully with the Congress while keeping you informed as to the other actions being taken.

Senator MUSKIE. With respect to cutting expenditures or cutting the budget, is it true that inflation has already had the effect of taking a toll on amounts programed in the budget? For example, what has been the cost of additional interest to be paid by the Federal Government as a result of inflation?

Mr. RUSH. We have had, of course, as a result of increased interest costs, as a result of escalation of procurement costs, through provisions in contracts and for that matter, on other procurements, and through other means, we have, of course, had inflation. Inflation has hit the budget very heavily. However, the budget that we have in mind has taken inflation into account.

Senator MUSKIE. Is not the effect of that inflation to reduce the $305 billion to something less in terms of real program outlays?

Mr. RUSH. Actually, Mr. Chairman, the $305 billion made what was considered to be a full allowance for inflation.

Senator MUSKIE. What was the estimate for interest in the budget as submitted?

Mr. RUSH. I do not have that but you can get that from Mr. Ash tomorrow.

Senator MUSKIE. I think we would like to have that, and also the current estimates. It seems to me the increase, if there is one, and I assume there is, represents a reduction in the budget estimates in effect because that amount of money has to be diverted to interest payments rather than to other purposes for which it would otherwise be allocated. Is that not true?

Mr. RUSH. Yes. A little over a month of the current fiscal year is gone and we, of course, have had high interest rates in effect for the last few months. We hope those interest rates will go down before the rest of the fiscal year expires, so that the interest rates, we trust, will be lower. However, the original budget was $304.5 billion and the figure I mentioned of $305.4 billion estimate, an estimate which takes into account further inflation which has taken place up to July 1.

Senator MUSKIE. Including interest?

Mr. RUSH. Including interest, yes.

Senator MUSKIE. We can get the details from Mr. Ash.

Mr. RUSH. Yes.

Senator MUSKIE. Staff tells me my time is up, so I will yield to Senator Dominick.

Senator DOMINICK. Mr. Rush, in my opening statement I pointed out that it took us 185 years to get to $100 billion expenditure of budget. Nine years later we were at $200 billion. And in 4 more years we are $300 billion, which is a pretty fast progression of expenditures. It would help me and I think members of the committee if it would be possible to get the data showing why those expenditure increases

occurred. In other words, what type of programs have been added and has there been a change in the method of determining what is or is not an expenditure. There may be a change in semantics there.

Would it be possible to get that?

Mr. RUSH. Yes, indeed, Senator Dominick. Basically, I might say this, that the defense budget has dropped roughly over the last 25 years from taking about half the budget to where it is taking about 26 percent. Social programs, social security and other social programs, have gone up to where they are the big factor in the budget today and represent about half the budget, over half the budget.

Senator DOMINICK. In the process of determining what your budget level is going to be, are we talking about—a unified budget of one kind and another kind of a budget on the other. In other words, is it a budget that takes in the question of what you get into in the highway construction fund and what you spend and one treats that the way I look at it, as a trust fund. It has got nothing to do with what we are doing in the way of expenditures.

What kind of a budget are we looking at?

Mr. RUSH. We are looking at a budget of actual receipts and actual expenditures.

Senator DOMINICK. But would that include trust funds?

Mr. RUSH. Yes.

Senator DOMINICK. So it is the same type of budget that we have been using for the last 3 or 4 years.

Mr. RUSH. In terms of receipts and expenditures, yes. Not in terms of the concept that the chairman was talking about which was, of course, just a concept. It was never the actual budget. It was just a concept.

Senator DOMINICK. How did we ever get on the full employment budget as not being inflationary?

Mr. RUSH. Well, at the time that was in effect, I was either in private——

Senator DOMINICK. I used to argue with Mr. Shultz on this.

Mr. RUSH. I was either in private law or in diplomacy and as a result, I never got into that argument and I am not an expert. I hear very little about it. But I assume doing it on the basis that a full employment budget really represented what the performance of the economy really should be and in fine tuning the economy, so to speak, you would look at the full employment budget and if we were able to have full employment, we then would have a balanced budget and the economy in actual fact would—the actual receipts and expenditures would be balanced because in that case you have reached your goal.

The big goal, of course, is to have full employment, as has been in this country for many years, and I think the basic concept is that as long as we do not have that, we should keep spending money to get there and then we will have a balanced budget in terms of actual receipts and expenditures.

Senator DOMINICK. Well, George Shultz used to say that if you had a deficit which did not exceed the full employment budget, that it was not in fact a deficit and was not in fact inflationary and I never could get that through my thick head in any way at all.

Mr. RUSH. Well, I would prefer it as Secretary Shultz analyzed his statements.

Senator DOMINICK. You speak quite a lot in your statement here, Mr. Rush, about the importance of getting the trade bill out. Why? Why is the trade bill important in any way whatsoever in this inflationary cycle?

Mr. RUSH. Well, our trade, of course, is a very vital part of our existence and even in our agricultural trade, for example, we have exports and imports roughly running about $90 billion each for this current year at the rate of, and perhaps reaching as high as $100 billion each. Much of our actual dependence—our economy is dependent upon imports as we so forcefully found out when the oil embargo went into effect and the world economy today is so intertwined that we cannot obviously be isolated from any one part of it. We are very interdependent for raw materials, for trade, and for the well-being of the economy.

We cannot have many parts of the world economically sick and ourselves be economically healthy without having the disease also hit us and I have a very strong feeling that the removal of unnecessary trade barriers is a very important force in allowing us to maintain our own prosperity and to maintain world stability for peace.

Senator DOMINICK. We used to go on reciprocal trade—in other words, if they would do something in steel in Europe we would do something in steel here. That is no longer in effect as I understand the trade bill we passed when I was one of the Members of the House to vote against it. It is my total delight now to find that the AFL–CIO has backed us strongly, and that really entertains me because they have never been on my side in any way whatsoever.

What I would like to know is why do we continue to move away from reciprocal balance of trade?

Mr. RUSH. We are trying basically to lower general trade barriers throughout the world. And the world itself has made great advances in this regard in recent years, the outstanding one, of course, being the Common Market and the revival of the Common Market. And our large amounts of trade with it are examples, I think of the mutual benefits that can come about by the removal of general trade barriers and where you get into individual bargaining with regard to special preferences, then, of course, it gets down to having trade restrictions against other countries and one country can be hurt while another one is helped, and my feeling is that we should have a general lowering of barriers as done in the Common Market.

Senator DOMINICK. Mr. Rush, perhaps I am oversimplifying but under the original bill the theory is still in effect, isn't it, that the President would have power to take away trade barriers on one industry which has nothing to do with whether or not any other community took it away from that industry. So in effect, they could take away all trade barriers on chemicals, we will say, and we get nothing in return. We may find a general lowering of the volume in an automobile carburetor or something.

Now, what that does is to allow imports to come in in a large form on the chemical industry but it does not necessarily help us on exports to balance the trade. Now, that power, as I understand it, would still be in the trade bill, would it not?

Mr. RUSH. Yes.

Senator DOMINICK. It frankly does not make much sense to me. Maybe I can get it explained to me better before the debate is over on it but I cannot see how this helps in terms of either cutting down our budget because if it is going to do anything, it encourages imports in to us and creates job problems.

Mr. RUSH. Well, of course, Senator Dominick, one of the purposes of imports is to reduce prices through competition. It may well be that one country can produce something much cheaper than we can, in which case it is far better for us to import it perhaps as has been done in many areas, such as, for example, as you know, in television sets or radio sets and the like, we started importing in large measure, or cameras, from Japan, whereas we may produce many things much cheaper than they can, such as agricultural products, and it is far better for us in order to be on top of inflation to be able to have our consumers have the cheaper thing that the other country can produce while they in turn can have the benefit of the things where we are economically more, and competitively more advanced than they. Thereby we keep prices down worldwide and if we just reciprocate, we do not achieve that advantage.

Each country should really be able to export those things that it can produce most economically and should have the advantage of importing for its people those things that it cannot produce as economically.

Now, there are some things such as, for example, items necessary for military defense where we have to protect the industry but in large measure if we want to get on top of inflation, it is far better, to repeat, to be able to import the things that other countries can produce more cheaply and have them import the things we can produce more cheaply and then employment for both should be up.

Senator DOMINICK. My time is up and I will be back, too.

Senator MUSKIE. Senator Magnuson.

Senator MAGNUSON. Mr. Rush, we talked a lot about the 1975 budget. The 1975 budget is here. You cannot change too much there that is already locked in.

Mr. RUSH. The Congress can, Senator Magnuson.

Senator MAGNUSON. Congress can change some. We are talking about appropriations. Congress can go below some recommendations, which it will. We are doing a great deal more than you even think. But the appropriations process will be over now in about 2 weeks and you cannot have a bunch of meetings going on down at the White House for weeks talking about the 1975 budget. You are going to have your appropriation bills pretty well set. We will know almost to the dollar what they are going to be in the next 10 days when we get the two big ones out of the way.

We are going to be under your budget. Now, I would suggest if you people down there want to cooperate with us, you will go along with these anti-inflationary steps.

Mr. RUSH. Well——

Senator MAGNUSON. We are under your budget. We are way under it.

Mr. RUSH. You are under it now.

Senator MAGNUSON. If you want to cooperate with us on budgets you will have a chance after we get back because you take a look at what the supplemental budget is—I mean, the amounts that are working down there. They are running into billions. Now you can—if you want to do a job on this budget business—you are talking about Congress and cooperation—you take that supplemental and cut it down only to a bare necessity and send it up here and we will agree to it. Do not send up a $3, $4 or $5 billion request when we are talking about cutting the regular budget. Last year the administration showed up with $7 billion in HEW in two supplementals. So let us get together. Don't you think we should?

Mr. RUSH. I certainly think we should, Senator Magnuson.

Senator MAGNUSON. You get together down there on the budget and we are going to be under. We are not cooperating with your budget at all, if you expect to get away with a large supplemental submission.

Now, I would like to have full employment and all our citizens being productive, so this country can continue its growth. I do not like to see a man out of work. He costs the Government money. When he is working he is paying taxes and your receipts go up. Your receipts go down according to the unemployment. Do you know that? The chart is almost the same, the ratio.

I would like to have some figure, for every billion, to use a figure of a billion, or $2 billion cut out of the budget, how much—how many jobs will that affect? Can you get that?

Mr. RUSH. We will do our best.

Senator MAGNUSON. I am talking about the Federal Government.

Mr. RUSH. Yes.

Senator MAGNUSON. How many jobs will that affect?

Now, one other thing. I want to correct your figures a little bit and I am no economist either, but the HEW budget is $33 billion as of now and if you add social security, which in effect is a tax that is not in the budget, but it is a tax, it runs over $100 billion. Now, that is one-third of the budget. That is not one-half.

Mr. RUSH. I think if you add other social programs you will get up near one-half.

Senator MAGNUSON. Well, I would like to get those. I think it is up into 40 percent.

Mr. RUSH. I will submit those, Senator Magnuson.

Senator MAGNUSON. And the defense budget will be about $80 billion but that does not include construction and things of that kind. It could be closer to 100. So you have another third there.

Now, I do not think there is anything wrong with that but there is one thing, too, that we will not have to bother about any more with the administration and those of us who handle these matters. You cannot impound any more, can you?

Mr. RUSH. I do not think there is any attempt to impound, no.

Senator MAGNUSON. No, you cannot, particularly in domestic fields.

Now, one last thing. It is my understanding that your position, the administration's position, on interest rates remains the same. Let them go higher.

Mr. RUSH. Well, our position basically is that we must exercise monetary restraint in order to get on top of inflation.

Senator MAGNUSON. But you have not any program for restraint.

Mr. RUSH. Of course, this is under the Federal Reserve.

Senator MAGNUSON. The Government has not done anything to restrain interest rates, have they?

Mr. RUSH. No. The Federal Reserve has been restraining the growth in the money supply.

Senator MAGNUSON. They said let them go. Now, my question is, don't you think they are reaching the proportions of usury?

Mr. RUSH. I think they have reached very high proportions that are most undesirable for people to pay but I think they are necessary for the purpose for which we have them. They are the natural result——

Senator MAGNUSON. I do not want to argue this with you now but as I understand your statement, the policy of the Government is still to do nothing about interest rates.

Mr. RUSH. In terms of control.

Senator MAGNUSON. Not the Federal Reserve but the administration.

Mr. RUSH. In terms of control.

Senator MAGNUSON. Yes.

Mr. RUSH. That is correct.

Senator MAGNUSON. All right.

Senator MUSKIE. I think Senator Magnuson raised some interesting questions. Would you like to respond?

Mr. RUSH. Sorry.

Senator MUSKIE. I think Senator Magnuson raised some interesting questions. Would you like to respond?

Mr. RUSH. I would be pleased to respond. I am going to submit the figures to you on the social programs.

Senator MAGNUSON. Yes.

Mr. RUSH. On the defense budget as I say it is——

Senator MAGNUSON. And on effect on unemployment. This is what bothers me.

Mr. RUSH. On that one I will see what we can get.

Senator MAGNUSON. If you can get those figures.

Mr. RUSH. Of course, what we do as we see it, Senator Magnuson, when we run a deficit budget what we do is increase demand without increasing production whereas if we cut back on the budget, what we then would do is leave that money in the private sector so you would have private jobs instead of public jobs, which is far more desirable and you would have production instead of just demand.

Senator MAGNUSON. Well, your contention is that we get more production but loss of a number of people employed under the Federal budget will not mean anything, is that correct?

Mr. RUSH. Yes. Basically, what I am saying——

Senator MAGNUSON. I mean the loss.

Mr. RUSH. The question is to what degree shall the Government take over the resources of the country and to what degree shall we allow them to be in the private economy. The higher the Federal budget the more the Government takes over the resources. The more the Government takes over employment——

Senator MAGNUSON. This is the big philosophical argument between Republicans and Democrats, is it not?

Mr. RUSH. Well, I think we——

Senator MAGNUSON. It has been going on for years.

Mr. RUSH. We have a few Democrats on our side and you may a few Republicans on yours.

Senator MAGNUSON. I am speaking generally. I have no further questions.

Senator MUSKIE. Senator Young.

Senator YOUNG. Mr. Rush, I believe our revenue sharing with the States costs about $5½ billion a year. That is a part of the $305 billion budget, is it not?

Mr. RUSH. Yes, it is.

Senator YOUNG. There is nothing we can do about that for a couple of more years. In my own State we have no indebtedness except for bonds to finance a Vietnam Veterans' bonus and more money in the general fund than at any time in our history. At the same time the Federal Government is giving us more money and it is going broke.

Let me ask a question.

Mr. RUSH. Senator Young, I think perhaps that is an area that we should reconsider. That is an area that should be reconsidered.

Senator YOUNG. I think so, too.

On page 8 I note the statement:

> We have underway at this time a broad review of all Government regulatory activities, emergency practices and allocation and price support programs which may be disrupting the productivity of the economic system.

Would you comment a little more on the price support programs that are disrupting our productive system?

Mr. RUSH. Yes. For example, where we give a price support program, for example, it can be in ships or it can be in agriculture, or it can be in various areas, we may be continuing to do things that are uneconomic and cannot stand on their own feet. You can have both direct and indirect subsidies. Indirect subsidies can consist of embargoes of imports or can consist of outright subsidies for various industries. But what we want to do in this setup, in this review, is to see just what price support programs do we have, just what purchasing practices do we have, just what regulatory activities do we have that are inefficient, that are preventing the full utilization of our resources.

Certainly I would say that the regulation of the railroads is a major factor in the terrible decline of the—essential productivity of the railroads in maintaining efficiency. This should be reviewed very carefully. I think this is probably true in other—in the case of certain other utilities, and it may well be true in the case of indirect subsidies that we may have.

Senator YOUNG. There is no farm price support program in operation today due to the fact that the cash price of farm commodities are above support levels.

Mr. RUSH. We are now going more and more toward a free agricultural economy which I think is very good.

Senator YOUNG. Then on page 11:

> Our overall policy is to seek ways to insure that food production is adequate to the world need and that reserves are accumulated to prevent shortages during years of poor crop yield.

In 1972 when we made the Russian wheat sale we had a carryover on July 1 that year of nearly 1 billion bushels of wheat and big sur-

pluses of other agricultural products. That surplus was carried under Government loan by our farmers. Are you suggesting that the Federal Government get in and buy surpluses of food?

Mr. RUSH. No. I am not, Senator Young. What I am saying is this, that the world now has pretty well depleted its food reserve and in times of food surpluses, we might well work out a program with other countries where all try to build up reserves and this is to be discussed at the Rome conference. And we have not outlined our position as yet but we all might try to build up reserves against the years when shortages because of weather or otherwise may come and we will then find that we do not have food and we have serious drought as we have today in many parts of the world.

Senator YOUNG. A farmer would be working against his own interests if he built up bigger surpluses because that would force the price down again. At the time of the Russian wheat sale the average farm price of wheat was only $1.41 per bushel whereas now it is about $5 a bushel.

Mr. RUSH. Yes.

Senator YOUNG. You have to have some kind of a program to protect the farmer against bankrupt prices if he over-produces.

Mr. RUSH. This is right, and I am not saying that we should not have it. I think we should have a program of that kind.

Senator YOUNG. The program worked quite well for the consumer through maintaining adequate supplies of food and fiber.

Mr. RUSH. That is right.

Senator MUSKIE. Senator Moss.

Senator Moss. Thank you for your good statement, Mr. Rush. You say that:

> Our firm intent is not to allow the cumulative effects of pending legislation to push spending higher and to seek every possible way to reduce spending using the figure of $300 billion as a target.

In the first place, even the $300 billion figure would be a deficit in this current budget, is that right?

Mr. RUSH. Under the estimates of receipts of $294 billion it would be——

Senator Moss. About $6 billion.

Mr. RUSH [continuing]. About $6 billion.

Senator Moss. What are the possible ways to reduce spending? Are we talking about Presidential vetoes or what else?

Mr. RUSH. I would think the President would—President Nixon, as you know, said he would veto and he did veto the agriculutural bill, any bill where the appropriation was substantially in excess of the budget. Now, President Ford may follow that policy. He is certainly intent on cutting the budget to the extent practical.

Now, as I mentioned earlier, there are other ways where we can reduce expenditures below the $305.4 billion. One of them would be to stretch out programs. Within the full authorization of Congress, often programs do not get started on time, for example. Another one may be to delay the start of programs. Another may be to actually bring about efficiencies, also bring about economies. For example, in many cases closing down military bases may result both in efficiencies and increased efficiencies and increased economy. And I am quite

sure that the 40,000 reduction in personnel planned for this year as a result of attritional results in increased efficiency rather than decreased efficiency by the Federal Government. So there are many ways I am sure Government can bring about increased efficiencies without resorting to such things as impoundment or things of that sort.

The other way that we may be able to balance the budget, as I mentioned, is through increased revenues not now budgeted such as the increased sale of offshore oil and gas leases and perhaps some other things.

Senator Moss. Well, would not the increased sale of offshore oil leases—was that not contemplated? Is that not going to go ahead in any event?

Mr. RUSH. That is not included in the estimated receipts that we have, $294 billion.

Senator Moss. How about——

Mr. RUSH. The increase is not included. The amount may exceed what we have included.

Senator Moss. In other words, you think there will be more leases granted than had been contemplated.

Mr. RUSH. Yes. There may well be. I might also point out, Senator Moss, that in the 1974 budget, receipts partly because of inflation exceeded estimates but by about $12 billion and it may be that receipts in 1975 will also exceed estimated—the estimated budget but we cannot count on it.

Senator Moss. What about possible tax increases? We keep talking about tax loopholes that might be closed. Do you contemplate recommending to the Congress any changes in that regard?

Mr. RUSH. No. We are not recommending tax increases at this time. I think that a tax increase could very well be the cause of prolonged legislative process. It could very well result perhaps in a lot of inflation rather than help, so I do not think we should have a general tax increase personally.

Senator Moss. On cutting the budget you talked about trying to get back to $300 billion. Do you think a $5 billion cut is feasible? I read in the paper that Mr. Ash said $2 billion might be squeezed out.

Mr. RUSH. I think what Mr. Ash was referring to was the actual reduction of expenditures through efficiencies. And he has spelled out something like $2 billion. The remaining $3 billion that we hope to achieve consists of the stretching out of programs, the delay of certain programs, and in many cases programs do not live up to estimates and we reviewed that and the additional receipt of funds that are not budgeted suc has I mentioned, the increase in oil and—revenues from the sale of oil and gas leases.

Now, there may be others and he is working on that now.

Senator Moss. In this same article, both Mr. Ash and Mr. Simon admitted that the cut would have a minimal effect on inflation. Do you see that as a minimal effect or is it noticeable?

Mr. RUSH. Well, in a gross national product running $1.350 trillion to $1.400 trillion for the year, a cut of $5 billion is not very large in terms of substance. However, it is very large in terms of the determination of Government to get on top of the economy. With regard

to the determination shown to the people that the Government is participating and intends to fight the battle of inflation, that it intends, to put its own house in order, and that it is reducing is expenditures and looking at them very, very carefully and trying to do a much better job than it has been doing.

Senator Moss. More symbolic than the actual impact.

Mr. Rush. More psychological, and more in terms basically of psychology, not only in terms of letting the world, our people know that this is how we feel but also letting Government people know that they must look for ways to reduce funds, that we must work not to add on. The add-ons are very serious and if we have a program, a demonstrated program, of fiscal restraint, then many programs—people will be looking in Government, in Congress, in the Executive, will be looking more at how can we save money rather than how can be find new ways of spending it.

Senator Moss. Thank you, Mr. Rush.

Thank you, Mr. Chairman.

Senator Muskie. Senator Javits.

Senator Javits. Thank you, Mr. Rush, we are glad to see you. Thank you for your statement.

It is a fact, it is not, that the Government budgetary situation is composed of three parts; appropriations, income, and priorities.

Mr. Rush. Yes.

Senator Javits. Now, we have talked a lot about appropriations. We have not talked very much about income. Is the administration prepared to make any immediate recommendations for recission of such tax indulgences, for example, as oil depletion and the capitalization of drilling costs? In other words, things which are likely to be in a tax reform bill but a tax reform bill that might come along next year while the administration may be very ready to buttress our budget position by improving our income immediately?

Mr. Rush. Well, as you know, the administration has submitted a bill for recovery of excess profits from oil except to the extent that it is reinvested in drilling and in new exploration and the like. The present depletion allowance, and we would be pleased to review this in our overall review, but the present allowances, of course, are designed—they are built into the system and they are designed to encourage the discovery of more oil and more gas and the great need we have today is how do we get more oil and more gas? If we take steps that may correct what we consider to be inequities in terms of favoring industry but at the same time hurting the economy very seriously by reducing the discovery of new oil and new gas, we may have hurt our Nation and our consumers much more than we have helped them and I think all of these must be taken into effect as we consider this.

Senator Javits. The general feeling, Mr. Rush, seems to be that prices are high enough that they do not need these other inducements. That seems to be almost universal. So I suggest to the new administration that it consider also the possibility of recissions, asking the Congress for recissions of tax indulgences, in order to buttress our situation in view of the fact that you can get at it that way, too, and there may be some immediate things that Congress can and is very willing to do that do not have to wait until a tax reform bill which could easily

be delayed until next year. I strongly urge that upon you and the President. The thing I think the American people want the most is that we should be self-starters and get off the starting blocks fast and not take a very slow pace. I strongly commend this to you.

It is true, is it not, Mr. Rush, that inflation works just as well on income as it does on appropriations. It may balloon our appropriations, it can also balloon our income, is that right?

Mr. RUSH. That is very true.

Senator JAVITS. Therefore, anything that stimulates the American income is highly desirable, is it not?

Mr. RUSH. To the degree that it does not create added inflation, Senator Javits. The basic cause of inflation is an excess of demand over supply and what has happened worldwide has been the creation, stimulated greatly by Government, of demand far in excess of the increase in productivity and in production, and, therefore, increasing additional demand without increasing supply only adds to inflation.

Senator JAVITS. Well, thank you for your answer because that is exactly what I am driving at. Why does not the administration undertake a major productivity drive? Why does the administration lend itself to giving the National Productivity Commission $2½ million, the most shameful and ridiculous performance in this whole Government, when that is the key to breaking the back of inflation? And why for a year was not George Meany in the White House until today as the representative of labor when they hold the whole key to the future of the country in terms of inflation right in their hands, both in wages and in productivity?

Mr. RUSH. Well, certainly labor is a very essential and very vital part of this. Now, we did ask the—I welcome your comments with regard to productivity. We did ask the Congress for $2½ million and they cut us back to $2 million, which I am not complaining about. But certainly, and this comes back really to your first question, one of the biggest needs of this country today is how do we get the cash flow for corporations and for industry really to expand and increase production. This is a major problem. We are faced with potential shortages in electricity and the utilities which can greatly curtail industry and, of course, vitally affect every home. We have vital shortages in steel production. We have vital shortages in steel production. We have vital shortages in chemical production. We have vital shortages with regard to oil and energy. And the cash flow of industry is nowhere near enough to build the facilities needed and then, of course, the cost is inflated a great deal to build the facilities needed to overcome this and this is one of our biggest problems and one of the biggest problems we must face as we consider depletion allowance and other things.

Senator JAVITS. Well, Mr. Rush, I would urge you, urge the President, to move on such detailed fronts as he can much more promptly than is now contemplated.

We have talked about productivity. A productivity drive, for example—I have been working for this for years—could be sponsored through the World War II concept of 5,000 labor-management productivity councils. As far as I can see, and I have talked with the top people, labor is ready and I think management ought to be ready and the springboard can be this summit meeting that the President is having.

Second, you mentioned the word "conservation" once in your whole statement, on page 12, and yet breaking the back of oil prices, and the only way you can do it unless you are going to send the Army and Navy and Air Force into the Persian Gulf, which is obviously unthinkable, is by conservation. If American demand reduces, you have got a chance to break that price. So in my judgment, talking about priorities, the two highest priorities, with all respect, are not budget cutting. The two highest priorities are productivity and conservation and the third is bucking up our income. And I would strongly urge you, just as I am urging the committee—our chairman and ranking member and others are very much for this—I think we ought to lean on the Congress in these matters, too. But I strongly urge you to direct the attention of our new President to these really key points. We will cut the appropriations, you can be sure of that. Everybody is going to put his back into that one. But these other things seem to have gone by the boards and they are absolutely critical to breaking the back of inflation, not just for this year but for the future. And I strongly urge it upon you.

Thank you.

Mr. RUSH. Your comments are very apropos and very sound, Senator Javits. Without in any way apologizing at this budget hearing I concentrated, of course, on fiscal and monetary and other matters. I could not agree more that productivity is the top priority of the country if we are going to get on top of inflation and conservation is a very vital part of it and the fact that I only used the word once in this statement does not mean that that is—how important I consider it to be. I think it is a very important thing.

Senator JAVITS. Well, you do not mind my using you as a sounding board to bounce a few off.

Mr. RUSH. No, indeed.

Senator JAVITS. Thank you.

Senator MUSKIE. Thank you, Senator.

Senator Hollings.

Senator HOLLINGS. Thank you, Mr. Chairman.

Mr. Rush, I appreciate very much your statement. Now you are getting over into productivity. I find you a two-armed economist. You know my trouble has always been that of economist says on the one hand, and by the time I am ready to understand, he says on the other hand, so and so, and I also said if I were king for a day I would get me a one-armed economist because now you are going into productivity.

In reading your statement you say, "This is not the proper time to reduce tax receipts."

Back to my original question. Do you intend to reduce tax receipts for business? Do you think this statement will last 6 weeks?

Mr. RUSH. When I talk about—this is not the prime time to reduce tax receipts. I am talking about a broad reduction of taxes. Now, we must balance priorities, as Senator Javits said. Which is the maximum priority? To not reduce any taxes or to increase productivity? Taxes have a very vital influence on securing funds for building new plants, for the consumer to be able to buy goods in plentiful supply and much cheaper than otherwise would be the case. So that where you give, for

example, an investment tax credit in order to—or accelerated depreciation or a current writeoff of nonproductive facilities such as environmental protection or safety, capital investment, if you are giving funds for the building of plants, not to be paid out in dividends but for the building of plants to produce the goods so that the consumer can get them cheaper and in plentiful supply, you may be helping society a great deal more than by not having those various tax changes, so that we do not rule out a reconsideration of the investment tax credit although it is not actively on the fire, or a reconsideration of depreciation allowances or reconsidering of current writeoffs in some cases perhaps of environmental nonproductive equipment that has to be installed because of governmental requirements. But those are important considerations to be taken. How do you get the money, how does industry get the money, and by industry I mean anyone who builds plants, get the money to increase production?

Senator HOLLINGS. Yes, but now we have Dr. Arthur Burns and the housing markets. Why not release some money there and why not lower the interest rates? Is that not one approach we can use? You see, the whole argument was at the very beginning whether it was a lack of the demand or lack of product and the Walter Heller crowd came in and said really it was a lack of demand and plenty of production and the administration said no, it is too much demand, and what we have got to do is get more production and we are going to have to have these policies of holding up on the money supply, not going to be able to cut taxes. The administration opposed the individual income tax reform and we had a good vote in the Senate. You come in and are saying this is not the proper time to reduce tax receipts but on the other hand, you are not for productivity and then you start giving it that rhetoric. And yes, we are ready to cut big business's taxes on investment credits. That would be losing tax receipts. Accelerated depreciation allowance and everything else. And still holding it to that individual and nobody can get a home, interest rates are high. Why do they not use a different approach or why do they not just see this thing through and not break the dam because if we are politically called on to reduce taxes for industry, I am going back and reduce and start on the demand theory of you economists and want to reduce individual income taxes.

Mr. RUSH. I would like to say first, I am neither a two-nor one-handed economist. I am not an economist at all. I am a lawyer.

But with regard to the economy, my view is this. A tax cut that increases demand without increasing production is inflationary. Obviously, if you create more demand by putting more money out for people to buy and do not increase production, then that is inflationary.

On the other hand, tax allowances that increase production without increasing demand are not inflationary. They are deflationary in the sense that you are allowing the funds to be available or obtained by industry in order to build the productive capacity to supply the goods and the benefit then goes to the consumer because then you get on top of inflation.

Senator HOLLINGS. Well, so that is the theory. I will jump, because my time is limited, to your statement where you say, "One of the responsibilities of this Committee"—of course, I assume the Administration—"is to see that your actions and the actions of Congress conform to our rhetoric."

Now, you are talking about, and you did state in response to one question, "Congress can change the 1975 budget. I assume the administration can help it."

Would you go along with the $5 billion cut in defense that the subcommittee, which included the chairman of the Armed Services and Senator McClellan who is chairman of that subcommittee, a fiscal conservative, and others, those gentlemen both strong for national defense, will the administration go along with the $5 billion cut in the defense budget or say keep up with the Russians? Are you going to go one way or the other? Will you go along with the Congress or not?

Mr. RUSH. Most of the last 5 years I spent in diplomacy and the Defense Department where I have seen firsthand the problems of dealing with the superpower, the other superpower and with world problems. If we reach a stage of being second in terms of military strength, then our diplomatic arm will be very weak. Our NATO alliance will be very weak and the safety of this country and security of this country will be very weak.

Therefore, I would not go along with any budgetary cuts that would in my opinion, result in our defense being second instead of first or at least equal.

Senator HOLLINGS. And a $5 billion cut would constitute that, that would make us second, in your opinion?

Mr. RUSH. We have in the last 5 years reduced our Armed Forces by a third while the Soviet Union has increased its armed forces by some 200,000. In the last 10 years we reduced our forces in NATO by about 30 percent while they increased theirs by about the same number. While we were reducing our ships they have greatly increased theirs. While we are staying steady on the basis of the quantity of nuclear missiles we have, they are increasing theirs tremendously, so that under the interim agreement they have 1½ to 1 in ICBM's and SLBM's. So that we cannot sit back and—and they are now in the process of the MIRVing of four new aircraft, GS–16, 17, 18, 19. So we cannot sit idly back and say we are still by all odds No. 1. We have to look to our defenses and frankly, I think we made a mistake in not giving very serious consideration to the views of our military as to their budgetary needs.

Now, the actual expenditures in real dollars, if you want to call constant purchasing power real dollars, of the Defense Department is the lowest it has been since the Korean war, except, of course, for the—yes, since the Korean war and probably since World War II and I think these cuts may in fact be justified. I do not know because I have not studied them in great detail as yet. But I would not endorse them without having a chance to see whether in my opinion, they would seem to turn us on the road to being No. 2 in the defense field.

Senator HOLLINGS. You do feel that the $5 billion could turn us on the road to making us become second?

Mr. RUSH. I would, of course, have to in that regard, as I say, take into careful consideration what the military have to say and after careful study the estimates be made. My reaction without having studied them carefully as yet, is that they pose some dangers.

Senator HOLLINGS. So now we know, Mr. Rush, that with respect to the proper time to reduce taxes, it is not now except for business

and we know also that what we have got to do is have our actions conform to our rhetoric except where the Defense Department is concerned. These exceptions—let me get to the broad picture. Do you not really consider the budget submitted in January an inflationary budget really in the sense that you are asking for some 7 to 9—well, let us put it $7.8 billion more in defense, $3 billion more in agriculture, $1 billion more in HUD–Space Science, $3 billion more in HEW, from what we spent in fiscal year 1974. Not that we are all for this full employment budget and look at budgets—what we used at the State level, what we spent last year and what we are going to spend next year, do you not thing that is inflationary and you really can perhaps try to go along on cutting this budget back some $10 billion and get it back into balance?

Mr. RUSH. I hope we can. I would like to say, however, Senator Hollings, I have not endorsed a tax cut for business. I have not endorsed raising the investment credit or giving additional accelerated depreciation. I merely stated the reasons why I thought they should be considered. I have not endorsed them yet and I am not sure I ever will.

Senator HOLLINGS. Well, in the context of cooperation by way of suggestion, I really think the President himself should have an immediate conference, not working up to summit but I think he could have an immediate conference and I will cut off now with respect to the chairman of the Appropriations Committee, the chairman of the Budget Committee, the leadership, chairmen of these several large appropriations subcommittees, because at 11:30 we mark up State-Justice-Commerce, probably tomorrow we will mark up Defense appropriations, and we will be back at the HUD-Space Science bill and rather than just waiting, what we are looking at is Government—Government is called the art of the possible. It is very possible and very easy to get immediately now this week or the early part of next week these particular chairmen in, looking at that January submission by your administration, and saying that is inflationary, if you folks over here, the No. 1 military man, the chairman of the Armed Services and Appropriations can find $5 billion of fat in defense, and certaintly those gentlemen would not make us second best, maybe we can have another looksee and go down all of these budgets and cut out that $10 billion. That is the kind of conference to have and now that is the time——

Mr. RUSH. I think that is a very excellent suggestion, Senator Hollings. I shall pass it on to the President. I know he is considering something similar to that right now.

Senator HOLLINGS. Thank you, Mr. Chairman.

Senator MUSKIE. Thank you, Senator Hollings.

Senator Dole.

Senator DOLE. Mr. Rush, what is the rate of inflation right now?

Mr. RUSH. For the second quarter, 8.8 percent.

Senator DOLE. If we cut the $10 billion in the budget what would be the rate of inflation?

Mr. RUSH. I do not think it would affect the rate of inflation very much.

Senator DOLE. Still be 8.8 percent?

Mr. RUSH. Well, there are so many factors going into the inflation rates in an economy which as I said, runs in the range of $1,350 trillion a year that I do not think you would see any discernible effect on the rate of inflation.

Senator DOLE. I guess——

Mr. RUSH. You could not identify it, in other words.

Senator DOLE. Pardon?

Mr. RUSH. You could not identify it in its inflation rate. It is far too complex for that.

Senator DOLE. The reason I raised the question, the President indicated the other day, in fact Monday evening, that we should keep an eye on Members of the Congress and how they vote on Federal spending.

I am just trying to find out to what degree it really does have an impact on inflation.

Mr. RUSH. I think what the President was saying is this. There are many factors that enter into inflation. Inflation today is largely a disease caused from our past mistakes in terms of our governmental action and action in the private sector programs.

Now, there are many, many things we must do in order to get on top of this inflation which is a worldwide thing. We must work with other governments to do it. We must also put our own governmental house in order because fiscal and monetary policy of governments are major factors in controlling inflation or inducing inflation. As has been pointed out we have been in deficit 14 of the last 15 years. The budget has trebled in a little over 10 years. That sort of thing.

Now, we must put our own house in order and exercise the fiscal and monetary responsibility starting right now and to actually—I think we started a bit earlier but we must do more to get on top of inflation, otherwise we never will.

Senator DOLE. The point I want to make, it must be more than symbolic. If the Congress and executive branch are willing to work together in finding ways to cut the budget it must have a greater impact. I am not content with merely symbolic acts that really do not achieve anything.

Mr. RUSH. I get your point. What I meant to say is that, if you take $5 billion and look at that just standing alone you cannot really say $5 billion has a big impact on an economy of——

Senator DOLE. That is an essential part of some package.

Mr. RUSH. If it is a central part of the package it is very important, yes.

Senator DOLE. You cannot argue with some that we do not look at the budget; we do not worry about cutting the budget; we look at all the other factors whether it is conservation or productivity or whatever.

There is another factor that may have some bearing on inflation, and it doesn't depend only on what the Congress does but what the Executive does. We are concerned especially about those on fixed incomes and the senior citizens. What do you project the rate of inflation might be in December of this year, late December?

Mr. RUSH. My projection has been that it would be between 7 and 8 percent. I would say it would be much nearer the 8 than the 7. And the unfavorable weather conditions we have had in the Midwest and the

loss of almost 1½ billion bushels of corn, some soybeans, of course, is going to have an effect but I would still say it would be in the range of 8 percent.

Senator DOLE. What about the rate of unemployment about that same time? Is that going to stay about the same?

Mr. RUSH. I think it will be in the range of 5½ to 6 percent, perhaps as high as 6 percent.

Senator DOLE. That is not an acceptable level in the administration is it?

Mr. RUSH. No unemployment level is acceptable but as Senator Javits said, we have to look at our priorities and we have to pay a price in order to get on top of inflation and that means we are going to have to cool off to a certain degree this excessive demand that we have.

Now, the unemployment problem is a highly important one and one that the American people are deeply concerned about. We do have programs, as you know, for public service works and the like which are designed to help on more of a rifle than a blunderbuss basis the unemployment. The President has sent up legislation for improvement in unemployment compensation. We have unemployment insurance and, of course, many workers receive very substantial amounts while unemployed under their collective-bargaining contracts. Just looking at an unemployment figure with welfare and all these other things does not necessarily indicate the amount of suffering that may be involved but nonetheless, I think if unemployment gets near 6 percent then we must look at it to see whether something further must be done.

Senator DOLE. In a related aspect, you mentioned the crop losses in the Midwest. Those prices do not necessarily reflect next year in the marketplace but there is always a potential threat, as far as the farmer is concerned, in the administration imposing export controls. They did that in soybeans and it was disastrous. It may be again a part of this inflation package. Maybe there are some who say it is, some who may not.

Has there been any new attitude expressed by the President or——

Mr. RUSH. No, there has not been, Senator Dole. I think export controls would be very unwise. We are a surplus agricultural country.

Senator DOLE. They are much like wage and price controls. The initial impact may be good in the minds of some but in the long range, it merely hurts our exports, hurts our balance of payments and, of course, drives down farm income.

Mr. RUSH. This is very true. The imposition of export controls by a country which is exporting in the range of $21 billion of farm products a year and that we are working very hard, of course, and I did this when I was Ambassador to Germany to try to get corrections in the CAP of the Common Market and removal of other barriers for our exports, for us to turn around and impose export controls would I think represent a backward step that would be quite harmful.

Meanwhile, of course, it would stimulate further competition with our exports, because people want a sure supply and it means we are going to lose future export markets.

Senator DOLE. Any Secretary of Agriculture worth his salt would make sure we do not run out of commodities and if we should run out, he will probably run out at the same time. But President Ford

has set the stage on a positive note. I know he was in contact with Chairman Mills on the House side and Senator Long. The suggestion of Senator Hollings is a good one. President Ford may have already done that but I would hope that there is not an atmosphere created now, with the new President, that suddenly inflation is going to end. It is noteworthy that the President said in his speech Monday night that the state of the Union is good but the economy is bad, so he was not trying to kid anyone or deceive anyone. That in itself will be helpful.

Mr. RUSH. Yes, I do, too. Inflation is not going to be cured quickly. This is going to be with us for quite some time. It is going to take a very strong effort for us to improve it.

Senator DOLE. Thank you very much.

Senator MUSKIE. Senator Cranston.

Senator CRANSTON. Mr. Rush, do I take your statements and those that President Ford made the other night in addressing Congress as indicating that there will be no effort by the administration to balance the current 1974–75 budget?

Mr. RUSH. No. I would not say that, Senator Cranston. We are now considering what further can be done with regard to the 1975 budget. Additional legislation—legislation may be required, will be required, if we get anywhere near the $295-billion figure which would be an essential balance.

If Congress and the President can pick out programs that can be cut back, then obviously you can get a balance but we would have to have the will power and political will to hit legislative programs and take out additional money.

Senator CRANSTON. Are there any specific plans or proposals in the administration for a cut that would get us back to the $295-billion level necessary to balance the budget?

Mr. RUSH. We are now working on various options that might be available to see whether—and those options, of course, can be considered. We can always cut back programs if—cutting back may involve some very serious opposition.

Senator CRANSTON. As to the 1975–76 budget, is there presently a target figure where income and expenses would be in balance?

Mr. RUSH. Yes. We hope that the—the 1975 figure, as you know, as of now is to try to reach $300 billion.

Senator CRANSTON. Try to what?

Mr. RUSH. Try to reach the $300-billion figure for expenditures. For 1976.

Senator CRANSTON. That is $5 billion in red ink, if that is the target?

Mr. RUSH. That is $5 billion in red ink if we achieve that and as I say, further legislation—legislation will be required to go further down and maybe even reach that figure. But for 1976 the tentative figure in taking into view the already built-in increases that are built into existing legislation which shall not be stopped without additional legislation cutting them out would be near $330 billion.

Senator CRANSTON. Three hundred thirty billion?

Mr. RUSH. The budget is in process of—we are working on it now but we do have a pretty good idea of what has—what we would have to

have in order to live up to the entitlement and other increases that are built into the budget now.

Senator CRANSTON. The June 30 Washington Post quoted Roy Ash as stating that a $5-billion cut in the budget would have a one-tenth of 1 percent reduction impact on the inflation rate. Do you roughly concur with that figure?

Mr. RUSH. I have no basis to either concur or dissent. I have not seen the basis for it and I do not even know—I just do not know.

Senator CRANSTON. If it would be that limited, and other economists have used roughly the same figure, I wonder why there is so much emphasis on the budget balance as a cure-all? Not that I am opposed to it. I am for it but I question whether there should be all this emphasis on it if that is all we can expect, according to Mr. Ash.

Mr. RUSH. I do not think we look upon it as a cure-all. We look upon it as one of the steps that is essential if we are to get on top of inflation. There are two things Government can do very directly with regard to inflation. One of them is to—is its fiscal policy and what it does with its fiscal policy. The other is monetary policy which is largely under Chairman Burns and the Federal Reserve. Those are the two biggest items with regard to fighting inflation.

Senator CRANSTON. If inflation accounts for only one-tenth of 1 percent of the rate of inflation if you knock off a $5 billion forwarded imbalance that is one-tenth of a total of about seven-tenths we want to cut if we want to get it down to 5 percent of the inflation. That is absolutely negligible in terms of achieving the goal.

Mr. RUSH. Yes. If you isolate $5 billion one may say that is the case. However, the $5 billion is more than that. The $5 billion, as I tried to say earlier, is action and notice that we are going to keep the budget down. We are not going to run the deficits that we have been running. And they have been very huge, as you know; that we are not going to continue to feed inflation, and, therefore, the thing for us to do is not only to show our determination by reducing the budget for 1975 and let—which would have a very profound impact I think on the American people in terms of showing our intentions psychologically but it would also have a very profound effect in terms of having everyone in Government, in Congress and executive branch, everyone, concentrate on how can we avoid these tremendous budgetary increases that are taking place? How can we keep this budget down to the fullest extent possible instead of going the other way?

Senator CRANSTON. Senator Magnuson asked you about the impact on the other side of cutting money out for each billion, how much unemployment would result. You did not come up with any figure and apparently were going to do some research on that. Do you have any rough estimates?

Mr. RUSH. Well, basically, you have a balancing, of course, and you have very serious time factors on cutting the Federal budget on the one hand and taking more money out of the private sector—taking the money out of the private sector on the other. When you take—as the Government takes money out of the private sector they are preventing the private sector from installing wealth-creating facilities and from having a larger share of our overall resources. So that we have to find a proper balance.

Now, just what we can do with regard to his question, I do not know but you might depend also on where are you taking the balance. You could have savings that would affect very little manpower, I would think. For example, suppose you cut back on social security $1 million. You do not affect manpower. Or suppose you cut back $15 billion on social security. You do not have much manpower savings at all.

Senator CRANSTON. I trust those are not places where there are proposals being worked on for cutbacks.

Mr. RUSH. I do not really see how I can answer his question but I will see what can be done.

Senator CRANSTON. In terms of unemployment, I gather both from what you said this morning and what Roy Ash said on July 24 and other times, that it is anticipated that unemployment may well get up to 6 percent as a result of continuing tight money policies.

Mr. RUSH. Yes.

Senator CRANSTON. Leon Keyserling testifying recently before the Banking Committee stated that it is his belief that the actual level of unemployment in May of 1974, and there would be no real change now, was 6.6 percent. He states that in his opinion the true level of unemployment includes full time unemployment as officially reported which, of course, is the first factor, but second, the full time equivalent of part time unemployment which is not factored in apparently, and thirdly, the concealed unemployment in terms of those not participating in the labor force and, therefore, not officially counted as unemployed because of scarcity of jobs.

Mr. RUSH. Frankly, there are many people not looking because it is hopeless and are not counted.

Senator CRANSTON. If you accept his viewpoint and actually factor those equations in, the unemployment may roughly be at 6.6.

Mr. RUSH. I think there are many ways of figuring unemployment. In most of the world we would now have unemployment of about 1.3 percent. It is 5.3. But in most of the world full employment would be for us about 4 percent because we count the people who want to enter into—among other things, people who want to enter the labor force but are not doing so. Now, many people, for example, may want to enter the labor force but only on their own terms. So they look for a job but they do not find anything they want. And, therefore, they are unemployed. So that whereas most countries figure those leaving the labor force and looking for work as the base, as I understand it, in our case we figure anyone wanting to enter, and there are the difficulties. So there are many ways to figure it.

I have to reason—if you take your base you then can get your figure.

Senator CRANSTON. How do you reconcile higher unemployment with the need for creating greater productivity which is surely one of the fundamental answers we must seek?

Mr. RUSH. Yes. Well, I do not think there is any particular correlation between—if we get greater productivity we should in fact have higher employment.

Senator CRANSTON. But if you are pursuing a policy that produces unemployment that is not going to contribute to greater productivity. It is a counterforce.

Mr. RUSH. In essence I would say this, that where you have unemployment, people are leaving positions that maybe are not essential

to productivity that is needed. In other words, the productive enterprises would still be operating. If they are still operating the same, you could have increased unemployment without the productive enterprises cutting back at all or even increasing. In fact, as you know, the great drive of industry always is, and this has nothing to do with what we are talking about, how can we further increase our mechanization, improve our processes, so that—I, as you know, am very familiar, particularly with the chemical industry, and the entire thing there is increasing productivity and needing fewer and fewer people. And people go who are in the service industries which are not productive or in the Government which is not productive.

Senator CRANSTON. Thank you. My time has expired.

Senator MUSKIE. Senator Abourezk.

Senator ABOUREZK. Mr. Rush, you gave some figures during part of your testimony earlier; you said the military budget at one point was 50 percent of the total budget and now it is down to 26 percent. What years——

Mr. RUSH. I will be glad to submit those to you.

Senator ABOUREZK. Which year—you mentioned it and I did not write it down.

Mr. RUSH. We ran that for quite a number of years. As I remember, it ran through the fifties and——

Senator ABOUREZK. It remained stable at 50 percent for how long?

Mr. RUSH. In this general range for quite a number of years.

Senator ABOUREZK. When did it stop?

Mr. RUSH. It has been changing gradually ever since we started in on very heavy social programs except for the Vietnam War, with the great increase in social security benefits, medicare, welfare, social services, health care, and all these many——

Senator ABOUREZK. Is it not true that for a number of years the social security trust fund and highway trust fund were not counted in in the total budget and then 1 year, I do not know which year it was—what year did that happen?

Mr. RUSH. I am not sure about that either.

Senator ABOUREZK. Four or five years ago?

Mr. RUSH. I am not familiar with that. I was not in this area at all.

Senator ABOUREZK. In other words, when you say military spending is a percentage of the budget, you are changing definitions because at one point the budget includes the trust funds which would make the military budget smaller——

Mr. RUSH. Yes. There here many, many factors.

Senator ABOUREZK [continuing]. In relation, and earlier on the trust funds were not included and the budgets would be smaller, so the military budget would have been bigger at that time as a percentage.

Mr. RUSH. I think my figures are accurate but I will submit a paper to you on this and, of course, Mr. Ash will have it in full tomorrow, but in figuring out budgets, there always are many things involved.

For example, the very heavy cost of military pensions is in the Defense budget. It is not in other budgets. But it is in the Defense budget, so when we look at Defense we also have a great big pension increment that is not in HEW's budget or is not in the other budgets of people and they have a very heavy personnel, as you know, very large personnel.

Senator ABOUREZK. But the statement that I have heard that you made and I have heard it made before by administration people is that the military budget is decreasing as a——

Mr. RUSH. Percent.

Senator ABOUREZK [continuing]. As a percentage of our overall budget.

Mr. RUSH. Yes.

Senator ABOUREZK. But you do not add you have thrown some more items into the budgets to make the percentage decrease.

Mr. RUSH. The figures in the budgets come and go and do vary.

Senator ABOUREZK. How much do you think we can cut the military budget next year?

Mr. RUSH. I have not myself deeply analyzed the military budget. I, of course, was in charge of the preparation of the budget that just went by because I was then Deputy Secretary of Defense. This budget I had nothing to do with and I am sure that there are cuts that can be made but I have not myself gone deeply into that budget to see just what can be done.

Senator ABOUREZK. In his Monday night speech I notice that in just very general terms the President said that we are going to remain—well, he indicated in general terms that military spending would remain the same or would increase and then he talked about cutting the budget. Now, I assume it is not going to be in the military area if he has anything to do about that. Is that accurate?

Mr. RUSH. I certainly think it is, that any cuts in the Defense budget that weaken our defense would not meet with my approval certainly, and I would not think would be wise. As I have mentioned earlier, we have made very substantial cuts in the Defense budget, in the Defense establishment, in terms of people, both civilian and military. In the case of the military about a third in the last 5 years. We have closed down bases which, of course, always creates problems. And the Defense Establishment has in essence been curtailing itself very effectively in the last 5 years. Further cuts, I feel, in its strength would be unwise at this time. I think we must go forward with our new strategic weapon plans, the Trident, the B–1, and in my opinion, there may be some cuts that would increase efficiency such as closing down some more bases or something of that sort, but anything that would result in the reduction of military manpower or would affect the strength that we are planning would not be wise.

Senator ABOUREZK. Well, I do not think anybody here that I know of would want the military structure to be a second class structure. I think the argument comes to what you decide is necessary for military and what you decide is unnecessary and a large part of the procurement systems that I have seen in the last few years around here have proved to be unnecessary ones. They were funded, developed, and dropped, and cost-overrunned and everything else that happens to them.

I want to ask you one more question, Mr. Rush. What do you intend to do about interest rates? Are you going to let them continue to go upward or are you going to try to control them?

Mr. RUSH. I would hope—the only way we can effectively get interest rates down is to curb inflation. Interest rates are a symptomatic elements of inflation. If we continue to feed money, if we feed money

into our economic system at a higher rate than has been done we might have some lower interest rates but we can also have some much higher inflation and I think what we want to get on top of is inflation.

Now, we do not control interest rates. The Federal Reserve, of course, controls the money supply.

Senator ABOUREZK. But you could control the maximum amount of interest rates.

Mr. RUSH. I think you would introduce very serious distortions, just as serious if not more so than wage and price control, because you then would have in essence, in order to keep those rates down, you would have to greatly increase the money supply or you would have crisis, monetary crisis. Money would not be available. You could not get it.

Senator ABOUREZK. Thank you, Mr. Chairman.

Senator MUSKIE. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman. I am sorry I was not here. We had votes in another committee and I was called out.

Mr. Rush, this may have been answered. If it has, please state so without commenting further on it.

Many have expressed varying views regarding deficit spending and its relationship to inflation. Nevertheless, if the Treasury must dip into this flow of national savings in a significant way to finance the budgetary deficits the remaining funds becoming available for borrowers will almost certainly not be adequate to finance our needs for housing, capital formation and State and local borrowing. Has this been covered in your comments?

Mr. RUSH. Somewhat, yes, but basically, I think, if I understand your question correctly, Senator Fannin, the allocation of resources as between the public sector and private sector is determined, of course, by the amount of money that the Government takes out. To the degree that we go into deficit financing, we, of course, are creating demand without increasing production because the Government is artificially creating demand. This is the big factor in inflation and that is why we want to stop this.

Senator FANNIN. I wholeheartedly agree. I just want to establish that relationship.

We have heard claims that appropriations bills have been reduced. That is undoubtedly true. We do reduce them. However, we get many programs outside the budget, which does not get them outside the GNP. Would you agree that a program promoted by a nonbudget agency borrowing or by loan guarantees is just as large a draft on the national savings flows and on economic resources as if it has been in the budget and financed by direct borrowing?

Mr. RUSH. Yes. It should be counted, yes.

Senator FANNIN. One other matter that we hear a great deal about, something that you have talked about. The deficit of payments that we have experienced has been of great concern and because, of course, of the balance of trade and the tremendous variation that has resulted because of the price of petroleum products, the tremendous increase in price of petroleum products. I am wondering as to the effect on the budget. As we make our changes evidently that are going to come about with the ownership of facilities in foreign countries, the Middle

East countries especially, that will cut back on the return to the United States. Do you feel that this will be a factor as far as revenue is concerned? We talk about a $10 billion revenue reduction, will that be greatly affected by this change?

Mr. RUSH. Well, as I understand it, Senator Fannin, the cash flow of the international oil companies is insufficient for their needs. So that while I do not have the latest figures on this, the additional cash flow coming in from overseas by no means represents the earnings overseas. A big part of those earnings go right back into exploration, development, expansion, and the oil companies are really instead of being flush with those huge profits of money, they have real needs for additional investment so that the benefits to this country in terms of money coming in and being distributed to the people or being paid out in taxes here are not very large.

Senator BIDEN. Will the Senator yield for a point of clarification, not a question? I am not sure I heard what Mr. Rush said.

Mr. RUSH. As I understand——

Senator BIDEN. I would like to be specific in what I did not hear. You said something about the cash flow of the international oil companies is not sufficient——

Mr. RUSH. That is our understanding.

Senator BIDEN [continuing]. To meet the demand of expansion?

Mr. RUSH. Yes. And, of course, replacement of inventory.

Senator BIDEN. That is what I thought I heard. Thank you.

Senator FANNIN. Now, the other companies involved in other industries than the petroleum industry, we have had over a period of years quite a return in revenue, estimated as I said before, as high as $10 million. If the trade bill is adopted as presently recommended by the administration, would this not help continue that program?

Mr. RUSH. I think if we adopted the trade bill and increased our trade it would greatly help our balance of payments and our balance of trade, Senator Fannin.

Senator FANNIN. And directly affect the budget from the standpoint of revenue received.

Mr. RUSH. Yes.

Senator FANNIN. Thank you.

Thank you, Mr. Chairman.

Senator MUSKIE. Senator Biden.

Senator BIDEN. Thank you, Mr. Chairman.

Mr. Rush, I apologize for making you sit through one more group of questions, but I guess I am limited to 10 minutes.

I would like to ask the chairman's permission to insert in the record an opening statement.

Senator MUSKIE. Without objection.

OPENING STATEMENT OF SENATOR BIDEN

Senator BIDEN. Yesterday we made a beginning on what may be one of the most important initiatives taken by Congress in this decade. We formally established the Senate Committee on the Budget.

Today we are starting hearings on one of the most important current issues—inflation and the growth of the Federal budget.

In his address to Congress on Monday night, President Ford welcomed the creation of the House and Senate Budget Committees. He pledged to work with them to bring the Federal budget into balance by 1976. I would like to think that we are beginning that cooperative process here today.

For many years now there has been an increasing concensus that the growth of the Federal budget is out of control. However, every time solutions have been sought, special financial constituencies have appeared and blocked effective action.

Now, the ever-growing Federal budget must be viewed against a background of double-digit inflation which affects everyone. Now, despite their individual interests, virtually all our citizens have one single reason for wanting budget reform—the need to curb inflation. So this may be the best possible time to begin our effort with a reasonable expectation of success.

All of the figures look bad.

Almost every statistic about the economy is discouraging.

The consumer price level has advanced 11 percent in the past year.

Worst yet, the wholesale price index rose 3.7 percent in July, a whopping compounded annual rate of more than 50 percent.

Arthur Burns forecasts a growth rate between 0 and 2 percent for the next 6 months—another way of saying that 1974 will be a recession year.

First-year settlements in major collective bargaining agreements concluded in June came to about 10 percent.

The price of a General Motors car will be up $1,000 over last fall.

The picture of congressional fiscal actions is no more encouraging.

While Congress has enacted only three appropriations bills for 1975, the Report No. 5 of the Joint Committee on Reduction of Federal Expenditures shows that we have already increased budget authority over original estimates by nearly $157 million.

Looking further, Congress has already passed legislation mandating spending increases of over $1,300 million.

If you look at bills adopted by one House or the other, the potential spending increase could be between $5 to $10 billion.

All of this just sketches in the problem. Everywhere I go people are desperately seeking a way out from under this killing inflation. The statistics do not really reveal the serious plight of so many of our families.

So I am anxious to get on with our hearings this week and next. I hope they will shed some light on what we can do this year to use the budget as an inflation-fighting tool. At the same time we must continue the job of putting together the new budget process. Only in that way can we assure fiscal stability in years to come.

Although I have many questions, some of which have been asked, some of which have not been and some which you have answered in hearings before the Banking Committee not long ago with Mr. Greenspan or at least acknowledged the existence of the questions, there may be some repeats here.

First of all, I would like to go back to that thing about cash flow of the international oil companies not being sufficient to meet their needs for expansion and replacement of inventory.

Mr. RUSH. Replacement of inventory, of course, is a current cost.

Senator BIDEN. Right.

Mr. RUSH. But their cash flow is their depreciation and their earnings after taxes.

Senator BIDEN. Now, it is not sufficient at the present rate of dividends? Or it is not sufficient, period?

Mr. RUSH. I have not followed whether there have been increasing dividends or not, but, of course, some of them are in the market for additional money because they do not have—Standard of Indiana still floated an additional bond issue in order to raise money. I think that is their—I think if we take their construction plans and capital expenditures and cash flow after dividends you will find that they may need some more funds.

Senator BIDEN. Now, Mr. Rush, I think it would be a little bit unfair of me to be critical of the new President's forthcoming economic policy. He has not had much of a chance to really get his feet wet, so I for one, think he should be given the benefit of the doubt and I do not mean what I am about to say to be—to sound—I am not trying to be critical. I am trying to be inquisitive.

It seems to me that one of the most important things for us to do at the time when we are dealing with the causes of inflation, one of which is the lack of confidence of the American people, it seems to me, in their governmental institutions, that at the time Mr. Ford comes on, President Ford comes on the scene, and I think he will be able to restore that confidence, at the same time, his administration not overpromise what they are likely to be able to do, either for their own short run good or for the good of restoring that confidence which is all-important, in my opinion. From the President's speech the other night which I understand was not intended to be a state of the Union address and probably not intended to be anything other than a statement of attitude, there are a number of people who have been dissecting that speech, many of us on the Hill, commentators, and it seems as though based on his speech, your testimony before this committee and other administration spokesmen, that your game plan to reduce inflation which will take—the last time you spoke, it was 18 months to 2 years, maybe a little longer—is to have no tax reform, higher interest rates, incentives for corporations, environmental degradation because of the costly effects on industry to implement the environmental safeguards, an increasing military budget, decreasing social programs and increased unemployment.

Now, I do not know whether that has been formulated to come out to that kind of package but everything you said here today and what I have heard in the past adds up to that package, which seems to me either not to have been a formulated game plan, or if it is, an unacceptable one to some of us, myself in particular.

We throw around figures about the rates of inflation, the determination of how much unemployment we really do have, what we can tolerate and what percentage of the overall budget the military budget is, and every time we start doing that, I think of that famous quote from the Prime Minister of England, Benjamin Disraeli when he said there

are three kinds of lies, lies, damn lies and statistics. I do not know what they mean and I do not know that anybody who has testified in the year and a half before the Banking Committee that I have been there really knows what they mean either.

Now, to get to some of the specific questions, you stated time and again here today, and I admire your perseverance—maybe I admire the second witness' perseverance even more than yours—but you stated that a cut in the budget would not much affect inflation. Yet, in your statement you say: "Because deficit spending on the part of the Federal Government is one of the major causes of our current inflation we must emphasize the policy of fiscal responsibility that will result," and it goes on.

Now, is there a causal relationship between——

Mr. RUSH. I covered that two or three times, Mr. Biden, but I will be glad to do it again.

A $5 billion—$5 billion in the abstract has not too much impact on an economy of a $1,350 billion.

Senator BIDEN. I would agree with that. Now, the next part of it——

Mr. RUSH. Second, the primary causes of inflation are fiscal and monetary policy. In our fiscal policy over the last many years we have been increasing demand, governments worldwide, including ours, have been increasing demand very markedly by running deficits, creating—thereby building up demand, pouring money into the economy, and preventing—by taking the money out of the economy through their borrowing, and the like, it does not go into productive capacity. So we build up demand without building up productive capacity and we get very serious inflation.

Now, how do we get on top of this? One, by entirely changing our approach, in my opinion, with regard to our fiscal responsibilities, and we do this by realizing that a balanced budget is absolutely essential. We have had a balanced budget for the last 18 months but it came too late. Now—virtually a balanced budget for the last 18 months, but we ran these tremendous deficits before that.

What we must do is to have balanced budgets and maintain balanced budgets for a long time and even run surpluses and thereby allow the private sector to build up productive capacity to meet demand and not build up demand artificially by Government through budget deficits.

Senator BIDEN. Now, with regard to building up demand artificially and—is it not true that budgets—if you take the budget as a whole, that there are varying effects on where you withdraw the $5 or $10 billion that you want to cut back in that total budget, a total budget of $305 billion, to take round figures, going to cut that budget $10 billion to assume the balance of $295 billion for the sake of this discussion?

Is not the impact on the total economy—does not that impact differ depending on where you cut that $10 billion?

Mr. RUSH. Well, the impact would differ on where you cut it, yes.

Senator BIDEN. Now, that impact differs in terms——

Mr. RUSH. If, for example, you should cut social security across the board you would reduce purchasing power and this would——

Senator BIDEN. It would also have a lot of people starving.

Mr. RUSH [continuing]. You would reduce purchasing power.

Senator BIDEN. I think you are right.

Mr. RUSH. This has one impact. Now, if on the other hand, what you did was, shall we say, fire $10 billion worth of people in the Government you would save a hell of a lot of money.

Senator BIDEN. That is true. I think maybe, though, if you make——

Mr. RUSH. They would lose their purchasing power. Maybe the impact would be the same.

Senator BIDEN. Well, it might be, but how about the difference between——

Mr. RUSH. I do not know that the impact would be very different.

Senator BIDEN. Is not the impact of cutting the Defense budget less on the total economy than in cutting, for example, education?

Mr. RUSH. You can say this, that if you——

Senator BIDEN. I can say it but do you agree with this?

Mr. RUSH. One can say this. I was using the impersonal "you." I I will use "one" instead. One can say that where the budget cuts hit nonproductive production of goods, that is, weapons and the like, this has one impact on the economy as against, let us say, a budget deficit that was going into building powerplants to supply power to industry and the VA or something of that sort, so that you can get results along those lines. It would probably work out——

Senator BIDEN. Now——

Mr. RUSH [continuing]. Not too much different.

Senator BIDEN. I have just been clocked.

I want to talk to you at some other time about what you are going to do with our environment and whether or not the President in his speech when he talked about things like, I have signed the education bill but I do not want to have too much spending, does that mean he is going to go to impoundment again?

Mr. RUSH. The answer is, no.

Senator BIDEN. The answer is "No." OK. My time is up.

Mr. RUSH. The program that you enunciated is not our program.

Senator BIDEN. Somebody else is saying it, though. Go catch that rascal, will you, and tell him to stop saying those things.

Senator MUSKIE. Senator Biden is operating out of frustration as to the time limitations. We all feel that way as we find it difficult to pursue lines of questions. But it is of great value to have so many Senators present.

Might I suggest that we break at 12:45? I think, Mr. Rush, that we ought to be able to excuse you before then, at least we ought to try, so we can begin with Mr. Ackley. We will not be able to finish with Mr. Ackley by 12:45, so we will come back at 2. As I understand, he is under pressure to catch a plane about 4 o'clock and we want to try to help him meet that schedule. I hope the committee will bear those constraints in mind. We obviously will not be able to take up all the questions that the subject stimulates, but perhaps we will have another chance.

I would like to ask a few questions which I would hope will touch upon some of the fundamental issues that this committee is confronted with.

First of all, there is the implication generated by a lot of excess rhetoric all around that unrestrained Federal budgets are the prime cause of inflation; ergo, that appropriate cuts of up to $10 billion in the Federal budget will cure inflation. I gather you do not subscribe to that as a simple statement.

Mr. RUSH. As a simple cause and effect, no. But I think it very important, however, with regard to the overall fight on inflation.

Senator MUSKIE. I understand, but I think it is very important to us as we enter a new era designed to reestablish the credibility of Government and the confidence of our people in governmental policy that what we advocate not overstate the prospects or the purposes of a particular policy.

All the information I get on the causes of this present inflation do not suggest that lack of budgetary restraints is a prime cause. That seems to run counter to your own view, Mr. Rush. But let me put to you an analysis that I received from Mr. Charles Schultze, who used to be Budget Director, and ask you to comment on it.

First of all, he undertakes to answer this question. Has the Government budget been the "principal responsible element of the current inflationary situation"?

To answer that question he addresses himself to total Government budgets, Federal, State, and local. He does so in part because Federal funds find their way into State and local budgets so that if you want to evaluate the impact of governmental budgets, then you have to consider the whole. And so he makes this point, that:

> The combined budgets of all levels of government averaged a $5½ billion surplus over the past five calendar years.

I know you have not had access to the mathematics that went into that statement but have you any reason to question it as a statement of fact?

Mr. RUSH. I have no reason to either question it or affirm it, Mr. Chairman.

Senator MUSKIE. I do not expect you would be able to respond specifically to these statements this morning but I am putting them in the record because if you care to respond subsequently, we would appreciate your comments.

Mr. Schultze makes this statement:

> The actual budget of all governments combined was indeed in deficit during 1970, 1971, and 1972 as the recession of that period eroded revenue. But in 1973 the combined budgets showed an actual surplus of $3.6 billion and continued in surplus $2 billion in the first quarter of 1974 despite the downturn in economic activity.

Now, do you subscribe or disagree with the thesis underlying these statistics, that if the combined Government budgets are in surplus, they are not inflationary?

Mr. RUSH. Well, I would say that one must look at all of Government, yes, in terms of—I would say that possibly that might be true. However, I really think you have to look at the Federal budget by itself. What is the Federal Government doing in terms of pouring personal power into the economy which is the paramount one?

Senator MUSKIE. You have made that point. I am trying to put the problem in another perspective so that we can see it as well.

With respect to the inflation of the past year, Mr. Schultze has this to say:

> The inflation of the past year has been dominated by fuel and food price rises and by higher prices for imported raw materials. Monetary and budget policy could have had very little effect on fuel and food price advances. The oil cartel and worldwide agricultural problems spark these price rises. Given the increase in fuel and food prices, all other prices combined would have had to fall three

percent in order to have held the overall inflation rate to a moderate four percent in the past year. Even the most Draconian budgetary measures could not have produced a three percent fall in all other prices or could have done so only by putting the country through a massive depression.

Mr. Schultze's credentials are clear. That does not mean all economists or those associated with budgetary reponsibilities would agree. But I would be interested in whatever response you would care to make to that analysis which carries heavy credentials.

Mr. RUSH. I would say, Mr. Chairman, that the basic underlying inflation that we have was not created by the oil or food crisis. It was first created in this—this started in this country back there in 1965–66 when we had a tax cut followed by deficit financing by the Federal Government of the Vietnam war and of the Great Society program simultaneously.

Then on top of that we had deficit financing through much of the Nixon years and the huge buildups of additional debt and a major worldwide industrial boom of unprecedented strength which created tremendous demand.

Now, this worldwide inflationary boom which created this tremendous demand, and I am not—we cannot just confine things to our own country—was caused in part by governments running deficits which were important. It was caused also in part by very large increases in the money supply which, of course, fed the inflation and we had a large increase of money supply in this country perhaps at the wrong times.

Then with all of these underlying inflationary factors there and causing inflation, it was given quite a boost, and certainly the first quarter of this year reflected that very thoroughly, by the energy crisis and by the food crisis, both of which in large measure caused the 7 percent of minus GNP that we had in the first quarter. Really, those are almost the entire—it was caused by an energy-related crisis in the first quarter but the food shortage and energy crisis added onto the underlying inflation gave it a substantial boost.

Senator MUSKIE. I am not so sure I have a personal judgment on the other factors you mentioned, so I appreciate having that insight. But it seems to me that that analysis ignores the particular factors that have come into play in the last year or two.

I have before me, for example, a table which shows the percent rise in the cost of living since 1955. Now, from 1955 until 1968, that rise annually never exceeded 3 percent. It was by and large under 2 percent until 1968, when it rose to 4.7 percent. In 1969 it rose to 6.1 percent. In 1970 it was 5½ percent. In 1971–72, primarily I take it in response to the new economic policy announced by the President in August 1971, it dropped to 3.4 percent in each of those years. And then in 1973 it goes to 8.8 percent, in 1974, first quarter annual rate, 14.2 percent. 1974, second quarter, 10 percent.

Now, it seems to me that that picture suggests not simply cumulative effects of the forces you are describing but an injection of significant new factors that are even more important. That is what Mr. Schultze describes. He does not—he may or may not disagree with your analysis of what happened in the sixties but what he is saying is that in the last year, the principal forces were forces, fuel and food price increases, beyond the reach of the impact of budget cuts, whatever

their potential for offsetting inflation. And it seems to me that that judgment makes eminently good sense.

Mr. RUSH. I certainly myself have often said, and I quite agree, that obviously the energy crisis is beyond our control. That was a military-political factor and budgetary of monetary policy in this country had nothing to do with it.

With regard to the shortage of food, I do think that the tremendously increased demand for energy and the tremendously increased demand for food worldwide were helped generated, in large part, by monetary policy, by the industrial countries of the world, and to a degree, by fiscal policy of the countries. So that when we did have the energy crisis, the amount of energy we were using may have been far more than the demands would otherwise have been, and the demands for food worldwide have gone up tremendously in terms of individuals, because they can afford more food and they can afford the food in a far more wasteful form, let us say, as far as intake is concerned by having beef and other things instead of eating rice.

So that I think that all these factors are intertwined, and I think furthermore that another basic factor why our inflation is so bad today is because of the fact that we did impose wage and price controls and thereby caused many dislocations in the production picture that are having their effect today where we have shortages that are far worse than would otherwise be the case, and therefore higher prices.

We now are faced with the problem of where food prices relatively have leveled off. They were about 1 percent above a year ago. They have been going up recently. They dipped a great deal, but they have gone up recently.

Oil prices to a certain degree have leveled off, although we still have, working through the economy, the effects of the very heavy oil increases because oil is not only energy, but raw material for petroleum, plastics, chemicals, textiles, so many things. But we also have a very serious price-wage increase that is contributing very materially to the inflation.

All these factors, Mr. Chairman, are very important and we must try to control all of them by, I think, our own country, our own Government, setting an example for its part of fiscal responsibility and the Federal Reserve exercising a policy of monetary restraint, which, combined with restraints by labor, by industry, and attempts to secure more plentiful supplies of food such as we are doing through the introduction of another 60 million acres of land to agriculture, removed from set-aside to agricultural production, the attempt to get more wide-spread sources of oil, conservation, uses of other resources, such as coal, all these help combat inflation as well as building new productive capacity.

Senator MUSKIE. I have run over my 10 minutes. I hope the committee will forgive me if I pursue this.

I don't want to take the time to pursue all the questions that your answer raises, because I do want to excuse you. I know you are busy and I want to get to Mr. Ackley.

But the point I am trying to make is this. If, in fact, lack of budgetary restraints at the Federal level is not the prime cause of inflation—if, in fact, massive budget cuts will not correct inflation,

then it is fair, it seems to me (1) and indeed essential to focus on the implications of what budget cutting is likely to cost us in other ways. That is why I think it is important to get a fine focus on the relationship of the Federal budget, to either the causes of inflation or to the possibilities of curing inflation.

I think if we exaggerate either, we are likely to stumble into mistaken policies that have other consequences.

Let me ask you this question, because it hasn't really been touched upon very exhaustively this morning. What connection is there between what we do with the Federal budget and unemployment? Mr. Arthur Okon has said that a $5 billion cut would produce an increase of 0.3 percent in the unemployment rate. Other economists project an even higher rate.

Do you think there is any connection between budget cuts and unemployment—a $5 billion cut would add anything at all to unemployment? I am not now talking about the Federal jobs that Senator Magnuson was talking about, although that is included in the budget.

Would a $10 billion cut have an impact on unemployment? Could we cut the Federal budget $20 billion without any serious consequences in terms of increased unemployment? Is there any connection? I am not clear what your economic philsophy is on that point.

Mr. RUSH. Yes. There can be a connecton, Mr. Chairman. As a matter of fact, the exercise of too great monetary restraints, or the cutting of the budget too much can obviously go to a point of having a recession where you can have unemployment that is quite unacceptable.

So, that obviously, if we create additional demand by the Federal budget, if you cut that demand—you will effect unemployment.

Senator MUSKIE. Let me present one other question for your response.

As I understand our present economic situation, consumer spending is down. I am told that in the second quarter, not withinstanding the rise in the cost of essentials—food, energy and so on—and notwithstanding the growth in population, for the first time in a long time there is an actual reduction in consumer spending of 2½ percent or more, and yet you speak of excess demand.

Second, inflation is continuing and will possibly rise even further because of the crop situation and the drought. Unemployment is climbing and will climb further, by your own testimony this morning as well as by other authorities. So, with consumer spending down, inflation continuing, possibly rising, with unemployment climbing, and with budget cuts having little impact upon inflation, by your testimony this morning—what would be the net impact upon the economy of budget cuts of $5 or $10 billion in terms of unemployment, in terms of consumer spending, and in terms of inflation?

Mr. RUSH. I have tried to say, Mr. Chairman, that I think reducing the budget does have a real economic effect. What I said was the $5 billion standing alone, nothing more, leaving out all the other factors, I tried to mention with regard to budgetary reductions, is not in itself a major factor. But, I do think that for the other reasons, I shall not repeat again, I think it is an important factor.

Now, with regard to the fight on inflation and with regard to unemployment you do get—you get less demand by reducing the budget which, of course, in turn helps bring about—contributes something to unemployment. The results are not great, as you say. The impact by itself is not great.

Now, you could of course get out of phase. You could cut the budget to a point where it would be quite disastrous, or you could increase the budget to a point where it would be very, very inflationary and very bad. We are talking now about a very narrow range of movement.

Senator MUSKIE. Could I put another question to you?

I have had other economists tell me that to reduce the inflation rate 4 percent by relying wholly on monetary and budgetary policy would take 2 to 3 years and would require an unemployment rate of up to 8 percent.

This is what I am trying to focus on.

Mr. RUSH. Yes.

Senator MUSKIE. Is that a reasonable projection of the consequences?

Mr. RUSH. I think we would have very serious consequences if we carried our monetary policy and our budgetary policy to a point where we try to hit 4 percent, let us say, within a certain period of time. I think we have to watch it very carefully and be very sure we do not go too far and trigger a recession.

Senator MUSKIE. You talked about targets for the budget. Do you have a target for what would be acceptable or unacceptable levels of unemployment?

Mr. RUSH. Unemployment? Well, nothing is acceptable, but I certainly——

Senator MUSKIE. I understand, but as a realist you know there is going to be increased unemployment.

Mr. RUSH. Yes.

Senator MUSKIE. If you pursue this policy.

Mr. RUSH. Yes. We do have, Mr. Chairman, a program of trying to help unemployment, no matter where it is, and certainly 6 percent—at 6 percent we should really look at our policy again, I think, in terms of what should we do for it? I have suggested that the unemployment compensation proposals be enacted. The unemployment insurance, of course, is a very good factor, but we certainly want to keep an eye on all the indices and Dr. McCracken at one point said that if we wait until we think the time is right to remove—to loosen on monetary restraints, it is too late.

So that, in essence, saying it another way, you should move before you really think you should.

Now, when that time is something that has to be very carefully watched and I think the Reserve should do it.

Senator MUSKIE. I would agree with that. What concerns me is, frankly that there are so many projections of a soft economy for the rest of this year, I am afraid that if we pursue the policy enunciated this morning that we may just be unleashing a momentum that will carry us down the road to something as high as 6 percent unemployment. I raise the question because I haven't any personal expertise on this point on which to base a judgment.

I think we have raised a wide range of issues and done it with your help and patience. We appreciate that.

Senator Cranston has one more question and Senator Fannin also. I yield to Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Rush, we are so prone to say that when we are going to cut back on the budget or going to—perhaps that it is going to result in unemployment. I know that that is not the goal naturally. I know that there is a feeling that if we can establish confidence, for instance, in the markets, the stock market and in business and industry generally by having a balanced budget or closer to a balanced budget, that it may have the opposite effect. It may result in increased employment. Isn't that true?

Mr. RUSH. I think basically what we are talking about are short-range trends. What we want to do basically, of course, is to get inflation down, get production up, and thereby be able to increase employment across the board. This is what we want overall.

Now, you may have temporary increases in unemployment, which I anticipate as a result of the policies. The alternative is very, very dangerous. The alternative, in my opinion, could result in harm to everyone through greatly increased inflation.

Senator FANNIN. My point is that with the knowledge that we are taking steps, knowledge that we are going to be carrying through with fiscal policies that are sound, results in greater confidence as far as capital investment, as far as the investment or expenditures by the individual, so I don't always necessarily agree that there is a curve there that will result, because I think if we look back over the history, we will find that there have been just the opposite reactions.

Mr. RUSH. I would not say, Senator Fannin, that we can get on top of inflation and carry out the policies that we have been talking about with regard to fiscal and monetary responsibility without the medicine tasting bad at times. There are certain aspects of the medicine that are not good. One of them right now is the higher interest rates. Another one may be unemployment may go up, as I think it may, to 6 percent by the end of the year, 5½ or 6 percent.

But, I think if those are the results, they are going to be greatly compensated for as interest rates will come down and as we start getting on top of inflation and getting production up and employment up.

Senator FANNIN. I understand that. With construction increases, interest rates coming down—we have a great problem in the housing industry and the construction industry generally, and I do agree, but I don't like to just say that we are working toward a goal that is going to result necessarily in any appreciable increase in unemployment. I would hope that we could get the confidence of the American people that this is going to result in beneficial effects that you anticipate and that it would not then result in increased unemployment.

Senator MUSKIE. I think it is important to note that following the new administration's inauguration in 1969, this very kind of policy—budgetary and monetary restraints—resulted in higher interest rates, in inflation rising well above the 4.7 percent of 1968, actually upward of 8 percent, and produced unemployment rising to 6 percent and above.

I just put those figures in the record. You can follow with that——

Senator FANNIN. And I would——

Senator MUSKIE [continuing]. And undertake to identify what you think are the other causes, but most of the economists I have talked to tie it together. I am not saying that the goal of the policies is unemployment, but as a particular consequence, we do not do our country a service to suggest that it won't follow.

Senator FANNIN. Well, I would say to the distinguished Senator that there are many economists that are in disagreement.

Senator MUSKIE. We will have a chance to hear from them.

Mr. RUSH. Certainly I would say this, Senator Fannin, that there are many factors that enter into what causes unemployment, and you can have high inflation and high unemployment. We have seen high inflation and high unemployment in many countries of Latin America, where inflation might be running at 100 or 200 percent a year, with very high unemployment, so that increasing, in other words, the money supply, increasing inflation in this country, combating fiscal responsibility does not mean that we will have less unemployment.

Senator FANNIN. Thank you.

Senator MUSKIE. Senator Cranston.

Senator CRANSTON. I believe you said in answer to a question from Senator Biden, "We have had a balanced budget for the last 18 months." Would you explain?

Mr. RUSH. Approximately, as I understand it, we have been close to a balanced———

Senator CRANSTON. Would you explain that in a bit more detail?

Mr. RUSH. Our deficit last year, of course—I will be glad to send in the figures—was about $3.5 billion and for the 6 months prior to that, the last three—6 months of the prior fiscal year, the deficit was very small.

Senator CRANSTON. Over the last 18 months, what has been the income and outgo?

Mr. RUSH. The outgo, as I remember was roughly $68 billion and the income was about $64.5 billion, something like that. The exact figures—$264 billion income and about $268 billion outgo, about $3½ billion deficit.

Senator CRANSTON. Taking into account the budgets which we are planning now for the 1974–75 fiscal year, that is out of balance by $10 or $5 billion, some such figure?

Mr. RUSH. For 1975?

Senator CRANSTON. 1974–75.

Mr. RUSH. 1974 was out of balance $3½ billion and 1975—on current figures—would be out of balance $11 billion. I was talking about the prior—the 16 months of the last fiscal year 1974 and the last 6 months of 1973.

Senator CRANSTON. Did you also say a bit ago that fiscal and monetary policy are mainly responsible for inflation?

Mr. RUSH. I would say they are very major factors, yes.

Senator CRANSTON. In your press conference on June 6, you stated:

> The bulk of inflation has come from causes that did not result from fiscal or monetary policies of the past or budgetary policies and those were and have been and are the fuel situation and the food situation. Two-thirds of the inflation has come from energy and from fuel and from food price increases.

Now, if you stand by that earlier statement, I would like to ask you how high interest rates, a balanced budget and increased unemployment can contribute in any way to solving the production, distribution, international problems, that cause the food and fuel inflation.

Mr. RUSH. As I tried to explain earlier, I was talking primarily as I remembered about the first quarter upsurge and the recent upsurge of inflation.

The underlying inflationary factors, as I tried to state, in my opinion, are caused by this great demand arising from the factors I mentioned, including the worldwide industrial boom.

Now, the great upsurge in inflation and in fact the entire GNP deficit in the first quarter of this year were caused by the food and fuel crisis. So that you have the underlying factors that were inflationary and we got the inflation going and these were great stimuli and gave it a great boost.

Senator CRANSTON. I just have one other question.

Mr. RUSH. Might I say, fiscal and monetary policy had nothing whatever to do with the great boost that came from the fuel or the food——

Senator CRANSTON. Yes.

Mr. RUSH [continuing]. Except as I tried to explain to the extent that much of this huge demand had resulted from monetary and fiscal policy earlier and therefore the demand was much greater than would otherwise be the case.

Senator CRANSTON. I have just one other question. It has been suggested that we return to the gold standard.

What effect, if any, would that have on inflation, in your opinion?

Mr. RUSH. I am very much against returning to the gold standard. I think we should demonetize gold.

Senator CRANSTON. What would you feel it would do to our efforts to halt inflation if we went to the gold standard?

Mr. RUSH. Well——

Senator CRANSTON. I am not suggesting that, but it has been proposed. I wanted your feeling about what that would do.

Mr. RUSH. Of course. If we go to a gold standard, we have this artificial commodity base for establishing the standard of monetary supply, and this, of course, places funds in certain countries and not in others. It probably would be inadequate for the world money supply and I really haven't given much thought to returning to the gold standard, because I had no idea we wanted to. I really don't have much of a reply as to just how I think it would affect inflation.

Senator CRANSTON. Thank you.

Senator MUSKIE. Thank you very much, Mr. Rush. Again, we appreciate your patience and cooperation.

Mr. RUSH. Thank you, Mr. Chairman.

Senator MUSKIE. Mr. Ackley, I think there is no point in trying to get started before we break at 12:45, so with your patience, we will come back at 2 o'clock. I might not be here, but Senator Moss will be and I will join him just as soon as I can.

We are in recess until 2 o'clock.

[Whereupon, at 12:45 p.m., the committee recessed, to reconvene at 2 p.m. the same afternoon.]

AFTERNOON SESSION

Senator Moss [presiding]. The committee will now resume its hearings. We are pleased to have as our witness this afternoon Dr. Gardner Ackley of the University of Michigan, who was the former Chief Economic Adviser to the President under the Presidency of Lyndon B. Johnson.

We are certainly pleased that you have come here to give us the benefit of your thinking as this new Budget Committee gets launched in the Senate, and we welcome you before the committee.

Mr. ACKLEY. Thank you, Mr. Chairman.

I rather apologize for the statement I brought with me. It was prepared on very short notice. If I had had a longer time, it would have been either shorter and more cogent or longer and more scholarly. I do not know which would have been better.

I plan to omit some sections of the prepared statement on the assumption that the entire statement, as prepared, will be in the record.

Senator Moss. The entire statement will be placed in the record as though delivered in full.

STATEMENT OF GARDNER ACKLEY, UNIVERSITY OF MICHIGAN, AND FORMER CHIEF ECONOMIC ADVISER TO PRESIDENT JOHNSON

Mr. ACKLEY. The first couple of pages of my statement relate to the Budget Reform Act and the work of the committee, which I characterize, and do so sincerely, as events of tremendous potential significance for the Government, the economy, and the people of the United States. But rather than to belabor that point, let me proceed.

I go instead to the top of page 3 where I state my conclusion, line 3. I urge that the Congress should feel free to consider either modest additions to the budget as originally proposed, and without a matching increase in taxation, or else some modest reduction in taxation.

I may add that if the committee should recommend that expenditures be reduced—and I am sure that there are many expenditures which might well be reduced—then any such reduction ought to be offset by a more than equivalent reduction in taxation.

My statement then briefly reviews the economic outlook, because it seems to me that the questions at issue here cannot be considered without that. Let me summarize simply by saying that I find the economy in a recession, and entering what I believe will be a fairly prolonged period of "stagflation," with the unemployment rate, on the best estimate I can make, rising to the neighborhood of 6 percent, and staying there through the first three quarters of 1975—which is the horizon of my forecast.

I think that there is rather general agreement among economists today—or at least the economists whom I know who work in this area—that this is in fact the situation. Indeed, the dissenters are basically those who forecasts are considerably more pessimistic than mine.

Yesterday, two of my colleagues at the University of Michigan, Professors Hymans and Shapiro, who are responsible for the rather well known Michigan Econometric Model, released the latest forecasts

of that model, and they are considerably more pessimistic than mine. The model foresees no increase whatsoever in real output throughout the entire year of 1975. That means that the margin of excess capacity and unemployment would be steadily growing throughout that whole period.

Thus arguments which are based upon the assumption that we are in and will be in an economy characterized by excessive demand, an assumption which it seems to me underlies the better part or all of Mr. Rush's argument this morning, seems to me to require the most serious challenge.

I will return to that theme a bit later. First, however, let me pick up at the bottom of page 4 of my statement where I try to make a few comments about the relationship of the Federal budget to the economy and later to inflation. There appears to be a widespread impression, assiduously cultivated by advocates of a reduction of Federal spending that the current budget is a highly stimulative or expansionary one. Indeed, some imply that the budgets for fiscal years 1974 and 1975 are the main source of continuing inflation.

This view seems to me very seriously mistaken. Let me try to make four fairly simple points to put that claim in perspective. The first point is one which, I gather from the chairman's remarks this morning, has also been made by Charles Schultze—although I was not aware of that. It seems to me we need to consider the Federal budget in relationship to the total Government budget. It is officially estimated that, as of the May revisions, Federal spending in fiscal year 1975 on a national income account basis will include $48 billion of grants to State and local governments, more than 15 percent of total Federal expenditures, and considerably more than double the amount of such grants in fiscal 1970.

In the first half of 1974 such grants are estimated to account for more than 21 percent of total State and local government revenues. It is essential, therefore, to consider the combined impact of Federal, State, and local government budgets on the economy. Relevant data are summarized in table 1, which appears in my prepared statement. Whereas, in the past, State and local governments have on the average, and in almost every year until 1971, run either small surpluses or small deficits, in the past 3 years these governments have run very large surpluses, in significant part as the result of the sharply rising Federal grants which have contributed to substantially both to the Federal deficits and to State and local revenues.

When we add Federal and State and local government surpluses or deficits to obtain a crude measure of the total impact of Government finances on the economy, we still see two recent periods of large total deficits—1967 and 1968, and 1970 and 1971—both basically the product of Federal finances. But in 1972 and 1973, despite continuing large Federal deficits, the total Government balance has turned into surplus, and it appears still to have been in surplus in the first half of 1974. It seems to me on the face of it implausible to argue that Government deficits have constituted "an engine of inflation" in the past 2 years.

Incidentally, those concerned with the monetary or financial impacts of Federal deficits—and this is quite a separate argument, one that Mr. Greenspan is quite fond of—should recall that State and local surpluses are normally invested in public obligations. If the

Federal Government borrows to finance grants to State and local governments which run surpluses which are invested in Government bonds, it certainly creates no extra pressure on financial markets.

My second point is that the possible inflationary impact of any budget deficit must also be judged in the light of the situation of the economy, and particularly the degree of overall pressure on our resources. The fact is, Mr. Chairman, that deficits in the Federal budget, or in the combined Government budget, may be inflationary or they may not be. It all depends upon the state of the economy.

There is a time for surpluses. There is a time for deficits; and I refer here either to the actual budget or the full employment budget. Incidentally, I would be happy to comment later on the full employment budget in light of some of the questions that were raised this morning, if the committee should desire.

The last column of Table 1 provides one simple, admittedly inadequate measure of the overall pressure on resources; namely the unemployment rate. The reason why the giant deficits of 1967 and the first half of 1968 were so inflationary is that they were superimposed on an economy with an extremely low unemployment rate—and incidentally also very high rates of capacity utilization—and placed excessive pressures on both our labor and capital resources.

We can argue what precise level of unemployment rate represents excessive pressure on labor resources, and we can hypothesize, as many have, that this critical rate may be somewhat higher today than the 4-percent rate which was believed to have represented this critical level in the 1960's. However, I have seen very little speculation that that rate should now be set higher than 4½ or at most 5 percent. The table does not present data on pressure on industrial capacity—for example, utilization rates in manufacturing—but taking account of that as well as the pressure on labor markets, I would contend that neither the large total government deficits of 1970 and 1971, nor the more modest one of 1972, nor the total Government surpluses of 1973 and the first half of 1974 were primary contributors to our recent inflation.

My third point about the budget, and referring now specifically to that for fiscal year 1975, is that, unfortunately, the rate of inflation is going to be considerably higher than was anticipated when that budget was first drawn up. If spending in dollars is merely held to the original budget figures, drawn up at the end of last year and published at the beginning of February, the real demand for goods and services which it represents may well be $10 billion less than originally contemplated. At the same time, the real tax rate will be substantially higher at any given level of real output and real income. Thus, as things now stand, the budget for fiscal 1975 is already appreciably more restrictive than it was when it was first proposed.

My final comment goes to the pseudosociological rhetoric of which we have heard a good deal recently, about how the present state of the budget reflects an unfortunately growing tendency for our people to want to do too much, to do everything at once, too much, too soon. This growing impatience, as it has been described, has been called the fundamental cause of inflation in the United States, and indeed, around the world. I would simply point out that the single best measure of the real burden which Government imposes on our economy for

public purposes is to compare the use of goods and services for public—that is for governmental purposes—with our total production of all goods and services. And the fact is that, in the United States, government's share of the total output has been declining since 1968, whether you are talking about the Federal Government alone or the combined Federal, State, and local governments.

It now stands at about the same level as it did in 1958 under President Eisenhower. And it is probably lower here than in any other major country of the world, except, I am quite sure, Japan. It is true that the countries of the world use quite different percentages of their total output for public purposes. But there is simply no correlation between these percentages and differential rates of inflation. For example, the two major countries with the highest inflation rates during the years 1955 to 1970 were France and Japan. France had one of the highest percentages of Government use of resources, and Japan one of the lowest. I would suggest that we use somewhat greater care in the simple rhetorical generalizations recently applied to explain that very complex phenomenon of inflation.

I am not, however, in this statement attempting to provide a full explanation of inflation—either in the United States or worldwide, and either over the last 2 or 3 years, or the growing inflationary bias that world economies have shown over the entire postwar period. Inflation is indeed a most complex phenomenon. It demands multiple explanations, no one of which alone is satisfactory.

I turn instead to the outlook for inflation. It is impossible not to be quite pessimistic about this. My own recent economic forecast implies an increase of 9.3 percent in the GNP deflator for the full year 1974 as compared with 1973. It involves a decline in the rate of inflation, still measured in terms of the GNP deflator, only to about 7 percent in the fourth quarter, and thereafter a probable edging up to higher rates in 1975. Many other forecasters are considerably more pessimistic.

The most recent price indexes suggest that no significant deceleration of inflation has occurred over the past year, 6 months, or 3 months. The figures in my prepared statement summarize the picture shown by the most recent price reports.

I direct your attention only to the first and last rows, the first because the GNP deflator is the best single measure of inflation in the economy, and the last, the wholesale price index for industrial commodities, because it is the most horrendous. Note that over the past 12 months the annual rate of increase in industrial wholesale prices has been 25 percent, over the past 6 months 36 percent, and over the past 3 months, more than 34 percent. For the past month alone it was something over 40 percent.

Although the wholesale price index is not a good measure of the overall inflation rate, the recent behavior of the industrial index is almost frightening. Industrial price increases following the end of price controls have surely been larger than anyone could have or did expect. Moreover, an ominous acceleration in wage increases is clearly evident in recent data; and strike statistics and labor rhetoric provide portents of worse to come. Bad crop news also supports pessimism about prices.

While it is clear that a weakening outlook for real output and employment would normally push an economist toward recommend-

ing a more stimulative fiscal policy—as it has pushed a great many—on the other hand, does not the increasing pessimism about the outlook for inflation push him in the opposite direction? My own answer is that these two changes which have occurred in my own forecasts over the past year are not offsetting in their policy implications. The fact that inflation rates are now forecast as higher even though the real economy looks considerably softer, means that whatever inverse connection may exist between real output and price levels is even weaker and less reliable than I may have though before. And I have long thought it to be both extremely weak and highly unreliable. Thus the policy of fighting inflation simply by further restraining aggregate demand loses even more of its already feeble justification.

Incidentally, I agree fully with Mr. Rush's conclusion that if the budget were cut by $5 billion or indeed by $10 billion, you could not find any difference in the price level. I recognize, however——

Senator CRANSTON. You doubt—what did you say? I did not hear the end of your sentence.

Mr. ACKLEY. You would not be able to find the difference it would make in the price level.

I do not wish to be misunderstood. Inflation can of course be kicked off by too much aggregate demand, as for example through an excessively stimulative fiscal policy. And I believe it extremely important that this committee and the Congress be exceedingly alert to avoid fiscal policy mistakes which would create or permit to exist, levels of aggregate demand which put to much pressure on productive resources, and which could thereby initiate inflation in a situation of price stability, or add to the momentum of an existing inflation. That is why I fought so hard, beginning late in 1965, first to help persuade President Johnson to recommend a tax increase to balance the impact of increased military outlays in Vietnam, and, after he recommended it, in the beginning of 1967, to help him to persuade the Congress and the country of its wisdom. The inflation initiated by our Nation's failure, from early 1966 until mid-1968, to prevent over-stimulus to an economy already at full employment must bear some share—by now rather tiny, I hope—of the blame for our present inflationary troubles.

But the connection which surely exists between the expansion of real aggregate demand and the rate of inflation is of the nature of a one-way rachet, not a reversible set of gears. Pushing demand too high can surely create or accelerate an inflation. But slowing down an already soft economy, increasing an already high level of unemployment, creating new excess capacity when there is already more than enough, have exceedingly little effect in slowing down an inflation already underway, and particularly one which has been under way for a long time. This has been so repeatedly demonstrated, most recently in 1970–1971 in the United States, that I am surprised that the idea still survives, that further weakening an already weak economy is an effective cure for inflation.

And, indeed, I have the impression that Mr. Rush this morning did not think so either.

To be sure, there is a new argument—which is not quite the one Mr. Rush made this morning, although it is related to it—which says that the reason why restrictive policy did not seem to work in 1970 and 1971 is that people did not really believe that the Government was

serious about it. This time, if we say that we really mean it, it will work. It is true that fiscal and monetary policy can, in principle, create whatever levels of unemployment and excess capacity you might wish to specify, and maintain them in being for as long as you want. Sooner or later, this should stop wages and prices from rising. And if everyone knows this is what will happen, then the inflationary expectations which help to keep an inflationary spiral turning will peter out more quickly. But everyone knows that we are not going to put down inflation at whatever cost. And because we all know it, the cost of putting down inflation by restricting aggregate demand has become prohibitive. This is exactly why we all know that it will not be done this way, and it is exactly why it will not work, no matter how many times we say, "Yes, but this time we really mean it."

No one believes it, nor, I think should. For it is clear that neither Americans nor, apparently, citizens of other countries believe that the cost of a creeping, or even a walking inflation are so intolerable that any sacrifice is worthwhile to stop it. And I think that they are right.

This certainly does not mean that I think we should be unconcerned about inflation. I do happen to believe that the economic costs of inflation are often misunderstood and sometimes exaggerated. But I have no doubt that its social costs are both very high and almost always underrated. They arise from the fact that almost all of us believe that the gains in our money incomes which are one result of inflation would have come about even if there had been no inflation. They are instead the result of our own cleverness, or the effectiveness of our trade union or trade association or our friends in political power, or just our good luck. And the rise in the prices we pay—which also goes with inflation—is therefore something which is unjustly robbing us of gains that are rightfully ours. Even those who benefit from inflation—and many do—think they are hurt by it. And if they think they are, they are. So we all, or almost all of us try to find someone to blame: those greedy employers or nasty trade unions, the bankers, the landlords, the farmers, or people overseas; our economic system, the Government, the administration, society.

Yes, inflation is costly, in economic terms to a great many individuals, more broadly, I think, to the political and social fabric of our Nation. And if a more restrictive fiscal policy—as weak a tool against inflation as it may be—were all we had, we might decide that we should continue to use it for whatever little bit it might be worth. But it is not the only tool we have.

Ever since the late 1950's, I have argued that there are three indispensable components of any effective anti-inflation policy. One is a fiscal and monetary policy that avoids the mistakes of overstimulus, which can kick off an inflation. The second is some form of a wage-price policy, preferably one which is mainly, although not entirely, voluntary in character. And the third is a concerted attack on structural rigidities in our economy, and an energetic effort to dismantle the many institutional, largely governmental, arrangements which raise particular costs and prices.

I do not know, frankly, why the administration needs any more studies of this third subject. The first such study that I recall was

made under the Eisenhower administration. It constructed a list of needed reforms in our markets and in our governmental structures which would remove sources of reduced productivity, or factors which directly raised costs or prices. It has been repeated. President Kennedy's administration made further studies along the same lines, and a very thorough study was made in the final year of the Johnson administration. The Cabinet Committee on Price Stability—as the study group was called—put together a very careful analysis of the kinds of things that might be done to remove sources of inflationary bias.

Arthur Burns, I, myself, and other economists over the years, have constructed shopping lists of reforms of this kind. Most of us have about the same items on our lists. A recent article on the editorial page of the Wall Street Journal by Hendrik Houthakker of Harvard University—who was a member of the Council of Economic Advisers until recently—incorporated a list of structural reforms which is very much the same as most of the rest of us have presented.

I think I know why we do not get ahead with this job, but instead continue to study it. It is that each of these things which needs to be done cannot, by itself, be claimed to be of crucial importance for the price level. But each of them involves the protection of some particular, specific economic interest. For that special interest, it is considered to be important. So it is exceedingly difficult to change these things one at a time. The only hope would be a concerted and simultaneous attack on a long list of structural reforms, which together might be of real significance for the future of the price level.

In any case, I greatly welcome the general agreement on the part of Congress and the administration to reestablish the Cost of Living Council, the purpose of which is, presumably, to pursue both the second and the third of the necessary elements in a viable anti-inflationary program.

Of course, if the views of a Herbert Stein or an Alan Greenspan were to prevail in the new administration, I would not expect anything very effective to emerge in the way of a wage-price policy. But if President Ford will listen, instead, to Arthur Burns and will rely upon the tremendous surge of good will and national unity that has greeted his taking office, I think something truly important and useful could happen. Even the very act of reviving the Cost of Living Council, if that does happen, would mark a change of Government posture which I think is most important. I simply do not see how anyone can believe that a government is "against inflation" which fails to oppose, even if only in principle, specific large inflationary wage and price increases of which we have had so many in recent months, and until last Monday, without a hint that the government did not welcome them. The idea that you can convincingly be against inflation, but not against inflationary price and wage increases, seems to me to be on the face of it ridiculous.

We heard this morning about the symbolic importance of budget cuts, as indicating a changed Government posture toward the problem of inflation. I think the symbolic importance of the Government being against large wage and price increases, whether it is able to do anything about them or not, is even more important. It is important

not so much because, if the Government criticizes a particular price increase, that price increase is likely to be withdrawn. To be sure in the past many have been withdrawn, when the Kennedy and Johnson administrations using "jawboning" for this purpose. The greater importance is the effect which this policy has directly on the decisions in the private sector.

I know that many decisions by large corporations to raise prices are not unanimously agreed upon by all the policy-makers involved. There are differences in view about what is the best policy. And simply to know that the Government has a policy does have a direct impact on the price-increase decisions which are made; and I believe it has some impact on trade union decisions as well.

I will be glad, if you are interested, to expand on my ideas about how a wage and price review apparatus might best operate, because I think there is a great deal more to it than merely passing a law and appointing a committee and assuming it will work. I certainly do not want to mislead anyone. I do not think that a wage-price policy, however well conceived and well administered, is going to reduce inflation very much very soon. I think such a policy may be far more effective in preventing inflation than suppressing it after it is already underway. But it can help. I am convinced its costs are relatively low—I mean its costs in all directions. And experience both here and abroad, although mixed, does seem to me clearly to indicate that it is worth some serious effort to attempt to develop its potentialities.

If we are really frightened by inflation and want to accomplish a lot in a hurry we could even return to some kind of widespread mandatory wage and price controls. It is simply wrong to keep repeating that such controls can never work, simply on the basis of the incredible botch which the Nixon administration made of the recent controls. Even a casual review of the Korean war wage and price controls proves, I think, that such controls can be, as they then were, exceedingly effective in stopping a galloping inflation in its tracks. And when those controls were lifted, after less than 2 years, in an economy in boom conditions, with an unemployment rate of about 3½ percent, inflation did not revive.

However, I want to say at once that I would oppose the institution of widespread mandatory controls today, just as I opposed them in 1971, and in 1951, too, before I was drafted to help design and administer them. But if we are prepared to pay the very real costs of controls, they can be highly effective.

Let me summarize. I may seem to have wandered rather far from the question of a ceiling on budget expenditures in fiscal year 1975. But I do not think this committee can consider that issue at all without first examining a far wider range of questions. They start with the question how costly is inflation, and what is the nature of its costs? How much would a $5 or $10 billion reduction of the budget reduce the rate of inflation? What are the human and social costs of a $5 or $10 billion reduction of the budget? And most important, how do these costs compare with the costs of whatever reduction of inflation is thereby achieved? And finally, what methods other than budget cutting and tight money are available to reduce the rate of inflation and what are their costs and what is their promise of accom-

plishment? I have said a little about each of these questions except the third, and will be prepared to expand upon or defend my views if members of the committee should wish.

These are not easy questions at all and they are questions for which no one can arrive at completely firm answers. But I do believe it is better for the committee to be struggling to find partial and perhaps not fully reliable answers to the right questions than to find simple answers to the wrong questions. I feel that such big and difficult questions are the kind your committee will have to deal with if it is going to do its job, not merely in 1974 but for a long time to come. But I do believe, as I said in the opening sentences of my prepared statement, that there are potentiially great rewards to the Nation from the work of this committee if it does address itself firmly, factually, and analytically to truly relevant questions about the Fedaral budget and its impact on the economy.

And I know that it will.

Senator MUSKIE [presiding]. Mr. Ackley, thank you very much.

I apologize for not being present in the earlier part of your testimony. I welcome it and would like to ask a few questions. Then I will yield to my colleagues.

PREPARED STATEMENT OF GARDNER ACKLEY

Mr. ACKLEY. I am deeply honored by my good fortune in being invited to testify at the first public hearing of the Senate Committee on the Budget. For this is a most auspicious occasion. Not this inaugural hearing, but the passage of the Budget Reform and Impoundment Control Act of 1974, and the establishment thereunder of this committee and its counterpart in the House of Representatives, constitute events of tremendous potential significance for the Government, the economy, and the people of the United States.

Many professional economists—I among them—have long recognized the compelling need for a mechanism and a procedure—such as this one—which will permit the Congress to consider simultaneously and in relationship one to the other, all three aspects of the Government's budget:

(i) its total amount;

(ii) the appropriate distribution of that total amount among the myriad purposes served by Government expenditures;

(iii) the appropriate relationship of that total amount to the revenues produced by existing tax laws and proposed changes therein.

I think it is correct to say that developments in economic theory over the past 40 years have made it clear to all but a handful of dissenters that Government's fiscal policy is a powerful tool—for good as well as for ill—in determining the performance of the Nation's economy. Yet, despite earlier landmark enactments such as the Employment Act of 1946, congressional procedures have, until now, greatly handicapped—indeed, have almost prevented—the Congress from participating effectively, with the executive branch, in using fiscal policy constructively in support of economic stability and healthy economic growth. Instead, these defective procedures have often permitted the

Congress—sometimes in agreement with and sometimes in opposition to recommendations of the executive branch—to adopt budgets which interfered with economic stability and healthy growth.

I believe that I can assure members of the committee that the economics profession will support and assist in any way possible your efforts to mold these admittedly complex and difficult new procedures into an effective instrument of congressional control of the budget of the United States.

Today, this committee—although just appointed and not yet equipped with the skilled staff which it will need to build to assist it—has been asked for a preliminary judgment about the appropriate size of the Federal budget for fiscal year 1975. In particular, as I understand it, some Members of the Congress have suggested that this committee should recommend a level of total budget expenditures $5 or $10 billion below the level initially proposed by President Nixon. Apparently, this is also the current position of the administration.

This request to the committee—even before it is fully in business—is a welcome demonstration of the widespread recognition of the importance of the committee and of its potential contribution to wise economic policy. However, I urge the committee not to recommend such a reduction. Indeed, I urge that the Congress should feel free to consider either modest additions to the budget as originally proposed, and without a matching increase in taxation, or else some modest reduction in taxation.

This position is contrary to that which I have held until recently; and I think it is important to explain the reasons both for my former position and for my change of view. Obviously, both positions rest upon (*a*) my expectations regarding the economic prospects for production and employment; and (*b*) my analysis of the existing and future problem of inflation and its control.

THE PROSPECTS FOR PRODUCTION AND EMPLOYMENT

With respect to my view of the prospects for production and employment, I can identify myself as having been until very recently among the relatively more optimistic of the economic forecasters. As recently as June of this year, I was still anticipating that real gross national product in the second quarter would slightly exceed that in the first, and forecasting a reasonably brisk recovery of output and employment in the second half of this year, and extending into 1975, at a rate sufficient, by the fourth quarter, to begin progressively to reduce the gap between our production and our ability to produce. This prospect (which assumed a Federal budget about as proposed in February and revised in May) seemed to me to make it unwise to provide new fiscal stimulus to the economy. I thus continued to reaffirm a position I had publicly taken in February, in testimony before the Joint Economic Committee, and in a letter to Senator Mondale (published in the Congressional Record of March 12) in which I had opposed Senator Mondale's proposal for a $200 optional personal credit under the income tax which would have reduced tax collections by nearly $6½ billion.

In mid-July, the Department of Commerce released preliminary national income and product data for the second quarter, along with revised—rather drastically revised—data for 1973 and the first quarter of 1974. As you know, these new data showed the economy to have been considerably weaker than we had thought. Based on these new and revised data, I undertook, as I customarily do once each quarter, a new review of the economic outlook, which was completed only last week. My new forecast is for a real GNP in 1974 slightly lower than in 1973, with real output beginning to recover in the current quarter, but at a rate too slow to avoid considerable further growth of unused resources during the rest of this year. For 1975, I anticipate an expansion of output which would only roughly parallel the growth of capacity. Unemployment would rise to around 6 percent—possibly higher—and remain at that level at least through the third quarter of 1975, which is as far as my horizon extends. According to the newspapers, this is very close to the present view of many other forecasters.

THE FEDERAL BUDGET AND THE ECONOMY

There appears to be a widespread impression—assiduously cultivated by advocates of a reduction of Federal spending—that the current budget is a highly stimulative or expansionary one. Indeed, some imply that the budgets for fiscal years 1974 and 1975 are the main source of continuing inflation. This view seems to me very seriously mistaken. Let me make four fairly simple points to put such a claim in perspective.

First, it seems to me, we need to consider the Federal budget in relationship to the total Government budget. It is officially estimated that, as of the May revisions, Federal spending in fiscal year 1975 (on a national income account basis) will include $48 billion of grants to State and local governments—more than 15 percent of total Federal expenditures, and considerably more than double their amount in fiscal 1970. In the first half of 1974 such grants are estimated to account for more than 21 percent of total State and local government revenues. It is essential, therefore, to consider the combined impact of Federal, State, and local government budgets on the economy.

Relevant data are summarized in table 1. They show that, whereas in the past, State and local governments have, on the average, and in almost every year until 1971, run either small surpluses or small deficits, in the past 3 years, these governments have run very large surpluses—in significant part as the result of those sharply rising Federal grants which have contributed so substantially both to the Federal deficits and to State and local revenues. When we add Federal and State and local surpluses or deficits to obtain a crude measure of the total impact of Government finance on the economy we still see two recent periods of large total deficits—1967–68, and 1970–71—mainly the product of Federal finances. But in 1972 and 1973, despite continuing large Federal deficits, the total Government balance has turned into surplus, and it appears still to have been in surplus in the first half of 1974. It seems to me on the face of it implausible to argue that Government deficits have constituted an "engine of inflation" in the past 2 years.

TABLE 1.—FEDERAL, STATE, AND LOCAL GOVERNMENT SURPLUS OR DEFICIT (NATIONAL INCOME ACCOUNT BASIS), AND UNEMPLOYMENT RATE, 1950–74

[Billions of dollars]

Calendar year or period	Surplus or Deficit (−)				Unemployment rate
	Federal Government	State and local government	Total government	Total government as percent of GNP	
1950–59 (annual average)	−0.1	−.9	−1.0	−.3	4.5
1960–69 (annual average)	−1.6	.5	−1.2	−.2	4.8
1960	3.5	.2	3.7	.7	5.5
1961	−3.8	−.5	−4.3	−.8	6.7
1962	−3.8	.9	−2.9	−.5	5.5
1963	.7	1.2	1.9	.3	5.7
1964	−3.0	1.7	−1.3	−.2	5.2
1965	1.2	1.0	2.2	.3	4.5
1966	−.2	1.3	1.1	.1	3.8
1967	−12.4	−1.6	−14.0	−1.8	3.8
1968	−6.5	−.3	−6.8	−.8	3.6
1969	8.1	.7	8.8	.9	3.5
1970	−11.9	1.8	−10.1	−1.0	4.9
1971	−22.2	4.0	−18.2	−1.7	5.9
1972	−17.5	12.3	−5.2	−.4	5.6
1973 [1]	−5.6	9.2	3.6	.3	4.9
1974 (first half, annual rate [2])	−.9	3.6	2.5	.2	5.2

[1] Preliminary.
[2] Preliminary, and partly estimated.

Incidentally, those concerned with the monetary or financial impacts of Federal deficits should remember that State and local surpluses are normally invested in public obligations. If the Federal Government borrows to finance grants to State and local governments which run surpluses which are invested in Government bonds, it creates no extra pressure on financial markets.

My second point is that the possible inflationary impact of any budget deficit must also be judged in the light of the situation of the economy, and particularly the degree of overall pressure on our resources. The last column of table 1 provides one simple, admittedly inadequate, measure of that pressure; namely the unemployment rate. The reason why the giant deficits of 1967 and the first half of 1968 were so inflationary is that they were superimposed on an economy with an extremely low unemployment rate, and placed excessive pressures on our labor resources. We can argue what precise level of unemployment rate represents "excessive" pressure on our labor resources, and can hypothesize that this critical rate may be somewhat higher today than the 4 percent rate which was believed to correspond to "full employment" in the 1960's. However, few have argued that it is now higher than 4½ or 5 percent.

Taking account, as well, of the pressures on our capital resources, I would contend that neither the large total Government deficits of 1970 and 1971, nor the more modest one of 1972, nor the total Government surpluses of 1973 and the first half of 1974, were primary contributors to our recent inflation.

My third point about the budget—referring, now, specifically to that for fiscal year 1975—is that, unfortunately, the rate of inflation is going to be considerably higher than was anticipated when the budget for that year was first drawn up. If spending, in dollars, is merely held to the original figures, the real demand for goods and

services which it represents may well be $10 billion less than originally contemplated. At the same time, the real tax rate will be substantially higher at any given level of real output and real income. Thus, as things now stand, the budget is already appreciably more restrictive than when it was first proposed.

My final comment goes to the pseudo-sociological rhetoric about how the present state of the budget reflects an unfortunately growing tendency for our people to want to do everything at once—too much, too soon. This growing impatience is called, in a fundamental sense, the true cause of our inflation. I would simply point that the single best measure of the real burden which Government imposes on our economy for public purposes is to compare the use of goods and services for public—that is, governmental—purposes with our total production of all goods and services. And the fact is that, in the United States, Government's share has been declining since 1968 (whether for Federal Government alone, or for combined Federal, State, and local governments). It now stands at about the same level as it did in 1958 under President Eisenhower. And it is probably lower here than in any other major country of the world—except Japan. The countries of the world use quite different percentages of their total output for public purposes. But there is no simple correlation between these percentages and differential rates of inflation. For example, the two major countries with the highest inflation rates during the years 1950–1970 were France and Japan. France had one of the highest percentages of Government use of resources, Japan one of the lowest. I would suggest greater care in some of the simple rhetorical generalizations recently applied to explain that very complex phenomenon of inflation.

THE OUTLOOK FOR INFLATION

So much for the economic outlook, and for the role of the budget in the economy. I turn now to the not unrelated question of the outlook for inflation. It is impossible not to be quite pessimistic about the inflationary prospect. My own recent economic forecast implies an increase of 9.3 percent in the GNP deflator for the full year 1974 as compared with 1973. It involves a decline in the rate of inflation (still in terms of the GNP deflator) only to about 7 percent in the fourth quarter, and thereafter a probable edging up to higher rates in 1975. Many other forecasters are considerably more pessimistic.

The most recent monthly price indexes suggest that no significant deceleration of inflation has occurred over the past year, 6 months, or 3 months. The following figures summarize the picture shown by the most recent price reports:

AVERAGE ANNUAL RATE OF PERCENTAGE PRICE INCREASE

	Last 12 months	Last 6 months	Last 3 months
GNP deflator (second quarter)	9.5	10.5	8.8
Consumer Price index, all items (June)	11.1	12.8	11.7
Wholesale Price Index, all items (July)	20.4	21.7	25.7
Wholesale Price Index, all industrial items (July)	25.1	36.0	34.2

Although the wholesale price index is not a good measure of the overall inflation rate, the recent behavior of the industrial index is almost frightening. Industrial price increases following the end of price controls have surely been larger than anyone could have expected. Moreover, an ominous acceleration in wage increases is clearly evident in recent data; and strike statistics and labor rhetoric provide portents of worse to come. Bad crop news—especially for corn—also supports pessimism about prices, although one suspects that reporting is automatically biased toward finding bad news about prices these days.

While it is clear that weakening outlook for real output and employment would normally push an economist toward recommending a more stimulative fiscal policy, on the other hand, does not the increasing pessimism about the outlook for inflation push him in the opposite direction? My own answer is that these two changes in my forecasts are not offsetting in their policy implications. The fact that inflation rates are forecast as higher, even though the real economy looks considerably softer, means that whatever inverse connection may exist between real output and price levels is even weaker and less reliable than I may have thought before. And I have long thought it to be both extremely weak and highly unreliable. Thus the policy of fighting inflation simply by further restraining aggregate demand loses even more of its already feeble justification.

I do not wish to be misunderstood. Inflation can of course be kicked off by too much aggregate demand, as for example through an excessively stimulative fiscal policy. I believe it extremely important that this committee and the Congress be exceedingly alert to avoid fiscal policy mistakes which would create—or permit to exist—levels of aggregate demand which put too much pressure on productive resources, and which can thereby initiate inflation in a situation of price stability, or add to the momentum of an existing inflation. That is why I fought so hard, beginning late in 1965, first to help to persuade President Johnson to recommend a tax increase to balance the impact of increased military outlays in Vietnam, and—after he recommended it—to help him to persuade the Congress and the country of its wisdom. The inflation initiated by our failure, from early 1966 until mid-1968, to prevent overstimulus to an economy already at full employment must bear some share—by now rather tiny, I hope—of the blame for our present inflationary troubles.

But the connection, which surely exists, between the expansion of real aggregate demand and the rate of inflation is of the nature of a one-way rachet, not reversible gears. Pushing demand too high can surely create or accelerate an inflation. But slowing down an already soft economy, increasing an already high level of unemployment, creating new excess capacity when there is already more than enough, have exceedingly little effect in slowing down an inflation already underway—and particularly one which has been underway for a long time. This has been so repeatedly demonstrated—most recently in 1970–71 in the United States—that I am surprised that the idea still survives that further weakening an already weak economy is an effective cure for inflation.

To be sure, there is a new argument which says that the reason why restrictive policy did not seem to work in 1970 and 1971 is that people did not really believe that the Government was serious about it. This

time, if we say that we really mean it, it will work. It is true that fiscal and monetary policy can—in principle—create whatever levels of unemployment and excess capacity you wish to specify, and maintain them in being for as long as you want. Sooner or later, this should stop wages and prices from rising. And if everyone knows that this will happen, then the inflationary expectations which help to keep the spiral turning will peter out more quickly. But everyone knows that we are not going to put down inflation at whatever cost. And, because we all know it, the cost of putting it down in this way becomes prohibitive. This is exactly why we all know that it won't be done this way, and why it won't work even if we say "This time, we really mean it."

No one believes. Nor should they. For it is clear that neither Americans nor, apparently, citizens of most other countries believe that the cost of a creeping, or even a walking, inflation are so intolerable that any sacrifice is worthwhile to stop it. And I think they are right.

This certainly does not mean that I think we should be unconcerned about inflation. I do happen to believe that the economic costs of inflation are often misunderstood and sometimes exaggerated. But I have no doubt that its social costs are both very high and almost always underrated. They arise from the fact that almost all of us believe that the gains in our money incomes which are one result of inflation would have come even if there had been no inflation. They are the result of our own cleverness, or the effectiveness of our union or trade association or our friends in political power—or just good luck. The rise in the prices we pay that also goes with inflation therefore unjustly robs us of gains that are rightfully ours. Even those who benefit from inflation—and many do—think they're hurt. And if they think they are, they are. So we all find someone to blame—those greedy employers or nasty trade unions; the bankers, landlords, farmers, or foreigners; our economic system, the Government, society.

Yes, inflation is costly—in economic terms to a great many individuals, more broadly to the political and social fabric of our nation. And if a more restrictive fiscal policy—as weak a tool against inflation as it may be—were all we had, we might decide that we should continue to use it for whatever little bit it might be worth. But it is not the only tool we have.

OTHER TOOLS AGAINST INFLATION

Ever since the late 1950's, I have argued that there are three indispensable components of any effective anti-inflation policy. One is a fiscal and monetary policy that avoids the mistakes of overstimulus, which can kick off an inflation. The second is some form of a wage-price policy—preferably one which is mainly, although not entirely, voluntary in character. And the third is a concerted attack on structural rigidities in our economy, and an energetic effort to dismantle the many institutional—largely governmental—arrangements which raise particular costs and prices.

Consequently, I greatly welcome the general agreement on the part of the Congress and the administration to reestablish the Cost of Living Council—presumably in order to pursue both the second and third of these elements of an anti-inflationary program.

Of course, if the views of a Herbert Stein or an Alan Greenspan were to prevail within the new administration, I would not expect anything very effective to emerge in the way of a wage-price policy. But if President Ford will listen instead to Arthur Burns, and will rely upon the tremendous surge of goodwill and national unity that has greeted his taking office, something truly important and useful could happen. Even the very act of reviving the Cost of Living Council—if that does happen—would mark a change of Government posture which I think is most important. I don't see how anyone can believe that a government is "against inflation" which fails to oppose—even if only in principle—specific large price and wage increases, so many of which have occurred in recent months and—until last Monday—without a hint that the Government did not welcome them. After all, Government spokesmen have kept calling for higher profits, and "everyone knows" that you can't have higher profits without higher prices. And if prices and profits are higher, "everyone knows" that wages have to be higher, too.

If we are really frightened by inflation and want to accomplish a lot in a hurry, we could even return to some kind of widespread mandatory wage and price controls. It is simply wrong to keep repeating that such controls can never work—simply on the basis of the incredible botch which the Nixon administration made of the recent controls. Even a casual review of the Korean war wage and price controls proves that they can be very effective.

Let me say at once that I would oppose the institution of widespread mandatory controls today—just as I opposed them in 1971 (and in 1951 before I was drafted to help design and administer them). But if we are prepared to pay the very real costs of controls, they can be highly effective. There are those who purport to find the costs of inflation intolerable, but who believe that the costs of controls exceed even the intolerable costs of inflation. Some who so argue are simply the captives of an ideology; I wonder if some others are not members of that fairly sizable group who actually benefit from inflation.

SUMMARY

I may seem to have wandered far from the question of a ceiling on budget expenditures in fiscal year 1975. But I do not think this committee can consider that issue without first examining a far wider range of questions:

(1) How costly is inflation?

(2) How much would a $5 or $10 billion reduction of the budget reduce the rate of inflation?

(3) What are the human and social costs of a $5 or $10 billion reduction of the budget? How do these compare with the costs of whatever reduction of inflation is thereby achieved?

(4) What methods other than budget cutting are available to reduce the rate of inflation, and what are their costs?

I have said a little about each of these questions except No. 3, and will be prepared to expand upon or to defend my views if the committee should wish.

These are not easy questions, and no one can arrive at completely firm answers to any of them. But it is better for the committee to struggle to find partial and perhaps not fully reliable answers to the right questions, than to find easy answers to the wrong ones. I fear that such big and difficult questions are the kind which your committee will have to deal with in order to do its job—not merely in 1974, but undoubtedly in 1984 and well beyond. But there are potentially great rewards to the Nation from the work of this committee—if it addresses itself firmly and factually and analytically to the truly relevant questions about the Federal budget and its impact on the economy. And I know that it will.

Senator MUSKIE. It is our objective, if we can, to try to develop at least some of the options in terms of economic policy that are available to us. There may not be any.

Since I missed the first part of your testimony, I may be asking questions which you have already touched upon but I do not think repetition does any harm. And in any case, sometimes those reading the record will pay more attention to the question and answer part than they do to the testimony.

First of all, what are the causes of the present inflationary pressures as we consider methods to deal with this particular inflation?

Mr. ACKLEY. I think that we could devote at least an hour to that question, and only begin to get down to some of the real questions which would still remain.

As some of the comments you yourself made this morning, or attributed to Charles Schultze, the primary causes of the sharp acceleration of price increases over the past 12 to 15 months are some very particular circumstances which few if any might have anticipated, and about which very little could have been done. The petroleum embargo and price increase are the most obvious case of this sort, and this clearly contributes substantially to the seriousness of our present inflation rate.

That particular cause, we hope, is largely behind us. And many of its effects have already worked themselves into the price level, but not all, by any means. In particular, through the energy and transportation chains, we are going to be seeing further effects of higher fuel prices on manufacturing costs for some time to come.

Obviously, there were a number of other specific commodity problems which more or less coincidentally hit us at more or less the same time. One reason for this was an unusual coincidence of booms in all of the major countries simultaneously. That is surely important. You do not usually have all countries reaching peak levels of business activity at the same time. Thus, there was a concentration of sharply rising demand on a number of primary commodities, and basic manufactured goods. In many cases, there were capacity limitations which prevented production from responding adequately to the increase in demand. Since many of these commodities are produced under highly competitive conditions, many of them internationally traded, their prices shot up, and have had to be reflected in the cost of producing everything that uses these commodities.

In order adequately to understand what happened, we need to look at each commodity separately, and I think we almost have to if we

are trying to draw the lessons of that experience, hoping to avoid circumstances of the same kind again. We will probably find rather diverse causes, or particular combination of circumstances which created these many sharp commodity price increases.

In many cases there was an absence of adequate investment in plant and equipment which, had it been made in time, would have permitted the increase in demand, however abnormal, to have been met with much less inflation. And the causes of that inadequacy of investment need to be the subject of considerable study.

The United States is itself an important producer of a great many of these commodities. In several instances, for example in paper, petroleum-refining, perhaps some metals and chemicals, clearly what had happened was an overbuilding of capacity in the late 1960's—the creation of excess capacity. The economy then was stagnant for several years, in 1970, 1971, and into 1972, and prices, or at least and profits, for producers of these commodities declined sharply, as a result of which they simply did not undertake investment of the sort that would be appropriate in view of any reasonable, long-run extrapolation of the demand for them.

How we avoid that kind of situation in the future is hard to say. It may be that there is some room for particular incentives to producers of particular commodities of critical importance. But I do not think the answer is the simple one that some have tried to grope for: for example, more generous depreciation provisions, or a larger investment credit, or lower corporate taxation, or just higher profits across the board. It is very easy, but not very helpful to say that we just need higher profits, and then industry will make adequate investments—because the problem is not across the board.

If you look at rates of capacity utilization during 1971 and 1972 and early 1973, you will find that on the average in manufacturing industries, capacity was not under heavy pressure. Peak rates of capacity utilization were not even close to peaks experienced in the past. But there are some special cases—industries that did experience serious pressures on plant capacity. I do not think we need a shotgun to try to deal with those kinds of situations, but rather a rifle.

I have wandered from the question of the causes of the recent inflation to possible remedies for some particular situations. Let me simply say that one can find a lot of specific causes of the surge of inflation in 1972 and 1973, which will account for most of it. But one also has to explain why, over the postwar period as a whole, and on a worldwide basis, inflation of a creeping sort has become more and more of a problem in more and more countries and why the rate of inflation, although usually modest, had gradually been increasing—even before 1966.

And here, I think you have to bring in sociological and political considerations along with economic. But I do not think it is anything so simple as to say merely that governments have increased their demands upon resources or that deficits have been more frequent than in the past. A whole lot of changes which have occurred are relevant to this. Many of them are changes which are welcome.

I am not sure that without a little more thought I can necessarily suggest some of these changes in the proper order of their importance. But let me suggest a few of the progressive changes that have occurred

in Western economies over the past 25 years that are relevant to the increased inflationary bias which we find.

One of them, very obviously, is different public attitudes and changing demands on the economic policies. People have come to believe that it is possible for governments to maintain reasonably full employment and fairly substantial rates of economic growth. And they have come, not only to expect it but to demand it. And rightly so.

Moreover, people have, I think, generally come to believe that it is appropriate for downtrodden groups of all kinds to demand their share of the good things of life, whether by political methods or through market pressures or whatever. And there is consequently less discipline on these pressures from public attitudes—what people will tolerate. This, I think, is more important than specific governmental restrictions.

It is the thing now for people to say, this is a prosperous and growing world. Other people's incomes are rising; we want our share. And to demand it and to expect to get it one way or another, through political action, trade union action, market pressures of any kind.

I think one has to recognize that there has been a general reduction of what were often irrational fears of deficits both in Federal budgets and in countries' balances of payment. This has caused economic policies in all countries to tend to move closer to the line of maintaining fully adequate pressure of aggregate demand on resources. And mistakes or accidents can much more easily push a country over that line.

I do not think that you can argue that there has been an increasing degree of monopoly power in the United States either on the part of labor or in the business sector. But I do believe there has been an increasing trend toward setting prices and wages by what I would call bureaucratic methods, which base them on costs of production, or the cost of living or comparable wages, or on some factor other than market supply and demand.

I think these are some of the elements. I think there are a lot more. But there are no simple threads which run through all of this, such as to say that inflation is greater because Government spending has become a larger percentage of output, which it has not in most countries, certainly not in the United States. Or that Government deficits are more frequent. I do not think that can be sustained either. In short, I do not think there are any simple answers.

Senator MUSKIE. I was going to observe until that last comment that in all of that answer, which was very helpful, you did not include expansions in the budget as a cause of our present inflationary pressures.

Mr. ACKLEY. I had included it in the sense that I said people have come to believe that full employment is possible and desirable, an obligation of Government, and that they have lost irrational fears of deficits and that governments therefore take more risks in order to achieve it.

Senator MUSKIE. Let me ask you this question and then I will yield. Between us we have occupied about 10 minutes.

How much of a swing in the size of the Federal budget—in terms of billions of dollars one way or another—does it take to produce signifi-

cant economic consequences, either of inflation or of unemployment, in our present circumstances?

Is that something you could predict or project?

Mr. ACKLEY. I think the answer has to be, it all depends. If you are in a situation of full employment, if you have full utilization of resources and Government expenditures increase without an equivalent increase in taxation, and you put too much pressure on resources, you can kickoff an inflation very easily.

Senator MUSKIE. My model was the present situation.

Mr. ACKLEY. If you are talking in terms of the present situation, I do not think the effect on the price level of a $10 billion reduction in the budget without reduction of taxation, or of a $10 billion increase in the budget without increase in taxes, would be significant.

As I said, perhaps before you came in, Senator Muskie, I agree with Mr. Rush that you would not be able to find the difference that it would make in the price level to reduce expenditures by $10 billion, and I doubt if you could find the difference it would make in the price level if you increased them by $10 billion—although a $10 billion increase is getting near the margin where I would want to be careful.

In my remarks I suggested that I thought policy now should be directed to giving somewhat more fiscal stimulus to the economy, and I used the word "modest" in connection either with increasing expenditures or decreasing taxation because I think we need to be excessively careful at this time not to take risks in the direction of overstimulus.

I certainly do not believe that it makes no difference what we do on the budget. But within the range of, let us say, $10 billion down or $5 billion up, I do not think it makes any difference that anybody can find, given the size of the margin of error in the data.

Senator MUSKIE. How about the unemployment side? There was considerable sentiment expressed this morning for cuts of $5 to $10 billion.

What would be the unemployment consequences, if any, of that kind of cut?

Mr. ACKLEY. I tried to make some crude calculations after this morning's session because that question had arisen.

As Senator Biden pointed out, it makes a difference where you cut because a cut of a billion dollars here is not the same as a billion there. The effect would be the greatest if it is occurs in Government purchases of goods and services, including the services of its own employees, or in transfer payments.

It would be least if it occurred in subsidies or grants to State and local governments, because as my testimony suggested, it seems clear that increased grants to State and local governments over the past several years have not caused State and local expenditures to increase by the same amount. Instead, they have led to large surpluses in those governments; so a cut, I would assume, in Federal grants would have very little effect on State and local government expenditures. It would have an effect on their surpluses, but little effect on their expenditures, and therefore, on aggregate demand.

I tried a little back-of-the-envelope calculation of the effect of a $10 billion reduction in the budget for fiscal 1975.

You must recognize that we are well into fiscal 1975 and that probably no difference could be made in the first fiscal quarter. But suppose you took $2 billion out of planned expenditures in the fourth quarter of this year and $4 billion each out of expenditures in the first two quarters of 1975, and assume that it was spread proportionately over all items. It would not be, obviously, and could not be, because you can not reduce interest and so on, but just to keep the calculations simple.

My quick calculation, if I did it right, suggests that by the middle of next year, GNP, gross national product, would be down somewhere around $20 to $25 billion. Incidentally, this would also reduce Federal revenues by something like $3 or $4 billion.

I do not think there would be enough difference in the GNP deflator to notice. So this would all represent a decrease in real gross national product of about 1½ percent, and an increase in the unemployment rate of something like four-tenths of 1 percent. That is, if the unemployment rate otherwise would have been about 6 percent, it would raise it to say, 6.4 percent. That is something like 300,000 or 400,000 jobs.

But in addition to the loss of jobs there would be shorter hours and therefore lower incomes for the money people who were working; and there would be some people who would have dropped out of the labor force and would not appear among the unemployed because of discouragement about the prospect of jobs. So the costs are substantial.

These costs might be entirely tolerable if there were some way of spreading the reduction of income that is implied evenly over the whole population. But people who would not be hurt by increased unemployment find it very easy to impose sacrifices on other people who would be. The thing you always have to remember is that unemployment is not something that is spread evenly over the entire population. It is not that everybody loses a few hours of work a week and the equivalent pay. It is that some people become pretty much totally unemployed for periods of several weeks or months, who otherwise would not have been. And it also happens that these are or tend to be the least advantaged members of our society, and that you are imposing these costs quite casually on a group of people who in many cases, are those least able to bear them.

And, while I surely do not think we should go in the opposite direction and say we have to rev up the economy and get the unemployment rate as low as you can possibly get it, still, one does have to consider the very real human costs—and the distribution of those costs—of a policy which attempts to deal with an inflation which creates a lot of injustices by creating more unemployment, which also involves very considerable injustices.

Senator MUSKIE. I will come back, but I will yield at this point to Senator Fannin and then to Senator Cranston.

Senator FANNIN. Thank you, Mr. Chairman.

I am sorry I was not here to hear your full comments but I have been looking over your statement and I earlier looked at the statement to determine just what I could ask of you.

Let me comment first on the items relating to the Federal deficits. Your point was, as far as I can understand, that the Federal Reserve claims that one of the reasons for increasing the money supply has been due to large Federal deficits which require them to intervene in the market to insure success of Treasury Bonds. If we had no deficits, it would ease the burden of monetary policy, if we follow the thrust of that theory.

Do you want to comment on that?

Mr. ACKLEY. Chairman Burns has addressed himself to this several times in the last few months in his testimony before the Joint Economic Committee, in speeches and so forth.

I think the way that you have stated the point is somewhat an overstatement of what the view of the Federal Reserve would be, although I do not wish to speak for them. It is true that during periods where the Federal Government is floating new issues of securities, the Federal Reserve, for a great many years and for very good reasons, has followed the "even-keel" rule, which says that they will attempt to stabilize interest rates and to make offerings of Federal securities successful; and, indeed, they intervene to support the market, if necessary, to prevent the failure or substantial undersubscription of a Federal bond issue.

But the Federal Government is not in the market all of the time with new bond issues. In between such issues, the Federal Reserve System can do its tightening, if it wants to tighten, and it can achieve whatever it needs to achieve in the way of monetary policy. You can argue that the larger the deficits are, the more frequently the Treasury will need to be in the market and, therefore, the greater the duration of periods of even keel. But the connection is not that close, because the great majority of new Federal security issues are for refunding purposes rather than for new money anyway. And I think there is plenty of time for the Federal Reserve to pursue any monetary policy it wishes to pursue.

Senator FANNIN. Thank you.

Is it not true that, in general, under the balanced budget multiplier theory, assuming we have a large balanced budget, that in itself would be expansionary and inflationary, having a larger budget even if it is balanced?

Mr. ACKLEY. The balanced budget theory is a famous theory of macroeconomics which is usually misunderstood and misapplied, and I think, with all due respect, Senator, it is misapplied in the way that question is framed. It is theoretically correct that an equal increase in expenditures and tax revenues does have some expansionary effect upon aggregate demand, a multiplier effect of one, so-called. The proposition that an equal increase in expenditures and revenues is inflationary, however, is relevant only to an economy in which the total productive capacity is not expanding. In fact, in our economy, our total ability to produce goods and services is steadily increasing over time and, indeed, equal increases in expenditures and revenues are needed in order to maintain the same pressure on total resources (to the extent that this is affected by Federal fiscal policy). Indeed, if they do not increase together (or unless there is some other expansionary combination), you will get a widening margin of unused re-

sources. In short, the the unsophisticated version of the balanced budget multiplier principle which you cite is irrelevant in a society in which total output capacity is growing because of a larger labor force, because of technological improvements, and so on.

And, indeed, as the figures I referred to earlier and in my testimony suggested, the budget has usually played a rather stable role in our economy, neither expanding nor contracting significantly relative to our total productive capacity. There were some questions—excuse me. I should not try to answer questions other than yours.

Senator FANNIN. That is all right. If you had something else that would tie in to that, I would appreciate your stating it.

Mr. ACKLEY. I would just make this comment.

Questions were asked this morning about the continual increase in Government expenditures, noting that it took 100 years to get up to $100 billion and only 20 years to get up to $200 billion, and so on. And that is true. But you could say the same thing about gross national product. It took us the first, I do not know how many years, of our national life to get up to a $100 billion gross national product in 1941. We were at $300 billion in 1951. We were at $500 billion in 1960. We were at a trillion in 1971. And we are going to be at a trillion and a half in 1975.

This is a growing economy. True, there is inflation in that too, as there is in Government expenditures. The greater part of this growth is real growth, but inflation does affect both the gross national product and the level of Government expenditures.

Senator FANNIN. You said the greatest part of it is real. It depends upon the years that you are referring to.

Would you say that the way we have been going in the last year, the greater part of both would be real?

Mr. ACKLEY. No. You are quite right. As I recall, my forecast for third quarter GNP in constant prices—that is real output—would be below what it was in the third quarter a year earlier. Dollar output would be up by something like 10 percent, the result entirely of inflation.

Senator FANNIN. I personally feel that not only should we look toward a balanced budget but I think we should look toward restricting the budget, especially where we are going beyond the needs that exist.

Just because in time we might be able to raise that amount of money does not mean we should expend that amount of money, and I think you would be agreeable with that.

Mr. ACKLEY. Could I say along that line, Senator, we often hear two theories about the effect of the budget on inflation or no aggregate demand. One says that it depends upon the balance or lack of balance in the budget—that is, the deficit. And the argument is that deficits are necessarily inflationary and surpluses are necessarily disinflationary.

The second theory has to do with the size of the total budget. There are those who argue that a mere increase in the size of the budget, no matter whether it is financed by taxes or deficit, is also inflationary. Arguments can be made, discussions can be conducted about each of these theories. But they are quite different.

What I did say, I guess before you arrived, was that deficits can be inflationary, sometimes have been, unfortunately, highly inflationary. But deficits are not always inflationary. And the objective of a rational fiscal policy, in my view, and most of the economics profession that I am familiar with, is that there are times when we ought to have surpluses, not just balance but surpluses. There are times when we ought to have deficits, and there are times when the budget ought to be balanced.

But there is no simple rule for a sound fiscal policy. If you need a simple rule, because that is the only kind that people can understand, then I guess I would say balance the full employment budget and keep it balanced.

But that is not a good rule, either. There are times when there ought to be a surplus or deficit in the full employment budget.

Senator FANNIN. In the statement you refer to total government balances. Turning to the surplus, if the Federal Government borrows to finance grants to State and local governments which run surpluses, and invest income in the bonds, it creates an extra pressure on financial markets.

I know that the State governments, the former Governor from the State of Maine, Senator Muskie, has probably had the same experiences, that surpluses are not invested in Federal bonds, I do not know about the general happenings around the Nation, but I know that in my State that was not true.

If they are, why should our country go through this? In other words, if the States are going to be getting funds and then investing in Federal bonds and have surpluses in that regard, what do you feel has been gained?

Mr. ACKLEY. I think I used the phrase "public obligations," which may indeed simply be the retirement of their own debt. But basically, the market in which Federal securities are traded is most closely related to the markets in which State and local governments would place any surpluses.

Senator FANNIN. The thing about that is revenue sharing.

What would be—depend more upon revenue sharing?

Mr. ACKLEY. It seems to me revenue sharing has contributed notably to the situation in which the Federal Government had indeed run deficits in order to allow State and local governments to run surpluses. If you are looking for some place to cut the budget, this would happen to be one of the places where I think might usefully be done.

Senator FANNIN. We cannot talk of Government surpluses and throw in State government amounts necessarily and feel that we have accomplished the objective in offsetting a Federal deficit.

Mr. ACKLEY. I think the relevance of this is the fact that the two have been so closely connected. The Federal budget, as my statement indicates, includes something more than $40 billion in grants to State and local governments, and this amount has more than doubled over the past 5 years.

Senator FANNIN. That has been the tendency.

Mr. ACKLEY. And that I think represents the kind of Federal expenditure which has not added very much to aggregate demand because State and local governments have not increased their expenditures to match that.

Senator FANNIN. I have just one other question.

Senator MUSKIE. Go ahead, and we will yield to Senator Cranston who can take whatever time he likes. I overstepped my time, so I am in no position to protest.

Senator FANNIN. I do not want to impose on Dr. Ackley but we are talking about balanced budgets and what effect is would have on a currency.

I have been disturbed. I attended an OEC meeting. There were 24 nations there, and the discussions were concerning the monetary programs and of course the threat they have to their monetary programs because of the tremendous price of petroleum, especially in some of the countries that are practically 100-percent dependent upon imports.

Do you not feel that this is becoming more of a factor as we get into this period when these countries are really in jeopardy, even to the point where we did pass a resolution, as you know, maintaining the status quo in order that we would not have one country calling upon one of the other countries in such financial straits that it would practically bankrupt them to pay off or to be in competition to the country that perhaps is in a better financial position.

Are we not really getting to a point now where the deficit budgets happen to be more of a measurement criteria than——

Mr. ACKLEY. The deficit balance of payments?

Senator FANNIN. Yes, deficit budgets. Of course, deficit balance of payments is a serious problem they face, but it is all tied together with whether they can stand that deficit balance of trade, deficit balance of payments, and still be in a position where they are running a deficit budget.

Mr. ACKLEY. I think in the present circumstance I would tend to want to discuss the balance-of-payment deficits somewhat more independently than your question implies from government budgets, because one of the countries you referred to having problems paying for its petroleum could run a very large surplus in its government budget and still not be helped in dealing with its balance-of-payments problem.

I do not pretend to be an expert in either the balance-of-payments area or in the international financial area, as it relates to the current problems of handling the money flows associated with petroleum payments.

To the extent that I understand it, it seems to me that the problem has at least a short run possibility of working itself out. I do agree that when one contemplates this thing going on for year after year after year in which most governments have a deficit on trade accounts and oil producing companies have surpluses on trade accounts, and in which the capital flows come back from the surplus countries, but directed not generally to the countries that are buying petroleum but rather directly to some countries where the capital markets are best, that if you sort of think about this going on for a long time, and the amounts involved, you can visualize some pretty staggering problems, and I do not know what solution there is to that other than for the petroleum price to come down.

Senator FANNIN. I agree with you but the exchange rates of the dollar with the other currencies of the world is what I was referring to as being so drastic at the present time, and I think it is one of the

greatest threats that we envision, especially as pertaining to the countries that we were discussing.

Mr. ACKLEY. Yes. The recent decline in the value of the yen relative to the dollar, for example, clearly reflects both the direct impacts on the currency markets of these flows, and also expectations about the relative ability of Japan and the United States to deal with them. And, of course, the decline in the value of the yen, even without the Japanese Government promoting that as a means of trying to increase its exports and reduce its imports, in other words, just the market effects are going to be such as to make Japanese goods cheaper on international markets, and cause potential disruptions perhaps in trade as well. These are very, very tough problems, and I am glad that we have an OECD. I used to spend a lot of my time over there. And I think international cooperation is absolutely essential, probably not limited to the financial problems, but also in terms of the more direct approach to the problem of petroleum price and supplies.

Senator FANNIN. Thank you very much.

I was very much impressed, Mr. Chairman, when I found that the OECD have 82 economists. I thought we should be able to settle some problem, either that or have very great disagreement.

Senator MUSKIE. If we could get the 82 to agree with each other——

[General laughter.]

Senator MUSKIE. Senator Cranston?

Senator CRANSTON. Thank you, Mr. Chairman.

Senator MUSKIE. Thank you for your patience.

Senator CRANSTON. Do you have any reasonably accurate estimate of what the unemployment increase would be if there was (*a*) $5 billion cut in the budget or (*b*) $10 billion cut?

Mr. ACKLEY. I went through that arithmetic a while ago with Senator Muskie.

Senator CRANSTON. Yes. I did not follow it.

Mr. ACKLEY. I think that I said that a $10 billion budget reduction spread in the particular way I suggested in terms of its time pattern and its impact on different kinds of expenditures would raise the unemployment rate about four-tenths of 1 percent, as best I can make out.

Now, that is a more conservative estimate than the one you or someone quoted this morning and attributed to Mr. Ash, who said, I think, that a $5 billion——

Senator CRANSTON. He said it would go up from 5.2 to 6 percent.

Mr. ACKLEY. About three-tenths of 1 percent.

In any case, I could be wrong. This is arithmetic that is more or less back-of-the-envelope.

Senator CRANSTON. Both you and Mr. Rush have indicated that cutting the budget $5 or $10 billion would have a negligible impact on inflation. There are some people who nonetheless say it would have great symbolic value in terms of confidence that we were going to come to grips with the problems, provided we are not deluded into thinking that we can solve anywhere, if we do something for symbolic reasons.

Do you think there is any symbolic value of any significance?

Mr. ACKLEY. Yes, I can see the potential symbolic value of a posture in which the Government says, we are going to do everything we can in a wide range of areas to deal with this problem of inflation, and

whether it is important in the short run or not to cut expenditures by $5 billion, nevertheless, it is just a better posture, and people have more confidence because you are acting in a lot of areas rather than simply one. And this promotes the objective.

I would not pay too much for that, but I think it cannot be completely disregarded. I gather that the argument, the symbolic argument was somewhat more than that. As Mr. Rush made it this morning, it was that the $5 or $10 billion would be a symbol, not merely of fighting inflation by what we do today, but a symbol of a different budgetary stance over the years ahead. Not only that we would have a more restrictive budget, a slightly more restrictive budget in fiscal 1975, but a somewhat more restrictive budget for a long period to come.

Now, I do not happen to think that is of very great significance, first because I do not think anyone will believe it. I think they will know and they should know that if this posture of steadily more restrictive budgets is maintained very long, it means growing unemployment, and that that is not going to be tolerated, and that budgets will be busted in order to deal with the situation. I do not think you can kid people very much. It was only as late as last March and maybe into April that administration officials were saying about the budget they had proposed in February, that if we really have a problem with unemployment, we will bust the budget.

Now, you can say that this time we really mean it; we are going to have a restrictive budget not only this year but next year and the year ahead. But can you also say, in the next breath—as they ought to say and as we ought to do—if too much unemployment develops, of course we do not mean it.

Well, you can play with symbols so long, but you have got to tell a convincing story, and I do not think anyone believes it because it does not make sense. And this means that it is not as easy to achieve things as it would be if everybody always believed that whatever the Government said was necessarily going to come true.

But that is the world we live in. We have lost our innocence and we cannot start over again. It is like this business about price controls. If you have a wage-price policy, people might believe that you are going to have controls and this will lead to price increases to beat the controls, and if inflation gets too hot people will think, ah, controls are coming, we had better get our prices up in time. I agree, it is a real danger. The trouble is, you do not avoid that danger by saying oh we will never have controls again. Because if we do get into a bad enough inflation problem, of course we will have controls again, and everybody knows it. We have lost our innocence, but OK, we have to live with it.

I think it very unfortunate for that reason alone that the administration in 1971 went for widespread mandatory controls. You can find it unfortunate for a lot of reasons, but that is one of them. It says that not just Democratic administrations but Republican administrations, too, will have price controls if the problem gets bad enough. And every time the inflation rate heats up a little bit, a lot of people are going to start thinking, well, if it gets a little worse, maybe they will start thinking about controls. We had better get our prices or our wages up now.

But I do not think we throw away policies because they may create expectations.

Senator CRANSTON. Mr. Ackley, a while back you stated, "the important cases of demand inflation result from Government expenditures, especially those associated with war appropriations. Even a glance at the statistics shows that major U.S. inflations have occurred at the time of the Revolutionary War, Civil War, World War I, World War II, Korea, and Vietnam wars."

Would you explain why in your view military expenditures are particularly inflationary?

Mr. ACKLEY. I do not think that military expenditures are particularly inflationary. It is just that in war time periods, without exception, unfortunately without exception, we have increased expenditures drastically without equivalent increases in tax revenues. Indeed in a major war, a World War II kind of situation, it would have been ridiculous to suppose that you could have increased taxes sufficiently to pay for the 50 percent of the gross national product we were devoting to military purposes.

But I think it is as simple as that. These are times when we have big deficits and these are inflationary. But deficits created by military expenditures are not more inflationary than deficits created by civilian expenditures or growth related expenditures.

Senator CRANSTON. Is there not a factor involved that much of the production for military purposes involves production of goods and services which are not purchasable by those whose income is increased during this time of expenditures, and therefore their income is used to bid up the price of what is on the market?

Mr. ACKLEY. That is another way of saying that if resources are withdrawn from producing civilian goods and services, the aggregate demand for the total goods and services is not only increased, but its structure is changed.

There is an important difference which you obviously have in mind, and correctly so. Expenditures for military purposes do not add to our productive capacity in the future, while expenditures for plants and equipment, education, health, do increase our productive capacities in the future, but that relates to down the stream. The immediate effects are exacly the same. You are devoting resources to other than current production and current consumption.

Senator CRANSTON. One of the principal responsibilities of this committee will be to assess national priorities as they are reflected in the Federal budget.

How do you suggest we do that in a way that will best promote a rational assessment of our priorities in terms of the effect on the economy of spending in this or that matter?

Mr. ACKLEY. I think that is a very, very difficult problem, and I guess I would tend to say that the evaluation of priorities—that is, the question of the division of the total expenditures—is a quite separate question from the fiscal policy question which relates to the size of the budget and the size of the budget relative to revenues. I am not sure that the priorities question is really an economic question primarily. It is a question of what it is we are trying to achieve in our society.

Basically we can achieve what we want to achieve with the resources we have, and I am not sure that economists can throw very much light on the question of priorities as among the broad categories of government expenditures.

Senator CRANSTON. Will not some forms of expenditure create employment, for example, money specifically allocated for public service employment?

Mr. ACKLEY. Yes, they have different impacts, and that can easily be taken into account in terms of the fiscal policy analysis. Indeed, any intelligent approach to the fiscal policy question, that is, the balance, the size of the budget, its relationship to revenues, automatically takes account of the different structure of expendiures, and provides the appropriate advice that if you are going to spend it mostly this way, then you either need a little more tax revenues or a little smaller total size of the budget than if you had done it another way. But that is a technical problem that is not particularly difficult. The difficult problem with priorities is where do we want to go as a nation, how much of our resources do we want to devote to making it a more livable place, improving the distribution of incomes between rich and poor, changing the geographical structure between urban and rural. How much do we want to devote to leisure and the humanities and the arts?

I do not think economists really have very much to contribute to this. Cost-benefit analysis formally permits you to frame the problems in economic terms; but the basic problems are value problems which have to be decided by the political process which you gentlemen represent. You are speaking for your constituents and what you understand to be the desire of the people generally about what it is we want, what kind of a society, and this is greatly affected by how we spend our Government funds.

Senator CRANSTON. In regard to monetary policy, would you favor a mechanism by which the Federal Reserve could direct credit to sectors of the economy that we consider the least inflationary and perhaps the most productive, policies that would discourage credit from going to less desirable speculative, for example, areas?

Mr. ACKLEY. I am prepared to create some kind of machinery, presumably in the Federal Reserve System, which would permit the Federal Reserve to influence not just the total volume of credit, or whatever measure you wish to use, but also the composition—where it goes. This is so often put in terms of trying to see that the credit is used for the most socially important purposes. And one reason why all members of the Federal Reserve Board—except Mr. Brimmer—have opposed this is that they say, and I think quite correctly, that we, superbureaucrats with 14-year terms, really very remote from public pressure, should not make value judgments about what is a good use of credit and what is bad. I think that that misses the point of those of us who think that the Fed ought to have some such authority. The point is that in periods of tight money, the very fact of the tightness of money, given the particular structure of our financial institutions, clearly warps the distribution of credit way out of normal. It takes money away from housing, for example, and does not take it away from a lot of other things. I do not think the Fed ought to have the

authority to influence the allocation of credit because, necessarily, housing is socially more important than something else.

It is just that, when you tighten credit, you ought not to distort its distribution. If we would stop talking so much about allocation of credit into socially desirable things, and instead describe this proposal simply as trying to prevent distortions of the flow of credit when we have to tighten credit, even members of the Federal Reserve Board might see that it does not involve the kind of delicate political questions which they believe are really questions for the Congress and not for them.

I am prepared to give the Fed that authority. I wish they wanted it.

Senator CRANSTON. One final question.

You indicated that there are times when you might want to have a balance, a surplus, or, conceivably, a deficit.

Roughly, what would those occasions or circumstances be when you would want one, the other, or the third?

Mr. ACKLEY. I think, basically, these relate to the strength of private demand in the economy which, despite Milton Friedman and a few others, cannot be taken to be self-stabilizing. At times private investment demand and private consumer demand are strong, and at times they are weak, either for reasons we understand and sometimes for reasons we do not understand. But we know there is this wide swing in the intensity of private desire to spend and to re-spend income in the purchases of goods and services.

When private demand is strong relative to our productive capacity, if we want to avoid inflation we have got to curb Government demand or else curb private demand so as to curb total demand. That is to say, we need to increase taxes which reduce private demand, or reduce Government expenditures which decreases the Government's demand, or some combination thereof.

In other words, I think we must approach the problem in terms that economists like to talk about, rather presumptuously, as "demand management." That phrase presumes a greater skill and ability than we really have; but when demand is otherwise insufficient, we ought to have deficits; when demand is otherwise excessive, we ought to have surpluses.

There is no valid simple rule, such as to say that the budget ought always to be balanced, or that the full employment budget ought always to be balanced. Any simple rule is wrong.

Senator CRANSTON. Thank you very much.

Senator MUSKIE. Thank you, Senator Cranston.

With respect to the Cost of Living Council, what is your view on Mr. Burns' suggestion that the Council be given the power to delay wage and price increases for a period of 45 days?

Mr. ACKLEY. In 1958, in testimony before the Joint Economic Committee, I said that I thought there ought to be created a Wage Price Commission which would have the authority, first, to require advance notice of price and wage increases, obviously not all, but the kinds which it might describe. Second, it should have authority to delay those increases for limited periods for study. And I do not think 4 or 5 or 6 days is adequate at all; they certainly ought to have the authority to delay them up to 30 days or, I would say, even 60 days.

Third, it ought to have the authority to compel testimony, so that if it wants to discuss with the parties whether a proposed price or wage increases are really necessary or adequate, people will come and bring their story. In most cases, they are obviously ready to come in with their reasons, but it helps to have the subpena power. I think those three powers would greatly assist the ability of a Price-Wage Commission to influence the course of prices without any ultimate authority to say no.

In an article, in 1970, I guess, in which I again collected my thoughts on this question, I suggested that it seemed to me there was one further power that it might be desirable to give to such a commission, which would be the power, under very exceptional circumstances, perhaps requiring reference to some other body, for limited periods and for clearly specified transactions by particular sellers of labor or services, it ought to have a fall-back, final, club-in-the-closet authority to say that for a year, you cannot go higher than this.

Now I do not know whether that is essential or not. Reviewing the experience of the 1960's with the use of jawboning, I am convinced that the first three are important. The last one might be helpful, but I can see arguments against it. But it ought certainly to have those first three. The authority to require advance notice; the authority to delay; and the authority to study and make recommendations which might, if necessary, require subpena.

Senator MUSKIE. Why would the creation of the Cost of Living Council, with or without the kinds of authority you have been discussing, be less of a stimulus to anticipatory price and wage increases than the legislative standby controls?

Mr. ACKLEY. I think it might be somewhat less. However, as I remarked earlier, I do not think you can get away from this problem of expectations. To be sure, we don't help things at all when the President or other high officials of Government say we do not want to do any of these things because they might lead to controls. That expectation is just what you do not want to encourage. And indeed, I do not think there is any evidence at all that this is the case.

For example, in the 1960's, under Presidents Kennedy and Johnson, there developed a very determined effort to deal with wage and price increases through voluntary methods. And at that time, as early as 1962, people were saying, do not get into this because inevitably, you are going to come to a case where people do not take your advice, and then you will have to move to controls and we will be right into it all of the way.

What happened when inflationary pressures mounted as they did after 1965? Did we move into controls? No. There is no evidence that there is any inevitable movement from voluntary methods to controls. How did we get into controls? We got into controls under an administration which abhorred any kind of voluntary jawboning, but when things got bad, went directly all of the way, not to jawboning, not to limited controls, but all the way across-the-board controls. I do not know how any one can say that experience shows that jawboning leads to controls.

I think what we need is an apparatus which people have some confidence is making a contribution, however slight, and people recognize it is making a contribution and that as long as it is making a contribu-

tion, it will continue. Thereafter, if it fails, who knows? We either accept the inflation or we do something else about it. I do not think we should play games about what conclusions people are going to draw.

Senator MUSKIE. I am for this Cost of Living Council proposal. I tried, along with Senator Stevenson and Senator Johnston, to persuade the Senate to adopt it. But the Senate was not disposed to go along with us and the administration was very reluctant to get off the fence. So here we are back to it again. I think we ought to adopt it for the reasons that were given.

But let me ask you this qustion. We have heard from different points of view, perspectives and philosophies, all day, about the impact of budget policy—how it might be used, how effective it will or will not be in rolling back inflation.

Is inflation going to be rolled back by any means that you can conceive of within any time frame that might be described as the foreseeable future?

Mr. ACKLEY. I think it is hard to be optimistic about that. On the other hand, I think you have just got to take the posture that we are just going to keep trying and our objective is not to reduce the rate of inflation from 12 to 10 or from 10 to 8. Our objective ought to be just to eliminate it.

Now we know we are not going to do that. But once you sort of say, well, we can accept 5 percent, then why in the hell can you not accept 7 or 10 percent? You do not get anywhere that way. I think the posture ought to be that inflation is a bad thing. We would be better off with less of it, and our objective is to get rid of it.

Realistically, I do not think we can do that, and realistically, I do not think any of the things we are talking about doing, short of allout controls, is going to have a major effect very soon. That does not mean the rate of inflation may not decline. We hope it will, almost no matter what we do, but it will not decline mainly because of things we are likely to do. We can have some influence on it; and we ought to use that influence so far as we can, if we have methods that are cost beneficial.

Senator MUSKIE. For instance, if two of the important factors behind the present inflation are the escalation of energy prices and commodity shortages, principally food, over the last year, it seems to me that, at least with respect to the first factor we have added a permanent increment of cost to everything that is produced in societies which are dependent upon energy, as we are and as others are. So we have reached a new high plateau of costs and prices.

How does that affect the prospect of reducing inflation that is produced by such factors?

Mr. ACKLEY. I do not think anyone suggests that we are ever going to get the price level back down to what it was in 1970 or 1920.

Senator MUSKIE. But beyond that, when is one of these constant influences on inflation going to fade?

Mr. ACKLEY. The petroleum one?

Senator MUSKIE. Well, even the commodities one factor. We are going to have shortages of commodities, too, are we not, in the future?

Mr. ACKLEY. Obviously, we will always have some commodities of which the supply is growing less rapidly than the demand and their

relative prices are rising. We will have other commodities whose supply is growing faster than demand and their relative prices should be falling, and do. I do not really think that is the problem with inflation. We can handle shortages in the sense that over the years we had a shortage of charcoal, so we moved from charcoal to coal, and from coal to petroleum, and soon to uranium or even hydrogen. The whole history of energy is one of moving from scarce resources to somewhat more abundant resources, because the prices of the older ones got too high and we shifted to less expensive ones, which either were there all of the time or which technology provided us.

That will continue to happen. I am not worried about the world coming to an end because we run out of materials. In the long run, there is no problem there.

The petroleum case is particularly important because it affected us suddenly by a large and obviously artificial amount, a basic source of energy which affects almost everything. That has still a ways to run before the direct effects of that to get through our system. We have not experienced the utility rate increases that we are going to have to have to reflect those increased prices in petroleum and substitute fuels that compete with it.

I am afraid we have not gotten all of the transportation increases out of our system either. So there is more to come. The problem is that this one-shot event has been setting off the old wage and price spiral again. You can eventually complete the working through of the petroleum increases; but the wage-price spiral can keep right on going independently of it.

That is the long run problem we have to deal with. You get these spirals going and it is very difficult to cut them back, much more difficult to cut them back than to get them tripped off in the first place. Inflation can be started in so many ways. There are just all kinds of things that can start an inflation, accidental mistakes of policy, acts of nature, political acts, and so on. And there is probably nothing you can do about that.

What we ought to learn to do is to prevent those mistakes or accidents from setting off a spiral which keeps going on its own and helps nobody. All price tags go up and no one is any better off or worse off—some people are a little better or a little worse—but basically, it is a process which is socially disruptive and we ought to learn to control.

Senator MUSKIE. Well, on that note——

Senator FANNIN. Mr. Chairman, may I have one more question?

Dr. Ackley has been very patient. I just recall that you said that there are times when you should have deficits and times when you should have a surplus.

Politically, you can have a deficit and that can be popular. But the surplus is somehow very difficult. Raising taxes is not the easy way of doing it and I am just wondering if we are not better off talking about doing what is necessary to the economy to stimulate it. Usually, if we stimulate it, having a deficit, everyone wants to cut the taxes.

Would we not be better off if we would have the goal of the balanced budget? Would that approach not obtain what you are talking about better?

Mr. ACKLEY. If one takes a completely despairing view of the possibilities and prospects of a more intelligent approach to fiscal policy, then maybe that is right. But even the despairing can do somewhat better than budget balancing every year.

There were discussions this morning about the full employment budget concept. People forget where that came from. It was basically invented by Herbert Stein in 1946, I guess, when he was working for the CED at the end of the war. And the CED, the Committee for Economic Development, in 1946 or 1947, proposed a reasonable compromise between the idealistic schemes of people like me who think we ought to be able to manipulate budgets and taxes and expenditures and get the best of all possible worlds, and those who simply say, balance the budget in every year.

His idea was simply the scheme to keep the full employment budget in balance; and that says that if you get a deficit because the economy goes slack, do not make it worse by either cutting expenditures or raising taxes. Play it cool. The deficit will cushion the decline in the economy and then when the economy picks up, that deficit will go away. If you get a boom, which creates a budget surplus, do not try to give that away by raising expenditures or cutting taxes. Let it sit there. It will act as a restraining force and then when the economy comes back to balance, you will have a balanced actual budget.

And I think it had a lot of appeal. And I hope people do not throw away the full employment budget concept, because it does make a lot of sense. It is not as good as something better, but if you want a simple rule, it is a heck of a lot better than balancing the budget every year. It is a lot better rule than "do not worry about the budget." If we had been following the full employment budget rule when we raised military expenditures for Vietnam, we would have raised taxes.

Senator FANNIN. I am in wholehearted agreement with you. The balanced budget proposal does not mean we are going to balance it every year. Since you are referring to, as far as Vietnam, we are going to have times when we know that it is not practical. But from the standpoint of just a general approach I am talking about, I know that you differ because you feel that a full employment budget approach is more practical in the way of handling it. And I do appreciate your comments. And Mr. Chairman, I certainly do not want to take more time because you have been certainly, as I said earlier, very, very patient.

Senator MUSKIE. Thank you very much, Senator Fannin and Dr. Ackley.

I expect we will see more of you as time goes on. Thank you very much.

[Whereupon, at 3:55 p.m., the committee adjourned, to reconvene subject to the call of the Chair.]

THE FEDERAL BUDGET AND INFLATION

THURSDAY, AUGUST 15, 1974

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 9:40 a.m., in room 4200, Dirksen Senate Office Building, Senator Edmund S. Muskie [chairman], presiding.

Present: Senators Muskie, Magnuson, Moss, Mondale, Hollings, Cranston, Dominick, Javits, and Fannin.

Also present: Alvin From, Lee Lockwood, and Lucinda Dennis, staff of Senator Muskie.

Senator MUSKIE. I think it is appropriate, on the second day of our hearings concerned with budget cutting, that we have testimony from an expert budget cutter. It is a pleasure to welcome the Director of the Office of Management and Budget and receive his testimony which I think is critical to the consideration of this issue. Mr. Director, if you will proceed in your own way.

STATEMENT OF HON. ROY ASH, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET; ACCOMPANIED BY DALE McOMBER, ASSISTANT DIRECTOR FOR BUDGET REVIEW

Mr. ASH. Mr. Chairman, I have a fairly brief statement that I think might be useful if I were to read it.

First of all, I think it is a proper occasion to say that I am especially pleased to meet with this committee even as it is now being formed and taking up its work, to discuss Federal spending and to discuss the current inflation.

While our subject is not a happy one to most anybody, I am sure that this will be the first of many productive meetings between this committee and representatives of the Office of Management and Budget.

There is virtual unanimity that inflation is the top priority domestic problem that faces us today. It is in the best interest of the Nation, therefore, that the executive branch and the Congress cooperate in a determined effort to bring this country back to a period of relative price stability through responsible Government action.

Before discussing the role of the budget in the effort to combat inflation, I want to emphasize our particular interest in working with this committee. As you know, the Congressional Budget Act sets certain specific requirements for consultations between the Budget Committees and the Office of Management and Budget. Beyond that, it is clear that we have a common interest in the development and review of the Federal budget. I pledge our constant cooperation with this

39-566—74——7

committee in finding ways to meet these common objectives. I can promise you that the staff of the OMB will work closely with your staff in developing an understanding of the budget system and in providing information on specific budgets. There is much work before us. Both my staff and I look forward to working closely and cooperatively with you on all of these matters.

As you know, the President plans to convene a bipartisan economic "summit" conference to devise an action plan for stability and growth in the economy. The administration's current economic policies will be thoroughly discussed at the conference. These policies have both shortrun and longer run aspects. In the short run, they are designed to restrain the growth of demand relative to the growth of supply by holding down Federal spending, and by moderating private demand—primarily by restraining the expansion of money and credit. Accordingly, in addition to the administration's plan to slow the growth of the budget, the Federal Reserve System is limiting the growth of the money supply, so as to lessen the problems of "too many dollars chasing too few goods," which is the heart of inflation. The Federal Government also will use its influence wherever appropriate to help bring about voluntary restraint in price and wage decisions. The cost of living task force would have primary responsibility for this activity.

In addition, measures are being taken to counteract inflation by stimulating increases in production, in productivity, and in supplies—especially supplies in the crucial areas of agricultural commodities (weather permitting) and energy. Project Independence, the return of millions of acres of farmland to production, and sales of excess materials in Government stockpiles are all elements of a broad effort to assure adequate supplies of food and other farm products, energy, and other factors for which serious shortages threaten.

A sweeping review of the effects of Government regulations on productivity and prices would be an essential part of any longer range plan. It would have the objective of developing recommendations for changes that will lead to increased productivity. This involves areas as diverse as building codes, regulation of transportation and of financial institutions, and environmental standards, some of which may have significant unnecessary effects of holding us back from doing our best when it comes to production.

Listing these other elements of a comprehensive economic program in no sense diminishes the importance of a budget policy of stringent but realistic restraint. Rather, it identifies budget restraint as one of several policies, each of which must be firmly applied in order to restrain the growth of demand and stimulate an increase in supply. Otherwise, we will simply end up squeezing one part of the inflation balloon, only to have the rest of it bulge out by an equal amount.

Our current emphasis on fiscal restraint continues the policy of the recent past. For fiscal year 1973, the administration set a goal of holding outlays to below $250 billion. As you may remember, actual outlays were only $246.5 billion, and the deficit was more than $11 billion below the $25.5 billion estimate in the original budget for that year. In fiscal year 1974, actual outlays were $6 billion below the estimate of last February, and a deficit of only $3.2 billion was realized, as com-

pared with the original estimate of $12.5 billion. The trend of restraint is clear, and is reflected in our present goals:

For fiscal year 1975, to cut below the current estimate of about $305 billion toward a goal of $300 billion, and

For fiscal year 1976, to present a budget that is in balance.

A reduction in 1975 spending will not be easy. A variety of forces threaten to push spending even higher than the current $305 billion estimate.

The Congress has already enacted mandatory authorizations that will add more than $900 million to 1975 spending (for which offsets must be found), and it has before it other mandatory authorization bills that would add another $3.7 billion. The pending bills would provide further increases in veterans' education benefits, housing programs, small business loans, mass transit operating subsidies, Trade Reform Act benefits, civil service annuities, and relocation assistance. Without arguing the merits or the desirability of any of these proposals, it is clear that in the current economic situation the Nation can ill afford an additional $4.6 billion in Federal spending when the financing for such spending—unless we are prepared to vote for tax increases—must come in the form of additions to, and a prolonging of, rates of inflation that are already intolerable.

The Congress has not enacted legislation proposed in the budget that would effect some $900 million in economies. These proposals include tightening administrative procedures and marginal or duplicative eligibility criteria for social security and public assistance and obtaining insurance reimbursement for some veterans' medical service. These, too, are very difficult choices to make, but the alternatives are even tougher.

As is customary in its consideration of appropriation bills, the Congress is contemplating some increases and some decreases. As you know, the Agriculture-Environmental appropriation bill has already been vetoed because of its effect on the budget and on borrowing. A significant increase is also threatened for the Labor-HEW appropriation bill. While these increases may have merit when considered individually, cumulatively they are inconsistent with serious budget restraint.

Cooperative efforts of the executive branch and the Congress are essential if we are to turn back pressures for spending increases. They are critical to moving the budget below the current estimate.

This administration is resolved not only to work with the Congress to prevent spending increases but also to find ways to reduce spending now planned. In examining those options, several realities must be faced.

The first reality is that most of the Federal budget is mandated by law and by past contractual commitments. We cannot seriously propose to default on payments of interest on the public debt. We cannot abrogate legally binding contracts that have been signed in good faith. We must pay our bills when they come due. A change in law is required to reduce social security benefits or pension rights to individuals who might earn the benefits by contributing to retirement systems all of their working lives.

A second general reality in curbing Government outlays is one of timing. The spending pipeline for Federal programs is often a long one. It sometimes takes years after we shut off the funding spigot for the flow out of the end of the pipe to stop. Typically, measures to cut back or terminate programs produce little, if any, savings in the short run. Indeed, spending may rise as employment is reduced and operations are consolidated. Nevertheless, it is important to make such changes to obtain long-run savings. My point here is simply that there is a practical limitation on our ability to reduce outlays greatly in any fiscal year once it is well underway—except by the most Draconian measures. The measures we have taken in the past few months, and such measures as we take in the months immediately ahead, will have a much greater impact on fiscal year 1976 and subsequent years than on the current year. We must continue to push for spending restraint now in any case.

Of concern to all of us is our national security. Defense programs already have been reduced by one-third since 1968, and defense manpower has been cut by over 1.3 million from 3.5 to 2.2 million. The forces programed for 1975 are at the minimum level necessary for our national security and the continuing success of arms limitations negotiations. Further substantial reductions would upset immediately the balance of power throughout the world. Our national security would be jeopardized and our hopes for further success in arms limitations dashed.

In my discussion, I have noted a number of problems which make it difficult to find ways to reduce the Federal budget. The fact that these problems exist does not lessen the administration's commitment to either a policy or an effective program of outlay restraint. Nor do they lessen the commitment of the Office of Management and Budget, the administration's principal agent in carrying out this policy. To be realistic, we must recognize that major budget reductions require tough decisions by both the Congress and the administration. But those tough decisions must be made. They must be made if we are to curb spending this year and also rein Government spending in the longer run.

Thank you, Mr. Chairman.

Senator MUSKIE. Thank you, Mr. Ash.

As we did yesterday, we will use the 10-minute rule in order to extend the opportunity for members to question.

On page 4 of your statement, you speak of a policy of fiscal restraint for fiscal year 1973, as well as 1974. Does that suggest, then, that lack of budgetary restraint is a principal cause of inflation, of the present inflationary pressures?

Mr. ASH. I think most economists and noneconomists would agree that one of the major causes, but not the sole cause, of today's inflation is the degree to which the Federal Government over past years has spent levels of money greater than its income. Sometimes there are substantial lags in that effect. The lag of 1966, 1967, 1968 spending cycle possibly is one that we are seeing some of now. In the spending cycle in 1971 and 1972, with lags, there is also some overspending by the Federal Government which contributed to inflation.

Senator MUSKIE. What I am getting at is this. We are considering several proposals to cut from $5 to $10 billion from the budget as a way of dealing with the inflation problem. Yet, on page 4 and page 5 of your statement you speak of the record of budgetary restraint. You make the point, for instance, that in fiscal year 1973 the deficit which was achieved was $11 billion below the estimate of the original budget.

If the present theory is correct, why should not that have had some impact on inflation? In fiscal year 1974 you say that actual outlays were $6 billion below the estimate of last February.

If the present theory is correct, why did that not solve the inflation problem?

Mr. ASH. Well, I think, Mr. Chairman, the issue here is the one that I mentioned of time lag. That is, the economy is a very big behemoth that goes of its own momentum. A fiscal action in 1 year may not have its main the economic impact for many years hence. We therefore cannot take any 1 year and say that its deficit or surplus is directly correlated to the inflation of that same year. I think we have a general effect here that has arisen from a number of years of Federal budget deficits. It is difficult to identify any 1 year's deficit with any 1 year's inflationary effect, but the general tendency has been one that we must, we believe, bring to an end. That requires getting budgets back nearer to balance. We will benefit in the longer run from doing so.

Senator MUSKIE. What we are trying to ascertain is whether or not the converse of that is true. Both Mr. Rush yesterday and you today argue that over a period of time increased Federal spending has added to inflationary pressures. What we are trying to find out is whether the converse of that is true and, if so, what we can expect for results. The President's emphasis in his speech on Monday was on budget cutting as an important answer to inflation. Mr. Rush said yesterday that cuts of $5 to $10 billion probably would not have a visible impact on inflation the rest of this year or even next year. Would you agree with that?

Mr. ASH. I would tend to agree and maybe the best way to express it is to think of the analogy of an aircraft carrier. This economy is big and large and has its own momentum. If we give it a hard right or hard left signal—a turn signal—in the first 50 or 100 feet or even first mile you might not see much difference in its location. But as it has turned and taken off at a different angle, 2 and 5 and 10 and a hundred miles later you will find a significant effect of that turn. So what we have to keep in mind here is that given the momentum of the economy, and its great size and great bulk, a turn of direction at any moment has very little perceivable effect in the immediately following moments. But it is essential if we are to be at a totally different place down the road some time hence. That is the key part of the views that Mr. Rush expressed and that I am attempting to express. We must not look at the budget as merely a year-to-year exercise. We must look at it as something that steers the course of the economy, or at least contributes to steering the course of the economy, for the longer run. Whichever actions we take—to spend, to not spend—we must keep in mind their effects in our years.

Senator MUSKIE. I understand that, and considering the long term implications is another question. But the question we are trying to nail

down here, if we can, is the extent to which inflation—which is eating the budget of every housewife in this country—is going to be controlled by budget cuts of $5 or $10 billion this year. I gather from Mr. Rush's testimony yesterday that in the short run, that is, this year and next year, the effect is not going to be very visible. Is that your judgment, too?

Mr. ASH. Certainly budget cutting is clearly not the only action that the Federal Government can and must and should take to reduce inflation.

Senator MUSKIE. In terms of producing visible results on the housewife's budget, would you rank budget cutting in the short term over the next 2 years as an important influence?

Mr. ASH. I would rank it very important, not that the statistically measured consequence would be a tremendous one immediately, but not only does it have a long run effect, it has a short term importance. There is a very immediate, important psychological effect. As the President said on August 12, it is important for the Government first to set an example by taking available actions to reduce demand upon the economy. Then we will be in a much better position to ask those in the private sector to take similar steps. So a budget cut can have a multiplying effect, over and above any statistical calculation of its own direct effect, as it affects the psychology of the country.

Senator MUSKIE. I am not talking about a statistical effect. I am talking about the psychology of the housewife who has to make her husband's paycheck stretch. I doubt very much that using the argument you have just given us is going to be very effective as an answer to many housewives in Maine when I go back there this weekend and they ask me, how much I am going to cut the budget and what effect that is going to have on their ability to meet their family's food needs? Is there going to be that kind of an effect?

Mr. ASH. If I were going back to Maine this summer——

Senator MUSKIE. Forget about the summer.

Mr. ASH [continuing]. I would suggest that the war against inflation has to be fought on many battlefronts. There are many individual battles, no one of which can win the whole war. Clearly the budget is one of the important battles to be engaged. I would certainly not want to say that in cutting the budget we have finally found the answer. That is not the fact. The budget is not the only battleground on which inflation will be won.

Senator MUSKIE. I understand that, but I want to make sure that it is in further perspective so that we do not overpromise. We are told by those who observe the political scene that one of the problems with this country is that politicians and political leaders overpromise. I just want to be sure that we do not overpromise what budget cutting will produce by way of dealing with inflation. The second problem I would like to raise—and I only have a couple of minutes more before I have to yield to my colleagues—is this. Offsetting that, the question of whether or not the impact on inflation would be visible in the next year or two is the question of what would be the impact on unemployment of cuts of $5 to $10 billion? What is your judgment in that impact?

Mr. ASH. There would, of course, probably be some effect on unemployment. In fact, this is really part of the issue that the Congress and the administration and the people have to be prepared to deal with. There is a trade-off between inflation, something that we clearly feel that we must do something about, and employment. We cannot totally ignore this tradeoff.

Surely as Federal Government expenditures are reduced, depending upon how they are reduced, unemployment is increased to some degree. If a Federal military base is closed, unemployment in that area is at that moment increased to some degree.

Senator MUSKIE. Will that increase be visible in the next year or two?

Mr. ASH. It would probably be a measurable amount, even as the effect on inflation would be a small but measurable amount.

Senator MUSKIE. Would it be more or less visible than the effect on inflation?

Mr. ASH. Well, for $5 billion, just to put it in a rough range, and, of course, it substantially depends on what form of Government expenditure reduction is pursued, there might be an effect of one-tenth of 1 percent or more for a $5 billion reduction in Federal expenditures. Now, there are some kinds of expenditures——

Senator MUSKIE. You are not talking about appropriations. You are talking about expenditures?

Mr. ASH. I am talking about cash outlays. There could be some kinds of expenditures that produce up to two- or three-tenths of 1 percent. Clearly, the issue is trade-off among unemployment, growth, and inflation. We must look at them as a simultaneous equation that needs to be solved, rather than taking them up and solving only one at a time.

Senator MUSKIE. I will pursue this further if my colleagues do not cover the subject exhaustively before my next turn.

I yield at this point to Senator Dominick.

Senator DOMINICK. Thank you, Mr. Chairman.

Mr. Ash, in your statement you say that we have to "lessen the problem of too many dollars chasing too few goods."

That brings up the Cost of Living Council right away. Would you not say controls put the system of supply and demand very substantially out of balance?

Mr. ASH. I would surely say so. I think in retrospect we can draw one conclusion to which I at this moment know of no exceptions. The wage and price control system that we had contributed nothing to increasing supply or reducing demand. It is perverse in its long range effect.

Senator DOMINICK. In fact, in many cases it reduced supply.

Mr. ASH. Quite often, and increased demand.

Senator DOMINICK. And increased demand. One of the things I am thinking about is when we kept the controls on meat prices. One of the things that apparently was not taken into account at all was that you get side products from the meat which make rubber. As a result, we have to go into some totally different type of process in order to try and supply enough rubber just because we did not have meat available.

Now, as I understand it, supply and demand are very interlocked in our economy and the question in my mind is how far or how long in your estimation, will it take to get supply and demand back in balance?

Mr. ASH. It is greater in some areas than in others. But I think what we need now is a set of programs and certainly as the chairman has indicated, this is not one that——

Senator DOMINICK. I am not talking about energy now. I understand that.

Mr. ASH. Yes. But even in other areas, other critical areas, I am sure that we are looking at years, not months, to fully get supply up to the level that either it would have been without controls or that we believe that it must be in order to meet demand and in order to hold down prices. The main way to hold down prices and, therefore, to control inflation is by having an adequate supply available to meet demand. This is what we must give primary attention to. Certainly, the short term measure of budget restraint is not the longer term answer, which is increased supply.

Senator DOMINICK. Well, I would say that this is, therefore, a big factor in controling inflation. Is that correct? One big factor, supply and demand.

Mr. ASH. Absolutely, yes, sir.

Senator DOMINICK. All right. Now, the second thing which relates to this problem, it seems to me, is what might happen, the feeling of confidence in the financial world in terms of investment. That small German bank—I have forgotten the name of it—that failed created a net loss almost in one afternoon of over $30 billion. Some of our own financial institutions were affected and I am talking about all the way from Seattle to New York. What are we doing, if anything, about that or should I address those to Mr. Burns next week?

Mr. ASH. Or Secretary Simon, who I believe will be following me this morning.

Senator DOMINICK. There are some articles presently appearing in the news magazines which would indicate that we are in for a collapse, economically, which is worse than the 1929 depression. What comments do you have on that?

Mr. ASH. I do not believe that to be the case. I think we certainly see signals that suggest plenty of work for all of us to do.

Senator DOMINICK. What kind of work?

Mr. ASH. The President is especially looking forward to the meetings that he will be having with the Members of the Congress for the purpose of determining the kind of work that we together should be doing. It is work that cannot be done solely by the Executive, solely by the Congress, or even solely by the Government. One of the purposes of the summit conference that he had called—and it includes people from outside of the Government—is to develop an agenda for work that needs to be done. I am sure we all have many ideas that will have to interact with other ideas to produce an agenda of work to be done. I think we can clearly identify some of that work even now. Part of it has to deal with the budget. Also we cannot help but acknowledge a very important role for monetary policy. If you will be meeting with Dr. Burns, that will, I am sure, be a key subject. There

is the matter of supply increases and the matter of reexamining regulation and its effect on the economy. Issues of capital flow and capital availability in the private sector to expand needed capacity are terribly important parts of the work that has to be done. The international work, in particular dealing with the Arab countries in the petroleum area, is certainly a key item on the agenda. There is the whole business of agriculture and increased supply. We cannot do much about the weather, but nevertheless we are fortunate to have planted so much that the problems of weather this year have been mitigated. There is work across a broad front.

Senator Dominick. Now, let me get back to this question of budget cutting and whether in fact it means unemployment. I gather that you think there is a relationship depending upon where you cut and how much you cut from the Federal budget. Most of the State treasuries are in surplus now, either from revenue sharing or from their own activities within the State. It is not necessarily true, is it, that if the Federal Government cuts back the budget that, therefore, whatever program is involved cannot be picked up by the States?

Mr. Ash. It could well be. It could work out as it has when we have from time to time gone through other expenditure reduction exercises, like closing a military base. People may be unemployed for the immediate moment but may become reemployed in the private sector, and could well turn out to be as productive or maybe more productive. I remember the anguish and concern last year when military bases were closed in Rhode Island and Massachusetts.. Yet, just 2 weeks ago I saw a Massachusetts newspaper that said it is probably the best thing that could have happened. Those people are no longer working for the Government. They are working in the private sector and improving the economy of the area, rather than having it dependent upon the Government payroll as it theretofore had been. So when I say that a reduction of employment would follow, I do not mean to discount the possibility of reemployment of those same people. Quite possibily they would be reemployed in a more productive activity and, therefore, improve the whole of the economy.

Senator Dominick. Yesterday I asked Mr. Rush if he could supply me, and I got a kind of a affirmative—maybe you can do it easier than he can—what programs have been instituted in the last 13 years which have given rise to the increase in the national budget from $100 to $300 billion. It took us 185 years to get to $100 billion. It took us another 9 years to get to $200 billion. And it took us another 4 years to get to $300 billion. If we keep on progressively at that rate, the Federal Government will be doing everything. What we need to do, it seems to me, is to look at some of those programs, find out why we did them and whether they are still necessary.

Mr. Ash. Senator, before we go into individual programs let me provide you with an overview using Federal outlay data from 1955 to 1975. I have it both in absolute dollars and in constant dollars. I think it may be more useful to look at it in constant dollars, since that series excludes the effect of the changing value of the dollar.

[The following material was subsequently supplied for the record:]

FEDERAL BUDGET OUTLAYS IN CONSTANT (FISCAL YEAR 1969) DOLLARS

[In billions of dollars]

Fiscal year	National defense	Payments to individuals	Grants-in-aid to State and local governments	Net interest	All other	Total outlays
1975 estimate	55.0	79.4	35.0	11.6	17.2	198.2
1974 preliminary	54.1	72.1	34.2	12.2	18.4	191.0
1973	56.7	67.1	35.7	13.0	21.0	193.5
1972	62.8	60.7	30.4	12.8	25.2	191.8
1971	66.8	55.9	26.3	12.5	22.2	183.7
1970	73.8	48.1	22.5	12.3	24.7	181.4
1969	81.2	45.4	20.2	12.7	25.0	184.5
1968	84.5	41.4	19.6	13.8	30.5	189.8
1967	75.5	38.2	16.9	13.1	29.6	173.3
1966	62.9	33.3	15.0	13.4	28.4	153.0
1965	56.5	30.5	13.0	13.5	25.8	139.4
1964	63.3	30.3	12.4	13.5	24.1	143.7
1963	63.5	30.0	10.8	13.6	20.8	138.7
1962	62.7	28.2	10.1	13.4	21.2	135.6
1961	58.0	27.5	9.3	13.0	16.8	124.7
1960	57.5	24.4	9.6	13.1	15.4	120.0
1959	58.5	23.4	9.2	13.2	17.9	122.2
1958	57.7	21.3	6.9	13.0	14.0	112.9
1957	57.3	17.6	5.8	13.0	15.1	108.7
1956	56.7	15.9	5.6	13.7	13.7	105.5
1955	59.7	14.9	5.0	14.3	13.6	107.5
FEDERAL BUDGET OUTLAYS IN CURRENT DOLLARS						
1975 estimate	87.7	113.9	52.1	23.0	28.7	305.4
1974 preliminary	78.8	94.3	45.9	21.5	27.8	268.3
1973	76.0	80.6	43.9	17.4	28.7	246.5
1972	78.3	70.0	35.9	15.5	32.1	231.9
1971	77.7	62.2	29.8	14.8	26.9	211.4
1970	80.3	50.9	23.9	14.4	27.1	196.6
1969	81.2	45.4	20.2	12.7	25.0	184.5
1968	80.5	39.5	18.6	11.1	29.1	178.8
1967	70.1	35.2	15.2	10.3	27.4	158.3
1966	56.8	29.8	12.9	9.4	25.8	134.7
1965	49.6	26.7	10.9	8.6	22.7	118.4
1964	53.6	26.2	10.1	8.2	20.4	118.6
1963	52.3	25.6	8.6	7.7	17.1	111.3
1962	51.1	23.8	7.9	6.9	17.2	106.8
1961	47.4	23.0	7.1	6.7	13.7	97.8
1960	45.9	20.1	7.0	6.9	12.2	92.2
1959	46.6	19.0	6.7	5.7	14.0	92.1
1958	44.4	17.1	4.9	5.6	10.6	82.6
1957	42.8	13.6	4.0	5.4	11.0	76.7
1956	40.3	12.0	3.7	5.1	9.4	70.5
1955	40.2	11.2	3.3	4.9	8.9	68.5

SOME MAJOR PROGRAMS IN SELECTED CATEGORIES OF THE PRECEDING TWO TABLES

Payments to Individuals:
- Social security
- Railroad retirement
- Civil service retirement
- Veterans benefits—disability compensation, pensions, GI bill, insurance
- Medicare
- Supplementary security income
- Benefits for disabled coal miners
- Unemployment insurance benefits

Grants-in-Aid to State and Local Governments:
- General Revenue Sharing
- EPA construction grants
- Federal aid to highways
- Urban renewal
- Low-rent public housing
- Education grants
- Manpower assistance
- Medicaid
- Public assistance payments
- Social and rehabilitation services
- Food stamps
- Child nutrition, special milk, and school lunch programs
- Law enforcement assistance

All Others:
Legislative and judiciary branches
Foreign aid
Agriculture price supports
General operations of most major departments—Agriculture, Commerce, Justice, State, Transportation, etc.
Health research
Federal public works construction
NASA
Veterans medical care

Mr. Ash. If I take the whole period, 1955 to 1975, in constant dollars, defense programs have decreased over 5 percent; alternatively, if I take the period from 1968 to 1975, defense is down one-third.

But now let us look at nondefense because this is where the increases have occurred. Over the period from 1955–75, while defense has been going down, payments to individuals on a constant dollar basis are up over 400 percent from $15 billion (in 1969 dollars) to $79 billion. So payments to individuals have multiplied over five-fold. Over the same time however, grants-in-aid to State and local governments have gone up 600 percent. These are two areas of tremendous increase.

Now, let us just take the 1968 to 1975 increases in payments to individuals and grants-in-aid to States and local governments. In each case they have nearly doubled, while defense has decreased by one-third. If we are looking at the change of mix and what has been the source of additions we will find them to be largely payments to individuals and grants-in-aid to State and local governments.

Now, if you wish, I can go into some of the individual programs or explain to you in some detail what is in each category.

Senator Dominick. Mr. Chairman, my time is up unfortunately, and I will come back to you on it.

Senator Magnuson. Go ahead. I will yield.

Senator Dominick. Thank you. Go ahead.

Mr. Ash. I can go into what some of those programs are. I do not happen to have with me the detailed outlay information over the 1955–75 period on particular programs, but let me at least identify the programs I have in mind when I say payments to individuals.

Senator Dominick. All right. I would ask the chairman if we could put in the record whatever paper you are reading from.

Senator Muskie. Without objections.[1]

Mr. Ash. All right. I will extract from the paper because it has lots of extraneous data as well but, I will put in that which is related to this particular line of questioning. Would that be satisfactory?

Senator Muskie. Yes.

Mr. Ash. Payments to individuals include social security, railroad retirement, civil service retirement, unemployment benefits, veterans' compensation and pensions, veterans' readjustment benefits, payments to disabled coal miners, supplementary security income, medicare, and military retirement pay.

Now, let us talk about the grants to State and local governments. These include public assistance, rehabilitation and social services, medicaid, and general revenue sharing.

These are the prime programs that have accounted for the kinds of increases we are talking about. So that is really what has been happening not only in the last 20 years but especially in the last 5 or 6 years.

[1] The information referred to may be found on p. 119.

There has been a substantial increase in these programs and substantial decreases in defense.

Senator DOMINICK. I thank the witness and I thank the Senator from Washington for yielding the time.

Senator MUSKIE. I yield to Senator Magnuson.

Senator MAGNUSON. Mr. Ash, I am sorry I was not here for your original statement but I did read it earlier this morning.

There has been a great deal said around the country, and it has been said mainly by people in the executive branch, not only the past administration but it even is being said now, that Congress is some sort of a big spender. Is that correct?

Mr. ASH. I heard those statements, yes, sir.

Senator MAGNUSON. All right. Do you not think as Budget Director you ought to correct this misinterpretation?

Mr. ASH. Well——

Senator MAGNUSON. I am asking you——

Mr. ASH. It seems to me——

Senator MAGNUSON. Well, I will preface it with this remark. Have we, the Congress, not been under the administration budget appropriation request every year of the last several?

Mr. ASH. No. That is not the case.

Senator MAGNUSON. I am talking about appropriations.

Mr. ASH. You are correct when you are talking about appropriations.

Senator MAGNUSON. Yes.

Mr. ASH. But a big portion of Government spending has nothing to do with appropriations. You have more than offset——

Senator MAGNUSON. I am talking about appropriations.

Mr. ASH. You are correct.

Senator Magnuson. Let us nail it down. Have we not been under the budget?

Mr. ASH. The Congress has year after year——

Senator MAGNUSON. All right. Then, why don't you or some administration spokesman say so?

Mr. ASH. I would like to say it quite publicly.

Senator MAGNUSON. All right. Tell it to these people.

Mr. ASH. If I can make it——

Senator MONDALE. Let us hear it.

Mr. ASH. Year after year the Congress has appropriated less moneys than in the President's budget even as the Congress——

Senator MAGNUSON. Stop right there. [Laughter.]

Mr. ASH [continuing]. Year after year has authorized payments far in excess of the President's budget.

Senator MAGNUSON. Well, all right. Authorizations.

Mr. ASH. And mandated programs.

Senator MAGNUSON. The new President of the United States said on Monday night he was going to sign a $1,700 million authorization bill.

Mr. ASH. But authorizations that have mandated expenditures are taken out of the control of the Executive.

Senator MAGNUSON. But they have to come through the budget and you have to ask for an appropriation.

Mr. ASH. No, sir.

Senator MAGNUSON. Yes, they do.

Mr. ASH. The expenditures are mandated. The Congress authorizes——

Senator MAGNUON. You have to come up and ask for it.

Mr. ASH. Yes, but we have no alternative but to pay the bills that are imposed on us.

Senator MAGNUSON. You have got to pay all of these things you just read off—retirements to the military. Military is now 56 percent payments to people.

Mr. ASH. That is right.

Senator MAGNUSON. Not the other hardware we used to worry about.

Now, one other thing. We are getting down to the budget aspects which are in my ball park; namely the HEW appropriations bill. We are going to cut this year's budget. We cut $5,700 million from the defense request and we are having a final markup. This morning I am going to start marking up the HEW bill at 11 o'clock. That is a very extensive bill and how you cut and where you cut are very important. The problem is one of priorities, really. But the overall total is going to be under the budget of the administration.

Mr. ASH. We would sure welcome that.

Senator MAGNUSON. We are trying to do our job with appropriations up here and I would like the cooperation of this administration and we want cooperation to go both ways. We do not want to be accused of all these things when they are not true.

Mr. ASH. We welcome the opportunity to work together in reducing the budget.

Senator MAGNUSON. Now, we will see how you cooperate. Have you started on a supplemental?

Mr. ASH. A supplemental will be prepared here soon.

Senator MAGNUSON. Yes, but you are ready to start.

Mr. ASH. Yes.

Senator MAGNUSON. The other one is out of the way. You will know what the appropriations will be by the end of next week within 1 percent. One percent one way or another.

Now, I have gone through this. We cut the original budgets and then lo and behold, up come appropriation bills in billions of dollars. Not hundreds of millions. In billions, sent up by the administration. That is true with all administrations.

Now, I want to know if you are going to cooperate with us in the good job we are going to do and have been doing on cutting the budget. Do not send up another $5, $6 billion supplemental bill. What good is it then to cut this one as we move along? And this Budget Committee will have a chance to look at the supplemental. There has not been much chance to look at what is going to date but the supplemental, I want you to send up a bare bones supplemental, only including those things that came up which you could not help, such as obligatory payments. But do not come up with all of these other supplemental requests. Last year on HEW you had a billion two or something like that, including OEO and all these other things. We had a $4 or $5 billion supplemental before we got through. So what is the use of us going through all of this if you are going to come up a supplemental that is going to undo it all?

Mr. ASH. Senator, I have not introduced——

Senator MAGNUSON. I do not say you are not going to do this. I am suggesting that you do cooperate with us once in a while.

Mr. ASH. Senator, I have not introduced Dale McOmber who is Assistant Director of OMB and is in charge of preparing that supplemental. He might like to describe the nature of the supplemental without getting into its particular programs and amounts but I think it is important that the record understand and the nature of the supplemental is going to come.

Senator MAGNUSON. How much is it going to be?

Mr. MCOMBER. Senator, there are before you a number of items which the Appropriations Committees have deferred from consideration in the regular appropriation bill.

Senator MAGNUSON. Yes.

Mr. MCOMBER. Now, among those——

Senator MAGNUSON. In order to cut.

Mr. MCOMBER. Pardon?

Senator MAGNUSON. That is some of the cuts we are making. Now, we do not want to defer them to supplement and then have you come with a supplemental and put them back in.

Mr. MCOMBER. No, sir. We do not intend to do so.

Senator MAGNUSON. All right. That is fine.

Mr. MCOMBER. But let me point out there are a number of education items that are not before you. Earlier, there was a reference to recent education bill that the President indicated he would sign. We have not transmitted those estimates and we must, of course, transmit them in order for the Congress to act on the programs. Those kinds delayed transmittals will constitute a major portion of that supplemental.

Senator MAGNUSON. And some things that have not been authorized.

Mr. MCOMBER. Yes, sir. Precisely.

Senator MAGNUSON. That might be authorized between now and the supplemental.

Mr. MCOMBER. Yes.

Senator MAGNUSON. You have to look at that.

Mr. MCOMBER. Yes.

Senator MAGNUSON. But I am just so hopeful we will not go through all of this exercise, and we are working hard on it up here, and then have a supplemental come along that does away with all of the——

Mr. ASH. You can be assured that we would like to do exactly what you have described. We will work with you to the maximum extent possible to achieve the objectives of keeping spending down.

Senator MAGNUSON. On that happy note I will yield back the balance of my time.

Senator MUSKIE. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Director, I do not agree that we are ahead. I think that Congress has the control over the so-called untouchables and we do not do very much about it and I think this is one of the greatest problems we have and until we decide that we are going to deal with those matters, I think we are going to be in trouble.

Mr. Director, I have been disturbed over the trend of expanding cost of Government as nonrevenue producing costs. I have two charts here,

one showing Government spending in 1970 as 30.1 percent of the national income with the projection of 1980 of 50.8. Another chart shows Government spending as 42.3 percent of the personal income for 1973 and I would like, Mr. Chairman, to submit these charts and statements for the record.

Senator MUSKIE. Of course, without objection.

[The information referred to follows:]

[From Newsweek (By Milton Friedman) 1974]

A NEW HOLIDAY

As the quiet succeeded the fireworks (ever more muffled thanks to consumer "protection" laws) on the Fourth of July, it occurred to me that this country needs a new holiday to complement our national Independence Day. The new holiday would celebrate our Personal Independence Day—that day in the year when we stop working to pay the expenses of government—Federal, state and local—and start working to pay for the items we severally and individually choose in light of our own needs and desires.

The new holiday would, of course, have a variable date. As the accompanying table shows, total government spending has grown from about 10 percent of national income prior to 1929 to about 40 percent today. Over the same period, the relative role of the Federal governments has been reversed. In 1929, state and local governments spent more than twice as much as the Federal government; in 1970, the Federal government spent almost twice as much as state and local governments. As he grew, Big Brother moved from town hall and state capitol to Washington.

This change is mostly a product of the past 40 years, dating from the onset of the New Deal. For the first century and a half of our nation's existence, total government spending—so far as we can judge from the meager data available—never exceeded about 10 per cent of national income except in time of major war. And state and local spending was throughout roughly twice as large as Federal spending. Total spending as a percentage of national income nearly doubled in the decade after 1929, and then nearly doubled again in the next three decades.

FROM WINTER TO AUTUMN

Our forefathers would have celebrated Personal Independence Day in dead winter, and our fathers as winter was turning to spring. We would now celebrate it in late spring. If the trend continues, our children will celebrate it in summer, and our children's children in autumn.

A simple statistical extrapolation from the dates recorded in the table for 1929 and later years gives 1988 as the year when Personal Independence Day would coincide with national Independence Day, July 4—though by the time that happens Big Brother may not permit innocent merriment to call attention to his encroachment on our lives and, of course, all signs of fireworks will have disappeared under the disapproving frowns of the NARJFL—the National Administration to Remove Joy From Life.

The variable date of the new holiday is an advantage. Congress or the President would be required to declare the date each year. This would force the one or the other to inform us each year, as neither does now, how much government as a whole is costing us. Such a public announcement might well be more effective than the recent, much-vaunted Congressional budget reforms in imposing some discipline on government spending and perhaps reversing the trend. Moreover, it would enable political candidates dedicated to enhancing our individual freedom to have an easily publicized slogan: "Return Personal Independence Day to March 31" or whatever other date can be made to appear feasible.

Of course the date of the Personal Independence Day that is recorded in the table is a national average. The correct date differs from state to state. Maybe, once a national Personal Independence Day is established, individual states will take steps to establish a state Personal Independence Day.

Can you think of a more attractive competition among states than for them to strive to see which can have the honor of having its holiday the earliest?

GOVERNMENT SPENDING AS PERCENTAGE OF NATIONAL INCOME

Year	Federal	State and local	Total	Date of personal Independence Day
1900	3.4	6.1	9.5	Feb. 4.
1929	3.0	8.9	11.9	Feb. 12.
1940	12.3	10.4	22.7	Mar. 23.
1950	16.9	8.3	25.2	Apr. 2.
1960	22.4	10.4	32.8	Apr. 29.
1970	25.5	13.6	39.1	May 23.
1988			50.8	July 4.

Sources: 1929–70, "Economic Report of the President," 1974; 1900 and 1988, author's estimates.

[From the Congressional Record, Senate, Aug. 13, 1974]

INFLATION

Mr. GOLDWATER. Mr. President, I doubt if there is one Member of the Senate who will disagree with me when I say that inflation, the issues of higher prices, higher taxes, and spiraling spending by the Government, is the No. 1 issue in America today. And, Mr. President, I doubt if many of the Members will dispute my contention that there is a enormous amount of confusion about the causes.

There is the whole question about levels of taxation, Federal and local; the question of how much should be spent on welfare programs, and the question of defense spending.

What we have here is a question of whether Government overhead may soon reach the point where it endangers economic stability. Many of us who have argued for years for economic soundness, for balanced budgets, payments on the national debt, and other facets of good spending politics, believe the point has been reached that the survival of the U.S. economy is now a question of seriousness.

Mr. President, needless to say, I have read many thousands of words about inflation and its relation to Government spending, personal income, and other items. But never have I found a more concise, direct treatment of this issue than a tract put out recently by the Committee for Monetary Research and Education, Inc. The pamphlet was written by Wesley H. Hillendahl, a vice president and director of business research for the Bank of Hawaii, and sent to me by Dr. Felix Warmser. Because of its enormous importance I ask unanimous consent that the entire pamphlet be printed in the Record.

There being no objection, the contents of the pamphlet was order to be printed in the Record, as follows:

BIG GOVERNMENT'S DESTRUCTION OF THE AMERICAN ECONOMY

(By Wesley H. Hillendahl)

The issues of higher prices, higher taxes, and spiraling government spending are on every thoughtful person's mind. It is generally understood in a vague way that the problems of inflation, expending credit demands and high interest rates are related to big government. Yet the notion is prevalent, among welfare recipients, educators and businessmen alike, that somehow funds from Washington are free for the asking—no strings attached—and each is obliged to compete for funds which otherwise will be granted elsewhere.

One may properly ask, just how critical are the levels of taxations and government spending today? Can government overhead reach the point where it endangers economic stability? Further, did the urgency in the President's message early in 1973 reflect a concern about a resurgence of inflation as a consequence of increased government spending, or did it reflect a deeper concern related to a more profound issue: namely, the survival of the United States economy?

For many decades the combined spending by local, state and federal governments has been creeping up as a share of the income of the private economy. In fact, the trend has been in effect for such a long time that it is largely taken for granted.

Our purpose here is to attempt first to establish a relationship between the size of governments in the United States and the requirement for accelerating inflation, more or less sustained high interest rates, and chronic problems in the credit markets; and second, to employ this relationship as a basis for evaluating the future consequences if government continues to take an increasing share of private sector revenues.

GOVERNMENT CAN ONLY SPEND THAT WHICH IT FIRST TAKES FROM PEOPLE

In this analysis, person income is used as a basic measure of the private sector of the economy. The concept of personal income is useful because all direct and indirect taxes and sources of government income are ultimately paid by the people out of personal income. For example, all corporate taxes must ultimately become part of the purchase price of consumer products. Taxes on intermediate products which are consumed by companies must in turn be included in the price of the final product or service for which the consumer pays. Also, all direct services and products provided by government-owned activities are ultimately paid out of personal income. So all government revenues must ultimately be paid by the people.

In passing we note that government spending is conventionally related to Gross National Product (GNP). However, this ratio tends to mask the growth of government because GNP includes government spending as one of its components and therefore is not useful in this analysis.

TREND OF EXPANDING COST OF GOVERNMENT

Following the Great Depression when combined government spending at the federal, state and local levels rose to between 20 and 23 per cent of personal income, World War II briefly required a level of government spending amounting to more than 62 per cent of personal income, accompanied by acute inflation of prices. By 1947, government spending returned to about 23 per cent. Subsequently, over the years government spending has gradually taken an increasing share of personal income. Spending reached 35.6 per cent in 1960, and 41.7 per cent in 1970. In 1973 government absorbed 43.3 per cent of personal income, twice the share of 40 years ago.

GOVERNMENT SPENDING RELATED TO PERSONAL INCOME IN THE UNITED STATES

Year	Total personal income (billions)	Total Government spending [1] (billions)	Ratio Government spending, personal income (percent)
1950	$227.6	$63.1	27.7
1955	310.9	100.8	32.4
1960	401.0	142.6	35.6
1965	538.9	198.0	36.7
1970	808.3	337.1	41.7
1972	939.2	408.6	43.5
1973	1,035.5	448.5	43.3

[1] Combined total of Federal, State, and local governments.
Source: Economic Report of the President, February 1974, pp. 266, 328.

1950–60 A REFERENCE PERIOD

Adjustments of the highly inflationary World War II period having been accomplished, business became relatively stable and profitable during the 1950's. Being one of the relatively more stable periods of this century, this period was selected as a basis for comparison with subsequent periods. It was characterized as follows: new capital for consumer and business investment was adequate, interest rates were reasonable. As an example, yields of AAA bonds were in the 3 to 4 per cent range. During this period, the money supply M2 (defined by money in circulation, and demanded and savings deposits in commercial banks) expanded at about 3½ to 4 per cent annually. This constituted a noninflationary growth of the money supply as it paced the growth in real income which, for well over a century, has averaged about 4 per cent in the United States.

However, the deterioration of liquidity (retained cash) in the economy, including business, financial institutions, and individuals, indicated trouble ahead. While liquidity may have been somewhat excessive in 1950 as a result of savings accumulated during the war, liquidity was clearly deteriorating by 1960.

This warning signal reflected in part the fact that government spending was becoming a larger share of the total economy and that the government was draining off liquidity through taxation. The burden of the federal, state and local government rose from about 28 percent to about 35 per cent of personal income during the 1950's.

1960–65: MILDLY INFLATIONARY

Then during the first half of the 1960's, inflation began to creep up. Capital remained generally adequate, but as inflation increased, interest rates also began to rise in anticipation of additional inflation. For example, AAA bond yields rose to between 4 and 5 per cent as compared to the previous 3 to 4 per cent level. The burden of government by 1965 had risen to about 37 per cent of personal income and the money supply, M2, was being expanded at about 6 per cent annually. The liquidity picture continued to deteriorate. The government burden having continued to increase, necessary credit expansion was becoming increasingly inflationary.

1965 A CRITICAL YEAR

During the second half of the 1960 decade, inflation of the money supply (M2) picked up additional steam.

Because the relationship between the rate of expansion of the money supply and wages and prices was well established, it followed that increases in the levels of both wages and prices, also began to accelerate. However, because prices paced the rise in income, the vast in average family incomes between 1965 and 1970 produced only a small increase in real income. The expansion of money reached a peak of over 10 per cent, and bond yields soared from the previous 4 to 5 per cent level to well over 8 per cent.

Apparently a critical point had been reached in 1965. The internal liquidity generated by individuals and business was no longer adequate to supply the credit requirements of the nation. While this condition had been imposed temporarily during wars and previous periods of tight money, it now extended continuously even through periods of monetary ease. By 1970, the burden of the government reached 42 per cent of personal income. Over the years, government spending at all levels nationally had been expanding at a rate of about 11 per cent per year as compared to personal income which was increasing at a little over 8 per cent. The gap between personal income and government overhead continued to close and the consequent loss of liquidity in the system forced more and more people into the credit markets.

As a further indication of loss of corporate liquidity, the average yield in constant dollars on stocks in the DOW Jones Industrial Index declined from between 2.7 and 3.0 per cent in 1965–1966 period to less than 2.0 per cent in 1973. This represents a decline during the period of about a third. Correspondingly, the Dow Jones Industrial Average, expressed in constant dollars, declined by about 25 per cent during the period. Similarly, the percentage after tax profits on stockholders equity in all manufacturing corporations is presently below the level of 1965.

1970 TO PRESENT: MORE GOVERNMENT AND INFLATION

Subsequently to 1970, the expansion of money supply continued to accelerate, expanding at times by as much as 14 per cent annually. This rate of inflation has had serious consequences, one of which has been the imposition of controls. However, the New Economic Program with its various phases of controls merely masked the basic problem of accelerating credit expansion in response to the critically low level of liquidity as a consequence of the expanding burden of government.

PYRAMIDING DEBT AND INTEREST

As a result of these trends, the total debt accumulated in both the public and private sectors of the United States economy has risen tenfold in thirty years from a level of $189 billion in 1940 to $1,839 billion in 1970. During the same period debt on a per capita basis has increased more than sixfold to $8,979 and interest payments more than thirtyfold to $651 in 1970.

PER CAPITA DEBT AND INTEREST PAYMENTS IN THE UNITED STATES

Year	Total public and private debt (billions)	Per capita debt	Per capita [1] interest
1940	$189.8	$1,431	$21.50
1945	405.9	2,889	43.35
1950	486.2	3,192	71.80
1955	604.9	4,008	140.25
1960	872.4	4,828	217.30
1965	1,245.6	6,441	288.50
1970	1,839.7	8,979	651.00

[1] Calculated at the prevailing prime rate in each year.

As in the case of total government spending, we have related combined public and private debt to personal income because in the long run, all interest and all repayments of principal must be borne by the consumer either in the form of direct payments to the government and financial institutions or in the higher purchase price of goods and services.

BIG GOVERNMENT CREATES NEED FOR CREDIT EXPANSION

A comparison of the 1950's when the rate of growth of the money supply (M2) was maintained at less than a 4 percent rate, with the 1960's when money and credit began to expand very rapidly, leads to the observation that about 20 to 25 percent in the maximum total government overhead on personal income that the economy can support while maintained at noninflationary environment. As the government absorbs 30 and 40 percent or more of personal income, what once was a highly expansonary growth in money, M2, say 8 to 10 percent, became inadequate to support credit demand. Then 14 percent growth became a policy of "active ease." Today, a reduction in the growth of money to the 7 percent range is becoming "constraint" on credit.

The amount of new credit required by the economy in proportion to personal incomes increases as government burden encroaches on the private economy. This reflects the drying up of retained cash as the government syphons it off via higher tax rates. On the basis of the experiences since the 1950's, at the point where government absorbs 40 percent of personal income, requirements for credit are almost twice as high in relation to personal income as when government absorbs 30 percent. At the 50 percent absorption point, new credit requirements will climb to three times what they were in relation to personal income at the 30 percent point. In other words, around 1950, for $1,000 of personal income, total credit requirements were about $75. For comparison, by 1978, credit required to support $1,000 of personal income may reach $200, depending on the phase of the business cycle. The growth of public spending and the resulting growing tax burden, which necessitates an ever more rapid expansion of credit, appears to be the underlying cause of the inflationary monetary conditions which historically have been associated with big government.

This relationship between public spending and the expansion of credit also accounts for an apparent paradox which exists during periods of accelerating inflation—the faster the money supply is expanded the less money is available to conduct private business.

CREDIT EXPANSION GENERATES MONETARY INFLATION

The basic point is that as government grows beyond where it absorbs more than about 20 to 25 percent of personal income, the growth of the nation's money supply must be accelerated to inflationary rates. Then, as the size of government grows from 40 to 50 percent or more of personal income, the rate of expansion of money must become hyperinflationary to accommodate the spiraling credit requirements of the economy.

This is not to say that turbulence in the credit markets and inflation cannot be engineered at any time, either by the monetary authorities under a central banking system as, e.g., in Germany after World War I, or by large financial interests in a less centralized system, e.g., financial panics in the United States

around the turn of the century. The point is, that once government grows to a certain point with relation to the size of the private economy, inflation is unavoidably necessary and must proceed at an accelerating rate as government continues to grow.

What was considered a highly expansionary rate before 1965, has now become restrictive, showing that the liquidity shortage is becoming more acute: a higher rate of credit expansion is necessary to maintain the economy. The critical transition occurred in 1965 from a relatively non-inflationary environment to one in which accelerating credit expansion became necessary to offset the drain of the total government overhead on the private economy. Nationally, credit requirements have doubled over the last decade as a consequence of diminishing liquidity, and may be expected to accelerate in the future.

MONETARY INFLATION CAUSES WAGES AND PRICES TO RISE

Rapid expansion of credit and the accompanying monetary expansion must always result in comparably rapid increase in wages and prices. The close correlation between inflating a nation's money supply and increases in prices is demonstrated by the following statistics compiled by Beryl Spinkel, Economist for Harris Trust and Savings Bank, for the Canadian Standing Senate Committee on National Finance, Ottawa, Canada, June 10, 1971.

MONEY SUPPLY AND PRICE INCREASES 1965–68

[Compound annual rates of change, in percent]

Country	Money supply/real gross national product	Consumer Price Index
Brazil	35.3	37.9
Chile	29.0	27.6
Argentina	22.6	26.6
Colombia	11.2	10.4
Peru	7.7	9.0
Ecuador	4.4	2.3
Mexico	3.8	3.6
Italy	6.2	3.1
Japan	4.9	4.3
France	4.8	4.9
West Germany	2.5	2.2
Canada	2.2	2.2
Switzerland	1.6	2.3
United Kingdom	1.4	3.1

Note: A high rate of increase in prices always accompanies high rate of monetary inflation. Conversely, when the rate of monetary expansion is held in check prices are stable.

Source: International Financial Statistics, International Monetary Fund.

Hence, only by alleviating those conditions including the growing tax burden, which require high rates of monetary expansion can a stable price structure be restored in the United States.

WHITHER INFLATION?

There is a tendency to treat inflation as if it were a threat rather than an actuality. In this regard the words "renewed threat" are frequently employed. The record tells another story. Since 1900 the money stock has been increased about 81 times, at an average annual increase of 6.6 percent before 1930, and 7.5 percent from 1933 to the present. On a per capita basis, the monetary stock was $2.712 in 1973 compared to $87 in 1900, an increase of more than 30 times, as shown below:

MONEY STOCK RELATED TO POPULATION IN THE UNITED STATES

Year	Money [1] stock M2 (billions)	Population [2] (millions)	Per capita money stock	
			Amount	Ratio to 1900
1900	$6.6	75.9	$87	1.0
1910	13.6	91.9	148	1.7
1920	34.2	105.7	323	3.7
1930	44.8	122.7	365	4.2
1940	54.2	132.6	409	4.7
1950	152.9	152.3	1,000	11.5
1960	214.6	180.7	1,188	13.6
1970	425.2	204.9	2,075	23.9
1972	525.5	208.8	2,517	28.9
1973	570.2	210.4	2,712	31.2
Estimate:				
1975	750.0	214.0	3,506	40.0
1980	1,700.0	224.0	7,585	87.0
1985	4,500.0	236.0	19,000	218.0

[1] Money stock projected after 1973 on the basis of a relationship of credit requirements shown in figure 6.
[2] Population projected by Bureau of the Census at present average fertility rate of 2.1 births per woman.

Translated into price comparisons based on historical relationship since 1900 between changes in price indices and growth of the money supply, the popular "Big Mac" hamburger which is priced at 75 cents today would have sold for 8 cents in 1900. A $50,000 house today would have sold for $6,000 or less in 1900. Projecting the money supply for 1985 on the basis of expected credit demands (as related in Figures 5 and 6), the corresponding price would be more than $2.00 for the "Big Mac." In little more than 10 years the price of the house would be $150,000 to $200,000, or more. Incredible? Yes, but not really! Not only has the country experienced periods of comparable inflation, but underlying conditions for such out-of-control developments have been in the making for more than 50 years.

THE OUTLOOK

Extending the trends of the last several decades into the future, we may expect that by about 1978, the government burden will reach 50 percent of personal income and well over 60 percent before 1990.

GOVERNMENT SPENDING RELATED TO PERSONAL INCOME IN THE UNITED STATES

Year	Total personal income (billions)	Total Government spending [1] (billions)	Ratio: Government spending, personal income (percent)
1975	$1,185	$554	47
1980	1,758	925	53
1985	2,607	1,545	59
1990	3,866	2,660	67

[1] Combines total of Federal, State, and local governments.
Note: Projected on the basis of 1973 dollars and present growth trends.

As to precedent for probable consequences, one can compare the period of World War II during which government spending rose to a maximum of 63 percent in 1943 and 1944. The money supply doubled over the 5-year period between 1941 and 1946, and by one-third in 1943 alone to accommodate war time credit requirements. Average wage and price levels after the war were proportionately about twice prewar levels in response to war time inflation of credit.

Consequently, as government expands and liquidity continues to decline in the future, the rate of growth of money must be accelerated. By 1980, an annual increase of some 15 percent would be necessary to accommodate the needs of the economy for credit. By 1985, an annual increase in the money supply of 20 percent or more is likely. And that's hyperinflation!

Should the growth of government continue to outpace the private economy, the share of personal income that is left over after the government burden, will begin to level out. Finally, unless the expansion of government is stopped, before the turn of the century residual personal income will plummet. However, as the rate of inflation continues to accelerate, the levels of personal income and government spending will accelerate much faster than is shown, reflecting spiralling prices and wages. On the other hand, "real" after tax purchasing power will follow the trend regardless of the rate of inflation.

Ultimately, as government proceeds progressively to confiscate all earnings, one might expect monetary inflation to reach proportions experienced in France in the 1790's, Germany in the early 1920's, Russia during the five years after the so-called revolution, and Hungary in 1946. Each was followed by a sharp and complete economic collapse, and, in time, some form of totalitarian government.

However, before hyperinflation of such proportion would be generated in the United States it is more likely that an attempt will be made toward the conversion to a totally controlled economy under the guise of some combination of combination of "crises" or "emergencies." Many of the mechanisms to achieve such a conversion have been on the books for years. Congress delegates additional "emergency powers" to the bureaucracy as each new "crisis" is engineered, while at the same time, state legislatures have been impressed with "uniform law" packages to facilitate the ultimate conversion.

As a consequence, the death of the free market in the United States is not likely to come in the wake of a sudden economic collapse, but rather as a gradual, prolonged sinking into the stagnation which is characteristic of controlled economies. The impact would be global, as so many countries are, in varying degrees, dependent on the wealth and production of the United States.

MORAL OVERTONES

The moral overtones to inflation and paternalistic government cannot be stressed too strongly. Whether the period is Greece, Rome, Spain after the Inquisition, revolutionary France of the 1790's or the present, the moral issue is the same: "When in the conquest of power and for political ends a government deliberately engineers inflation, all the monetary evils occur as before, and then to these you add such consequences as: first, that as the government expands explosively the people will lose control of it; secondly, as the people receive millions of checks from the automatic printing machines in the United States Treasury they learn to become dependent on government for aid and comfort" (Who is willing to say "No" to federal aid to education, revenue sharing, food stamps, medicare, medicaid, subsidies for housing, transportation, etc., etc.?) "Thirdly, people are first enticed by the benefits and then obliged by authority to exchange freedom for status" (the strings attached to federal aid);" and finally, the revelry of public money, which for a while seems to cost nobody anything, brings to pass a state of moral obliquity throughout society. The monetary debacle is relatively unimportant. The moral debacle is cancerous and possibly incurable."[1]

And it is to the moral debacle which we must ultimately attribute the ensuing economic dark age.

One might be inclined to feel that the economic collapse could be avoided by the government as it is reported to have done during the Great Depression by deficit spending. However, the role of government during the depression is moot, some believing that monetary and fiscal manipulation induced the depression in the first place and then aggravated its effects rather than improving conditions.[2] It must also be remembered that government represented less than 20 percent of personal income before the depression, whereas in the future government will be much larger. Furthermore, even today the market is offering increasing resistance to the outpouring of government issues, and abroad the flood has disrupted the entire international monetary structure. Today excessive government spending is, of itself, the problem, and economic dislocations will only be aggravated by more spending.

---

[1] Garrett, Garet, *The People's Pottage,* The Caxton Printers, Ltd., Caldwell, Idaho, 1965, pp. 101–102. Original copyright 1953.

[2] Rothbard, Murray N., *America's Great Depression,* D. Van Nostrand Co., 1963.

The Keynesian concept of spending our way out of recessions via federal deficits while acting as lady bountiful to the nations of the world in the long run has proved to be destructively inflationary and unworkable as Henry Kaufman of Salomon Brothers wrote: "Compromises with inflation are detrimental to real economic expansion. High rates of inflation ultimately set in motion deflationary forces rather than economic stimulants. Consequently, the distorting influence of inflation should by now have debunked the myth that a moderate rate of inflation does not interfere with real economic expansion and therefore is tolerable. Substantial real economic growth can best be attained in a noninflationary setting." It is clear that constraint in government spending, both domestically and abroad, is the only course that will contain inflation, and provide for real economic growth and a sound monetary system both domestically and internationally.

The extension of present trends offers quantitative evidence in support of this statement. The present size of government is demonstrably excessive. In answer to the question posed initially, the economy is in fact in danger of being toppled or converted to a totalitarian regime within the forseseeable future by further increasing the size of government.

INTERNATIONAL OVERTONES

Inflation is perhaps the most infectious of the 20th Century's chronic diseases, and it has been gaining momentum on a world-wide basis during the last two decades.

The combined average annual growth rates in the money supplies and consumer prices of six European countries, the United Kingdom, Japan and Canada compare with the United States as follows:

[In percent]

Period	Money supply		Consumer prices	
	9 countries	United States	9 countries	United States
1958–64	9.7	2.3	2.8	1.2
1964–69	8.5	5.2	3.8	3.4
1969–73	12.9	5.5	6.1	4.9

The most rampant inflation has occurred in those countries which have developed the most extensive export markets. Under the international fixed exchange rate monetary system, these countries have accumulated the vast amounts of paper dollar credits which have flamed domestic inflation far beyond the rates required to keep their own bureaucracies afloat.

To escape from the inflationary spiral, the European Economic Community (EEC) or Common Market could insulate the economies of its members from imported inflation by establishing a common currency and erecting trade barriers with the United States. Under a policy of isolationism, monetary and price stability could be achieved within the EEC by establishing a fully convertible gold backed currency. However, such a prospect is unlikely because a sound currency would not accommodate the expansive economic policies of the existing European governments, much less the cost of another bureaucratic layer representing the central EEC government which is presently supported by a highly inflationary value added tax (V.A.T.).

RATIONAL ALTERNATIVES

With these sobering prospects in mind, it seems only reasonable that the overall role of government should be reexamined toward the objectives of developing guidelines to limit its size. To implement a program to contain excessive governmental overspending is not easy; the American taxpayer has allowed and even encouraged the condition to become increasingly more acute. If the trend is to be turned around, there must be a genuine desire and steadfastness on the part of the public to do so at this time.

A first step in this direction would be to bring down the rate of growth of combined federal, state and local government spending to parallel the growth of personal income. Having stabilized this relationship, long range targets should

be established to gradually bring total government spending successively to 35 percent of personal income, then to 30 percent and finally to 25 percent of personal income as an upper limit. The goal is to achieve a viable inflation-free economy.

An immediate prohibition must be placed on any further tax increases at the national, state and local levels. More taxes will simply fan the fires of inflation and economic instability. Business, labor and the consumer are constantly cajoled to live within their means; a comparable hard line position with respect to government must be adopted at once.

In working toward a limit on the size of government, it will be necessary to establish rigid priorities for those projects and programs which are conducive to broadening the productive base of the private economy. Emphasis should be placed on improving productivity and profitability of the nation's workers and industries.

On the other hand, as little public money as possible should be spent on programs which stimulate consumer spending and dissipate the nation's resources.

A timetable of specific objectives should be adopted, providing for short, medium and long-term goals in achieving an overall and complete reduction in the size; funding and power of the government over the economy and the individual consumer/taxpayer.

The following are high on the list of the many objectives that demand attention:

1. A review of operating budget requests to trim excesses. Manpower requests, except in absolutely essential public services, e.g. public protection, should be frozen. Present positions should be allowed to lapse by natural attrition.

2. Repeal the Employment Act of 1946. Unless the concept underlying the Employment Act of 1946 with its present interpretation in the full employment budget is abandoned, the burden on the private sector will expand to the point where a reasonable level of unemployment is impossible and the resultant expanding deficits will accelerate inflation and assure ultimate economic collapse.

3. Roll back governmental regulatory and control functions over private enterprises. A by-product of government control has been an increase in nonproductive overhead. Over the last 20 years professionals, such as tax specialists, accountants and attorneys needed to cope with the red tape have doubled their share of the work force.

Successive federal administrations have courted disaster by constraining domestic energy production through two decades of price controls on natural gas.

Laws dealing unrealistically with environmental problems have caused major setbacks in the nation's production capacity. More than two years of futile price and wage controls have generated shortages in virtually every industry. Unreasonable O.S.H.A. regulations have hamstrung or bankrupted many small companies.

Utility rates nationwide have increased while service and ability to meet future demands have decreased under regulation. The air and surface transportation industries have been ravaged by federal agencies and Public Utility Commissions. Current moves to convert even more consumer items, e.g. gasoline, housing, food, land, to "public utilities" must be stopped at the outset before more acute shortages develop.

4. Divest government of activities that should be operated with private capital. Government inefficiency in its management functions is most pronounced when it becomes involved directly in business enterprises. Any future solution to the entire problem of spending requires that gradually but surely the government divest itself of all income producing enterprises from parking lots to electric power production, that should be under profit making, tax paying private operation. Many profitable self-supporting private operations have been removed from the tax rolls, thus shifting the total operating burden to "the people" as a result of government's assuming responsibility to operate the enterprises—sometimes in direct competition with private business—on a tax free basis.

5. Stem the growing assault on private property. Restrictive zoning laws, originally designed to provide orderly development of property, have been used to attempt social programming and have instead produced social disruption within the community.

The proposed Federal Land Use bill threatens to eradicate the traditional concept of private property, the very cornerstone of the free market economy.

6. Rather than abrogate the process of collective bargaining, as is being advocated in some quarters, subject monopolistic labor unions to the same type of anti-merger and anti-monopoly laws under which business operates, or overhaul both labor laws and anti-trust laws. Repeal collective bargaining laws which permit public employees to strike and to hold the taxpayers as economic hostages. The massive economic deprivation of citizens by the blockades of monopolistic unions must be eliminated.

Likewise, any additional labor legislation that allows compulsory unionization and/or special tax privileges to political pressure groups should be abandoned. All sectors of the economy should be equal before the law.

Subject labor unions to the same restraints on political activity as business, or exempt both from restraints.

7. Target incremental tax reductions and remove regressive and punitive tax assessments from those that contribute the most to economic development through investment and greater productivity. A flat tax rate, applicable to all who must pay taxes is the surest way to drive home the point that the burden of taxation is a deprivation of the economic freedom of all individuals.

8. Eliminate the need for burgeoning welfare roles by checking the root causes of inflation. The cushion against failure became excessive when it became possible to derive more income by being on welfare roles than from being a productive worker.

9. Review the role and functions of the central banking system with regard to monetizing federal deficits and economic manipulation. A halt must be brought to the growth of the federal debt which reached $475 billion in March, 1974.

10. Bring the far-flung federal foreign aid program into reasonable limits. President Nixon reported the federal government has given $200 billion in foreign aid since World War II. These programs have been a major factor in the accumulation abroad of short-term credits against gold, and have had a serious impact on the nation's debt.

11. Finally, move toward a realistic readjustment of the value of reserve gold to reflect the realities of international trade. Return of dollar convertibility to gold is essential to restore the confidence of our trading neighbors, and to provide a brake against out-of-control government spending.

Senator FANNIN. With the public sector representing 39 percent of economic activity we are depending on only 61 percent of all activity to generate increases in real income. Total activity in my estimation cannot be great enough to generate increase in real income if 39 percent is drained off into the public sector. If we are going to continue or increase apparent level of public sector activity then we must prepare ourselves to accept one of only three possible alternatives. No. 1, lower real income growth. No. 2, inflation. And No. 3, some combination of the above.

Would you care to comment?

Mr. ASH. I would comment by agreeing that your statement points out important problems.

Senator FANNIN. When we are talking about cuts in the budget, many feel that cuts in the budget cannot be made or should not be made in many instances but if we are going to have confidence in the dollar, if we are going to have confidence in many sectors, would not cuts in the budget have a salutary effect domestically and internationally?

Mr. ASH. They surely would. That was the point I was making to the chairman. One of the main objectives, over and above the direct effect on the economy of reducing demand, is the effect on the psychology of the country, that the Government is taking the lead and setting the example, is pointing the way. It is showing the other countries of the world that we mean business. It is important that we reduce

the budget for those purposes alone, let alone any direct effect on inflation.

Senator FANNIN. We have heard a great deal about special drawing rights and the problems that we have as far as the exchange values of currency, the measurement that is utilized that I have heard most about has been the budget, the condition of budget, of members of the IMF whether they are balanced or surplus budgets, whatever it might be, surpluses—is that not true? When we start talking about the monetary sytems of the world?

Mr. ASH. Certainly, as others look at us and we look at them, we give special attention to their own budget position as evidence of their commitment to operate a sound economy. We, therefore, must expect exactly the same treatment from them.

Senator FANNIN. There are exceptions to it because if other varying conditions, especially now with some of the countries that are a position of having tremendous natural resources, the Mideast with their oil resources and then some of the other countries and other resources that are imported into this country, but generally speaking, the condition of their budgets determines the whole program of monetary reform as I understand it.

Mr. ASH. It is certainly a very important part.

Senator FANNIN. We just were discussing about what can be done as far as reducing expenditures and we hear so many times that, well, 70 percent classified as untouchables. I do not know why we have to consider it on that basis. I realize that every dollar in the budget does have a constituency and we are all prone to fight for our personal interests, but also I know that there is a basic responsibility that we all have to fight for a fiscal policy.

Do you feel that we should take a different attitude that affords the so-called untouchables?

Mr. ASH. Let me, if I may, Mr. Chairman, show you a chart that, I think very vividly points out the issue of untouchables versus touchables.

Senator FANNIN. I think that would be——

Mr. ASH. If I may, I would like to work from that chart.

Senator MUSKIE. We will be delighted. I think that would be very helpful if there is no objection. By all means, do so. Without objection, the chart will be included in the record.

[The chart referred to follows:]

FY 1975 BUDGET - COMPOSITION OF OUTLAYS

(IN BILLIONS OF DOLLARS)

MANDATORY SPENDING		
CONTRACTUAL OBLIGATIONS:		
NET INTEREST		23.0
HOUSING SUBSIDIES AND INSURANCE, FARM SUPPORTS, ETC		5.8
OTHER PRIOR-YEAR OBLIGATIONS:		53.1
DEFENSE	(23.0)	
NONDEFENSE	(30.1)	
SUBTOTAL, CONTRACTUAL OBLIGATIONS		81.9
ENTITLEMENT PROGRAMS		142.1
LEGISLATIVE AND JUDICIARY		1.1
TOTAL, MANDATORY SPENDING		225.1
DISCRETIONARY SPENDING		
DEFENSE:		57.1
PERSONNEL	(37.0)	
ALL OTHER	(20.1)	
NONDEFENSE:		35.1
PERSONNEL	(20.0)	
ALL OTHER	(15.1)	
TOTAL, DISCRETIONARY SPENDING		92.2
OFFSETS (OFFSHORE OILLAND RECEIPTS AND CONTRIBUTIONS TO EMPLOYEE RETIREMENT FUND)		-11.8
TOTAL		305.4

AUGUST 1974

FY 1975 BUDGET - CURRENT CONDITIONS

(IN BILLIONS OF DOLLARS)

LATEST PUBLISHED OUTLAY ESTIMATE (JUNE 12)	305.4
POTENTIAL CHANGES:	
MANDATORY AUTHORIZATIONS ENACTED SINCE JUNE 12	.9
PENDING MANDATORY AUTHORIZATIONS	3.7
NONDEFENSE APPROPRIATIONS	.9
DEFENSE APPROPRIATIONS	-1.4
INACTION ON PROPOSED DECREASES	.9
POSSIBLE TOTAL OUTLAYS	310.4
OTHER CHANGES	?

PRESUMES CONGRESSIONAL SUPPORT FOR PRESIDENTIAL DEFERRALS AND RESCISSIONS OF BUDGET AUTHORITY OF APPROXIMATELY $20 BILLION--AND THUS AVOID A SIGNIFICANT INCREASE IN FY 1975 AND LATER OUTLAYS.

AUGUST 1974

SOME MAJOR PROGRAMS IN SELECTED CATEGORIES OF THE PRECEEDING TABLE

Entitlement Programs	Est. FY 1975 Outlays ($ billions)	Beneficiaries affected 1/ (millions)
Social security (OASDI)	62.3	31.5
Railroad retirement	2.8	1.0
Civil service retirement	7.4	1.4
Veterans compensation and pensions	7.5	4.9
Veterans readjustment benefits	2.6	2.5
Disabled coal miners	.9	.5
Supplementary security income	4.8	5.0
Food Stamps	4.0	15.8
Medicare	14.2	12.2
Military retired pay	5.7	1.0
Public assistance (AFDC)	4.6	11.5
Rehabilitation and social services	3.1	10.0
Medicaid	6.3	28.6
Unemployment insurance	8.3	1.9 2/
General Revenue Sharing	6.2	
Postal Service	1.6	
Total	142.1 3/	

Other Prior-Year Obligations vs. Discretionary Spending

Generally, the distinction is between outlays which will result from contracts or other legally binding obligations in existence at the beginning of the fiscal year, and outlays for which, at that time, there are not these commitments. A very wide variety of programs -- including foreign aid, health research, education grants, manpower assistance, military research and evaluation -- have major portions of their outlays falling into both categories.

Personnel, both military and civilian, fall almost entirely into discretionary spending.

Among defense programs, procurement and construction outlays are predominantly from prior-year obligations. Operation and maintenance outlays are almost entirely discretionary.

Among non-defense programs, construction outlays arise predominantly from prior-year obligations.

1/ Includes substantial overlap.
2/ Average number of beneficiaries per week.
3/ Details may not add to totals due to rounding.

Mr. ASH. What this chart attempts to do is to take the 1975 budget of $305 billion—can you all see the numbers from there or are they too small? They are not too small, they are billions. [Laughter.]

Senator MUSKIE. I think the chart is attached to your statement.

Mr. ASH. As you can see there are limits as to what we can do because of our contractual obligations. We must pay interest on the Federal debt; we cannot abrogate that liability. On housing subsidies and insurance and farm supports, we have contractual obligations to third parties which even with legislation cannot be changed unless we intend to abrogate governmental commitments. Similarly, the other prior years' obligations of $53 billion reflect contracts already entered into—to build highways, or environmental installations, or buy military equipment. We already have existing contractual obligations. In order to amend those, we would have to renegotiate contracts. It's not that we cannot, but the likelihood of being able to amend them without tremendous cost is fairly low. Altogether then we have contractual obligations of $82 billion that are right there in front of us.

Now, the next category we have is called entitlement programs. I read to Senator Dominick a list of the beneficiaries of the entitlement programs. These entitlement programs are largely payments to individuals, and to State grants and local governments. They total $142 billion. These all require legislation to change. This is the point, made in the discussion with Senator Magnuson, of mandated authorizations versus appropriations. All of these expenditures derive from mandated authorizations where we have provided a right of entitlement to some individual or some city and State. We have said to them, "If you present credentials that show you meet specific criteria—like being the right age or being ill or having inadequate income—you have a legal right to collect money from the Federal Government." We have, among ourselves, no discretion to change the payment to that person or that city or State. The only way to do so is by changing legislation that changes this right of entitlement. Only legislation by the Congress could do that.

The budgets of the legislative and judiciary branches are considered to be relatively fixed. Under the rule of comity, we in the executive branch presume ourselves not to have any authority to deal with the $1.1 billion that runs the Congress and the courts. We put that as an untouchable, from our point of view at least. Thus there is mandatory spending, by the definitions that I have given, of $225 billion. We can, of course, change entitlement programs by changing the law. But short of such law changes, that is where we are.

Do you wish to stop?

Senator MUSKIE. Would the Senator yield to a question on that point?

Senator FANNIN. Yes.

Senator MUSKIE. With respect to the proposals to cut the budget, are any of them directed at any portion of that $225 billion?

Mr. ASH. Specific proposals to cut the budget are not a matter of public record. Senator Magnuson has discussed the congressional appropriations, at least the Senate part. The House has already taken its position on the defense budget and foreign aid. We have before you now no specific proposals to cut any of those programs. This is not to say that in the discussions that the President will be having with the

Congress, there will not come some reconsideration of our budget recommendations. They certainly should be reconsidered. But we have no specific proposals before you to make any legislative changes other than those that were presented in the budget. The budget presented to you in February proposed specific reductions of $900 million in entitlement programs. These proposals dealt with some of those programs that we have listed, and they are in our current budget estimates.

Senator MUSKIE. If there is no objection, I think it would be useful to include in the record, if the staff would, an itemization of those reductions.

[The information referred to follows:]

Proposed 1975 Reductions Requiring Legislative Action

[Outlay in millions of dollars]

	Amount
Agriculture: Commodity Credit Corporation—repeal disaster payments authorization for feed grain	−175
Health, Education and Welfare:	
Public assistance, reduce income disregard for work-related expenses	−203
Medicaid, end Federal matching for adult dental care	−55
Social security trust funds, eliminate retroactive benefits for months before an application is filed when their payment would require a permanent reduction in the beneficiary's future benefits	−345
Veterans' Administration: Medical care, obtain reimbursement from private insurers	−98
Total, reduction proposals	−876

Senator MONDALE. Would you yield, Senator Muskie.

Senator MUSKIE. Senator Fannin has the time.

Senator MONDALE. I was going to suggest also, if I might, that same record submission could include a detailed recital of the items that go in each of these major headings.

Mr. ASH. We will do that.

Senator MONDALE. I think that would be very helpful.

Mr. ASH. We will do that because I think it is essential that we together look at the budget constructed this way. It provides a feel for the constraints that exist in cutting the budget, or, the other way, it gives a feel for what kinds of actions need be taken if we are to effect budget totals.

Let me go further now and take up the $92 billion under the heading of "Discretionary spending." It becomes quite significant as we move into this discussion. First, there is $57 billion of defense spending. It should be looked at alongside of the $23 billion of contractual obligations if you are looking at the total defense budget. Of the $57 billion of discretionary spending for defense, $37 billion is personnel. I put that separately so when you contemplate action, you can contemplate the different action that has to be taken when you are dealing with defense personnel as opposed to when you deal with defense operations or hardware. All other defense is $20 billion. This is largely operations and the contracts that have not yet been committed but will be made or are in the budget to be committed.

Now we get down to $35 billion of nondefense spending or 11 percent of the budget that we are left to talk about. Personnel costs account for $20 billion of this total. As you know, there is an intention

to reduce personnel of the Federal Government. The reduction will be through turnover, but it will nevertheless be a real reduction. It will cut this $20 billion by some small amount. That leaves $15 billion of other nondefense spending. This is all that remains to be dealt with after excluding mandatory programs, personnel cuts and, defense cuts We have only $15 billion to work with here.

Now, that begins to show you the constraints that we have. What we have done over the years is to move away from a budget that had a fair amount of steering room. In any one year we could take into account the view of the economy and say let us turn it a little to the left, let us turn it a little to the right. Maybe that is not the way to say it. Alternatively, then, let us spend a little more, let us spend a little less and affect the economy. We now have a budget that has our steering locked tightly. We can just turn it very, very small amounts because $225 billion of it is in mandatory spending. If you want to add in personnel on top of that, add another $57 billion. Now you have $282 billion out of $305 billion. Thus you have very little steering room in the short run.

As I said in my statement, we have tough decisions to make. If we want to steer for the long run, even a 1° turn is important in the short run, because it will become 10° and 20° in the long run. This is another view of the budget that I think we all should have in mind when we begin to consider what kind of actions we can take—what kind of actions we must take—if we are to change the budget and use it as an instrument of fiscal policy.

Senator CRANSTON. May I ask one question about figures? The defense budget, if you add the two figures, one mandatory and one nonmandatory, come to 80.1 but the budget figure we are discussing is 87, approximately.

Mr. ASH. Retirement pay for military personnel is under entitlement programs. When I listed those entitlement programs I listed military retirement pay. That accounts for much of the difference. Remember, this table is merely the budget data reconstructed to provide an understanding in accord with the nature of this committee's assignment and responsibilities. I think we should all look at it that way.

Senator JAVITS. Could we have one other question?

Senator FANNIN. Yes.

Senator JAVITS. The 20 which you say is nondiscretionary is in defense, but that is because you and the President believe that the defense appropriation is, as it were, untouchable. I gather, however, that hardware and lots of other things which could conceivably be reduced.

Mr. ASH. It is under the heading of discretionary. I merely said that I would not recommend that we reduce defense spending, but it is a discretionary expenditure. The $20 billion is operations—the steaming and flying and all of the operating activities of the Defense Establishment—and that part of their procurement that will be spent this year but is not yet under contract. In effect, this is that part of their procurement that there are opportunities to change if there were a desire to do so.

Senator FANNIN. Thank you very much, Mr. Director. I feel that since the executive branch has the responsibility to see that funds are expended properly and even the mandatory spending is certainly one that commands your attention, full attention, that you would be in a

better position to advise and counsel on what could be done in regard to those expenditures and I would hope that an effort will be made, in fact, a great effort will be made to make recommendations to the Congress because I do feel we need legislation in that regard and I think it would be highly essential that we receive th counseling of the OMB.

Mr. ASH. Yes, sir. Senator, the President's contemplated meeting with the Members of the Congress on this subject of the budget has as one of its subjects for very important discussion the possibilities and the opportunities that lie within the budget. Even though I present the budget this way to show the difficulty of reducing outlays, I said in my opening statement that tough decisions have to be made, but we must make them. The President's hope is to meet with Members of the Congress to go over the possibilities, not to have a decision out of the executive branch ahead of that consultation. He wants to meet and consider the options and possibilities. We are prepared for that discussion, and it should include dealing with all programs. Touchable or untouchable, controllable or uncontrollable, they have to be reexamined from a zero base if we are going to turn this ship of the budget just a degree or two.

Senator FANNIN. Thank you, Mr. Director, and my time has expired.

Senator MUSKIE. Senator Hollings.

Senator HOLLINGS. Mr. Director, the whole thing as you pointed out, though, is time. This is all well and good to be informed and, heaven knows, we on the Budget Committee must have a thorough, comprehensive overview before we would recommend a course of action. But, on the other hand, I have the feeling that we are fiddling while Rome burns.

Now, these decisions are not all that impossible. For example, let us look at your statement that a significant increase is threatened for the Labor-HEW appropriation bill. That is inaccurate. The House has cut off $121.9 million and the Senate will meet shortly. I am also on that subcommittee with Senator Magnuson. We are going to cut off a substantial amount, we can assure you of that. The fact is that yesterday I went to a very interesting meeting chaired by Senator Pastore on State-Justice-Commerce Appropriation bill. He had gotten together with the staff and they had come up first with a 2-percent cut, which he said that was not enough, and after we urged for a little bit more, we adopted a series of cuts, slightly different on the State Department, a little bit more or little bit less on some of the other agencies, but together constituting an overall 3.5-percent reduction, or a saving of $190 million.

Now, that is what we did yesterday. We did not talk about it, we did it.

On the floor of the Senate a week ago we cut the Transportation bill $256.5 million below the budget estimates. We are working on State-Justice-Commerce. We reported back to committee the HUD-Space Science Appropriation bill and we are going to try to effectuate a cut there. So we have gotten to transportation and are working on the others I mentioned.

Now, we are cutting all of the bills that we can catch up with and work on, including Labor-HEW, and then we come to the real biggie and that is the Defense bill and we find that that bill has been cut 5.9 percent by subcommittee, or about $5.01 billion.

Now, my question to you as the Director of the Office of Management and Budget, is, Are you going to make those hard decisions? You keep saying so but are we going to have every admiral and every general running up on the Hill, saying the Senate is really wrecking the national defense and impairing the security of this country? Mind you, with me on the Appropriations Committee are Senators Thurmond, Jackson, Young, and Senator Stennis, chairman of Armed Services. These gentlemen would not let us become second rate in national defense. When that bill was reported out of the subcommittee, the record shows it was reported unanimously.

Now, what is the administration going to do? It has $5 billion of the deficit right there. We are talking about cutting all of these other bills and what gets me is that we act like there is sort of insecurity. In other words, if we come up—and I hope this committee will help you effectuate a discipline. It is not easy to do but we are going to do it. Yet as the President is saying that the public enemy No. 1 is inflation, the first administration witness, Mr. Rush, says, oh, the $5 million cut really is one-tenth of 1 percent. It really does not make much difference. That does not help us, although it is economically accurate.

I like your description of the aircraft carrier better, you know, that the trip of a thousand miles is begun with one step. You have got to take that one step. And then when you come to testify, Senator Fannin asks what is possible and then you put up a big chart and state that you cannot get from here to there, just cannot do it, just makes it almost impossible.

We are doing it. This is the hour. Not a summit meeting 2 weeks into September or later. We need help now and we need help from you and my question is is the administration, is OMB, going to come up and help us on that defense cut of $5 billion, let us say, and some of these others?

Mr. ASH. First, Senator, I am sure I would join with many in commending you for the actions that you are taking and the reductions that you have described. There always is, as you indicated in your own statement, an issue of priorities. That, of course, is what the Congress deals with every day.

The charts were not for the purpose of saying you cannot get there from here. The charts were for the purpose of saying there are some very tough decisions, but we must make them and we must get there from here. They are to point out the difficulty of getting there, not the impossibility of getting there.

Now let me speak to the defense matter in particular. I have already indicated in my earlier statement that the defense budget is less by virtually any way you want to measure it than it was 6 or 8 years ago, 20 years ago, or other numbers of years ago. It is already on its down curve. The point is how much is enough? With how much can we still preserve world order and world peace—and that means—and that means American peace? That, of course, is what your committees have been debating, how much is enough.

One other point that I would like to make, and it perhaps is not even essential here. The $5 billion of authorization that you are talking about would translate to about a $1.8 billion reduction in outlays. Again this points out the leadtime of even a $5 billion decision. It is

in a sense supportive of the general proposition that we are driving a big aircraft carrier. A $5 billion decision translates into a $1.8 billion outlay effect in the first year, the year that we are now talking about.

I would, and OMB does, leave the departments and agencies the role of testifying as to particular pieces of legislation that bear upon those departments and agencies. We do not ourselves take part in the process of testifiying for or against a particular piece of legislation or an appropriations amount. That goes through the departments and agencies.

Senator HOLLINGS. I have seen you switch around Department Secretaries. It is almost embarrassing. I had the Secretary of Commerce testify he needed $19 million to put the ships back in and get the proper environmental data and OMB called me up and he had to call me personally and say cancel my testimony and cancel my letter I wrote in support of it. You fellows, OMB, you just cannot be sort of a nebulous fellow. Are you going to help make those hard decisions? That is what the public really wants to know because we are coming right down the pike and Senator McClellan is working, and Senator Pastore, and Senator Stennis. It has been very hard and difficult for him but all of us are working on this Appropriations Committee but your testimony—does not quite answer the thing.

Mr. ASH. Let me answer it.

Senator HOLLINGS. Looking forward to that 1976 budget. Why can we not look at this 1975 budget and really do the job?

Mr. ASH. Sometimes I wish I had the authority and power that you suggest. It may seem that way. But really, what we say is as spokesman for the President. On this subject of the defense budget, he spoke fairly clearly on the night of August 12. I would think that, I as Director of OMB, should not have, and will not have, any position different than his. I am sure he will be expressing his position when he gets the legislation that will result from the action of the Congress on the defense budget. I have no position of my own. When I speak, I reflect as best I can the President's position, rather than having an independent one. It may not seem that way, but that is basically my role.

Senator HOLLINGS. Mr. Rush yesterday testified this is not the right time to increase taxes. This is not the proper time to reduce tax receipts. Do you agree with that?

Mr. ASH. Yes, sir.

Senator HOLLINGS. You do not propose a study now, a proposal to reduce tax receipts for corporations come September, after Labor Day?

Mr. ASH. There is no proposal to affect the tax structure that I know of other than, of course, that being considered right now in the Ways and Means Committee.

Senator HOLLINGS. But the next witness, Secretary Simon, is going to talk of the long, hard road. You talked of the long hard road. It is not an easy thing. We are going to be struck this fall?

Mr. ASH. Well, I think taxes are an area that we must always keep in front of us as we talk about fiscal policy. Fiscal policy is largely the net of outlays and revenues, and we cannot talk about it on the outlay side only. Thus the revenue side of fiscal policy is always fair game for

discussion. We should not want to consider ourselves frozen in cement on that any more than on policies regarding the expenditure side. I would not want to suggest here that there will never be any thought of changing the tax structure. I am merely saying at this time and under these circumstances——

Senator HOLLINGS. I would only then suggest, Mr. Ash, that these meetings occur immediately. I mean, just informally——

Mr. ASH. Yes.

Senator HOLLINGS [continuing]. With these subcommittee chairmen. It is fine business to come up with a good TV thing for the public and labor leaders and business leaders and everything else but if you want to get to the nitty-gritty you can get up to these subcommittee chairmen and say, we really do mean business. You cannot get into these uncontrollables as you indicate. There are revolving funds in many of these budgets and everything else. But many of these budgets are extravagantly over and above just the last fiscal year. We cannot go in two different directions. Either we talk stronger and affect a tough discipline or else, and I think now is the time to do it.

Mr. ASH. Now is the time, and the President does intend to move very rapidly on this. I am meeting with him this afternoon on this subject. He in turn certainly intends to move quite expeditiously with Members of the Congress to deal with the fundamental question of how do we get there from here, not whether we get there from here, but how do we get there from here.

Senator HOLLINGS. Just tell him to invite Senator Magnuson up there and we will save a billion dollars.

Thank you, Mr. Chairman.

Senator MUSKIE. Senator Javits.

Senator JAVITS. Mr. Ash, I am interested in the item you marked "Entitlement", $142 billion, which you say can be changed by legislation.

Now, does that include those items which the Treasury has to report on as representing tax benefits or tax indulgencies, like depletion and drilling costs and various subsidies, et cetera?

Mr. ASH. No sir. This does not include the tax expenditure side of the budget. As you know, the new act that established the committee provides that tax expenditure data be provided in a more comprehensive way than it has been before. I think it will be very useful for all of us to look at.

Senator JAVITS. That is particularly what I think has been dominant.

Do you have any idea of all that is involved? What is the total?

Mr. ASH. I don't have the data but it is tens of billions of dollars depending, of course, on the agreement on what is considered a tax expenditure and what is not.

Senator JAVITS. My recollection is that it is somewhere in the ball park of $30 to $40 billion.

Mr. ASH. It may be way more than that. Again the exact number depends upon precisely what you include.

Senator JAVITS. Wouldn't you agree to provide us the necessary options in this committee? Isn't that what distinguishes this committee from Appropriations Committee. That is why Senator Hollings and I and others have been agitating that we ought to give a voice or opinion to the Congress for the fiscal 1975 budget. Wouldn't you agree with us that this set of variables is also something that we need to consider in present fiscal situations?

Mr. ASH. I surely would. As we were discussing earlier, fiscal policy is a function of both expenditure policy and tax policy. The whole can't be discussed without looking at all of its parts.

Senator JAVITS. Now, to what extent can we be furnished in an accelerated way or anticipatory way that information so that we can crank into our budget recommendations that picture as well, if we have any recommendation on that?

Mr. ASH. The Treasury Department does submit data annually. I am not sure exactly when the last submission was but I am sure in terms of identifying the areas and spreading the rough amounts involved in each, that most recent report of the Treasury Department could be useful.

[The most recent tax expenditure estimates referred to follow:]

ESTIMATES OF FEDERAL TAX EXPENDITURES

COMMITTEE ON WAYS AND MEANS

PREPARED BY THE STAFFS

OF THE

TREASURY DEPARTMENT

AND

JOINT COMMITTEE ON INTERNAL REVENUE TAXATION

JUNE 1, 1973

U.S. GOVERNMENT PRINTING OFFICE

95-926 WASHINGTON : 1973 JCS-20-73

FEDERAL TAX EXPENDITURES

In the Senate version of the Revenue Act of 1971, a provision added on the floor would have required the inclusion in the budget of estimates of losses in revenue from provisions of the Federal income tax laws and also estimates of indirect "expenditures" through the operation of the Federal tax laws. Data of this type have commonly become known as "tax expenditures." The statement made by the conferees in this respect is as follows:

"The conferees concluded that it would be more appropriate to have such estimates of tax expenditures made by the Treasury Department and to have the estimates submitted annually to the Committee on Ways and Means of the House, the Committee on Finance of the Senate, and the Joint Committee on Internal Revenue Taxation. It is expected that these tax expenditure reports to the tax committees will initially be modeled after similar reports previously made and included in the annual reports of the Secretary of the Treasury in 1968 and 1970. Modifications may, of course, be made from time to time in consultation with the tax committees. In addition to making these reports to the tax committees on an annual basis, the Treasury Department may desire to include these data on tax expenditures in the annual report of the Secretary of the Treasury. The Treasury Department has indicated its willingness to submit information to the tax committees in the manner indicated above and as a result the amendment no longer appears necessary."

The Staffs of the Treasury Department and Joint Committee did cooperate in the preparation of such a report last year. This pamphlet, which is a continuation of this cooperative effort, presents data for 1972 and reproduces the data for calendar years 1967 through 1971 which were contained in the report issued on October 4, 1972.

In general terms "tax expenditure" items are intended to represent the amount of tax reductions which occur because of the allowance of an exclusion, deduction, preferential rate of tax, or deferral of tax liability. There are differences in points of view as to the "tax expenditure" concept,[1] including differences as to the items which should be included in, and excluded from, such a listing. Questions have also been raised as to whether there should also be included in such an analysis those items which are taxed more heavily than income generally (such as corporate income) or deductions which are subjected to special limitations (such as capital losses). In this report the staffs have not attempted to consider any changes in the items listed as "tax expenditures." Instead, the items included in this report are those which have previously been included in any of the earlier reported versions of tax expenditure estimates made by the Treasury Department prior to the Revenue Act of 1971 plus items in the Revenue Act of 1971 which are of a similar character. Among items not included as tax expenditures are the personal exemptions and the minimum standard deduction.

[1] See, e.g., the criticism in Bittker, "Accounting for Federal Tax Subsidies in the National Budget," XXII *National Tax Journal* 244 and the reply in Surrey and Hellmuth, "The Tax Expenditure Budget—Response to Professor Bittker," XXII *National Tax Journal* 528.

This report includes two tables. Table 1 shows estimated Federal income tax expenditures for the calendar years 1967 through 1972. The 1971 and 1972 tabulations are broken down into effects on corporate income tax liability and effects on individual income tax liability. Only the 1972 data represent a new tabulation. The data shown in this table are broken down into categories which are comparable to those in the functional classification of budget expenditures. The report also includes a table (Table 2) showing the estimated distribution, by adjusted gross income class, of the decrease in individual income tax liability estimated to result from tax expenditure items affecting such liability.

The purpose of these tax expenditure data is to provide information as to the economic benefits provided by the tax laws to the various sectors of the economy. To aid in the analysis, the cost and beneficiaries (in terms of areas of activity) are shown by the same functional categories as outlays in the Federal budget. The listing of any of these provisions involves no direct, or indirect, presumption about the desirability of any of them in terms of public policy. These tables, however, are intended as a tool which may be helpful to the tax committees of Congress in reviewing various provisions of the tax laws.

The estimates of tax expenditures are difficult to determine and are subject to important limitations. It is believed, however, that despite these limitations, the order of magnitude of the amounts involved may be helpful to the tax committees.

The major limitations with respect to the estimates of tax expenditures are:

1. The estimate of each tax expenditure item is made independently of any other tax expenditure item. As a result, if two or more items were to be eliminated, the result of the combination of changes being made at the same time might produce a lesser or greater revenue effect than the sum of the amounts shown for each item individually. This, of course, also means that the addition of the various tax expenditure items is of quite limited usefulness. This is why totals are not shown for table 1, except in a footnote.

2. In the case of many of the items, especially those for which information is not available on tax returns, the lack of data makes estimates quite tenuous. Where information is not available on tax returns, it has been necessary to obtain information from whatever sources are available, and, when sources are limited, to make assumptions on which to base the estimates.

3. The estimates for the various tax expenditure items do not take into account any effects that the removal of one or more of the items might have on investment patterns, consumption, or other aspects of economic activity. In other words, the estimates shown do not take into account the induced effects of changing the provisions. Repeal of a provision, therefore, would not necessarily raise the revenue associated with removal of that provision.

4. Often, tax expenditure items which have been added in recent years do not become fully effective until the lapse of several years. As a result, the eventual annual cost of some items added in recent years is not fully reflected in the year 1972. Conversely, if various items now in the law were to be eliminated, it is unlikely, in many cases, that the full revenue effects shown would be realized until an extended period of years has passed.

5. In some cases, if a tax expenditure item were to be eliminated, it is probable that Congress would, at least to some extent, desire to deal with the underlying problem by a direct expenditure program. The effect of any such program is not taken into account in the estimates shown. In addition, if some of these provisions were removed from the tax laws, this removal might be accompanied by revisions in tax rates, personal exemptions or the minimum standard deduction, as has happened in the past. This has not been taken into account in the estimates.

6. There are features of the law which are not taken into account in the estimates shown. For example, personal exemptions, the minimum standard deduction, the foreign tax credit, and the effect of income splitting and head-of-household treatment, as well as the graduation in the rate structure of the individual income tax, are not taken into account in these tables. Also, the effect of estate and gift taxes is not shown nor is the interrelationship of these provisions with some of the tax expenditure items taken into account.

7. Differences in personal income levels and corporate profits can also account for differences in the cost of tax expenditure items from year to year. Also, some tax expenditure items themselves may be larger or smaller from year to year, wholly independent of tax considerations.

TABLE 1—ESTIMATED FEDERAL INCOME TAX EXPENDITURES,[1] CALENDAR YEARS 1967–72[2]

[In millions of dollars]

Item	1967	1968	1969	1970	1971			1972		
					Corporations	Individuals	Total	Corporations	Individuals	Total
NATIONAL DEFENSE										
Exclusion of benefits and allowances to Armed Forces personnel	500	550	550	500	----------	650	650	----------	700	[3] 700
INTERNATIONAL AFFAIRS										
Exemption for certain income earned abroad by U.S. citizens	40	45	45	40	----------	50	50	----------	50	50
Exclusion of income earned by individuals in U.S. possessions	10	10	10	10	----------	10	10	----------	10	10
Western Hemisphere trade corporations	50	55	55	50	75	----------	75	50	----------	50
Exclusion of gross-up on dividends of less-developed country corporations	50	55	55	55	55	----------	55	60	----------	60
Deferral of income of controlled foreign corporations	150	165	170	165	165	----------	165	300	25	[3] 325
Exclusion of income earned by corporations in U.S. possessions	70	80	85	80	80	----------	80	80	----------	80
Deferral of income of domestic international sales corporations								100	----------	100
AGRICULTURE										
Farming: Expensing and capital gain treatment	800	860	880	820	50	790	840	50	850	900
Timber: Capital gain treatment for certain income	130	140	140	130	125	50	175	125	50	175
NATURAL RESOURCES										
Expensing of exploration and development costs	300	330	340	325	260	65	325	580	70	[3] [4] 650
Excess of percentage over cost depletion	1,300	1,430	1,470	980	785	200	985	1,400	300	[3] 1,700
Capital gain treatment of royalties on coal and iron ore	5	5	5	5	5	----------	5	5	----------	5
COMMERCE AND TRANSPORTATION										
Investment credit	2,300	3,000	2,630	910	1,495	305	1,800	3,050	750	3,800
Depreciation on buildings (other than rental housing) in excess of straight-line	500	550	550	500	320	160	480	330	170	500
Asset depreciation range					600	100	700	850	10	[3] 860
Dividend exclusion	225	260	290	280	----------	300	300	----------	300	300
Capital gains: Corporation (other than farming and timber) [5]	500	525	525	425	380	----------	380	400	----------	400
Capital gains: Individuals (other than farming and timber) [5]	(6)	(6)	(6)	(6)	----------	5,600	5,600	----------	7,000	7,000
Bad debt reserves of financial institutions in excess of actual	600	660	680	380	400	----------	400	400	----------	[7] 400
Exemption of credit unions	40	45	45	40	40	----------	40	90	----------	[3] 90
Deductibility of interest on consumer credit	1,300	1,600	1,700	1,700	----------	1,800	1,800	----------	1,100	[3] 1,100
Expensing of research and development expenditures	500	550	565	540	545	----------	545	570	----------	570
$25,000 surtax exemption	1,800	2,000	2,300	2,000	2,300	----------	2,300	2,500	----------	2,500
Deferral of tax on shipping companies	10	10	10	10	10	----------	10	30	----------	30
Rail freight car amortization				105	45	----------	45	80	----------	[3] [8] 80

HOUSING AND COMMUNITY DEVELOPMENT										
Deductibility of interest on mortgages on owner-occupied homes	1,900	2,200	2,600	2,800		2,400	2,400		3,500	3,500
Deductibility of property taxes on owner-occupied homes	1,800	2,350	2,800	2,900		2,700	2,700		3,250	3,250
Depreciation on rental housing in excess of straight-line	250	250	275	255	300	200	500	350	250	600
Housing rehabilitation					10	15	25	15	25	40
HEALTH, LABOR, AND WELFARE										
Disability insurance benefits	[6]	100	120	130		155	155		175	175
Provisions relating to aged, blind, and disabled:										
Combined cost for additional exemption, retirement income credit, and exclusion of OASDHI for aged	2,300	2,700	2,800	2,950		3,250	3,250		3,550	3,550
Additional exemption for blind	10	10	10	10		10	10		10	10
Sick pay exclusion	85	95	105	105		120	120		225	[3] 225
Exclusion of unemployment insurance benefits	300	325	350	400		800	800		700	700
Exclusion of workmen's compensation benefits	150	180	210	210		320	320		375	375
Exclusion of public assistance benefits	50	50	50	50		65	65		65	65
Net exclusion of pension contributions and earnings:										
Plans for employees	3,000	4,000	3,150	3,075		3,650	3,650		4,000	4,000
Plans for self-employed persons	60	135	160	175		250	250		200	200
Exclusion of other employee benefits:										
Premiums on group term life insurance	400	400	440	440		500	500		550	550
Deductibility of accident and accidental death premiums	25	25	25	25		30	30		35	35
Medical insurance premiums and medical care	1,100	1,400	1,450	1,450		2,000	2,000		2,500	2,500
Privately financed supplementary unemployment benefits	25	15	15	20		5	5		5	5
Meals and lodging	150	165	170	170		170	170		170	170
Exclusion of interest on life insurance savings	900	1,000	1,050	1,050		1,100	1,100		1,200	1,200
Deductibility of charitable contributions (other than education)	2,200	3,000	3,450	3,550		3,200	3,200		3,100	3,100
Deductibility of medical expenses	1,500	1,600	1,700	1,700		1,900	1,900		1,900	1,900
Deductibility of child and dependent care expenses	25	25	25	25		30	30		180	180
Deductibility of casualty losses	70	80	80	80		165	165		150	[3] 150
Excess of percentage standard deduction over minimum standard deduction	[9] 3,200	[9] 3,600	3,800	3,000		700	700		1,040	1,040
Pollution control amortization			15	15	15		15	25		25
Credit for employing public assistance recipients under WIN program								5		5
5-year amortization of child care facilities								5		5
EDUCATION										
Parental personal exemption for student age 19 or over	500	500	525	500		550	550		640	640
Deductibility of contributions to educational institutions	170	200	200	200		275	275		275	275
Exclusion of scholarships and fellowships	50	60	60	60		110	110		125	125
VETERANS BENEFITS AND SERVICES										
Exclusion of certain veterans' benefits	550	600	600	650		700	700		480	[3] 480
GENERAL GOVERNMENT										
Political contributions									100	100

See footnotes at end of table, p. 6.

(Continued)

TABLE 1.—ESTIMATED FEDERAL INCOME TAX EXPENDITURES,[1] CALENDAR YEARS 1967–72 [2]—Continued

[In millions of dollars]

Item	1967	1968	1969	1970	1971			1972		
					Corporations	Individuals	Total	Corporations	Individuals	Total
AID TO STATE AND LOCAL FINANCING										
Exemption of interest on State and local debt	1,800	2,000	2,200	2,300	1,800	800	2,600	1,900	1,000	[3] 2,900
Deductibility of nonbusiness State and local taxes (other than on owner-occupied homes)	2,800	4,150	5,100	5,600	----------	5,600	5,600	----------	5,300	5,300
Total	([10])	([10])	([10])	([10])	([10])	([10])	([10])	([10])	([10])	([10])

[1] Estimates are prepared on an individual basis for each item on the assumption that the item would be eliminated from the law without any other changes in the law with respect to the other items. If two or more changes in the law are made, the aggregate revenue effect will frequently not equal the sum of the revenue effects of the individual changes. Accordingly, the costs of the items are not additive.

[2] Roughly reflect fiscal years 1968 through 1973.

[3] Changes in the 1972 figures as compared to 1971 which are due wholly or in part to revised data and/or new sources of data and/or improved estimating methods.

[4] The estimate for 1972 considers this tax expenditure in isolation rather than in conjunction with percentage depletion as has been done for the years 1967–71.

[5] Assumes present restriction on capital losses is retained.

[6] Not available.

[7] This will decline over time as present law becomes fully effective.

[8] This item is being superseded by use of the investment credit.

[9] Standard deduction.

[10] As explained more fully in the text and in footnote 1, these totals are of limited significance and utility. However, as a matter of convenience the mathematical sums of the respective 10 columns are given here: $36,550,000,000; $44,140,000,000; $46,635,000,000; $43,945,000,000; $9,860,000,000; $41,850,000,000; $51,710,000,000; $13,350,000,000; $46,460,000,000; and $59,810,000,000. Much of the increase in the total figures given for 1971 and 1972 over that for 1970 is due to the fact that the 1970 figure does not include any estimate for capital gains of individuals while the 1971 and 1972 totals include $5,600,000,000 and $7,000,000,000, respectively.

Note: Changes in the figures from year to year not only reflect changes in the tax laws, in utilization of the items and in personal income and profit levels but also, in some instances, reflect revised and/or new sources of data and/or improved estimating methods.

TABLE 2.—ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1972

[In millions of dollars]

Adjusted gross income class	Exclusion of benefits and allowances to Armed Forces personnel	Exemption for certain income earned abroad by U.S. citizens	Exclusion of income earned by individuals in U.S. possessions	Deferral of income of foreign controlled subsidiaries	Farming: Expensing and capital gain treatment	Timber: Capital gain treatment for certain income	Expensing of exploration and development costs	Excess of percentage over cost depletion	Investment credit	Depreciation on buildings (other than rental housing) in excess of straight-line	Asset depreciation range	Dividend exclusion
0 to $3,000	15	(1)	(1)	(1)	15	(1)	(1)	1	(1)	1	(1)	2
$3,000 to $5,000	150	1	(1)	(1)	50	2	1	5	45	3	(1)	10
$5,000 to $7,000	180	3	1	(1)	90	2	1	4	55	5	(1)	18
$7,000 to $10,000	130	5	1	(1)	130	3	2	11	95	10	1	27
$10,000 to $15,000	115	7	2	1	170	4	9	18	125	19	1	56
$15,000 to $20,000	55	16	3	1	100	3	7	20	90	17	1	55
$20,000 to $50,000	50	17	3	6	185	9	17	75	185	58	4	109
$50,000 to $100,000	4	1	(1)	6	60	8	11	61	80	36	2	20
$100,000 and over	1	(1)	(1)	11	50	19	22	105	75	21	1	3
Total	700	50	10	25	850	50	70	300	750	170	10	300

[1] Less than $500,000.

(Continued)

TABLE 2.—ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS BY ADJUSTED GROSS INCOME CLASS. CALENDAR YEAR 1972—Continued

[In millions of dollars]

Adjusted gross income class	Deductibility of interest on consumer credit	Deductibility of interest on mortgages on owner-occupied homes	Deductibility of property taxes on owner occupied homes	Depreciation on rental housing in excess of straight-line	Housing rehabilitation	Disability insurance benefits	Provisions relating to aged, blind, and disabled: Combined cost for additional exemption, retirement income credit, and exclusion of OASDHI for aged	Provisions relating to aged, blind, and disabled: Additional exemption for blind	Sick pay exclusion	Exclusion of unemployment insurance benefits	Exclusion of workmen's compensation benefits	Exclusion of public assistance benefits
0 to $3,000	(1)	(1)	5	1	(1)	30	880	1	8	60	12	25
$3,000 to $5,000	10	15	25	4	(1)	45	820	2	16	95	26	20
$5,000 to $7,000	40	85	95	7	(1)	35	460	2	18	95	41	15
$7,000 to $10,000	145	310	240	14	(1)	35	640	2	34	160	66	5
$10,000 to $15,000	275	845	590	28	1	12	265	1	62	200	96	(1)
$15,000 to $20,000	235	835	640	25	1	7	135	1	55	60	63	(1)
$20,000 to $50,000	285	1,160	1,135	86	3	7	235	1	27	25	65	(1)
$50,000 to $100,000	60	195	340	53	8	3	75	(1)	4	5	5	(1)
$100,000 and over	50	55	180	32	12	1	40	(1)	1	(1)	1	(1)
Total	1,100	3,500	3,250	250	25	175	3,550	10	225	700	375	65

[1] Less than $500,000.

(Continued)

39-566 O - 74 - 10

TABLE 2.—ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1972—Continued

[In millions of dollars]

Adjusted gross income class	Net exclusion of pension contributions and earnings		Exclusion of other employee benefits									
	Plans for employees	Plans for self-employed	Premiums on term group life insurance	Deductibility of accident and accidental death premiums	Medical insurance of premiums and medical care	Privately financed supplementary unemployment benefits	Meals and lodging	Exclusion of interest on life insurance savings	Deductibility of charitable contributions (other than education)	Deductibility of medical expenses	Deductibility of child and dependent care expense	Deductibility of casualty losses
0 to $3,000	45	(1)	10	(1)	45	(1)	3	10	5	5	1	(1)
$3,000 to $5,000	150	(1)	40	2	180	(1)	13	35	20	60	12	5
$5,000 to $7,000	240	1	50	3	225	1	22	65	80	155	21	5
$7,000 to $10,000	580	2	95	6	430	1	33	105	195	300	36	10
$10,000 to $15,000	1,080	5	150	10	675	2	37	175	410	460	42	25
$15,000 to $20,000	740	9	90	5	400	1	27	160	380	320	43	30
$20,000 to $50,000	885	93	95	6	420	(1)	28	400	820	435	25	40
$50,000 to $100,000	195	76	15	2	85	(1)	5	130	450	115	----	15
$100,000 and over	85	14	5	1	40	(1)	2	120	740	50	----	20
Total	4,000	200	550	35	2,500	5	170	1,200	3,100	1,900	180	150

[1] Less than $500,000.

(Continued)

TABLE 2.—ESTIMATED DISTRIBUTION OF SELECTED ITEMS OF TAX PREFERENCES OF INDIVIDUALS BY ADJUSTED GROSS INCOME CLASS, CALENDAR YEAR 1972—Continued

[In millions of dollars]

Adjusted gross income class	Excess of percentage standard deduction over minimum standard deduction	Capital gains: individuals	Parental personal exemption for student age 19 or over	Deductibility of contributions to educational institutions	Exclusion of scholarships and fellowships	Exclusion of certain veterans' benefits	Tax credit or deduction for political contributions	Exemption of interest on State and local debt	Deductibility of nonbusiness State and local taxes (other than on owner occupied homes)
0 to $3,000	0	20	(1)	(1)	4	20	(1)	5	(1)
$3,000 to $5,000	1	70	8	3	26	45	1	(1)	30
$5,000 to $7,000	12	120	39	7	32	50	2	(1)	110
$7,000 to $10,000	63	190	102	20	26	110	7	5	335
$10,000 to $15,000	609	340	207	58	19	140	21	10	785
$15,000 to $20,000	254	340	122	70	12	60	17	25	835
$20,000 to $50,000	98	1,260	69	90	6	45	37	125	1,770
$50,000 to $100,000	2	1,080	72	20	(1)	9	11	375	770
$100,000 and over	1	3,580	21	7	(1)	1	4	455	665
Total	1,040	7,000	640	275	125	480	100	1,000	5,300

[1] Less than $500,000.

Senator JAVITS. I would request the Chair to let us get that information as much up to date as possible.

Senator MUSKIE. Without objection, of course.

Senator DOMINICK. May I just have a second. I would like to ask the Senator from New York exactly what you are talking about. Are you talking about the amount of money that involves a discussion of interest on mortgages? Are you talking about double exemptions which you get if you are 65, blind, and so on?

Senator JAVITS. I am talking about the list of items which is called for by this very bill, whatever is the definition of those items is in the Treasury.

Senator MONDALE. Would the Senator yield?

Senator DOMINICK. I'm not sure what is called for by this bill except for us to give a voice or opinion on how to put receipts and expenditures in balance.

Senator JAVITS. No. This is an amendment of money, so I know about it. There is a specific requirement in this bill for annual filing, respecting these tax indulgences and they are specified with particularity and I will insert the catechism if somebody can find the section in the bill.

Senator MUSKIE. There is no question about that.

Senator JAVITS. And they are in the nature of specifics, about which ones they are, and I think we ought to know about that in connection with our action on the budget.

I yield.

Senator MONDALE. I just wanted to comment. Stan Surrey has been a great advocate of this tax expenditure analysis. I think it an indispensable part of this committee's work and I am glad you are pursuing this line of questions. I hope we can come to it with the same particularity with which we analyzed expenditures made in the form of appropriations.

Senator JAVITS. Exactly right. As a member of the committee which wrote this legislation, that was the main thing to recognize that you needed a committee which looked down the road beyond the horizon of a fiscal year, which is essentially a function of the Appropriations Committee, and that is why we always argued that there was nothing that we were doing which in any way aborted or interferred with the Appropriations Committee because we had a much broader horizon to survey. This is a critical part of it because you may get to the point where when you are talking about "budget cuts", $5 or $10 billion gobs, you may go to $20 billion or more and the financial situation of this country may demand it, real austerity, and as you say, there is no place in it if all you are going to do is look at the appropriations. You can't find it, so you have got to yield elsewhere.

Senator MUSKIE. Will the Senator yield?

Senator JAVITS. Certainly.

Senator MUSKIE. I think it would be appropriate to read the statutory language into the record for purposes of undergirding Senator Javits request.

Section 3(a)(3) reads as follows:

The term "tax expenditure" means those revenue losses attributable to provisions of the Federal Tax Laws which allow a special exclusion, exemption, or deduction from gross income or which provide a special credit, a preferential rate of tax, or a deferral of tax liability, and the term "tax expenditures budget" means an enumeration of such tax expenditures.

The next provision, section 101, reads as follows:

Such committee shall have the duty to request and evaluate continuing studies of tax exepnditures, to devise methods of coordinating tax expenditures, policies and programs with direct budget outlays, and to report the results of such studies to the Senate on a reporting basis.

It is those provisions which I understand Senator Javits is referring to.

Senator JAVITS. Exactly.

Senator MUSKIE. It is very appropriate that they be placed in the record at this point.

Senator JAVITS. Exactly. And that Mr. Administration, is itself a very legitimate target for us and indeed our duty, so I am very hopeful that we will get the necessary information and that when we make our recommendations to the Congress. I am all with you and Senator Hollings on the appropriations question, but we should also survey this broader horizon. You would agree with that?

Mr. ASH. Yes. And may I suggest that Secretary Simon, whose staff will do the computations, as in the past, would be the one better able to answer the specifics on it.

Senator JAVITS. Exactly.

Now, the other thing that I am sure you would concur in is that the other side of the coin, aside from these tax indulgencies as I call them, is the aggregate tax take of the United States which is legally involved in the economic activity of the United States. Therefore wouldn't you agree that we must track that carefully in order to determine what we can spend? We know from the conversation which has already gone that education and health and housing are going to be aborted or curtailed by our present stringency, and it is just as important, wouldn't you agree, that we watch the economic activity of the country, try to increase productivity efforts, and so on, to stimulate the economy, thereby giving us the ability not to have to abort the desirable programs for the health, education, and welfare of America if we can aggregate the income to justify them.

Mr. ASH. Clearly we need to look over the income side as a part of making any trade-off decision that needs to be made.

Senator JAVITS. And to try to stimulate that income. In other words, if there are less unemployed, if people earned more money, that is. My own concept is that it is very unlikely that you are going to do much about reducing prices. Sure, you may knock down the price of oil but generally speaking it is pretty tough to knock down prices, but you can give the economy a chance to catch up and that is what I am talking about. In other words, instead of a factory worker earning today roughly $12,000 a year he might have to earn 15 or 17. That is a way of stabilizing the situation, too. So you would agree, would you not, that we have to keep our eye on that ball as well.

Mr. ASH. I wouldn't want to buy all of that reasoning but I would certainly agree we should keep our eye on the other side.

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

Senator MUSKIE. Thank you Senator Javits

Senator Cranston.

Senator CRANSTON. I yield to Senator Mondale in whose seat I am sitting.

Senator MUSKIE. Senator Moss hasn't had his turn yet.

Senator Moss. Thank you Mr. Chairman. I was absent during most of the questioning and therefore it might be repetitive. I did have to go to the floor and just got back. I will just pose one question and if it has been covered before, I apologize.

But yesterday, Mr. Ash, Gardner Ackley was before us and he suggested that a $10 billion budget cut might add as much as 0.4 percent to the unemployment rate which is between 300,000 and 400,000 jobs.

Now, you and Mr. Rush who testified yesterday indicated that the $10 billion cut isn't going to have any immediate effect of great consequence any way on the rate of inflation. Do you think then that this cut is justified with that much unemployment possibly riding on it?

Mr. Ash. Well, again, Senator, we are reverting back to an earlier discussion. A budget cut of any amount may have only little discernible effect on inflation in the immediate period ahead, but it may have a very very significant affect further on down the road. Moreover, it may have a very significant effect on psychology and on behavior of the private sector, thus contributing indirectly reducing inflation. So it is an equation that has a number of dimensions to it. When you look at all of the deminsions, certainly it suggests that we give very careful consideration to ways in which we can hold down and reduce spending because the large payout justifies the work.

Senator Moss. And that seems a reasonable trade-off against that many jobs that might be involved.

Mr. Ash. Well, I am not sure I concur with this number. I have already quoted a number on a lesser cutback. In a trade-off, of course, everybody has to make his own individual summation as to desirability not only of immediate trade-off but the longer term trade-off.

As an example, and I am only posing this hypothetically, if one could take a little more unemployment right now and firmly and confidently believe that he would substantially increase employment 1 year, 2 years, 5 years, and 10 years from now, that might be a very good trade-off in contrast to running a course that would have a high level of unemployment for all of the next 10 years. So the trade-off is not only inflation verses unemployment but it has to be put in a time period of now verses the future as well.

One person unemployed now might be well worth 10 additional persons employed over the next 10 years.

Senator Moss. Well, is there any assurance, though, that that is the effect that it would have, ultimately be able to——

Mr. Ash. There is not a tremendous assurance that any of us can have that we know exactly how to forecast the economy into the future. But we do know some of the fundamentals at work. We do know that certain types of actions tend to generate certain kinds of responses. But nobody can guarantee how an economy will work. Things like the weather and the dramatic change in petroleum supplies upset models that were prepared by any of us here, a year ago, 2 years ago, or 5 years ago.

Senator Moss. Well, thank you. Thank you Mr. Chairman.

Senator Muskie. Senator Cranston.

Senator Cranston. I am delighted to have this opportunity to hear you and talk with you.

Hobart Rowan quoted you in the Post on August 4 as stating this:

Ash sticks by his public statement last month that only $2 billion can be juiced out of the Fiscal 75 budget by tightening up here and there.

Today you stated this goal to cut below the current estimate of about $305 billion toward a goal of $300 billion. Does that mean in effect you feel we can not balance the current year's budget?

Mr. ASH. No sir. He quoted part of what I said but didn't have enough space apparently to quote all of it and——

Senator Cranston. Today's quote still has you cutting—advocating cutting 5 off and we would have to cut 10 to balance the budget.

Mr. ASH. It is quite possible that we can get from the $305 billion down to the $300 level. There are a number of kinds of actions. Some of them are direct actions taken by the Executive, some by the Congress. Some are the variations from a budget plan that result from the inability to know with great precision what the outcome might be.

Let's talk Outer Continental Shelf leasing. We put in our last budget estimates that we would generate revenues of $8 billion from Outer Continental Shelf leasing. We can't guarantee we will generate $8 billion. In both of the last 2 years, we generated more than we had estimated in the budgets. That could happen again. On the other hand, it could go the other way.

In 1973, for example the actual outlay total for the black lung program was quite different from the original budget estimate. This was not because we cut, but because of unexpected processing delays resulting from the enactment of new standards and regulations.

We see some of these phenomena possibly at work in this budget over and above what we can do by direct action. The aggregate of all of these events could well produce a $5 billion reduction.

Senator CRANSTON. Well, the $5 billion reduction would still leave us $5 billion in red ink, would it not, under current estimates,

Mr. ASH. Again, revenues are more difficult to estimate than outlays. Our most recent estimates of revenues have been around the $295 billion level. But if you look back at the original estimate of receipts for the last 2 years, in the aggregate we under estimated receipts by bout $20 billion for the 2-year period. This is not to say that we are going to underestimate this year. It is only by way of saying that estimating revenues is more difficult than estimating outlays. Thus while we originally estimated about $295 billion in the budget, and while we presently estimate something similarly, the number could be a bit higher, or could be a bit lower. It really depends on the economy more than it depends on any other factor.

Senator CRANSTON. What figure are you presently shooting for as a budget figure for the next fiscal year 1975 or 1976,

Mr. ASH. We have provided guidance to the departments and agencies which, when added together, would bring in outlays of about $330 billion.

Senator CRANSTON. Would you agree with Gardner Ackley who said yesterday there are times when you want to have a balanced budget, there are times when you want a surplus, times when you want a deficit.

Mr. ASH. Yes.

Senator CRANSTON. What would be your rule of thumb? Upon what circumstance would you want each of those?

Mr. ASH. Well, it depends again on the relationship of unemployment, real growth, and inflation. It is a form of simultaneous equation with those three variables at work. It is hard to think of all the possible permutations and combinations. Certainly, however, if we had what we might consider a socially unacceptable and economically unacceptable unemployment rate, then one should think of the budget as a tool for stimulating the economy by any one of the many possible means. It could be on the revenue side, not just the outlay side.

On the other hand, if the economy were running all out, fully utilizing its capacity—both people capacity and plant capacity—it is a very good time for the Federal Government to generate a surplus.

Senator CRANSTON. You spoke this morning of what you feel is a lag time between reducing a deficit and when that would show up in the rate of inflation. How long is that lag roughly taking you?

Mr. ASH. One can not specify a specific time because there are so many other factors at work. Sometimes the effect gets intertwined with other actions such as when wage and price controls were established. The direct effect begins immediately but sometimes drags out over years and the indirect psychological effect is a very difficult one to measure.

When the public looks back and sees that their government has been profligate and begins to have inflationary expectations, then their own behavior can respond to that inflationary expectation. It is hard to calculate this in any statistical way, because the lag translates not just to economic factors at work but translates to psychological factors at work. I don't know how to quatify the degree of lag.

Senator CRANSTON. Does your month to month or quarter to quarter calculation indicate that we have had a balanced budget and have been operating under one for approimately 18 months now?

Mr. ASH. While we have not had a balanced budget in the last 18 months, we have been closer to balance than in several years.

Senator CRANSTON. Shouldn't that be beginning to reflect itself on inflation, taking into an account the lag?

Mr. ASH. It should be were there not a lot of other factors working in the other direction simultaneously—including, I am sure, the psychological factor in ways that are very difficult to measure, to know, or to quantify.

Senator CRANSTON. In regard to that chart that you showed on manditory spending and discretionary spending, where does military assistance and foreign aid fit in that chart?

Mr. ASH. Part of that is under discretionary spending and part of it is under the already contracted and obligated expenditures. In fact, foreign aid is mostly the latter. A big part of military assistance and foreign aid is already obligated, and thus is not under the heading of discretionary expenditures.

Senator CRANSTON. Does that fall under defense or nondefense in your figures?

Mr. ASH. Nondefense.

Senator CRANSTON. Including the military assistance.

Mr. ASH. No. The military assistance program is under defense. Foreign aid is under nondefense.

Senator CRANSTON. And you put all that under what you call manditory?

Mr. ASH. A big portion, but not all, of that is mandatory because it is already contractually obligated. That is, much of it is actually contractually obligated to third parties.

Senator CRANSTON. What is your recommendation with regard to that military aid that is not obligated in terms of cuts or not cutting?

Mr. ASH. I have no recommendation on my own. I am sure that the appropriate departments and agencies will have one. The President will have his own position. Since my function is only to represent his position, I have no position of my own to report.

Senator CRANSTON. Secretary Schlesinger has been quoted with various figures that seemingly range from $1 to $5 billion in terms of that amount of economic stimulation being added to the Defense budget. Could you tell us how much and if so what was added to the Defense budget for that purpose?

Mr. ASH. There was nothing added to the Defense budget for the purpose of economic stimulus. On the other hand, it is true that whenever the Defense budget is changed, and particularly in the ways it was changed this year, it does have an economic stimulating effect. But the difference between cause and purpose here I think is the issue. It was recognized that economic stimulus would result but that didn't make stimulus the purpose.

Senator CRANSTON. If it is the administration's feeling that we should not cut the Defense budget it is obviously rather hard to make cuts when so much of what is discretionary in the Defense budget.

I would like to insert in the record at this point, Mr. Chairman, a chart that appeared in Fortune magazine in May 1970 which indicates each time we have had a war, we have had inflation, automatically beginning at that time and not ending until the year the war was over.

There are two explanations, that accompany that sort of a chart normally. One is when you have a war you normally do not increase taxes to pay for it. That was not done when we entered Vietnam until 1965. The other is the Defense spending is particularly inflationary because it pumps a lot of money into the economy unaccompanied by the production of goods and services people can buy with that money. So that produces money chasing more goods and services than may be in existence or brought into existence by the military spending and that that is basically why it is inflationary. Do you accept that latter concept? Inflationary impact?

Mr. ASH. It depends on the level of taxes. If we don't run a deficit then the latter phenomenon you describe does not have an inflationary effect. It is only as we run a deficit in the process that there is an inflationary effect. If we choose to pay as we go, we finance the purchase of military goods through tax financing, not deficit financing. Tax financing reduces disposable income which in turn reduces demand for personal consumption goods, thus preventing a buildup of excess demand. Providing we balance the budget as we go, there is not a contribution to inflation.

Senator CRANSTON. But if there is—if labors and businesses have higher wages and profits, or at least substantial amounts of same, due to military production of bombs, bullets, napalm, and so forth, that they cannot purchase, that obviously pumps into the economy a lot of other money.

Mr. ASH. Unless it is taxed away. That gets back to the necessity of balancing the budget. If higher military spending is financed by taxes—as a balanced budget would do in war time—then it would not produce that excess demand capability in the private sector. Typically, we do not tax it away totally. One need only look back at earlier war times to see that we contribute to inflation by not financing totally the increased military spending.

Senator CRANSTON. If we have so much defense spending going on right now, which we do, should we then have an increased tax to deflate the effects of that money on the economy?

Mr. ASH. I think not, for the following reason. Money is fungible, and it is very difficult to say which increment is the increment that makes the difference on the deficit. Still, if we refer back to the data that I was quoting earlier, the increments added have been increments to nondefense. So we have been gradually reducing spending for defense and increasing spending for other programs. The incremental expenditures have not been defense.

Senator CRANSTON. Thank you very much.

Senator MUSKIE. Senator Mondale.

Senator MONDALE. Thank you, Mr. Chairman.

Mr. Ash, when you make a determination to cut off all spending, I assume you seek to determine sometime what the impact of that cut would be upon the economy—inflation, unemployment, et cetera.

Mr. ASH. That is right, except the President makes the determination. I do not.

Senator MONDALE. Yes.

Mr. ASH. That is right.

Senator MONDALE. But in developing your own recommendation you have to make your best judgment.

Mr. ASH. Yes, sir.

Senator MONDALE. Not only on how this might reduce appropriations spending but what its impact would be on the economy.

Mr. ASH. That is right. The Council of Economic Advisers, the Secretary of the Treasury, and OMB, with advice from the Federal Reserve Board, all consider those implications of budget levels.

Senator MONDALE. What is your rule of thumb now, if you have one—what would you expect to follow from a $5 billion cut in Federal spending in terms of its relationship to inflation and upon unemployment?

Mr. ASH. I will answer it again as I did earlier. A $5 billion cut in Federal spending will reduce inflation to some degree. The amount depends on the kind of cut.

Senator MONDALE. How much?

Mr. ASH. Not a very big amount, in the tenths of percentage levels.

Senator MONDALE. I would like to get your approximation——

Mr. ASH. It depends on exactly what you cut and what you do but we are talking not about full percentage points. We are talking about tenths of percentage points.

Senator MONDALE. Yes, but how much?

Mr. ASH. Down in the one or two range, for the immediate period. In future periods, it may have a bigger effect.

Senator MONDALE. What do you mean by the immediate period, the next year or so?

Mr. ASH. Next quarter, two quarters, three quarters.

Senator MONDALE. Now, what will be its impact on unemployment?

Mr. ASH. In the same range. That is, a fraction of a percentage point—0.1 to 0.2 or 0.3, in that range. Again this is for the immediate period. Again in the process of making the budget, one has to look at more than just the immediate period.

Senator MONDALE. Now, what would three-tenths of 1 percent mean in terms of the actual numbers who are unemployed?

Mr. ASH. Well, three-tenths of 1 percent—if we take that high end of the range that I quoted—would be 280,000 people. It might—and this is hypothetical—be that this would make possible the hiring of a million people that otherwise wouldn't be hired a few quarters later.

Senator MONDALE. But that would be a poor speech to give in a room full of people who just lost their jobs.

Mr. ASH. I am only answering questions at this point. I am afraid I am not making a speech.

Senator MONDALE. So, in other words if we cut $5 billion out of the budget, you estimate somewhere between one-tenth and three-tenths percent in reduction in inflation in the near term and one-tenth to threetenths percent increase in unemployment?

Mr. ASH. In the near term.

Senator MONDALE. Right. All right. Now—would it be proper to say that if we went $10 billion, you might have up to a six-tenths abatement in inflation and a six-tenths increase half a million people unemployed.

Mr. ASH. I am not sure it can scale up as you have done. It just may not be a linear curve.

Senator MONDALE. Now, do you also seek to grapple with the social implications of these cuts?

Mr. ASH. Yes.

Senator MONDALE. It seems to me one of the great problems in the credibility of the Federal Government today is not only the existence of inflation but what appears to be a whole range of policies which reflect insensitivity to the problems of the average family and low income family. For example, in the tax field, taxes are actually going up on the average American. Payroll taxes have soared and as inflationary wage increases are given, most of which do not keep up with inflation, they go into higher income tax brackets. And so their taxes increase. The dollars are worth less but the taxes are still going up. These are the same people that are paying through unemployment and through reduction of the average workweek. These are the same Americans who are paying because there is no housing policy. The average American can't buy a house any more. That is gone.

These are the same Americans who are paying through a reduction in educational assistance or health assistance or environmental protection or food stamps or in a host of other ways.

Now, how is this country going to deal not only with inflation but also with the problems of fairness in American life. I think that involves more than just satisfying Chase Manhattan Bank that high

interest rates are great. What can we do to try to get a mix in our budgetary process that will restore trust on the part of the average American?

Mr. ASH. Our main consideration is the social consideration because the economy only exists to serve social purposes. Therefore, the main consideration has to be social issues. Inflation is probably a bigger social problem than it is an economic problem. Particularly, it is said to be the most regressive tax of all. And it is therefore something that we must deal with especially because it is a problem with such social consequences.

To deal with inflation is to deal with a central social issue. What we all have to come face to face with is not whether to deal with it or not. It is how to deal with it and the trade-offs that we can make. It is clearly an issue of trade-off. One can not at any one time have the best of all worlds if they can't exist simultaneously with each other. One must make trade-offs, and take some cost or penalty here in order to get some benefit there.

Consider the point I was making earlier about unemployment. It might be the basis of a good speech because it is essential that people of this country realize that there is no panacea by which we can have the best of all worlds at all times. On unemployment, that hypothetical case of 280,000 people unemployed today that makes possible a million employed a year from now, might be a thing well worth doing.

Senator MONDALE. All right. But let's take the $5 billion appropriations cut that will cost 250,000 jobs. Which would make more sense—to put those 250,000 people out of work where they can't care for their families and have to come home with all the problems that unemployment brings, including having to go on welfare? Or would it make more sense to the major multinational oil companies that are now paying 1 percent, 2 percent, 3 percent in taxes and say, "look boys, why don't you start paying 20 and 30 percent taxes like everybody else?"—and pick up $3 or $4 billion there. Now, what makes more sense? What has more social equity? What does this country need more?

Mr. ASH. In February, we proposed a windfall profit tax on the oil companies, thinking along some of the lines that you are describing. The Congress has not enacted it, causing the Federal Government to forego many millions of dollars.

Senator MONDALE. We just tried to increase taxes on the multinational oil companies in the Senate the other day, and the administration has been fighting it like a mad dog.

Mr. ASH. Well, your proposal was different from the windfall profits tax that we put forth in February but that windfall profit tax would have generated by now hundreds of millions of dollars of revenue had it been passed then. Months go by and the money doesn't come in and here we are.

Senator MONDALE. The President just made a plea to cut spending. Do you have some specific recommendations for picking up some revenues that we might use to avoid some of this unemployment and abate inflation on the tax side?

Mr. ASH. I have no specific recommendations. The Ways and Means Committee of the House is considering a tax bill at the moment. That probably is the only tax legislation that we could expect this year. There are no other specific recommendations for action this year that are pending.

Senator MONDALE. Just two points, Mr. Chairman, if I might.

I would like if possible to have someone on your staff try to collect in one category, if possible, all the risk and reserve expenditures made by various agencies of the Federal Government. There might be some difficulty in defining that, and I would be pleased to talk to your staff personally. I would like to pull together a different category all of the money we spend on health, education, space, research and development, what you might call risk reserve things, pull them together and see if we can evaluate the relative importance of that.

Mr. ASH. I am sure our staffs working together can find a definition that would be useful.

[An analysis of Federal research and development programs was subsequently supplied for the record and follows:]

SPECIAL ANALYSIS O

FEDERAL RESEARCH AND DEVELOPMENT PROGRAMS

Reprint of Pages 219 to 234 From
Special Analyses, Budget of the United States Government, 1975

Detail may not necessarily add to totals because of rounding

OFFICE OF MANAGEMENT AND BUDGET
January 1974

SPECIAL ANALYSIS O

FEDERAL RESEARCH AND DEVELOPMENT PROGRAMS

Federal funds for research and development will increase by 9% from 1974 to 1975 reflecting recognition of the larger potential contribution of science and technology to the solution of critical national problems. This is particularly true in the case of energy, where the 1975 budget reflects a substantial increase in research and development.

In addition to energy, the 1975 funds provide for the research and development needed to:

—maintain the deterrent capabilities of strategic military forces and improve the readiness and combat capabilities of general purpose forces;
—maintain a balanced space program that advances space science and the practical application of space technology; and
—respond to other pressing societal needs such as health, transportation, environment, natural hazards, drug abuse, and crime prevention.

Estimated Federal obligations for the conduct of research and development are shown in table O–1. Total obligations will increase by $1.9 billion to $19.8 billion. Civilian research and development will increase by 21% in 1975. Defense research and development obligations will increase by about 10%. Space related research and development will continue close to the 1974 funding level.

Table O–1. **THE OVERALL FEDERAL R. & D. OUTLOOK**

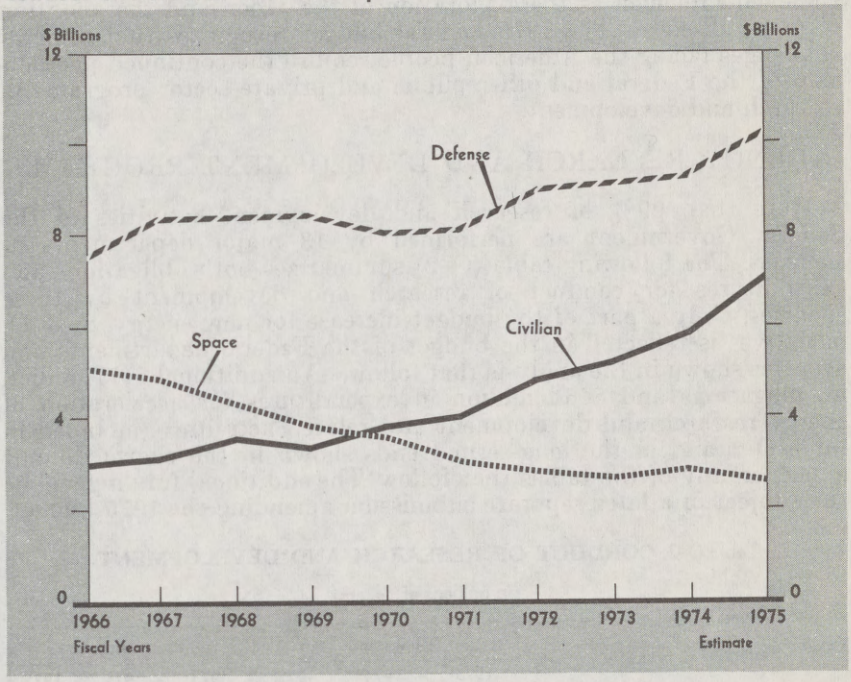
(obligations for conduct of R. & D. in billions of dollars)

	1973 actual	1974 estimate	1975 estimate
Defense, including AEC military related programs	9.0	9.3	10.2
Space program [1]	2.6	2.8	2.6
Civilian programs	5.2	5.8	7.0
Total	16.8	17.9	19.8

[1] Includes all NASA programs except those dealing with aeronautical research, communications and environmental satellites, earth observations, and technology utilization which are included under civilian programs.

The long-term trends of the Federal research and development (R. & D.) effort is shown in the following chart.

Conduct of Research and Development— Obligations



Federal funds for research and development in the 1975 budget reflect an investment on priority national needs, ranging from national defense to energy to cures for diseases. Attention also is being directed toward a balanced program of research and development which not only emphasizes short-term needs but also invests in areas of longer term importance such as basic research. This balance particularly recognizes a reluctance of industry to support basic research where benefits are not easily capturable by individual companies. Therefore, support by the Federal Government is particularly important in such areas of research.

There continues to be a growing awareness among Federal agencies that the effectiveness of an R. & D. program is often limited by institutional barriers to utilizing the results of R. & D. Thus, increased attention is being devoted by a number of agencies—including Agriculture; Health, Education, and Welfare; Environmental Protection Agency; National Science Foundation; and the Department of Commerce—to efforts which speed up the utilization of federally sponsored research and technology.

Non-Federal investment in R. & D. in 1975 is estimated to be about $16 billion or 45% of the total national investment of about $36 billion for the year. The partnership between the Federal Government and

industry, State and local government, and other investors in science and technology is an important one. It has contributed to a vigorous economy through agricultural and industrial productivity, to national security, and to some of mankind's greatest scientific and technological achievements such as the exploration of the Moon and the abolition of many diseases. The 1975 Federal budget recognizes that difficult challenges facing the American people require the continued partnership of the Federal and other public and private sector programs in research and development.

AGENCY RESEARCH AND DEVELOPMENT PROGRAMS

More than 99% of research and development activities of the Federal Government are performed by 13 major departments or agencies. The following table (O–2) summarizes both obligations and expenditures for conduct of research and development by these agencies. Only a part of the budget increase for new energy R. & D. initiatives is reflected in the budget of the Federal departments and agencies shown in the analysis that follows. An additional $777 million in obligations and $461 million in expenditures for acceleration of energy research and development and related activities (included in table O–1 and in the long-term trends shown in the chart) do not appear in any of the tables that follow. The additional funding will be the subject of a later separate submission amending the 1975 budget.

Table O–2. **CONDUCT OF RESEARCH AND DEVELOPMENT**

(in millions of dollars)

Department or agency	Obligations			Expenditures		
	1973 actual	1974 estimate	1975 estimate	1973 actual	1974 estimate	1975 estimate
Defense—Military functions	8,382	8,573	9,581	8,417	8,676	9,201
National Aeronautics and Space Administration	3,085	3,309	3,122	3,271	3,104	3,173
Health, Education, and Welfare	1,844	2,332	2,228	1,791	2,191	2,354
Atomic Energy Commission	1,361	1,429	1,586	1,361	1,429	1,586
National Science Foundation	480	530	549	428	460	498
Transportation	311	358	396	312	342	364
Agriculture	371	393	412	349	389	416
Interior	254	287	345	235	282	317
Commerce	191	210	266	179	192	233
Environmental Protection Agency	181	174	150	145	180	186
Veterans Administration	74	85	94	75	85	94
Housing and Urban Development	58	65	70	48	58	67
Justice	35	52	56	24	46	56
All other	176	132	128	150	151	125
Total, conduct of research and development [1]	**16,802**	**17,930**	**18,934**	**16,784**	**17,585**	**18,669**
Total, conduct of research	**6,478**	**7,287**	**7,325**	**6,428**	**6,971**	**7,333**
Total, conduct of development	**10,324**	**10,643**	**11,660**	**10,356**	**10,613**	**11,335**

[1] Details in this and other tables may not add to totals due to rounding.

Table O–3 identifies funding by major agency for new construction or renovation of research and development facilities and for the acquisition of major items of equipment. Funding for facilities generally parallels program levels for the conduct of research and development but the acquisition of individual large facilities may cause the overall obligations and expenditures for this purpose to fluctuate more markedly. For example, completion of the funding of the Environmental Protection Agency research laboratory in Cincinnati, Ohio, in 1974 accounts for a drop in obligations to zero in 1975 for that agency.

Table O–3. **RESEARCH AND DEVELOPMENT FACILITIES** (in millions of dollars) [1]

Department or agency	Obligations			Expenditures		
	1973 actual	1974 estimate	1975 estimate	1973 actual	1974 estimate	1975 estimate
Atomic Energy Commission	349	387	411	262	385	432
Defense—Military functions	146	201	189	157	175	168
National Aeronautics and Space Administration	69	132	156	45	75	102
Transportation	38	32	20	25	30	22
National Science Foundation	57	39	49	43	43	50
Health, Education, and Welfare	43	71	33	49	72	80
Interior	26	88	55	16	53	49
Commerce	8	12	11	6	10	12
Environmental Protection Agency	23	13	-------	3	9	16
Agriculture	3	11	8	9	10	10
All other	15	24	25	10	27	32
Total, facilities	**776**	**1,010**	**958**	**624**	**894**	**974**

[1] Does not include 1975 estimates for all additional facilities related to the accelerated energy research and development program.

In the sections that follow the thrust and content of the R. & D. programs, including facilities, of each of the major agencies are discussed.

Department of Defense—Military

Department of Defense obligations for research and development, including construction of R. & D. facilities and the cost of associated military personnel, will increase by $996 million over the 1974 level (which includes a supplemental request of $103 million) reaching a total of $9,770 million. Obligations for the conduct of research will increase by $75 million to a level of $1,862 million. Obligations for development programs and for the operation of test and evaluation facilities will increase by $934 million to a level of $7,720 million.

Both the 1974 supplemental and 1975 budget request provides for acceleration of R. & D. effort to exploit lessons learned from the recent Mideast conflict and increase force readiness, particularly in the areas of air defense suppression, combat mobility, weapons delivery, and ship defense against missiles and other weapons. In 1975, there are significant increases to improve both strategic and tactical force capabilities and to strengthen underlying technology efforts.

39-566 O - 74 - 11

In the strategic area, the Trident submarine and missile system, and the B–1 advanced manned strategic bomber both receive increased support. In addition, a number of programs will be initiated to give the United States the option to produce new and more capable strategic systems, should they be required. These include more accurate missile guidance systems, higher yield warheads, and a new standoff cruise missile for air launched delivery. Efforts will begin on a small-size strategic submarine. Later decisions to produce and deploy these weapons will depend on the outcome of ongoing SALT negotiations.

Major tactical systems receiving increases include the Aegis antimissile fleet defense system for the protection of carrier forces against missile attacks, the Airborne Warning and Control System to improve the command, control, and warning capabilities of our tactical air forces, and a new attack helicopter and tank to improve our ground capabilities. The Air Force will enter engineering development of a new combat fighter and the Navy will initiate a new fighter program. These fighter aircraft programs will provide lower cost alternatives for the modernization of tactical air forces.

Increases will also be provided for key technologies that are essential for the development of more capable and efficient military systems and that will allow quick response to changing threats. Lasers, guidance technology, and reconnaissance technology are examples.

The Department of Defense will continue to pursue management approaches such as design-to-cost aimed at increasing the efficiency and effectiveness of its R. & D. effort.

Table 0–4. **DEPARTMENT OF DEFENSE—MILITARY RESEARCH AND DEVELOPMENT** (in millions of dollars)

	1973 actual	1974 estimate	1975 estimate
Conduct of research and development:			
Research, development, test, and evaluation:			
Military sciences	457	426	431
Aircraft and related equipment	1,881	1,658	1,832
Missiles and related equipment	2,141	2,112	2,340
Military astronautics and related equipment	421	594	525
Ships, small craft, and related equipment	634	633	726
Ordnance, combat vehicles, and related equipment	381	460	512
Other equipment	1,548	1,687	2,090
Programwide management and support	525	592	712
Other appropriations	394	411	413
Total, conduct of research and development, obligations	**8,382**	**8,573**	**9,581**
Total, conduct of research, included above	**1,750**	**1,787**	**1,862**
Total, conduct of development, included above	**6,632**	**6,786**	**7,720**
Research and development facilities, obligations	146	201	189
Total obligations	**8,528**	**8,774**	**9,770**

National Aeronautics and Space Administration

The 1975 NASA budget—which is classified entirely as research and development—provides for a continuing balanced effort among programs in manned space flight, space science, applications, and aeronautics. The decrease in obligations in 1975, in some areas, compared with those in 1974, represents delayed obligations of 1973 budget authority in 1974.

The funds in the NASA budget for 1975 are tied to the support of a number of near and longer term space projects. Following the Skylab experimental space station in 1974, the next mission in manned space flight will be the Apollo-Soyuz test project to rendezvous and dock U.S. and U.S.S.R. spacecraft in 1975. The Space Shuttle will be developed through the 1970's. It will greatly enhance the flexibility and reduce the cost of space operations by permitting recovery of satellites for refurbishment and reuse, repair of satellites in-orbit, and reuse of launch vehicles.

The main thrust in the space sciences program will be the exploration of the solar system with the two Viking unmanned orbiter/lander spacecraft scheduled for launch to Mars in 1975 and two Mariner spacecraft for the Jupiter-Saturn flyby mission scheduled for launch in 1977. A Pioneer spacecraft recently completed the photographic examination of Jupiter in a flyby of that planet, and another is en route. A spacecraft is on the way to Venus and Mercury; and Venus orbiters and probes are being initiated. Development will continue on the Orbiting Solar Observatory to study the sun and on the High Energy Astronomy Observatory to study celestial X-ray and gamma-ray sources and cosmic rays.

In the space applications program research and development will continue on a new generation of weather satellites to provide major improvements in weather forecasting. A satellite to demonstrate techniques of monitoring the earth's pollution from space will be developed. In addition, the survey of the earth's resources (e.g., water and land use) will continue with the launch and operation of the second Earth Resources Technology Satellite. Two new missions in the applications program are being initiated in 1975. One mission will locate geothermal sites which are potential sources of energy, and the other mission will study the oceans from space.

Aeronautical research and technology will emphasize ways to reduce engine noise of existing aircraft and to improve the performance, reduce the energy requirements, and mitigate undesirable environmental effects of civil and military aircraft. Work is in progress on clean, quiet, efficient propulsion systems for short takeoff and landing aircraft. Similar technological advances are being pursued on conventional takeoff and landing aircraft including current narrow-body civil jet transports.

Table 0–5. **NATIONAL AERONAUTICS AND SPACE ADMINISTRATION—RESEARCH AND DEVELOPMENT** (in millions of dollars)

	1973 actual	1974 estimate	1975 estimate
Conduct of research and development:			
Manned space flight	1,136	1,056	1,125
Space sciences	662	588	540
Space applications	205	175	184
Space and nuclear research and technology	82	69	75
Aeronautical research and technology	151	168	166
Supporting activities	252	249	256
Research and program management	722	745	750
Total, conduct of research and development, budget plan	**3,210**	**3,050**	**3,096**
Research and development facilities, budget plan	79	101	151
Total, research and development, budget plan	**3,289**	**3,151**	**3,247**
Total, research and development, obligations	**3,154**	**3,442**	**3,278**

Health, Education, and Welfare

The Federal Government remains the principal source of financial support for biomedical research in the United States, providing almost two-thirds of all the research funds. The largest single agency supporting medical research is the Department of Health, Education, and Welfare (HEW) through the National Institutes of Health (NIH).

Biomedical research and development supported by NIH will continue the trend of the last several years. Expenditures for 1975 will increase by $140 million from $1,643 million in 1974 to $1,783 million in 1975. The funds will support research into diseases affecting human health, including cancer, heart and lung diseases, sickle cell anemia, aging, and venereal disease. Preventive health care research is being pursued through investigation into infant and child health, new approaches to drug treatment, new pharmacological agents for the treatment and prevention of addiction and on the general epidemiology of the drug problem; new ways to treat, control, and prevent alcoholism and alcohol abuse; basic and chemical research on the multiple causes of alcoholism; and development of new knowledge and approaches to the causes, diagnosis, treatment and prevention of mental illness.

Additional preventive health care research and development is being pursued through funding of demonstrations of health maintenance organizations, family planning, and emergency medical systems.

Social services research will investigate the causes and possible means of remedying poverty, the results of various income main-

tenance efforts, redistributive effects of social security benefits, and the effects of various methods of health insurance financing on economic security. Research on vocational education and education for the handicapped is being pursued by the Office of Education, while under the National Institute of Education, research endeavors involve learning for the disadvantaged, reading career education, educational technology, alternative financing for education (education vouchers), and experimental schools. Table O–6 exhibits the departmental expenditures by agency, and reflects a recent reorganization within HEW.

While the program level of R. & D. in the Department, particularly for the NIH, appears to decline from 1974 as reflected in the lower level of obligations in 1975, the 1974 obligations represent, in part, delayed obligation of 1973 budget authority. Expenditures—which reflect the actual impact of Federal research funding—rise markedly from 1974 to 1975.

Table O–6. **DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE—RESEARCH AND DEVELOPMENT** (in millions of dollars)

	Obligations			Expenditures		
	1973 actual	1974 estimate	1975 estimate	1973 actual	1974 estimate	1975 estimate
Conduct of research and development:						
National Institutes of Health	1,338	1,745	1,662	1,327	1,643	1,783
Alcohol, Drug Abuse, and Mental Health Administration	122	157	129	112	132	132
National Institute of Education	107	101	130	36	96	114
Health Resources Administration	53	61	71	51	48	63
Office of Education	58	55	[2] 15	94	61	[2] 51
Social and Rehabilitation Service	53	50	[1] 33	63	66	[1] 47
Food and Drug Administration	30	35	38	23	33	38
Center for Disease Control	33	38	34	34	37	32
Social Security Administration	18	25	27	18	25	27
Office of the Secretary	------	21	[1] 34	------	15	[1] 23
Assistant Secretary for Human Development	12	15	[1] 24	9	12	[1] 17
Health Services Administration	12	12	12	12	13	13
Assistant Secretary for Health	8	16	18	11	11	14
Total, research and development	**1,844**	**2,332**	**2,228**	**1,791**	**2,191**	**2,354**

[1] Reflects the transfer of certain research functions from the Social and Rehabilitation Service to the Assistant Secretary for Human Development and the Office of the Secretary.
[2] Reflects the transfer of certain research functions to revenue sharing accounts.

Atomic Energy Commission

Research and development by the Atomic Energy Commission will increase from $1,429 million in 1974 to $1,586 million in 1975. Obligations for related construction and equipment will total $411 million in 1975, as compared to $387 million in 1974. The additional funds, in the main, will be used to accelerate energy research in response to the pressing energy needs of the Nation. Further increases from funds for acceleration of the Federal energy R. & D. effort will further augment the total AEC program in 1975.

AEC's top priority civilian program continues to be the development of an economic Liquid Metal Fast Breeder Reactor (LMFBR). This program will be strengthened in 1975. On July 25, 1973, AEC entered into contracts with Commonwealth Edison Co. of Chicago, the Tennessee Valley Authority, and two not-for-profit corporations, the Breeder Reactor Corp. and the Project Management Corp. for a cooperative endeavor to design, construct, and operate the Nation's first demonstration LMFBR power plant. Funds for the development of the High Temperature Gas Reactor will also be increased and R. & D. will be continued on the Light Water Breeder Reactor, the Gas Cooled Fast Breeder Reactor, and the Molten Salt Breeder Reactor.

Increased emphasis will be placed on the controlled thermonuclear fusion research program. It seeks to develop a new energy source based on the nuclear fusion process that may provide a basis for a long range solution to the Nation's energy problem.

AEC's research program includes investigations in the physical sciences to develop a fundamental understanding of the properties and behavior of both matter and energy; studies in the biomedical and environmental sciences of the effects of energy production on living systems in order to assess, evaluate, and control environment; and research related to weapons technology and detection techniques.

AEC's development programs include design and testing of nuclear weapons, process development in support of nuclear material production activities, development of techniques and facilities for long-term storage of radioactive wastes, and the development of advanced reactors for power and propulsion.

The AEC budget for construction of research and development facilities in 1975 provides for obligations of $266 million, which is $15 million more than the 1974 level. Included in the 1975 amount is $132 million for continued construction of the Fast Flux Test Facility in support of the LMFBR program; $12 million for completion of construction of a facility for development and testing of a new prototype nuclear propulsion plant in support of the naval reactor program; and $8 million for construction of heavy ion facilities to support research under the physical research program.

Table 0-7. ATOMIC ENERGY COMMISSION—RESEARCH AND DEVELOPMENT [1] (obligations in millions of dollars)

	1973 actual	1974 estimate	1975 estimate
Conduct of research and development:			
National security:			
Weapons research	61	58	59
Weapons development and testing	394	383	393
Naval reactor development	149	154	162
Waste management	6	12	17
Total, national security	610	607	631
Energy:			
Reactor research and development	256	290	350
Controlled thermonuclear research	37	53	82
Nuclear materials (production)	33	40	44
Applied energy technology	10	15	12
Other programs	9	9	12
Reactor safety research	34	41	48
Total, energy	379	448	548
Physical research	241	250	268
Biomedical and environmental research	93	98	112
Space nuclear systems	39	26	27
	373	374	407
Total, conduct of research and development	**1,362**	**1,429**	**1,586**
Research and development facilities	348	387	411
Total, research and development	**1,710**	**1,816**	**1,997**

[1] Does not include added funds for research and development or facilities, that are part of the funds for further acceleration of the Federal energy R. & D. effort.

National Science Foundation

National Science Foundation obligations for research and development and related facilities will increase from $569 in 1974 to $598 in 1975. These increases reflect the Administration's support for scientific research to provide the fundamental knowledge necessary for economic growth and long-range solutions of problems of national concern. The main problem areas addressed by much of the NSF research include energy, environment and productivity.

In 1975, NSF will expand significantly its support for energy related research as a part of the President's accelerated program of energy R. & D. Further increases for acceleration of the Federal energy R. & D. effort will augment the total NSF energy program in

1975. The NSF will strengthen its funding of fundamental research to provide better understanding of a wide range of energy problems leading to the development of new materials, techniques, and processes for energy systems. Basic and applied studies in solar and geothermal energy will result in the near future in the design and testing of systems for heating and cooling buildings and for commercial utilization of geothermal energy. Selected advanced research will be pursued on unconventional energy sources and alternative energy systems, e.g., photovoltaic and bioconversion systems.

Support of fundamental research will increase by $34 million to $325 million. This research—though broadly based—will emphasize such areas as catalysis, industrial processes, biological pest control, plate tectonics, and atmospheric physics. Under its support of major research facilities, the Foundation will provide $13 million for accelerated construction of the Very Large Array radio astronomy facility begun in 1973.

In addition to the substantial energy program, the Research Applied to National Needs Program will continue its efforts in environmental systems, earthquake engineering, technology assessment and improving productivity in industry and the public sector.

Under its national programs the Foundation provides the management capability for operating large national facilities such as the National Center for Atmospheric Research and the academic oceanographic fleet as well as organizing and managing large research programs, such as the International Decade of Ocean Exploration or the Antarctic Research Program. These national programs will continue to emphasize environmental research (earth, atmospheric and ocean sciences) to improve our knowledge of how to better manage the environment.

Department of Transportation

The research and development obligations for the Department of Transportation, including facilities, have grown rapidly from $130 million in 1969 to $390 million in 1974 and are projected at $417 million for 1975.

The obligation level for 1975 provides funding for maintaining the thrust of transportation research to solve the near term transportation problems facing the Nation, as well as providing funding for technology development which may be needed for future transportation systems. Transportation alternatives are being better defined and tradeoffs are being evaluated so that our near-term problems of energy conservation, urban mobility, environmental protection and improved safety will receive urgently needed emphasis and attention.

Urban mass transportation R. & D. in 1975 will emphasize the development of improved higher capacity, quieter, and low pollution transit buses, the development of advanced personal rapid transit (PRT) systems, and the continuation of the intermodal integration program designed to encourage low-cost service innovations and regulatory actions to improve and maximize the use of current urban transportation systems.

Highway research funding will continue to strengthen cooperative programs with State governments to increase highway and pedestrian safety, reduce the high costs of highway construction and maintenance, and increase the capacity of highways and roadways through improved traffic management techniques. Highway traffic safety research in 1975 will emphasize accident investigation and data analysis, vehicle safety, biomechanics research, and alcohol countermeasures.

Railroad research will emphasize the solution of industry cost and freight car management problems, improved freight service, and rail safety, including tank car improvements.

Air transportation research provides for continued upgrading of the air traffic control system and for increasing airport and airway capacity through improved surveillance, communication and landing aid development, and increased automation of the air traffic function. Also emphasized are aviation safety, aircraft noise and pollution abatement activities, the development of ground-based systems to improve the precision navigation of aircraft, and other air safety research.

R. & D. in the Coast Guard in 1975 will continue to stress maritime pollution control systems development, all weather harbor traffic monitoring, improved aids to navigation, and programs to improve public safety at sea including recreation boating.

Department of Agriculture

Obligations of the Department of Agriculture for the conduct of research and development will increase from $393 million in 1974 to $412 million in 1975.

Developments during the past year in the supply and demand situation for food highlight the need for research to support the production of ample supplies of high quality food and fiber to be marketed at prices consumers can afford to pay. Efficiency in the use of energy must be met in agriculture as well as in other industries. New funds for 1975 will focus on developing new knowledge and technology for reducing the production costs of red meats; increasing productivity of oilseeds—especially soybeans; reducing the costs of producing wheat, feed grains and milk; and minimizing crop losses from disease, insect and environmental stresses—especially from the standpoint of vulnerability associated with narrow genetic bases in most of our major crop varieties.

Increased attention will be given to research on the nutrient composition of our foods and the nutrition status and requirements of the American public.

Improved environmental quality in rural America will be further pursued through increased research on the control of water erosion and sedimentation and other facets of agricultural-related pollution. New studies on nitrogen nutrition of crops will seek to serve the dual objective of improved efficiency of fertilizer and naturally available nitrogen and decreased potential for water pollution.

The Department of Agriculture and cooperating State and private research organizations will reassess their programs during 1975 to insure that the United States has the research base for agricultural preeminence. In addition, new efforts will be made to improve our ability to forecast agricultural trends to aid in production, marketing, and price setting decisions. This will include more detailed and complete cattle and swine surveys and new means for drawing upon data from satellites and other means of remote sensing to survey crop and natural resource conditions and supplies.

Department of the Interior

The Department of Interior undertakes research and development involving mineral, land, water, fish, and wildlife resources, as well as geological and energy research and development. Obligations for the Department of Interior for research and development will show an increase from $287 million in 1974 to $345 million in 1975. The 1975 amount will be further increased by funds for acceleration of the Federal energy R. & D. effort and will augment the total Department of the Interior's energy program this year.

The Department is accelerating its programs for current land-use mapping in order to speed completion of its long-standing program of mapping the United States at a scale of 1:24,000. It is also accelerating its geological and geophysical evaluation and classification studies of the outer continental shelf and of coal lands in preparation for advanced leasing schedules. The Department is actively pursuing the development of safe mining systems that will at the same time permit maximum recovery of the useful minerals. Programs in metallurgy and ceramics emphasize more efficient processing of raw materials, the derivation of energy from waste materials, and the development of high-temperature, corrosion-resistant materials. Together with the Department of Agriculture, Interior will continue demonstration programs in strip mine restoration in 1975.

Land and water resource studies involve investigations into land-use problems, efforts to improve the quality of the physical environment, and the promotion of efficient allocation and conservation of scarce water and water-related resources. Research programs will be continued to better understand basic principles of hydrology necessary for the appraisal and evaluation of the Nation's water resources, including the effects of underground waste storage. Other research programs include application of environmental resource data in urban decisionmaking processes; and the application of satellite-acquired data in the earth sciences to land and water resource management.

Basic and applied research on principles and processes related to geologic hazards such as land slides and earthquakes will continue. The Department's program is enlarged as a result of the consolidation of Commerce's earthquake program with that of Interior during the past year.

Increased efforts will be applied to find safe and effective control methods for managing nuisance bird populations, research on migratory game birds other than waterfowl will be expanded, and studies of pollution effects on wildlife will be initiated. Research relating to predator animal damage will be expanded.

Department of Commerce

Department of Commerce obligations for the conduct of research and development and facilities will increase by $55 million in 1975, from $222 million in 1974 to $277 million in 1975. This reflects increases for the research and development programs of the National Oceanic and Atmospheric Administration (NOAA), the Maritime Administration (MARAD), and the National Bureau of Standards (NBS).

The principal objectives of the research and development programs in the Department of Commerce are to continue to improve the Nation's environmental prediction and warning capabilities, develop technology to improve the competitive position of the U.S. maritime industry, and encourage technological advancement through improved performance and measurement standards.

In 1975, NOAA will continue research to help reduce loss of life and property from natural disasters by improving the detection and tracking of weather systems and violent storms, by extending the forecasting and data gathering programs, and by exploring the modification of severe storms.

In the marine sciences, NOAA will conduct biological research aimed at the conservation, development, and management of commercial fisheries of the United States. NOAA will also continue research programs in ocean dumping and in coastal zone management, and begin the readjustment of the North American Datum.

The technology development and utilization programs of NBS will be increased, with emphasis on efforts to develop measurement methods and standards for energy conservation, the abatement and control of environmental pollution, the improved reliability and effectiveness of clinical testing laboratories, the technology of radiation control, and improved Federal management and utilization of computers.

The Maritime Administration will continue to emphasize research and development to assist the U.S. maritime industry to develop the technology necessary to improve its international competitive position. The 1975 emphasis will be on improvements related to ship-building methods and equipment, nuclear ship propulsion and shipping operations information systems.

Research to reduce loss of life from fires will be consolidated and expanded in a new National Bureau of Fire Prevention in the Department.

Environmental Protection Agency

Environmental Protection Agency (EPA) research and development in 1975 will continue to emphasize research on human health effects, ecological effects, measurement methods research, and quality assurance. The expansion of these program areas will strengthen the basis for standards set by EPA and support the development of effective control strategies while continuing to identify and evaluate long-range environmental problems. The accelerated energy research and development program for 1975 will include some additional environmental research and further increase in funds to augment the total EPA program.

Air quality research and development efforts will involve expanded epidemiological and toxicological studies of the effects of pollution on human health and continued studies of the health effects of combustion products and catalytic reactor emissions. Ecological effects research will include studies of atmospheric chemical and physical processes of pollutants and continued studies to characterize the combustion products of fuels, fuel additives and catalytic reactor emissions and their environmental effects. The air measurements technology program will be expanded to determine compliance with standards and to provide for the continuous monitoring of stationary sources. Ongoing demonstrations of stack gas treatment technology will continue and attention to control of fine particulates will be increased.

Water quality research will emphasize on the development of criteria for the safe treatment and disposal of effluents and sludges from municipal and industrial wastewater treatment plants. Work will continue on the development of criteria for marine and freshwater fish and aquatic life; further understanding of the eutrophication process and lake restoration procedures; and pollution problems of the Great Lakes. In the area of control technology the major thrust will be aimed at area pollution control research and improving technology for existing municipal source control and advanced waste treatment. Industrial source control program will concentrate on developing techniques to meet effluent guidelines for critical industries.

Water supply research will focus on the health effects of asbestos in drinking water with continued support for research to determine the presence of organics and infectious agents in drinking water in order to develop criteria for setting standards. Research into the effects of trace organics, asbestos, nitrates, trace metals and suspended solids, and their removal will continue.

Pesticides research and development will concentrate on expanding the health effects program by undertaking inhalation toxicology studies to assess the significance of respiratory versus dermal exposures to people handling pesticides, and development of human exposure data relating to the safe handling of pesticides. Other research will focus on health effects involving non-ionizing radiation and toxic substances.

RESEARCH AND DEVELOPMENT IN COLLEGES AND UNIVERSITIES

An important component of Federal support of science is the level of funds to universities for research and development. These funds represent grants and contracts with colleges and universities for research and development that can contribute to the achievement of agency missions. The funds are part of the total research and development efforts of the various agencies as shown above in this analysis. The 1975 budget will provide $2,262 million in expenditures for this purpose, as contrasted with $2,107 million in 1974, and $1,888 million in 1973. These expenditures do not include the support to universities and colleges that will result from the allocation of the additional 1975 funds for acceleration of energy research and development and related research activities. A significant increase in the 1975 expenditure level for R. & D. at colleges and universities is anticipated as a result.

While continuing Federal support for basic research on all fronts, the 1975 budget supports educational institutions in their efforts to undertake research focused on important national and regional problems—ranging from studies of the causes of cancer and heart disease to the problems of industry in improving economic productivity. The increase in research funding will not only assist in the support of faculty investigators, but will also provide valuable experience and training for science and engineering graduate students through employment on research projects. Obligations and expenditures are shown by agency in table O–8.

Table O–8. **RESEARCH AND DEVELOPMENT IN COLLEGES AND UNIVERSITIES** [1] **(in millions of dollars)**

Department or agency	Expenditures		
	1973 actual	1974 estimate	1975 estimate
Health, Education, and Welfare	937	1,159	1,232
National Science Foundation	329	339	409
Defense—Military functions	218	204	203
National Aeronautics and Space Administration	127	97	91
Atomic Energy Commission	83	84	94
Agriculture	88	95	99
All other	106	128	134
Total	**1,888**	**2,107**	**2,262**

[1] Amounts reported in this table are included in the totals for conduct of research and development in table O–2, and do not include the support to universities and colleges that will result from the allocation of the additional 1975 funds for accelerated energy research and development and related research activities.

Senator MONDALE. The second thing is, I would appreciate it if you have someone on your staff who could submit a paper on what we might do for—what you might call "performance accounting." One of the things that I think aggravates most Americans—I suspect you have the same problem—we have it here all the time—is that all of our budgeting gets into the question of what goes into a program, its input, and you can never find out what is coming out. You can't run a business that way. You can't run a family that way. I think it aggravates the average American that we try to run Government just in terms of inputs. And one of the dreams I have about this committee is that we can start for the first time in this country to have an evaluation program, an independent evaluation program. I think we should want an evaluation program built into our Federal programs so that we can get independent appraisals on an ongoing basis as to whether these programs make sense, whether we are getting our money's worth, whether there is something else that might work better, and so on. I would appreciate that.

Mr. ASH. That subject takes more than just a paper. I think that when you have the time and any of your committee members or staff have the time we can afford to spend a number of hours with many papers rather than just a paper. We should deal with discerning and defining the problem, and with the things that are being done, and still must be done. It is a subject of much more than a paper. We would like to have it be an important discussion we would have with this committee and anybody else.

Senator MONDALE. I think it would be very important but I think if I could have a memo in which you set forth some of the salient strategies that are being used, that could be used to give us a better drift on the evaluative function that I hope we could commence with it.

Mr. ASH. It is a very important subject. We would very much like to begin talks on it. Your point is well taken. Too often, we think of inputs and we do not think of outputs; we think of best efforts, and do not think of results. We have got to get more orientation toward output and results and less on inputs and best efforts.

Senator MONDALE. Thank you.

[Two papers by OMB staff subsequently submitted for the record which deal with program evaluation and the need to concentrate on output and results, follow:]

[Public Administration Review, Vol. 34, No. 4, July/August 1974]

FEDERAL PROGRAM EVALUATION FROM THE OMB PERSPECTIVE

(By Frank L. Lewis and Frank G. Zarb, Office of Management and Budget)

(*Editor's Note:* At the time of preparation of this article, Mr. Zarb was OMB Assistant Director for Management and Operations, whose responsibilities included OMB evaluation policy. That position is now held by Dr. Robert H. Marik. To develop and carry out this policy, a new Division of Evaluation and Program Implementation was established within that office, under the direction of Clifford W. Graves.)

Program evaluation represents one of the most useful and essential tools available to federal officials for assuring rational policy decisions and effective program management. The purposes of this article are to provide some perspective on the evaluation effort currently conducted within the Executive Branch and to describe some of the activities which OMB plans to undertake in cooperation with the various federal agencies to improve the quality and usefulness of evaluation as an aid to the decision process.

DEFINITION AND ROLE OF EVALUATION [1]

Evaluation, as used here, is defined as relatively structured, systematic analyses of operating programs designed to assess their impact or effectiveness in attaining their stated objectives, or to assess their efficiency. Within this broad definition are four general categories of evaluation, delineated generally on the bases of their purpose and predominant methodology. These are: (1) substantive impact evaluations, (2) relative effectiveness evaluations, (3) process or management evaluations and (4) project evaluations.[2]

Substantive impact evaluations attempt to measure the impact which federal programs have upon their stated objectives. This type of evaluation seeks to determine what the program accomplishes, how these accomplishments compare to their intended purposes, and their costs. The purpose of such evaluations is primarily to provide information for use in major policy formulation.

Relative effectiveness evaluations seek to compare the effectiveness of two or more major program strategies or approaches in attaining ultimate objectives within a national program. These studies are designed to help policy officials and program managers select the most effective mix of services to maximize programs' total impact, such as the mix of skill training, remedial education, and job search assistance in a manpower program. However, these studies do not necessarily measure the impact of the total program in absolute terms on its objectives.

Process or management evaluations are designed to measure the operating efficiency of national programs. They are intended principally to help program managers achieve the most efficient deployment of available resources, rather than help policy officials arrive at major decisions affecting the scope and focus of the national programs.

Project evaluations are directed to individual, locally based projects which are components of a national program, regarding the impact or efficiency of the total national program. Project evaluations may entail any of the three preceding types (substantive impact, relative effectiveness, or process evaluation) as well as project rating—comparing the effectiveness of one or more individual projects against others.

The definition presented above is deliberately intended to focus upon a relatively narrow sub-set of a broad range of activities which might be construed as evaluation in a broader context. It emphasizes the application of scientific method (research) to program assessment. Excluded from this definition are certain activities carried out as part of normal, day to day functions in connection with policy analysis and development, budget review, legislative review, and other similar but less structured approaches. Also excluded are basic research, data collection, and audit activities, all of which are closely related to evaluation but not treated as such here.

EVALUATION AS A MANAGEMENT TOOL

There are neither ready nor easy means for determining attainment of the basic objectives of most federal programs. Unlike a business firm with its profit and loss statement, federal programs confront a variety of conceptual and measurement problems when attempting to determine success or failure. A federal program usually has multiple objectives, many of which are never clearly stated. Moreover, which objective, or set of objectives, is paramount is seldom clear. It may in fact differ among various policy spokesmen—individual members of Congress, the President, and the public at large. Further, two or more objectives may be incommensurate—i.e., the attainment of one may be directly counter to the attainment of another.

The difficulty of measuring attainment of federal program objectives enhances the importance of evaluation activities. It is our view that federal evaluation is, or should be, an essential management tool for policy officials. Good evaluation studies (especially impact and comparative effectiveness evaluations) not only help to measure program results but also assist policy officials in the specifica-

---

[1] The discussion in this section is directed primarily to evaluation as it should exist, which may not conform to the existing situation in all cases. For instance, in the definition of evaluation, reference is made to programs' "stated" objectives. However, as suggested later, a major obstacle to performance of useful evaluations is the absence of a clear statement of objectives. Similarly, the types of evaluation described in this section are not necessarily performed by some agencies, but, in our view, should be.

[2] The types of evaluation described generally conform to those which have been described in other studies on evaluation. See particularly Joseph S. Wholey, John W. Scanlon, Hugh G. Duffy, James L. Fukumoto, and Leona M. Vogt, *Federal Evaluation Policy: Analyzing the Effects of Public Programs* (Washington, D.C.: The Urban Institute, 1971).

tion of program objectives. In addition to the basic management decisions which program evaluations support (decisions concerning efficient deployment of resources, and policy decisions concerning program level and focus) evaluations assist policy makers in implementing difficult decisions.

EVALUATION PROGRAM EXAMPLES

The central importance which evaluation should play in effective program management of evaluation activities themselves highly critical. The is no single best approach toward carrying out an evaluation program, and approaches vary from agency to agency. It may be helpful to review briefly examples of current evaluation activity.[3]

DEPARTMENT OF HEALTH, EDUCATION, AND WELFARE[4]

The authorizing legislation for many HEW programs includes specific provision for program evaluation. The bulk of the resources identified for evaluation are administered by the constituent operating organizations within the Department—i.e., the Office of Education, the Social and Rehabilitation Service, etc.

To provide overall direction and focus to the department's total effort, a central evaluation office has been established within the Office of the Assistant Secretary for Planning and Evaluation (OASPE). Until recently 25 per cent of all evaluation funds within the Department were made available at the discretion of the Assistant Secretary, while 75 per cent was to be used by the constituent agency. This procedure has been modified recently, leaving the distribution to be determined on a less rigid basis.

The Office of the Assistant Secretary for Planning and Evaluation is assigned the responsibility for developing and coordinating the Department's overall evaluation plan and resources. This includes those funds specifically allocated to OASPE and those reserved for the operating programs. The purposes of this coordination are to insure that evaluation activities are related to the central policy concerns of the Department, to eliminate duplication of effort and bring about coordination of complimentary efforts and to improve the quality of HEW's evaluation activities while making available to all others the expertise and insights that are gained in any one area.

Evaluation funds to be used at the initiation and direction of the Assistant Secretary for Planning and Evaluation serves several important purposes. A major portion of the funds has been directed to projects relating to policy questions for which the Assistant Secretary for Planning and Evaluation has been assigned the lead responsibility. This assures integration of the evaluation activity into the planning and policy development process. This system of handling the funds also serves to facilitate a desired balance of influence between the agencies and the Office of the Secretary. It enables the OASPE to negotiate with the HEW constituent agencies during the complex process of reviewing and approving their evaluation plans to develop some of the more important details of specific evaluation projects that the constituent agencies wish to undertake. Finally, the funds are used to sponsor major "crosscutting" evaluations—i.e., those that bridge more than a single operating agency's area of responsibility.

As it turns out, much of the evaluation funds which have been reserve for the Office of the Secretary (out of a total of $40 to $50 million) is ultimately returned to the operating programs for use at their discretion on evaluation activities. However, the initial reservation of such funds, combined with the overall responsibility for managing and coordinating the Departmentwide evaluation activities, supports the capability of the Department in achieving a more fully integrated and coordinated evaluation activity directed to those areas of highest priority both to the Secretary and to the operating program heads.

THE DEPARTMENT OF LABOR

The Department of Labor also has moved to strengthen its program evaluation efforts by giving top-level policy support and by establishing a centralized evaluation staff in the Office of the Secretary. Recently, the Secretary of Labor estab-

---

[3] The discussion of evaluation systems provided below are based upon descriptions provided by each agency. The descriptions are intended to provided an illustration of some existing federal evaluation programs. However, these should not be construed necessarily as models of examples of ideal approaches to federal evaluation.

[4] For a more complete discussion of HEW's evaluation system and examples of evaluation studies, see: Laurence L. Lynn, Jr., "Notes from HEW," *Evaluation*, Vol. 1, No. 1 (Fall 1972), pp. 24–28.

lished a new emphasis on evaluation in order to provide departmental management with better information and empirical evidence for making policy and resource decisions. A goal was established to develop performance information for all department programs during the next four years. Each agency was directed to strengthen its program evaluation capability. The Assistant Secretary for Policy. Evaluation, and Research in addition was assigned a number of major responsibilities in order to provide centralized direction and coordination for departmental evaluation activities. These include:

(a) Development of an annual evaluation work plan for the Department.

(b) Approval of all major evaluation projects within the Department.

(c) Review of evaluation project proposals and provision of technical assistance and training to program agency evaluation staff.

(d) The conduct of independent evaluations of program performance.

To help finance these activities, the Assistant Secretary was given authority to tax agency evaluation funds with the exact amounts to be determined annually by the Secretary.

A natural division of labor is developing within the Department between the central evaluation staff under the Assistant Secretary for Policy, Evaluation, and Research (ASPER) and the program agencies. The former is concentrating on substantive impact evaluations and the program agencies in other types of evaluations. This division coincides with the difference in the principal focus of the Office of the Secretary and of the managers of operating programs. The program agencies are concerned primarily with achieving efficiency within a given program structure and funding level which requires process evaluations. The Office of the Secretary is more concerned about overall departmental resources and the allocation of these resources among different programs; this requires program impact and relative effectiveness evaluations.

The ASPER evaluation staff are concentrating their attention at present on developing methodologies for doing impact evaluations on a regular, periodic basis using wherever possible existing data systems. This typically involves combining two or more data systems. For example, the staff is testing the possible use of Social Security earnings records to evaluate the impact of manpower training programs. Also, the use of equal employment opportunity reports filed by employers with the federal government is being tested to evaluate the impact of the federal contract compliance programs on increasing employment opportunities for minorities and women.

As in HEW, the central evaluation staff works in close relationship with the policy and program analysis staff who are responsible for budgetary and legislative analysis. The close cooperation between these two groups assures that the evaluation efforts will be relevant to the major policy concerns of the Department, and that the results of evaluation studies will be used in the policy and program decision process. However, the designation of a separate unit within ASPER to be responsible for impact evaluations allows work to proceed on a regular basis, avoiding diversion of skilled analytical staff to solve immediate policy crises.

DEPARTMENT OF TRANSPORTATION

The Department of Transportation represents a somewhat different approach to managing and organizing program evaluation than reflected in the preceding examples. In keeping with the decentralized management philosophy of the Department of Transportation, there is no attempt to develop a single unified evaluation program for the myriad activities under the Department's domain. The head of each of the Department's seven operating administrations is directly responsible for developing, executing, and utilizing the results of its internal evaluation program. The Office of the Secretary has assumed a positive, but limited, role with respect to the administration's internal evaluations to assure that a reasonable program is established and that progress is selectively monitored. This is accomplished largely through the Department's program planning process in which each operating administration presents in summary form its evaluation in terms of past year accomplishments, current year plans, and new proposals for the planning year. Finally, the administrations are requested to utilize evaluation findings in their participation in the Department's annual program planning and budget process.

The primary focus for the central evaluation responsibility with the Department of Transportation rests with the Office of Planning and Program Review under the Deputy Under Secretary for Budget and Program Review. This office each year identifies a limited number of specific evaluation studies which reflect top management concern, the results of which are expected to impact on major

planning, budget, and legislative formulation decisions. For the most part, primary reliance continues to be placed upon the individual operating administrations for the actual conduct of the studies, with overall direction and support provided by the Office of the Deputy Under Secretary. Since the end of 1971, approximately 30 such evaluation studies have been initiated under this Departmentwide activity.

FOCUS AND ROLE OF OMB

In one sense, program evaluation has always been considered a major responsibility for OMB as a whole, defining the term broadly. Certainly program assessment is an essential and crucial element of the substantive review of programs performed by OMB when developing recommendations to the President of an appropriate funding level for an agency's budget. Similarly, results of past program assessment efforts of OMB staff enter into advice rendered with respect to OMB's legislative and management and organization functions.

However, in terms of the narrower definition of evaluation presented above, OMB has not in the past performed a major role in the conduct of evaluation studies, nor does it do so currently. Rigorous, systematic evaluation studies have been performed by OMB only on an occasional basis in response to a significant perceived need or new policy initiative.

Moreover, it is not contemplated that the role of OMB in this respect will change materially in the future. As suggested above, a major outgrowth of the efforts to develop improved planning and budgeting systems in the federal government in recent years has been a substantial expansion of analytical capability within the various departments and agencies. At this point in time. OMB takes the position that each agency head is primarily responsible for managing the programs under his jurisdiction and that program evaluation constitutes an essential element of effective management. It follows that each federal agency should be responsible for carrying out its own evaluation program.

However, concern has been expressed as to whether the results obtained from many of these efforts have been as useful and relevant as they might be to major policy decisions confronted by program managers agency heads, the President and Congress.

What then remains for OMB as an institution with respect to evaluation Briefly, OMB will initiate a multi-agency cooperative effort to upgrade and strengthen the overall quality and relevance of evaluation carried out by the various federal agencies and to assure that evaluation results are utilized in arriving at major policy decisions.

In pursuing this objective of upgrading the overall quality of federal evaluations, a wide range of OMB resources will be employed, working with the various federal agencies on a cooperative and mutually supportive basis. The recent reorganization of OMB, designed to strengthen its governmentwide management capability, represents a critical element in its renewed evaluation thrust. The newly established management associates, working closely with the program examining divisions, will carry out activities directly related to program evaluation as part of their overall management effort. This will include initiatives to help improve the management of the various agencies' internal evaluation programs, and may include direct conduct of occasional evaluation studies which respond to specific major policy initiatives.

To provide focus and direction to OMB's total evaluation effort, we have established a central Evaluation Division under the Associate Director for Management and Operations. This division will develop the internal capability to stay abreast of latest techniques and developments in the management and performance of program evaluations. It will utilize this capability to identify strengths and weaknesses in current federal efforts and support OMB's total effort to upgrade the overall quality of federal evaluation.

MAJOR OMB EVALUATION INITIATIVES

The following discusses some specific major evaluation initiatives which OMB has initiated, or is now considering, to carry out its broaden mission of upgrading the state of the art of federal program evaluation. These specific initiatives should not be viewed as isolated activities undertaken in isolation from other OMB functions. Rather, they are intended to be a part of continuing OMB activity directed at strengthening governmentwide management capability.

1. Consultation with Senior Evaluation Officials

OMB has recently prompted the establishment, on a very informal basis, of a panel of senior federal executives to serve as a forum for the mutual exchange of ideas and development within the federal evaluation community. This group comprised of individuals familiar with and responsible for evaluation activities within their own agencies, should be instrumental in fostering the development of new ideas and approaches to evaluation and in facilitating the exchange of information among one another. This group will be especially helpful to OMB, both in guiding and directing OMB's own effort and in providing a mechanism for transmission of findings to the federal evaluation community.

2. Inventory of Federal Evaluation Activities

Resources currently available for conduct of program evaluation are substantial, but scattered through the federal establishment. There exists no ready means of identifying, describing, and measuring these activities in a comprehensive and consistent manner. To fill this gap, OMB will initiate a comprehensive survey of federal evaluation programs that will inventory and catalogue the universe of such activities.

The results of this effort will serve as a basic information source to a continuing effort to upgrade federal evaluation. In addition to simply identifying resources currently available, it will provide a means for determining which efforts are yielding useful results and where improvements are required.

3. Cross-cutting Budget Review of Evaluation Activities

OMB currently conducts annual reviews of agency programs when preparing the President's budget submission to Congress. Evaluation activities, though large in total, normally represent a relatively small part of any single agency's entire budget. As a result, the budget cross examing process frequently accords less attention to this management function than might be desired in light of its potential significance for the efficient operation of the larger operating program.

To rectify this discrepancy, the new Evaluation Division will direct a cross-agency budget review to assess the adequacy of funding levels for evaluation programs in a number of federal agencies. The survey of evaluation programs discussed above will serve as a useful input to this effort. The built-in knowledge of OMB staff especially those in the examining divisions, will also be utilized to the full.

4. Review and Comment on Agency Evaluations Plans

Most agencies currently performing evaluation activities to any significant extent prepare formal plans on a periodic basis to direct and guide individual studies to high priority topics. OMB will urge that those not already doing so initiate a planning process, and subject them to interagency review and comment, utilizing the panel of evaluation executives discussed above.

The purpose of this exercise will not be to impose a new rigid planning requirement on the agencies, nor will OMB attempt to exercise direct control or veto over the content of agencies' plans. Maximum flexibility will be left to each agency concerning the form and content of such plans. The major objectives will be (a) to assure that there does, in fact, exist some planning process with respect to each major evaluation activity, (b) to facilitate exchange of various agencies' plans in order to minimize duplications and maximize complementarity, and (c) to enable OMB to influence initiation of occasional studies of particular interest to OMB and the White House.

5. Continuing Legislative Review

The ability to develop useful and timely information on a program's impact can be significantly enhanced by building in an evaluation capability from the program's inception. OMB intends to carefully review all new legislative initiatives to assure that adequate provision is made for evaluation, and that the evaluation capability be in place as soon as the new program begins operation.

6. Relationship to Management by Objectives

A major management initiative recently launched by OMB is the identification of major program objectives of presidential interest among the major federal agencies and development of a routine system for tracking their attainment. This process, commonly referred to as management by objectives (MBO), has a direct bearing upon OMB's evaluation activity in two general respects.

First, the MBO process will help guide evaluation efforts to the highest priority policy issues. The process of identifying and specifying major short term management objectives for individual programs will inevitably lead to identification of a number of major economic or social objectives which do not readily lend themselves to measurement by routine management information systems. For instance, we may be able to determine through existing management systems the total numbers of persons treated by a drug rehabilitation center. However, such information does not necessarily tell us how many drug or narcotic addicts are actually rehabilitated, nor what the cumulative impact is upon the society at large. It is to questions of this nature that evaluation activities are appropriately addressed.

Accordingly, we will review each major objective identified under MBO to assure that the broader social implications are specifically identified and, where appropriate, identify the major evaluation efforts necessary to measure their attainment. The review of agency evaluation plans discussed above will enable use to determine where new or redirected evaluation efforts are required in this connection.

The second area of MBO/evaluation relationship relates to the management of the evaluation program itself. In addition to identification of specific management initiatives associated with large operating programs, MBO objectives will be established for their evaluation components—i.e., completion of specified major studies with significant policy results, or improvement in the overall management of the evaluation activity.

7. Monitoring Individual Studies

On occasion, major evaluation studies will be undertaken by individual agencies which are of critical concern to the White House and OMB. On a selective basis, the OMB will identify those of particular interest and monitor them closely to assure that the analysis is adequately reflective of presidential priorities, and that adequate attention is accorded the evaluation findings upon completion. The recent evaluation of federal housing programs leading to a new federal housing policy conducted by HUD serves as an example. Although HUD was appropriately responsible for conduct of the study, OMB worked closely with HUD during the implementation stage.

CURRENT PERSPECTIVES ON FEDERAL EVALUATION ACTIVITIES

The evaluation program outlined above for OMB should permit us ultimately to speak definitively about how well the federal evaluation effort has performed, which approaches generate the best results, and what its contribution has been as a management tool. Currently, our knowledge is not sufficient to permit this, except in a limited sense.

Nevertheless, on the basis of limited experience and investigation to date, we are able to offer some evaluation efforts, the difficulties encountered, and some principles for overcoming these problems.

BARRIERS TO APPLICATION OF EVALUATION TO POLICY DECISIONS

The enormous difficulty in developing program evaluation products which can make a significant contribution to policy decisions should be recognized at the outset. There appear to be four major problems in this regard.

1. *Timeliness.* To be useful, it is essential that results of evaluation be available when decisions are actually made. The short time frame within which major policy decisions are made does not allow policy officials to await completion of a long, carefully conducted study.

2. *Relability.* However, it is important to produce conclusions that will support a credible management decision. Client groups and other program beneficiaries can be expected to attack evaluations which conclude that a program in ineffective, and such attacks will normally be directed at the reliability of the data and methodology employed.

3. *Relevance.* Too frequently, the criticism has been made that evaluation studies are not directed to the problems most relevant to major policy issues.

4. *Utilization.* Even if the preceding problems are adequately resolved, there remain formidable problems in assuring that evaluation products are utilized in the decision-making process. There frequently is no assurance that evaluation products will be made available on a routine basis to decision makers. Moreover, in some cases there may be strong incentives on the part of program managers to sublimate evaluation products which cast doubt on a program' worth either in terms of its intrinsic value or how well it is administered.

SUGGESTED MANAGEMENT PRINCIPLES

The problems discussed above do not lend themselves to solution by any select few management or operating decisions, if for no other reason than that the effort to address one is often at the expense of others. For instance, if timeliness is of paramount concern, reliability through adequate methodology may suffer.

Individual agencies' past efforts to improve the quality and usefulness of their evaluation appear to have emphasized a mutually supportive set of operating and administrative procedures designed to address each problem individually, but in concert with other actions so that attainment of related objectives is not subverted. The following outlines a tenative set of management principles which appear to emerge from these efforts. They should not be interpreted as exhaustive or definitive. A major thrust of OMB's evaluation role in the immediate future will be to test these and other principles with a view toward enhancing our collective ability to generate useful evaluation products.

1. Development of Evaluation Capability at Initiation of Program

The problems confronted in obtaining reliable information upon which to base program evaluations are frequently a major impediment to conduct of reliable program evaluations. These problems are greatly magnified if the data on program operations and results must be reconstructed from old records and past experiences. Therefore program evaluation capability should be built into the administrative machinery from the outset of each new federal program. This will help assure that data collection and assessment is performed on a current basis, and that the results are available sufficiently early to influence policy decisions affecting the program's scope and direction subsequent to its initiation.

2. Staff Adequacy

This is perhaps the single most important element to a successful evaluation activity and the one least realized Staff adequacy must be determined in relation to the specific mission of the unit (contract, direct study, or oversight) and is dependent on two variables sufficient numbers and overall quality (ability, training, background, experience).

3. Planning Process

An adequate planning process to outline both the major focus of evaluation activity, as well as specific evaluation projects to be undertaken, is essential to assure relevance to policy decision needs. In this connection, it is crucial that those involved in the policy decision process, both decision makers and staff, be formally injected into the development, review, and approval of such plans.

One highly rigorous approach to the planning process has been advanced by the Urban Institute.[5] In effect, the Urban Institute urges that systematic models be developed by evaluation planning staff to assess beforehand the most desirable types of studies needed and the most cost-effective means of obtaining the needed data. Only after making such estimates, in relation to an assessment and the probable value to be derived from such decisions, can intelligent decisions be made on the precise data collection and analytic efforts which should be undertaken.

The Urban Institute's proposal may be more systematic and rigorous than necessary. But it points up the need and significance of an active planning process to guide each agency's overall evaluation effort.

4. Organizational Administrative Integration with Related Activities

As discussed above, a number of activities are closely related to evaluation but are not defined as evaluation in this discussion—e.g., policy analysis. However, to assure that evaluation activities are focused on the high priority areas of maximum relevance, and that each area is mutually supportive, certain steps can be taken to assure operational integration.

One of the most fruitful aspects of organizational integration is between evaluation staffs and policy analysis units. While each has a particular objective and operating style, the interdependence of each is strong. A similar relationship can profitably be developed with units responsible for program data reporting systems, though perhaps on a less integrative basis.

---

[5] John W. Scanlon, Ralph E. Schwartz, John D. Waller, Thomas W. White, Reynold B. Madro, and Joseph S. Wholey, *An Evaluation Strategy and Plan for the Department of Labor* (Washington, D.C.: The Urban Institute, January 1973).

5. Relationship of Evaluation Unit to Program Administrator

A critical dilemma faced by any evaluation effort is the likelihood of arriving at adverse judgments concerning individual program accomplishments. Program managers naturally resist such conclusions and can be expected to argue against their validity. This leads to the conclusion that, to assure adequate objectivity, evaluation capability should lie outside the direct line of command of responsible program managers.

It can be argued that this will result in alienation of the cognizant manager from the results of evaluations and consequent resistance to adoption of concrete findings. It is also argued that if evaluation is, in fact, a management tool, the program manager most directly responsible for operations should possess his own evaluation capability.

A suggested principle to be followed in the face of this dilemma is that evaluation capability should exist generally at two levels, performing generally different types of evaluation. Program managers should have the capacity to undertake or fund evaluation studies designed to measure program efficiency and to identify major operating problems. Capability for basic impact evaluations, especially designed to yield "go—no go" conclusions, should be performed by units outside the scope of the immediate program manager and at a hierarchical level above the program manager, typically at an assistant secretary level. This should assure sufficient "clout" to obtain needed cooperation from program operators, objectivity in performance of studies, and economies of scale to conserve limited evaluation resources.

6. Follow-up Procedures

A prevalent criticism of many federal evaluation activities is that studies, once completed, are "put on the shelf" and ignored. In fact, there exist powerful incentives to avoid wide publication of evaluation studies which yield negative findings. To offset this built-in resistance, procedures should be adopted to assure the routine extraction from evaluation studies of major operating and policy implications and to pursue the course of their implementation.

The approach taken by several agencies is to prepare for major decision makers (agency or program head) a policy implications memorandum upon the completion of a major study. A complementary approach is to assign one or more staff members to "follow-up" in a systematic way the major recommendations for implementation.

7. Operating Practices in Contract Administration

Units engaged primarily in contracting for evaluation studies frequently involve themselves almost exclusively in the ministerial functions of contract administration. Aside from the obvious impediments such practice has to effective recruitment of qualified staff, the practice almost guarantees, in the large, studies irrelevant to the needs of the funding agency because contracting organizations normally are not sufficiently close to the federal agency to comprehend its needs fully.

To assure maximum relevance, the following general practices should be followed:

(a) Requests for proposal (RFPs) should be highly directive indicating not simply the general questions for which answers are sought, but references to the problems being encountered by the program, and an initial outline of how the study should proceed.

(b) During conduct of the study, one or more federal staff should be assigned to work with the contractor on a continuing basis, almost as a part of that contractor's own staff. In this way, the details and content of the study, including a perception of its reliability, is vested in staff of the federal agency.

(c) As suggested above, upon completion of the contracted study, the federal staff should prepare its own implications analysis.

Another approach which has been suggested, but on which there has been little experience, is to use contractors primarily for specialized data collection purposes, leaving to the federal staff the primary responsibility for analysis. The logic for this approach is that federal staff are best equipped to perceive the decision needs to which the analysis is designed to contribute. Contractors are in a favorable position to collect special data because of sudden start-up and contraction problems which federal agencies do not possess sufficient flexibility to handle.

8. Need for Both Long-Term Basic Evaluation and Short-Term Reactive Evaluation Capability

As suggested above, a fundamental issue concerning the appropriate focus of evaluation is whether it should focus on short-term analysis designed to meet immediate policy needs or proceed within a longer time frame to assure adequate quality and methodology. Resolution of this issue can perhaps best be realized by following both courses of action simultaneously:

(a) Basic long-term evaluation can frequently best be performed, at least in part, through contract arrangements. However, it may be a mistake to treat each evaluation study as a separate, independent, and self-sustaining entity. An alternative strategy is to develop an accretion of knowledge over time for a given program or functionally related group of programs. In this way the attacks on the validity of individual studies can be handled best—i.e., while individual studies might be attacked on methodological grounds, it is more difficult to sustain criticisms across the full scope of evaluations performed on a group of programs. The approach also recognizes the difficulty of securing unambiguous results from individual studies, even with the most careful methodology. This approach implies still greater importance and significance for adequate planning of evaluation activities.

(b) Short-term analysis responsive to immediate needs of major policy officials generally can be performed best by federal staff. Such studies will frequently be less well structured and sophisticated than the long-term analyses discussed under (a) above. However, valid insights and impressions, based upon intensive scrutiny and examination, can be derived in many instances that will meet short-term decision needs. These studies should, to the extent possible, rely upon the longer-term analyses already completed, or surface problems or issues which require longer-term analysis.

SUMMARY

The major problems associated with program evaluation in terms of their impact on policy decisions appear to be four-fold: (1) timeliness, (2) quality, (3) relevance to policy needs, and (4) utilization.

A productive administrative approach toward coping with these problems is, of necessity, multifaceted. A set of operating principles is suggested as a composite, though not exhaustive, package to achieve a well-managed evaluation activity. These principles can be summarized as (a) development of built-in evaluation capability from the inception of each new federal program; (b) adequate staff to assure quality of output; (c) sufficient planning to focus attention on the high pay-off areas; (d) follow-up procedures to assure that results are utilized; (e) organizational alignments to assure full integration with the policy decision process and related and supportive activities; and (f) a proper balancing of long-term and short-term efforts (in-house and external) to meet both quality and timeliness needs. In short, effective management of evaluation is contingent upon simultaneous efforts on a number of fronts.

The validity of each of these principles, development of others, and detailed approaches to attaining each will require substantial further consideration, and specific implementation approaches will vary among agencies. The effort of OMB in the coming months and years will be to test and advance these principles in general and in specific agencies, utilizing the management initiatives discussed above.

[From Business Horizons, April 1974]

Managing for Results in the Federal Government

PRESIDENTIAL INTEREST IN BETTER MANAGEMENT HAS BEEN A FACT OF LIFE SINCE THE MID-1930S. THE PRESENT ADMINISTRATION HAS LAUNCHED A MAJOR INITIATIVE TO UPGRADE MANAGEMENT IN THE EXECUTIVE BRANCH

(By Frederic V. Malek, Deputy Director for the Office of Management and Budget in Washington, D.C.)

A government without good management is a house built on sand.

—Franklin D. Roosevelt, 1937

Effective action must be taken to improve efficiency.

—Dwight D. Eisenhower, 1957

I mean to insure that in each of the various Federal programs, objectives are achieved.

—John F. Kennedy, 1963

There is no subject of greater importance to the people of this country and to me than the efficient operation of our programs.

—Lyndon B. Johnson, 1966

I am now asking each department and agency head to seek a sharper focus on *results.*

—Richard M. Nixon, 1973

The period from 1789 to 1849 was a most active time in the development of this country: a new government was formed under George Washington, and a great city bearing his name was constructed on the swamplands of the Potomac River; Thomas Jefferson almost doubled the size of the nation with the purchase of the 800,000 square mile Louisiana Territory from France in 1803; and we fought an important war with Britain in 1812 and another with Mexico in 1846. A good deal of money was needed to finance these activities; the total cumulative expenditures by the federal government came to a little more than $1 billion over the sixty-year period. However, even this impressive sum becomes relatively insignificant by today's standards. In 1973 our expenditures averaged over $1 billion *each working day.*

Request for results-oriented objectives. The President personally launched the initiative with a memorandum to each of the twenty-one agency heads on April 18, 1973. This memorandum noted the need to focus on results and not just actions in design and operation of federal programs and asked each agency head to identify those objectives he or she considered to be of Presidential level importance during the coming fiscal year. Where an objective was part of a longer term goal, the goal was also to be indicated.

Staff interactions. OMB was given the responsibility of coordinating the review of agency submissions before they were forwarded to the President. We looked for the following key features in each objective: its feasibility and achievability within budget constraints; its importance and consistency in terms of stated Presidential policies; the extent of its measurability; and, above all, emphasis on accomplishments instead of merely activities.

With regard to the last point, we asked for a brief action plan showing both intermediate milestones and projected end dates for each objective. Specialists from the Domestic Council, the National Security Council, and other interested staff members from the Executive Office of the President were also asked to participate in these reviews.

Top level management conferences. The objective-setting phase of the effort was brought to a close with a management conference, which was attended by the agency head and his or her key staff members. The purpose of these sessions was to hammer out a final agreement on the objectives before they were submitted to the President.

Presidential review and feedback. Once the President completed his review of the agency submissions, he personally communicated his thoughts to the agency head. In many instances, he noted areas of particular interest to him. In every case, he emphasized the need to be constantly on the alert for new initiatives that could be added to the list of objectives as the year unfolded.

Certainly the people deserve and have a right to expect the highest quality service possible, whether we are spending $1 billion a day or $1 million a day. However, there is no question that this enormous expansion in the cost of running the federal bureaucracy is at least partly responsible for the elevation of better management to its current position as a major Presidential-level priority. The creation of the Brownlow Committee by Franklin Roosevelt in the mid-1930s is generally conceded to be the first major expression of concern by a Chief Executive in the management field.

During his first Administration, President Nixon formed the Ash Council to take a fresh look at the problem of management effectiveness within the federal government. Based upon its recommendations, he introduced sweeping legislation to realign and revitalize the Executive Branch. He also created a central point of reference for all management policy by establishing the Office of Management and Budget (OMB) within the Executive Office of the President.

At the start of his second Administration, the President was determined to further build on the organizational framework he had established in 1970. When Roy Ash and I were appointed as director and deputy director of OMB in February 1973, we were given a mandate by the President to develop a program whereby the American public could be certain that the best possible benefits were resulting from the expenditure of their tax dollars.

THE BUREAUCRATIC ENVIRONMENT

In order to understand the nature of the program that was undertaken in response to the President's directive, it is important to note the unique environment that exists within the federal government. It is significantly different from the private sector, and these differences tend to create three problems that are especially critical:

The highest priority items are often subsumed by the welter of routine tasks.

Managers are frequently not held accountable for producing a specific result.

There is poor follow-through on major programs.

Establishing Priorities

Columnist Joseph Alsop has described the Executive Branch as "the essential great engine of the U.S. government." Few people realize just how complex and cumbersome this machine really is. In terms of sheer size alone, it involves a civilian workforce of approximately 2 million people.

Like any large organization, there is a tendency for management to become totally immersed in the maze of everyday business. All too often, the important breakthrough opportunity is lost in the ongoing routine. Therefore, we felt an urgent need to counteract this tendency by selectively spotlighting high priority initiatives in each agency so that they can be given special attention by managers at all levels, right up to and including the President.

Accountability for Results

The practice of setting specific objectives, measuring the results attained, and then rewarding outstanding performance is perhaps the most significant difference between private and public sector operations. Generally, the problem of developing a specific, results-oriented objective is considerably more difficult in a public institution because it deals to a great extent with intangibles. The chief executive officer in a private company has a wide variety of quantitative yardsticks to measure performance (for example, profit and market share) that are not available in the public sector.

Consequently, objectives are rarely set and progress is measured in terms of activities rather than accomplishments. You can always find a manager who is responsible for performing a certain function, but you can almost never find one who is accountable for producing the end result.

There had to be, in our view, a renewed emphasis on setting objectives and then holding the responsible managers accountable for their attainment. Granted, there is a measurability problem, but a lot can be done with nonquantifiable or subjective evaluation techniques if the problem is approached sensibly.

Effective Follow-through

Effective management follow-through is an especially difficult task in the public sector. First of all, there is always a crisis to deal with. The outbreak of hostilities in the Middle East, the demands of the energy crisis, the truckers' strike, an unusually large monthly growth in unemployment, and so on are all recent examples that required federal managers to turn their attention away from important long-term goals to deal with short-term contingencies. The practice of jumping from one hot, highly visible issue to another without returning to the high priority objective is a luxury that the government executive can afford without penalty.

Second, statistics show that the average time in office for the appointee who takes an executive position in Washington will be on the order of twenty-two months. This fact of life also tends to destroy continuity and executive follow-through. We felt better ways had to be devised to get an executive up to speed quickly, enable him to effectively delegate and decentralize his operations without abrogating his management responsibility in the agency, and help him to constantly focus on the progress being made toward the achievement of his objectives.

A PRESIDENTIAL INITIATIVE

These are the problems that motivated the President when he directed Roy Ash and me to launch a major new management initiative in the spring of 1973. The approach we worked out with him was a selective adaptation of the management-by-objectives concept that has been successfully introduced into a wide variety of private and public institutions. MBO offers many answers to the problems noted above.

First of all, it is a selective process that requires the segregation of important items from those that are more routine. Sound, it is based upon the development of objectives by the same manager who will ultimately be held responsible for their achievement. Since it requires action plans for achieving objectives, it does provide the executive with a simple method for keeping his eye on the ball despite the distractions that may arise during the year. Finally, it enables the President to delegate more to his agency heads with confidence since he has agreed in advance as to what they will achieve and has the means to follow their progress toward achievement.

As in any mammoth organization, major changes cannot be installed overnight, particularly when they affect something as fundamental as the way the organization is conducting its business. But we have made substantial progress toward creating a new style of public management as illustrated by the following discussion.

The Planning Phase

Twenty-one of the major departments and agencies were selected to participate in the new management initiative. Together, these agencies account for more than 95 percent of all federal government expenditures.

A Variety of Objectives

Before discussing the operational phase of the effort, it might be desirable to briefly touch upon a few of the objectives that were established.

First of all, no constraints were placed on the types of objectives that could be submitted. Eventually, all objectives contribute to the delivery of needed services to the American public through the effective execution of federal programs. However, in some cases an objective would point to completing the necessary studies to define a new program or specify changes to an existing program. Or perhaps the study may have been concluded, but the objective was to complete the difficult task of working out acceptable legislation with Congress.

Finally, in many cases there are important administrative objectives that are keys to the operation of an entire department or a group of programs (such as a major reorganization). We did not want to preclude the submission of objectives in any of these areas if the agency head felt the effort was significant enough to bring to the President's attention. As a result, agencies focused on many different types of objectives. Generally, they can be divided into the four categories previously noted: policy formulation and program definition, legislative enactment, programmatic results, and administrative improvement. Some illustrations follow.

A transportation policy statement. The various transportation systems of this country have evolved on an independent basis over the past one-hundred years. This has produced a rather fragmented set of policies and quasi policies depending upon the mode (air, rail, water, or automotive). Both the President and the Congress have stressed the need for developing an integrated strategy that will help guide future decisions in this area.

For example, are current federal subsidies (encouragements) consistent with our long-term needs for moving goods and people from one location to another? What is the proper mix of economic regulation versus competitive pricing now and in the future? What are the proper roles of the federal, state, and local governments as well as the private sector? To what extent will other national priorities, such as the conservation of energy, be affected if the transportation systems now in the planning stage are implemented? Clearly, Transportation Secretary Claude S. Brinegar was correct when he designated the formulation of a national transportation policy statement as worthy of Presidential concern for this fiscal year.

Federal housing. We look back to the Housing Act of 1949 to find the original statement of our long-term goal in this area. It was repeated by President Nixon in his September 19, 1973 message to Congress on housing policy: "This Administration will not waver in its commitment to the objective of the Housing Act of 1949, 'a decent home and a suitable living environment for every American.'" The message actually contained a set of principles that came about through the completion of one of the Presidential level objectives. It was initially submitted by James Lynn, Secretary of Housing and Urban Development, on May 3, 1973 in response to the President's memorandum.

The objective as finally approved called for the completion of a major study of federal housing policies and programs, and the development of options and recommendations for Presidential consideration. The urgency of this effort stems

from the lack of success of several housing programs in the past toward the achievement of the long-term goal. Unfortunately, many of these extremely costly, albeit well-intentioned, efforts had produced a result we were not pleased with—the designation of the federal government as the largest "slumlord" in the United States.

Trans-Alaskan pipeline. The October 1973 outbreak of hostilities in the Middle East transformed our energy problem into an energy crisis almost overnight. However, well before that unfortunate event, Secretary of the Interior Rogers Morton had responded to the President's April memorandum with a significant, energy related legislative objective—the enactment of a bill that would permit the start of construction on the Trans-Alaskan pipeline from Prudhoe Bay in the north to the port of Valdez in the south.

His target date for enactment was September 1973, and, although several difficult issues including those associated with conservation and the environment made the date unattainable, the legislation was eventually signed into law by the President on November 16, 1973. This significant step has opened the door to an increased supply of oil starting in 1977 that should eventually come to almost 2 million barrels a day.

Welfare ineligibility and overpayment. The welfare system in this country is in our view highly ineffective and inequitable. Our long-term goal is to replace the existing tangle of competing, overlapping programs with one program that will provide direct cash assistance to the individual who can then decide how he or she should use it to buy food, housing, clothing, or other essentials.

In the meantime, HEW Secretary Caspar Weinberger is committed to correcting deficiencies in the existing programs. One of these programs, Aid to Families with Dependent Children (AFDC), was selected by him as the subject for a solid programmatic objective. It consists of two major parts: to more accurately determine the extent of the ineligibility and overpayment rates, and to eventually reduce these rates to 3 percent and 5 percent, respectively. The first part has essentially been completed, and the results are even worse than we expected. Over 40 percent of the cases fall into the ineligible or incorrect payment categories at a net cost to the taxpayers of more than $1 billion per year.

The Operational Phase

Management conferences. Objectives without results are meaningless. The real payoff depends on the determination and competence of the line manager in working toward the objectives. Here again, the management conference plays an important role. Our main concerns in these sessions, which are generally held on a bimonthly basis with the agency head and his top people, are as follows:

Is the line manager keeping his eye on the ball? Is he making progress toward the end result in keeping with his action plan?

Are there major problems that should be brought to top management attention for resolution?

Are there recent developments that may require the modification, deletion or addition of new objectives?

When the effort was first initiated with the agencies, many predicted that it would lead to a new snowstorm of bureaucratic paperwork. However, the emphasis is on a person-to-person dialogue with a minimum amount of paperwork. No written reports are required from the agencies, and personal contact is the primary means of communication at all organizational levels.

Use of the objectives. Recognizing the usefulness of MBO in effectively running their operations, top officials are now setting objectives and then managing to achieve the desired results. Secretary of Agriculture Earl Butz is not "from Missouri." However, as those who know him will attest, he comes from the pragmatic "show me" school. He generally reserved judgment during the objective-setting phase, but, after a lively give-and-take review conference, he remarked enthusiastically: "Maybe we have something here; maybe for the first time we will be able to coordinate positions and get concrete results."

There are also signs that the existence of objectives and action plans is helping new agency heads get on top of their operations more rapidly. For example, at the Environmental Protection Agency, the Presidential level initiative fitted rather nicely into a previously developed MBO program.

On September 14, 1973, Russell Train was sworn in as the new administrator of EPA, and only thirty-five days later, a management conference was held to review progress on the agency's Presidential objectives. He played an active leadership role in the discussions and noted that his ability to do so was directly related to "the excellent management process" that made it possible for him to focus on the material within a relatively short period of time.

Finally, there is no question that the existence of specific objectives has served the interests of the President. In many cases, a high priority objective such as National Health Insurance is the subject of a specific meeting between the President and an agency head. Presidential objectives are also discussed at Cabinet meetings and other broader based sessions that may be scheduled with him as the need arises.

The Real Challenge

We have come a long way in this first year. Thanks to a significant effort on the part of the agencies, which have worked long and hard to make our joint efforts a success, over 200 Presidential objectives have been defined and solid progress is being made toward their fulfillment. This approach to management is now fairly well accepted across the top levels of the government.

However, if we look back at our original mandate from the President, the real challenge still lies before us. The Presidential level objectives are extremely important—but in this larger context they merely represent the tip of the iceberg. What the President really desires is fundamental and enduring reform of the way in which government executives approach their responsibilities. If we are to make a lasting contribution, we must make an impact on the infrastructure—the middle manager who is on the firing line every day and who in the aggregate can really change the way things are done. We want him to start thinking about what he is trying to accomplish for the American public. He is the one who must reach the conclusion that there is a better way to approach his job and serve the public's interests. Roy Ash has a simpler way of saying it: "We want to make managing for results a way of life." This means for all agency programs, not just those of Presidential significance.

How should this be done? We think this question should largely be left up to each agency with only general guidance from us and the requirement by the President that it most certainly must be done. How to do it depends upon the agency's size and mission, the nature of its programs, the suitability and adaptability of its existing management techniques, and the like. General George Patton once said: "Never tell people how to do things. Tell them what to do and they will surprise you with their ingenuity." We are confident that our surprises will be pleasant ones.

Senator MUSKIE. Mr. Director, I appreciate this morning's testimony. There are a number of questions that are left in the minds of each of us, I am sure. But we are conscious of the fact that you sent up word of your willingness to cooperate with this committee as it undertakes to organize for its work in establishing congressional budget procedures. We appreciate that offer and we will take advantage of it.

I also recall that you offered to come up again to testify when we can get into more detail on these questions. Apart from the differences of philosophy and approach, I think it is our responsibility to get a lot of hard information. You are in a peculiarly good position to give that to us.

Senator DOMINICK. Senator, would you yield at that point?

Senator MUSKIE. Yes, I will.

Senator DOMINICK. Mr. Director, Senator Javits proudly professed himself a liberal. I proudly profess myself a fiscal conservative. In the process of asking for tax expenditures, which he did, would you also furnish for the committee, which I think would be helpful, a breakdown of where our income comes from, in other words, the amount of corporate taxes, private individual taxes, excise taxes, and so on?

Mr. ASH. Yes, sir. The Secretary of the Treasury who I gather is going to be testifying next, is the source of that information and you may want to ask it of him. You may want to get it directly from him. Either way. We will make sure you have it.

Senator DOMINICK. Thank you.

[The information referred to follows:]

BUDGET RECEIPTS

[Fiscal years, in billions of dollars]

	1973 actual	1974 preliminary	1975 estimate
Individual income taxes	103.2	118.8	131.0
Corporation income taxes	36.2	38.7	44.5
Social insurance taxes and contributions			86.1
Employment taxes and contributions	54.9	65.9	
Unemployment insurance	6.1	6.9	
Contributions for other insurance and retirement	3.6	4.0	
Excise taxes	16.3	16.9	32.4
Estate and gift taxes	4.9	5.0	
Customs duties	3.2	3.3	
Miscellaneous receipts	3.9	5.4	
Total	232.2	264.8	294.0

Note: Details may not add to totals due to rounding.

Senator MUSKIE. I have just one question, simply as a matter of information. Will the administration be submitting recommendations for specific budget cuts, aimed at particular programs, to achieve a particular objective such as a $5 billion reduction or a $10 billion reduction in expenditures?

Mr. ASH. The next step toward that is a meeting that I have already alluded to between the President and Members of the Congress to get a commonsense of what course should be pursued. Out of that meeting will come the answer to the question. I would be running ahead of the meeting if I were to answer it now.

Senator MUSKIE. That is understandable. Thank you very much.

I notice the Secretary of the Treasury has been here for quite some minutes now and I suspect he is under time pressure, too. Thank you very much. We look forward to having you with us again.

Mr. ASH. Thank you, Mr. Chairman.

Senator MUSKIE. Our next witness is Secretary of the Treasury William Simon.

We appreciate your patience, Mr. Secretary. We have had unusually good attendance at these opening hearings of the committee. We are all searching for information and suggestions, with the result that the questioning is quite time-consuming.

We do welcome you this morning. Do you have some time constraints before we begin?

Secretary SIMON. I have a meeting with the President and his economic advisers early this afternoon, at 2 o'clock, Mr. Chairman, so if I could be excused shortly before then, that would be fine.

Senator MUSKIE. I am sure you will because I think all of us have more severe problems than that. [Laughter.]

Thank you very much. Without further delay, may I welcome you this morning and invite you to proceed with your testimony.

STATEMENT OF HON. WILLIAM E. SIMON, SECRETARY OF THE TREASURY; ACCOMPANIED BY EDGAR R. FIELDER, ASSISTANT SECRETARY FOR ECONOMIC POLICY; AND FREDERICK L. WEBBER, ASSISTANT SECRETARY FOR LEGISLATIVE AFFAIRS

Secretary SIMON. Thank you, Mr. Chairman. As far as the last question that I heard from the rear from Senator Dominick, we have

the information, Senator, on revenues in the Treasury Department. They are broken down by components as well. We will supply that for the record.

[Table referred to follows:]

UNIFIED BUDGET RECEIPTS FOR FISCAL YEAR 1975 AS ESTIMATED IN MAY 1974

[In billions of dollars]

	May 1974 estimate
Individual income tax	131.0
Corporation income tax	44.5
Employment taxes and contributions	75.1
Unemployment insurance	6.6
Contributions for other insurance and retirement	4.4
Excise taxes	17.3
Estate and gift taxes	5.6
Customs duties	3.7
Miscellaneous receipts	5.8
Total budget receipts	294.0

	Underlying income assumptions, calendar year 1974	
Gross national product	1,390	1,401
Personal income	1,135	1,142
Corporate profits before tax	124	134

Source: Office of the Secretary of the Treasury, Office of Tax Analysis.

Senator DOMINICK. Thank you.

Secretary SIMON. I have a brief statement, Mr. Chairman, and that is why I would prefer to read it.

I am glad to be here this morning to participate in these first hearings of the Senate Budget Committee. I have been an enthusiastic supporter of budget reform since I first came to the Treasury Department, and I am pleased to see that you are moving so very promptly to implement the Budget Reform and Impoundment Control Act of 1974.

This is an important time for the Budget Committee to begin its work. In my judgment, there is nothing the administration and the Congress, working together, can do that is more important for the economic welfare of the American people than to reduce the very rapid momentum that has built up in the growth of Federal expenditures. Such action would have many important benefits in both the short and long term.

First, it would help us meet the premier long-term challenge that we have for economic policy, which is to make sure that during the next decade our economy generates the enormous volume of savings and investment that will be necessary for Project Independence, new mass transit systems, housing, and all the other capital requirements of our society. I believe that we will have to raise the share of national output devoted to savings and investment by a substantial margin. It is not widely recognize that our investment performance has been relatively poor. Since 1960, plant and equipment spending in the United States was only 15 percent of total output, whereas France invested 18 percent, Germany 20 percent and Japan 27 percent. And furthermore, for gross domestic investment (which includes inventories, housing and public investment), the proportions for 1973 are: United States 17 percent, France 26 percent, Germany 25 percent, and Japan 37 percent.

It will not be a simple matter to raise our investment share; quite the contrary. We will have to change our many policies that encourage consumption at the expense of savings and investment. Among the most important changes that we will have to make is to maintain regular surpluses in the budget, so that the Federal Government would be adding to the supply of savings available to the private economy, instead of using up those savings—as we have been doing in 13 of the past 14 years. If we could maintain, on average, a budget surplus equal to even one-half of 1 percent of GNP, we would add about 3 percent to the flow of savings available to the private sector. And if we are to slow the ongoing momentum of growth in Federal expenditures, we had better get on with it by making some spending cuts right now.

Second, in the near term, control of budget expenditures has an important psychological value in demonstrating to the American people that we are serious about inflation. Without some cuts in the budget, the credibility of our efforts will be suspect. I believe that bringing the budget into better balance would be the most important single step that could be taken to restore the confidence of the American people in their own as well as the Nation's economic future.

Third, a tighter fiscal policy will reduce the Treasury's demands for funds and will thereby reduce the heavy pressures that we now see in our financial markets. A tighter fiscal policy would mean that monetary policy will not have to bear the main burden of the stabilization effort.

On this point, I think we should remember that the Federal Government has a greater impact on the financial markets than is indicated by the deficit in the unified budget. For one thing, the Export-Import Bank and the Postal Service are not in the budget and, correspondingly, their credit demands do not get included in the budget deficit. Much more important, there is a large volume of credit that is guaranteed by Federal agencies—to assist public and private housing, urban and rural development, shipbuilding and railroads, health, education, small business, and other functions. These all represent demands that we in the Government place on the financial markets. It is not often realized how large these demands are; in fact, in many years the net borrowings for these programs exceed the deficit in the unified budget, as shown in the table below. (Note that these figures do not include the borrowings of the federally sponsored agencies: the Federal National Mortgage Association, the Home Loan Bank System, and the Farm Credit System.)

[The table referred to follows:]

[Billions of dollars]

Fiscal year	Unified budget deficit	Additional Federal credit	Total
1971	—23.0	—16.8	—39.8
1972	—23.2	—18.0	—41.2
1973	—14.3	—15.6	—29.9
1974	—3.5	—16.8	—20.3
1975 (estimate)	—11.4	—14.9	—26.3

Secretary Simon. If the sponsored agencies are also added in, the Federal presence in the credit markets reaches rather startling dimensions. In the fiscal year 1973, total Federal and federally assisted bor-

rowings accounted for 62 percent of all the funds raised through borrowings in the capital markets.

The fourth reason for curbing Federal expenditures is the most important reason, because it involves the No. 1 problem in the country today—inflation.

Americans are experiencing their first sustained seige of intolerably rapid peacetime inflation. It is a new and most unwelcome experience. They do not understand where double-digit inflation came from and they lack confidence that their Government will be able to get the situation under control.

How did we get here? I will not try to retrace all the causes of the current inflation, or try to fix the blame one place or another. Without too much risk of oversimplification, I think it is fair to say that the price explosion of 1973–74 is primarily attributable to (*a*) a series of severe temporary shocks that originated mostly outside the U.S. economic system and (*b*) almost a decade of excessively stimulative fiscal and monetary policies.

The outside shocks are, by now, familiar to all of us; the worldwide agricultural crop failures of 1972 enormous pressures on the prices of internationally traded raw materials, two devaluations of the dollar, and the oil embargo. In addition, the end of the controls program is now operating as an additional temporary force to raise some prices and wages faster than otherwise would have been the case.

But all these special factors, as important as they have been, are of a temporary one-shot nature. Had our general economic policies not been too stimulative, the outside shocks would have had only a one-time effect. Once they had worked their way through the system, the inflation would have settled down again to a tolerable rate.

But our general economic policies have, in fact, been far too stimulative for a long period of time. Let me give you two examples of how policy changed in the mid-1960's. First, on the fiscal side: from 1955 to 1965 Federal expenditures rose at roughly a 6 percent annual rate. From 1965 to 1974, however, Federal expenditures surged to a 10 percent annual rate of growth. This rapid spending growth created huge Federal deficits which, coming as they did during periods of high business activity, added enormously to economic demands. These deficits were, therefore, directly responsible for creating strong upward pressures on the price level. Second, monetary policy also broke out of a previously established pattern. From 1955 to 1965 the money supply grew at a 2½ percent rate. Since then, the growth rate has more than doubled to a 6 percent annual pace. It is no accident that during the earlier period we had a rather stable price performance, but since 1965 we have had the worst peacetime inflation in our history.

What has and is happening, then, is that the excessive budget deficits and the excessive growth of money and credit in recent years prevented the "temporary" price pressures from running their course and fading away. Instead, much of the inflation from the outside shocks is or soon will be deeply embedded in our entire system. It is or soon will be embedded into the pattern of wage settlements and into the structure of interest rates. It is or soon will be embedded into the economic expectations of consumers, of workers, of investors, of businessmen—everybody.

And because this inflation is becoming so deeply embedded, squeezing it out of the system will be a long, tough process. It is a most difficult challenge for economic policy.

Our only viable policy alternative, in my opinion, is to apply the necessary fiscal and monetary discipline persistently and consistently to keep the economy operating within the limits of its capacity to produce. The economy can be prosperous and it must continue to grow, but we must not let it continue to run away with itself. Demand will have to be held slightly below total potential output. Sales can show a healthy growth, but that growth will have to be constrained so that if businessmen try to raise prices too fast, competitive pressures will prevent them from doing so. Employment can grow, too, but our labor markets must not be too tight, so that the joint worker-management process of wage determination can result in a gradual deceleration of the upward trend of pay scales.

Let me emphasize that this fight against inflation will take years. There are no shortcuts, no acceptable quick solutions. Frequent and abrupt changes in policy are the worst policy of all. To cure the price disease, we must be prepared to stay the long course and take an even strain on economic policy year after year. This is the only way to get the job done.

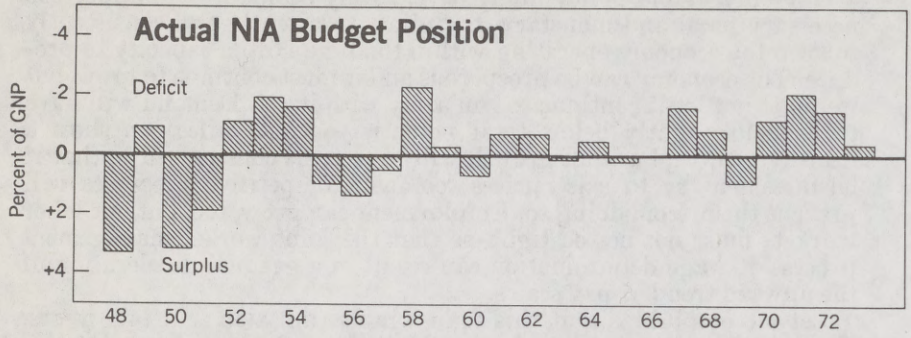
There are many who question the effectiveness of restrictive fiscal policy to counter these fundamental inflationary pressures. In my view, however, the evidence of experience is clear that fiscal restraint applied consistently and in tandem with monetary restraint can bring inflation under control.

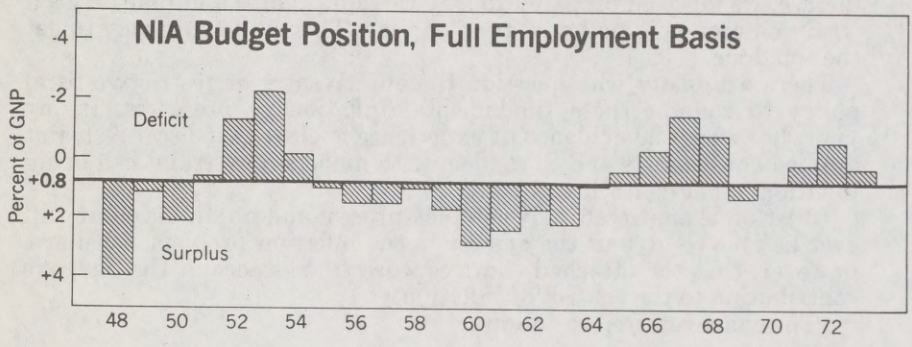
Inflation is an exceedingly complex process and no simple chart will ever be able to give us the answer to the inflation problem. I believe, however, that the attached chart captures the essence of the budget's contribution to the control of inflation.

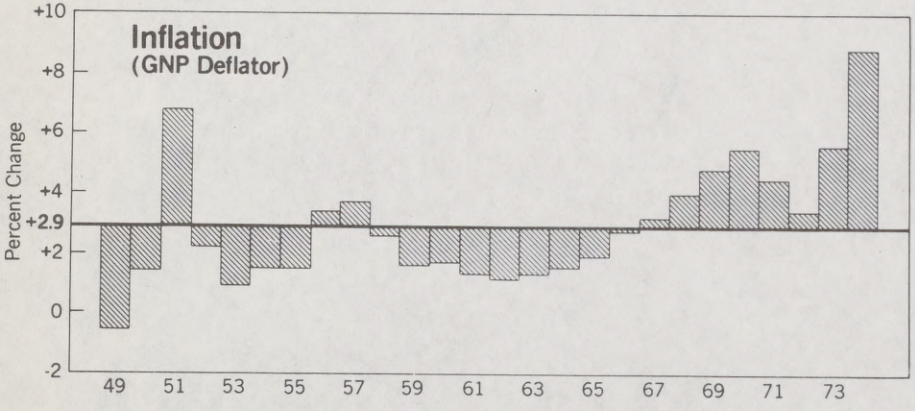
[The chart referred to follows:]

39-566 O—74——13

THE BUDGET AND INFLATION







NOTES TO CHART

Panel 1 The budget data shown here are the actual surpluses and deficits, on a national income accounts basis, for calendar years expressed as a percent of Gross National Product. Data from U.S. Department of Commerce.

Panel 2 These budget data are the same as in Panel 1 except that the surpluses and deficits have been adjusted by the Federal Reserve Bank of St. Louis to a full-employment basis by standardizing the figures to a constant 4 percent unemployment rate. The bars are plotted -- for the purpose of better displaying the relationship between the budget and inflation -- as deviations from the average surplus for 1948-73 of 0.8 percent of GNP. (Panel 1 was not plotted this way because the average was virtually equal to zero.)

Panel 3 Inflation is represented here by percent changes in the GNP deflator from the previous year. In effect, therefore, the inflation measure is charted with a 6-month lag compared to the budget data in Panels 1 and 2. The bars are plotted as deviations from the 1949-74 average price increase of 2.9 percent.

Secretary SIMON. It can be seen that the actual budget position (top panel) does not correlate closely with the rate of inflation (bottom panel). This is where the full employment budget proves itself to be a useful guide to economic policy. The full employment calculation adjusts the budget data to remove the impact of the economy on the budget, and thereby brings out the impact of the budget on the economy. When the full employment budget position (middle panel) is compared to the rate of inflation, a fairly striking pattern emerges. There is a strong general relationship between the two. In the broad sweep of things, it is clear that sustained and sizable budget surpluses are associated with below-average inflation and sustained and sizable budget deficits are associated with above-average inflation.

There are 2 years during the 26-year span covered by the chart in which the inflation is far higher than can be accounted for by fiscal policy. These years are 1950–51 and 1973–74, which were the two occasions when commodity inflation (food and industrial raw materials) had an extraordinarily large, one-time impact on the general price level. Aside from these two occasions, the relationship strongly supports the general notion that budget deficits are inflationary and budget surpluses are not inflationary.

It is for these four reasons, all of which I think are persuasive, that I am so strongly committed to budget discipline, not only for this year but for many years ahead. It is indeed fortunate that the Congress has placed itself in a position—through the new budget mechanism of which this committee is a vital part—to deal effectively with the difficult fiscal decisions that lie ahead.

ECONOMIC ADJUSTMENTS

Any well-conceived anti-inflation program must also have regard for the casualties of inflation and for those whose earnings may be interrupted for a time by a program of disinflation. Without getting into detail, let me say that I believe we can gradually reduce inflation without suffering massive unemployment. For a time, we will have to live with more unemployment than we would like, but it will not have to be a large amount. To deal with this contingency, we have proposed improvements in our system of unemployment compensation, and I again urge congressional passage of that legislation.

Strains in the financial markets have had particularly adverse effects on housing, and in May we put forward a $10 billion program to augment the supply of mortgage funds. These financial strains together with higher prices of primary energy have—because of the slow pace of the regulatory process—produced dangerously low earnings for many companies in regulated industries. While these are largely State and local regulatory bodies which must act, the administration is examining what might be done to speed up the needed changes. These illustrate the kinds of economic adjustments that must be accommodated in order to facilitate the disinflationary process.

WHERE TO CUT

It is easy for me to come before you and say that we must cut the budget. It may be, in fact, that the explosive inflation of the past couple of years has caused a shift in public opinion to the point where it is now a very popular position to advocate slowing down the growth of Federal spending. The people are aware, in a general way at least, that it took us 185 years to get up to the $100 billion mark in Federal spending, but only 9 more years to reach the $200 billion mark; and just 4 more years after that to get to $300 billion. A national consensus appears to be developing that we should slow this process down, and what is good economics may now also be good politics.

The next step, however, is the tough one: Where should the budget be cut? What specific programs are to be eliminated or at least stretched out? This is the nub of the issue, and although the general idea of cutting the budget may now be popular, that is almost certainly not true for individual programs. Specific budget cuts are never popular. Nobody wants to see their own high-priority areas cut back; that is entirely understandable.

But if we are to cut the budget in total, there is no alternative but that some individual programs will have to give way. I think you will agree with me that this hearing is not the place to decide where to cut the budget. We now have a new mechanism that provides the legislative and executive branches of Government with the means to cooperate closely on budget matters, and we should use this mechanism to determine our budget priorities. I want to stress the cooperative nature of this process. Only in this way can we strike the necessary balance between what is economically practical and what is politically practical. Only in this way can we be sure that in making cuts in specific programs we do not turn back the clock on economic and social progress in this Nation. Only in this way can we take a thoughtful, careful approach to the task of pruning the budget, rather than taking a meat-ax, across-the-board approach in which the good programs get cut along with the bad. Only in this way can we have the kind of tough give-and-take that is the hallmark of democratic government. I am not suggesting it will be an easy task but it is a vital one and I look forward to working on it with you, Mr. Chairman, and other members of the committee.

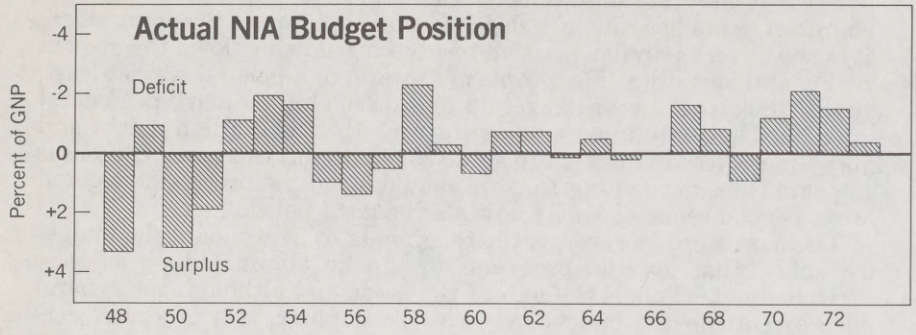
Senator MUSKIE. Thank you very much, Mr. Secretary. We are observing the 10-minute rule so that members of the committee will have an equitable share of the time available.

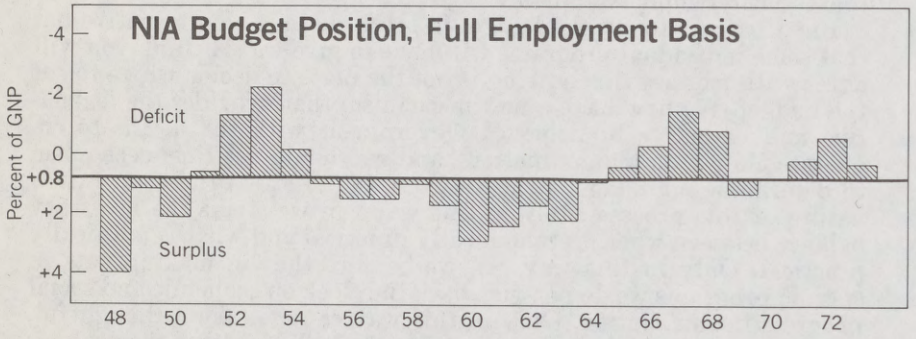
First of all, you have given us three useful charts identifying the connection between the budget and inflation. Could you provide for the record similar charts giving us the relationship over those same time periods between the budget and unemployment?

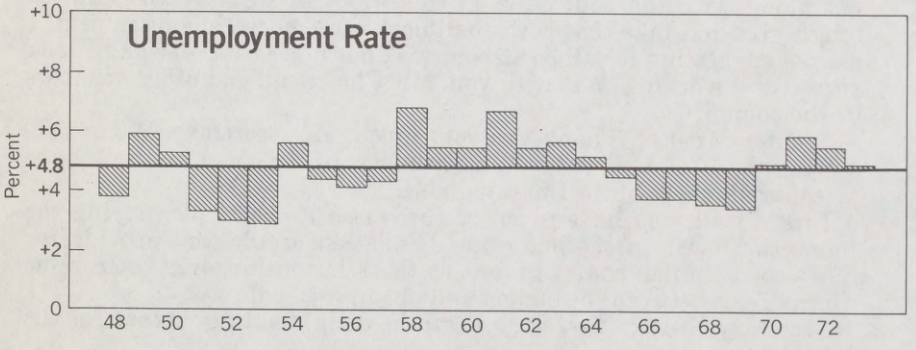
Secretary SIMON. Yes, sir; we will be delighted to give that for the record.

[The charts referred to follow:]

THE BUDGET AND UNEMPLOYMENT







NOTES TO CHART

Panel 1 The budget data shown here are the actual surpluses and deficits, on a national income accounts basis, for calendar years expressed as a percent of Gross National Product. Note that these data are plotted on an inverted basis in order to provide an easier visual comparison with the inflation rate.

Panel 2 These budget data are the same as in Panel 1 except that the surpluses and deficits have been adjusted by the Federal Reserve Bank of St. Louis to a full-employment basis by standardizing the figures to a constant 4 percent unemployment rate. The bars are plotted -- for the purpose of better displaying the relationship between the budget and inflation -- as deviations from the average surplus for 1948-73 of 0.8 percent of GNP. (Panel 1 was not plotted this way because the average was virtually equal to zero.)

Panel 3 Unemployment is measured as a percentage of the civilian labor force -- the usual measure. The bars are plotted as deviations from the 1948-73 average unemployment rate of 4.8 percent.

Source of data: U.S. Department of Commerce

Senator MUSKIE. We are concerned with unemployment, of course. There are two aspects of your presentation that I would like to pursue a little bit.

In your statement you say that we are going to have to change our many policies that encourage consumption at the expense of savings and investment.

What kinds of consumption must we cut in order to effect that transfer in the way in which we use GNP or national income?

Secretary SIMON. I suggest that the major one is Government spending. It encroaches on the spending process in our economy and on the financing process in our economy. And as I point out, just a very small budget surplus would add substantially to the total flow of savings in this country. A half of 1 percent would equal approximately 3 percent. This is the major contribution that could be made in shifting consumption patterns.

Senator MUSKIE. My question really was for what groups within the economy must consumption be cut.

Secretary SIMON. I think allowing the process——

Senator MUSKIE. There would be millions of Americans affected by cuts in some Government programs. I wanted to move the focus from the rather impersonal notion of programs to that of their impact on the people.

Secretary SIMON. It puts the decisionmaking process to the people rather than to the Government, Mr. Chairman.

Senator MUSKIE. Let us look at the other point raised at the end of your statement. You said the specific cuts that ought to be made have to be arrived at in consultation between the President, the Congress, and others. But Mr. Ash this morning presented a chart that identified the difficulty of reaching those decisions and of narrowing the focus to those programs which are really controllable. He made the point, for example, that mandatory spending totals about $225 billion of the $305 billion, that in the area of discretionary spending, defense occupies $57 billion, and that nondefense spending in the discretionary area is only about $35 billion. When we talk about $5 or $10 billion cuts and about cutting consumption is it that $35 billion that we are talking about, in your judgment?

Secretary SIMON. We are talking, of course, when we talk about prolonged budget surpluses or balance, more on a longer term view. I also stressed several times that it is not going to be an easy task to cut the fiscal 1975 budget. I am not one who says that it will be easy with such a high proportion of our expenditures controlled by statute. They are called uncontrollable I think, however, that this new mechanism that has been established can constantly take a look at our priorities in this country, and reorder some perhaps that require reordering. We can make headway by this process of consultation.

We will have differences of opinion, of course, as to where the budget should be cut. There will be some who will prefer defense cuts to be the major thrust of it and others would prefer other items in the budget. Everybody has their pet budget peeve. That is part of the process.

Senator MUSKIE. I am not really trying to get at preferences or differences of opinion. I am trying to get some guidance because up to

this point you have talked in general overall terms. That is useful to give us perspective, but at some point—if this committee is to make an impact upon the budget—we are going to have to get down to specific programs. And if we are going to generate public confidence as a result of what we do, we have got to be rather specific in the impacts of what we do so that the people can understand what it is that we are asking of them.

Secretary SIMON. That is correct, Mr. Chairman.

Senator MUSKIE. If we are talking of tax increases to eliminate deficits at some point, then we have an obligation to tell people whose taxes we are talking about, what taxes we are going to increase, and so on. And it seems to me that we need to go beyond this very valuable analysis that Mr. Ash gave us this morning into areas of specific cuts that we are likely to be asked to consider.

For instance, entitlement programs account for $142 billion of the total budget. That includes Social Security, military pensions, other pensions, food stamps, and so on.

Are we going to be asking the people to consider cuts in those programs in order to reduce consumption? That is a lot of consumption. That is $142 billion consumed by individuals, only people, young people, retired people. So when you speak of the need to cut some consumption, I am talking about individuals. Are we going to ask them to consider with us the possibility of cutting those entitlement programs? Just as one specific possibility.

Secretary SIMON. I agree with you, Mr. Chairman, that in order to make this whole process creditable to the American people and regain the confidence in the American people that the Government indeed is doing something about the No. 1 problem, all of us must become specific in our recommendations on budget cuts. This is one of the topics that we will be bringing up with President Ford this afternoon. I would hope, as I said in my testimony, and I believe Director Ash did, too, that this will not be a process where we would send a list up to the Hill and suggest this, and then you would suggest something else, and they would be far apart. I would hope that we could do it in a joint process of working together, assessing what the economic impact is, assessing what the disinflationary policy of budget cutting is on the economy and on the individuals. What do we do if unemployment does indeed increase? How do we assist these people? All of these things have to be taken into consideration. We must look out for the casualties of a disinflationary policy, while we are in the process of attempting to control inflation and bring the rate down. All of these things have to be taken into consideration, not just the $142 billion of these particular type expenditures.

We are not really, you know, talking about cutting that much money when you take a look at the total size of the budget. Imagine, a $305 billion budget. That is up 30 some odd billion from last year. I have continually stressed that as we move toward a balanced budget in 1975 and attempt to——

Senator MUSKIE. Could I interrupt at that point?

Secretary SIMON. Certainly.

Senator MUSKIE. Only because we are limited by the 10-minute rule and I want to pursue my point.

We are talking about a $305 billion budget, so it ought to be simple to cut $5 or $10 billion. But if $225 billion of mandatory spending is not touched, if the $57 billion of defense spending is not touched, and every administration witness has argued strongly that we not touch that, then what we are talking about is cutting $5 to $10 billion out of the remaining $35 billion. That is a massive cut and that is why I pursue the question of whether we are really going beyond that $35 billion figure? If so, is defense spending subject to review? Are entitlement programs subject to review? When you talk about $5 to $10 billion—and the administration has not yet focused on the figure—are you talking only about the $35 billion?

Secretary SIMON. No, I am not.

Senator MUSKIE. May I make one other point and then I want you to respond?

Secretary SIMON. Excuse me.

Senator MUSKIE. In several statements that we have heard, administration witnesses have argued that we need to take legislative action in addition to action by the Appropriations Committee to achieve these cuts.

Legislative action obviously has to be directed toward the entitlement programs or something in that $225 billion. I am curious as to what are you seeking to focus our attention on in this respect.

Secretary SIMON. I would hope that the dialog and identification of specifics would not take the narrow form of just focusing on this year's budget. It would obviously bring everything under review, not just the $35 billion you point out, but the whole budget. Whether it is defense or the $35 billion or the transfer payments, everything should be reviewed in this joint process, recognizing the fact that many of the spending programs that have been mandated by law are difficult to cut in this fiscal year.

The real impact of that cut will appear in future years. But if we do not start the work now, then we will have the same problem when we sit down a year from now to deal with the budget.

Senator MUSKIE. Let me ask you this hard, practical question because this is the language started by the President. My time is up and I will just ask this one question. Expenditures for social security, military pensions, and other pensions, which are included in entitlement programs, are subject to serious review by Congress as a possible target for cuts. Do you think the country can take it? Do you think you can ask old people to accept that burden? As a practical matter, as well as a matter of equity, are not those outside the range of possible cuts this year?

Secretary SIMON. I am not at all suggesting that I am insensitive to the situation of the people who are on social security or on welfare. I do not propose doing away with these programs or concentrating on that area, Mr. Chairman, for our cuts. No, I do not. They should be compensated adequately for the cost of living increase that has occurred. A program should not be touched if indeed we are cutting into something and causing a great portion of our less fortuate people to adversely affected.

Senator MUSKIE. So we exclude that $142 billion?

Secretary SIMON. I am not saying I would exclude that. I would take a look, to be sure, at what the compensation was. Have the increased benefits in social security outpaced the rise in the cost of living? I think that that is a pretty key question.

Senator MUSKIE. Do you think they may be receiving too much?

Secretary SIMON. Do many of our welfare programs overlap? I think that is a very important question. Can they be replaced by a more efficient system? These are——

Senator MUSKIE. Than social security?

Secretary SIMON. How are we going to pay for social security through the tax system, looking ahead 10 years? I am not talking about cutting the 1975 budget with a massive cut in social security or any of the welfare programs. That is not what I am suggesting. I am suggesting that we look at the budget process in its entirety right now with an eye toward what is going to happen 10 years from now and in the ensuing period.

Senator MUSKIE. My time is up. I may have a chance to get back to this point and others may pursue it.

Senator Dominick.

Senator DOMINICK. Mr. Secretary, in your statement you are referring to restraints Government places on the financial markets and you show in here that 62 percent of all the funds raised through borrowings in the capital markets came from the Federal Government. You are not just talking about interest, is that correct?

Secretary SIMON. I am talking about the debt market, Senator Dominick.

Senator DOMINICK. The debt market. So it is refinancing the debt that we now have which is, what, $485 billion?

Secretary SIMON. It is not only refinancing. It is also the additions and the additional agencies that have been created. I think the volume of outstanding debt of just the Government sponsored agencies, and this is rough because I do not have the figures in front of me, has grown from $12 to $65 billion in the last 11 or 12 years.

Senator DOMINICK. Now, I have a friend of mine who is active and successful as a young man in business remodeling and fixing up old buildings in core cities. His partners and he would like to expand but they have been unable to get any money whatsoever, even though they have a profitable report, from everybody—banks, insurance companies, real estate companies—at an interest rate, on the ground that there just is not any money available. Whether that is true or not, of course, I do not know. That is what they have been told.

He came up with a suggestion which pertains to your savings comments in your talk here that perhaps one of the ways to generate more savings and, therefore, more money for the private sector to invest would be a tax credit on savings accounts. Have you had any suggestion or any thought along this line at all?

Secretary SIMON. We are in the process now of looking at the various incentives that can be created for increasing saving and investment in this country which is in our judgment, so critical. At the same time we have to make sure that our tax system remains progressive and not regressive as far as the poor are concerned. So we have to

look at ways also to assist them and conversely to keep the tax policy, the tax package, if you will, balanced. We have to look for ways to raise revenues that will not damage what our long run objectives are. This is being worked on right now in our tax department, Senator.

Senator DOMINICK. The reason that I ask that is that there is not any doubt that the problem that we face is multifaceted. One of the problems may be the budget which we are wrestling with here and you say monetary and fiscal restraints. That is fine. I think I agree with both of them. But if you are in the business of trying to get more investment and, therefore, more opportunities and, therefore, more economy, you need to expand and you cannot get any money with the high interest rate because the Government is slopping up most of the money, frankly.

Now, apparently some Members of Congress and some members of the administration—I do not include you in this—think that all income belongs to the Government. People should only be allowed to keep what is left after the Government gets through. I thought our system was built up and that all money belonged to the people, individuals, what they could make, and the only thing that Government got was what people gave.

In the tax field many comments have been made on so-called tax "loopholes," but almost every one of those is for a social purpose of some kind. If you have got a double exemption because you are 65 it is to try to help the older people support themselves for the remainder of their lives. If you get a deduction for interest that you pay on your mortgage, it is to help you try and buy a house which is what I think the American dream is by and large, of most people. And if you have got a depletion allowance, as you well know, and you eliminate that, they are going to raise their prices at the tank. So the consumer can be the one that gets hurt all the way through by this so-called elimination of tax loopholes.

Now, my question is, How do you generate investment capital and savings money, which are available for the private sector, without legislative action of some kind, and should it be done on a tax basis or should it be done on some other basis?

Secretary SIMON. No. 1, the greatest enemy of saving and investment is inflation and to reduce the rate of inflation is our No. 1 aim. That will tend to increase savings and investment tremendously in this country.

The issue of tax reform is one that is extremely complex and also very time-consuming. We are going through one of these exercises in the Ways and Means Committee right at present and have been for the past year. But, yes, I would like very seriously to consider the use of tax incentives to do this, to increase our capacity in many of our basic industries.

Senator DOMINICK. Recently I had a conversation with another Senator whose name I will not use, about the problems that were created by the German bank failure. I forget——

Secretary SIMON. Herstatt.

Senator DOMINICK. I understood that there were a great number of our banks that were involved in that and that we, in our international institutions, lost a great deal of money. Now, what do we do about that kind of a problem? That is money that otherwise would be available, I presume, for lending or for investment.

Secretary SIMON. I can try to get for you information on the amount of the funds that were not paid to U.S. banks. I do not believe that a great number of our banks were involved. I would be surprised Senator Dominick, if over ten were involved in the foreign exchange transactions in question. But these are being adjudicated through the usual channels. It is not clear that they are going to lose this money, because they do not know yet the extent of the assets available to meet the claims.

Senator DOMINICK. Do we have any control over that federally or should we?

Secretary SIMON. Yes, there is some control over these transactions. But basically the regulatory system is looking at the day-to-day domestic management of banks. It is extremely difficult when banks overextend themselves as in the case of the Franklin National. The cause of that problem appears to have been mismanagement.

Senator DOMINICK. That is all I have at the moment.

[The information referred to and subsequently supplied follows:]

U.S. LOSSES RESULTING FROM HERSTATT BANK FAILURE

The German Banking Supervisory Authority withdrew the banking license for Herstatt Bank in June and ordered liquidation. The full extent of the claims against Herstatt by U.S. and foreign banks will be revealed during the course of the liquidation proceedings.

As a clearing agent for Herstatt on international transactions, Chase Manhattan Bank had some $156 million on deposit in Herstatt's account and became involved in claims against these assets. On July 15, Chase informed the U.S. Court for the Southern District of New York that it was without means to determine the validity of conflicting claims and asked the Court to rule on the claims. Moreover, in early August, First National City Bank and others petitioned the Court to have Herstatt declared bankrupt under U.S. law. The filing of claims by U.S. banks against Herstatt will also reveal the extent of losses by U.S. banks as a result of the German bank's failure.

From published information, it appears that U.S. banks may have experienced the following losses in the Herstatt failure: Zurich subsidiary of Seattle First National Bank, $22.5 million; Morgan Guaranty Trust Co., $13 million; First National City Bank, $10 million; Girard Trust Co., $5 million.

Senator MUSKIE. Senator Moss.

Senator DOMINICK. Let me ask one more question, if I may, in the balance of my time. There were a number of people in recent news magazines who have been saying that we are so troubled financially at the present time that we could easily be going into a recession which would be worse than 1930 and they tie this together with the bank failures, and the problems of getting money, and so on. What is your feeling about this situation as a whole?

Secretary SIMON. As I commented, the problem of the bank failures, Herstatt and Franklin, seems to have been mismanagement and excessive speculative positions that were not warranted on the assets of those institutions. As far as the ability to get money, interest rates are extraordinarily high. Interest rates in this country, while they are below the interest rates of most industrialized countries in this world, are high enough to act as a discipline to reduce the demands for capital. This is what we have to do to cool off the demand for a period of time. But that is why monetary policy has been perceived by many to be carrying the load all along. It should be given a hand by fiscal policy so that monetary policy would not have to be as stringent or have to move to an even more stringent posture.

Senator DOMINICK. Thank you, Mr. Secretary.

Senator MUSKIE. Senator Moss.

Senator Moss. Senator Mondale.

Senator MUSKIE. I yield to Senator Mondale. Before I do I would like to apologize for the fact that I do have to leave for a commitment at 12:30. My doing so does not reflect lack of interest in your testimony, Mr. Secretary, as I am sure you know. May I say on behalf of the committee that we look forward to the cooperative analysis of the problem and development of a program to meet it that the President enunciated on Monday, and that you have repeated here today. I think the whole committee looks forward to that opportunity, whatever differences we may have. I think that is an excellent suggestion for trying to resolve our differences and coming up with a program of action.

Secretary SIMON. Yes, sir. Thank you, Mr. Chairman.

Senator MUSKIE. Senator Mondale.

Senator MONDALE. Thank you, Mr. Chairman.

What concerns me, among other things, is fear that in this fight against inflation, which we all agree must be fought and won, the full pressure or most pressure is being put on the Federal budget. It is being identified as the key villain and it is thought to be the key remedy in terms of its reduction. If we reduce the budget we will reduce inflation.

Yet, I think it is quite obvious that in the last year—at least according to President Nixon's own Council of Economic Advisers—the budget is restrictive on a full-employment basis. So that much of the inflationary push is not to be found in excess demand but in so-called cost-push factors—dramatic quadrupling in the price of oil, energy, dramatic increase now in car prices, increases across the industrial sector and, of course, the dramatic and I fear even increasing thrust in food prices particularly in the light of the drought conditions that we are facing.

Now, do you not think that in addition to this review of the budget to cut out waste, to cut out unnecessary expenditures, that we must as well return to a strong incomes policy which asks the major oil companies, auto companies and the rest, to contribute something to the abatement of inflation by restraining their prices? Is it really necessary that General Motors, for example, charge $500 or $700 more this year than last year? Can they not be persuaded or required to roll back those prices? Is that not an essential element of a decent and equitable anti-inflationary policy?

Secretary SIMON. We would expect, Senator Mondale, that our corporations and all components of our society and our economy would act responsibly in the demands they place on the consumer. As you know, President Ford was very upset with the General Motors increase.

Senator MONDALE. Yes, and I was glad to see that.

Secretary SIMON. And I agree, to put it mildly, with what President Ford did.

One must also look at what we have mandated by law in increased costs to the oil companies for environmental—auto companies, I beg your pardon—automobile companies for environmental emissions systems. These costs along with the increased labor costs and inflation in general has greatly increased their costs.

Senator MONDALE. Do you think we need an incomes policy to review these pricing policies, say, of the oil companies, of the auto companies, and so on, in order to make certain that their pricing policies are conducted in a way which helps contribute to a reduction in inflation? Or is it your position that these judgments by General Motors and Ford and Exxon are always made in the public interest?

Secretary SIMON. No. I never make an assumption like that, Senator Mondale. Let me answer the first question you asked me, do I think we should have an incomes policy? I think without a doubt standby controls—an income policy that would threaten that if something happened we would put into place the mandatory wage and price controls—would be highly inflationary in our economy because we would get anticipatory price increases and wage increases in anticipation of this weapon being used. I think that one of the useful purposes that the Cost of Living Council task force monitoring system will provide is to do exactly what you suggested, to bring labor, management, industry in to discuss these increases. I have seen this work. I saw the Cost of Living Council and John Dunlop exercise through the consultative process great restraint in the last couple of years. Industry and labor want to cooperate. The chase-your-tail syndrome of large wage increases followed by price increases really does not benefit anyone. They recognize this. The American people want to be responsible. They want help from us and we need their help while our fundamental policies of fiscal restraint and monetary restraint are bringing down this rate of inflation.

Senator MONDALE. Is this an announcement of an incomes policy? In other words, the new administration intends to put persuasive pressure upon major industries to restrain price increases? Would that be fair to say?

Secretary SIMON. I would say—I would not call it an incomes policy, although I do not know what your definition of incomes policy is.

Senator MONDALE. Well, it is going to General Motors and telling them their prices are to high and urging them to roll back and if they do not roll them back, see whatever clubs you have got in the closet to encourage them to do so.

Secretary SIMON. Well, of course, that is controls, which is what I suggested you had in mind. Absolutely controls, which I believe is——

Senator MONDALE. There are different kinds of clubs.

Secretary SIMON. But it very definitely means calling General Motors in, although I would suggest you would not even have to call them in. I would suggest before they made that increase that they be down here in Washington, explaining, showing us the figures, the costs, et cetera, and at that point you would have a negotiation with them as to what was fair and what is desirable.

Senator MONDALE. Well, let me just make my point. I think a key element in any kind of decent program to abate inflation is not alone budget restraints—which I think we must have—but it is also a policy of using the persuasive powers of the Government, and if necessary the legal powers of the Government, to ask all elements in the American economy, the oil industry, auto industry and the rest, to contribute to the abatement of inflation by restraining unnecessary price increases. And if you do not do that, then I think the average American is going to say that there is one policy of high profit and high interest

rates for the wealthy and another one of high unemployment, reduced work week, reduced public services, and the rest, for him. I think the average American is more than willing to sacrifice. There is no free way out of this and they know it. And, as a matter of fact, they want to sacrifice. But they want to see that it is fair.

Secretary SIMON. Yes, sir.

Senator MONDALE. And the real issue before us and the real issue before this new administration is as to whether we can fashion a strong and stringent program that applies to every one.

Secretary SIMON. I agree with that, Senator. It is the desire of the Treasury Department and always has been to have a progressive tax system in this country, recognizing that if the American people do not perceive our tax system as being generally fair, compliance is going to fall and our revenues are going to fall. We have to make sure that everybody in this country bears the fair burden. We made a proposal on artificial accounting losses to the Ways and Means Committee in April 1973, which would effectively do away with tax shelters which we consider uneconomic. So far it has been rejected, but we will continue to push for adoption.

The effects of the 1969 and 1971 tax acts have been to decrease individual taxes in this country by $30½ billion. They decreased excise taxes on automobiles and telephones by $4.7 billion, and they increased corporate tax revenues by $5½ billion. Those are steps in the right direction as far as progressivity is concerned. I think we have a good tax system. It is not perfect, and we have got to continue to work on it to make it perfect.

Senator MONDALE. I have used more than my time. I would like to ask one further question.

You talk about the need for increased availability of credit in the private market. Do you think we have arrived at the point where the total overall demand for credits of all kinds is such that we must begin to think about credit rationing, such as the measure introduced by Congressman Reuss in the House and by myself in the Senate—where for the first time we start asking questions about what elements in American life deserve the highest priority for sure, reasonable credit, in the light of the restrictive sources, and the high cost of credit? For example, we are in the middle of a disastrous housing market where the average American cannot afford a house which is certainly a desperate and intolerable situation in a country like ours. Could there not be a decision made that, say, a half a billion dollars that for an oil company to use to buy up Marcor is not as important from a credit standpoint and national standpoint as half a billion dollars more in the housing market, and so on? Are we at that point where we can consider——

Secretary SIMON. I most certainly do not think we are. I do not happen to believe that Government has the wisdom to establish the priorities for credit allocation in this complex economy and—on housing, over 50 percent of our people own their own homes now. There are always periods where high interest rates exert a disciplinary effect.

Senator MONDALE. You know, it always hits housing disastrously.

Secretary SIMON. It is a contracyclical industry and I used to testify on this in setting up all of the financial mechanisms that have been set up to help housing before I came down to Washington. And one of the

major things that can be done, Senator Mondale, as far as housing, is to enact the financial regulation bill that the President sent up exactly a year ago to make the thrift industry, the traditional mortgage lending industry, competitive and give them the ability to compete for funds.

Senator MONDALE. Well, there is a decision by the Federal Government to restrict the lending options of the smaller investor in order to divert and to allocate priorities for credit.

Secretary SIMON. No.

Senator MONDALE. Are there not other kinds of——

Secretary SIMON. No. It is giving them the ability in a free market process to attract savings and pay the consumer-saver a fair rate of interest which today is restricted at 5¼, 5½ percent, with a 10, 11, 12 percent inflation rate. They want to be compensated elsewhere and there are many ways for them to disintermediate and that is what occurs.

Senator MONDALE. Thank you very much.

Senator DOMINICK [now presiding]. Senator Fannin.

Senator FANNIN. Thank you, Mr. Chairman.

Mr. Secretary, we are pleased to have you with us here this morning. You have been very patient and I have been very impressed by the answers to the questions.

Mr. Secretary, would not cuts in the budget moving to balancing the budget have a salutary effect both domestically and internationally?

Secretary SIMON. Yes, it would. It would show as far as the strength of the dollar, and this is my judgment, Senator Fannin, that it would show that the United States is serious in its battle against inflation. Obviously in this interdependent world, countries tend to export their inflation to other countries, and everybody in the world that I have talked to, my counterparts, the Finance Ministers in the European Communities in particular, want us to do the same thing that most of them, Germany in particular, have been doing for a long time and employ demand restraints. That is why Germany has a lower rate of inflation than we do.

Seantor FANNIN. Is that one of the principles of the special drawing rights, to try to bring that about?

Secretary SIMON. Yes, sir.

Senator FANNIN. Mr. Secretary, the chairman also referred to your statement on page 2. You indicate that we must reverse our long held policy that penalizes savings and encourages consumption and in my opinion, if we do not give increasing incentive to save and invest, our productivity will decline and unemployment will increase. Thus, I believe we should amend our tax laws to increase the investment credit and depreciation allowance and further provide an incentive for individual taxpayers to save by way of tax credit. If we are not competitive with many other countries of the world it does affect our employment tremendously. And I think we really talk about the jobs 2, 5, 10 years from now, not just for today.

Has the Treasury been considering proposals that might bring about assistance in that regard?

Secretary SIMON. Yes, Senator. In response to one of the earlier questions, we have been working on that and will continue to work on that. That is, as you suggest correctly, a longer-term aspect of fighting

inflation. As you know, we talk about unemployment and everybody gives a judgment on what is going to happen to unemployment. Last fall many said unemployment would reach 8, 9, 10 percent, and then with a great degree of confidence, everybody predicted that unemployment would be rising this year. The fact of the matter is that unemployment has not gone up substantially. Forecasting is a very precarious business and some will suggest that a $5 or $10 billion cut will produce 0.3 percent increase in unemployment. But who knows, maybe these people have the ability to tell the future.

We know that that danger exists, but we also know that when the American people have confidence that their Government is going to do something about inflation, this creates the climate for greater investment. An employer will think twice before he will lay people off, when he believes that we are doing something to fight this insidious inflation. And we do not even begin to measure—and I have talked about this for so long I am almost tired talking about the budget deficit and how big has it really been—as the charts in my testimony showed, on what our federally sponsored agencies and our Federal guarantee agencies are doing. These are off-budget items and they have a short-run inflationary impact and we have not done a thing about that. We have not talked about that at all.

Senator FANNIN. Mr. Secretary, I certainly would agree and I think when we are talking about cuts, if we are talking about program priorities and in some cases it may be a cut in one field, an increase in another field, that would really increase employment in our country. Is that not true?

Secretary SIMON. Yes, sir. I think also that where there is a danger that the unemployment rate might increase we should deal with that. We should deal with it through the unemployment system, through benefits in the unemployment system. Simultaneously we should look for cuts in other areas in the budget to bring about balance, but we must pay attention to the social consequences of potential unemployment in our disinflationary policies.

Senator FANNIN. Mr. Secretary, on page 3 you state that a tighter fiscal policy will reduce the Treasury's demand for funds and will thereby reduce the heavy pressures that we now see in the financial markets. A prior witness stated that when we add the Federal, State, and local surpluses or deficits the total Government balance has turned into a surplus. That is, Government's balance. He also stated that the Federal Government borrows to finance grants to States and local governments which run surpluses which are then invested in Government bonds that create no extra pressure on financial markets.

Now, based on your broad experience in the financial markets, could you comment on this feeling?

Secretary SIMON. I most certainly do not agree with the latter part of the statement whatsoever on the basis of my experience. It is not clear to me—I do not have at hand the components of investment in the California State funds and New Jersey and New York, to mention three of the largest in the country, as to what they are investing their moneys in. But I would suggest a good portion of it is in short-term instruments and the Federal Government borrows in many other areas. The fact is that our gross debt grows each year in our Federal deficit

financing and becomes a major source of economic and financial instability when it occurs during periods of high economic activity, which it certainly has in the last few years; and this startling number of 62 percent of the capital market is preempted by us. Who becomes the disadvantaged? Many smaller businesses in this country. That is the regressive portion of this. They are forced to go to other higher sources, higher cost sources, of funds or there is a total unavailability of funds. And so the deficits in the past decade have added enormously to the aggregate demand for goods and services and financial instability and I do not know very many people that would disagree with that.

Senator FANNIN. I do not know who said every dollar in the budget has a constituency but I know this has been testimony before our Finance Committee. We all know that is true, so everybody is working for their own interest as far as States are concerned, or a typical project is concerned. I feel that the answers you gave to questions this morning indicate that we can touch the untouchable, that there is an area in which something can be done. I know that you—you explained I think quite thoroughly that you are not saying that you are going to be so frugal that you are going to cut back on humanitarian programs but that you are going to look at those programs to determine just what can be done. I would hope that since the executive branch does expend the money that they will go into that very thoroughly because I think you are in a better position to know exactly what is happening and where those cuts may be made and if it requires legislation I hope that we will accept your recommendations to carry through the legislation if it be needed. Do you have any comments on that?

Secretary SIMON. Senator, I agree with you and I think the establishment of this Budget Committee in the Congress demonstrates to me that you have taken the first step toward exercising the responsibility and now we have to work together and disagree, if we must, on certain specifics. That has happened before and will again. But we will hammer it out because we know it is in the best interests of the country.

Senator FANNIN. Thank you very much. My time has expired.

Senator DOMINICK. Senator Cranston.

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

Thank you for this opportunity to hear from you and to talk with you.

In regard to your statements on page 2 about the need to increase savings and invest in the private sector for developing capacity there, do you feel we need to take some steps to sort of guide investment in the proper channels? For example, I am thinking specifically of the Federal Reserve Board and its across-the-board tight money policy. Would it not be wise to have them seek to provide some incentives in some way that would direct money that is available for investment into productive channels and not into speculative channels, into housing, for example, into expansion of utilities, for example, and farm production, for example?

Secretary SIMON. Senator Cranston, this has been a long argued subject, what the function of our central bank is in the United States, and does it exist for other than reserve priorities and establishing monetary growth and control of same? Does it fly in the face of common-

sense? If they are to become a social priority institution could they exercise their monetary restraint as at present? Would they not be forced to act in a counterproductive fashion?

I have always felt that the central bank's function is just as has been stated, and if we wish to identify certain priorities, as we have in the area of housing in particular, with Fannie Mae and Ginnie Mae and the Home Loan Bank System, then we should do it through the budgetary process and do it specifically here in Congress.

Senator CRANSTON. How do we do it through the budget process, however, when the effect of tight money policy when it is applied across-the-board is to bring housing, for example, to a complete standstill, to inflate the cost of expanding utility construction and services tremendously, which is now reflected in the billions of consumers? It seems to me that I agree with you that the Federal should not make those determinations about priorities but the Congress could, by passing legislation that would empower them or direct them to apply the credit in a more selective basis, and they are determining priorities now by their procedures. They are determining that despite whatever housing bills we pass there just is not mortgage money at a decent price, so it is not being produced. They are determining that these things are happening to the utilities.

Secretary SIMON. It is the inflation rate, that, of course, is the major contributor to the high interest rates we have got in this country. Taking your two examples, Senator Cranston, first, the utilities, an extraordinary thing happened a year ago when the world price of oil almost quadrupled. This is the feedstock and a major portion of the cost of the public utilities. They have need to grow.

Eighteen major public utilities have announced significant construction curtailments during 1974. For this group of companies, construction curtailments in terms of kilowatt hours amount to 29 percent of present generating capacity in service. To place the significance of these curtailments in perspective, the proposed reductions in construction spending for this group of companies would reduce total industry spending by 9 percent in 1974, 11 percent in 1975 and 7 percent in 1976. As additional curtailments are announced, these percentages would have to be revised upward. The problem is their present and anticipated inability to generate adequate funds for expansion.

The utilities are discriminated against in our tax system, with a 4 percent investment tax credit, and that should be increased to match all other industries to 7 percent. That is No. 1.

But No. 2, more importantly, you can increase the investment tax credit but if the utilities are not profit entities, profitmaking entities, then it is not going to do them any good and the ratemaking bodies, the State regulatory bodies, have to recognize this and increase the rates for those particular utilities who need it. Your utilities on average today are selling in the marketplace at 76 percent of book value and this is a clear indication of their inability to raise any money. As far as housing is concerned, the traditional institutions that have always supplied money for mortgages, it is contracyclical, as I said before.

When interest rates go up, it creates the disintermediation process that we all know occurs and has occurred every time since 1966. As more people are educated as to where they have an alternative to put

their funds during periods like this, the problem grows. What we have to do is make these institutions more competitive and broaden the base of lending to the housing industry by encouraging the commercial banks with a mortgage tax credit to invest more in the mortgages than we are seeing now. I would hope that we would get to work on that.

Senator CRANSTON. What do you suggest we do in terms of using the budget process that you suggested earlier to determine priorities in investment on a sounder basis beyond what is now being done?

Secretary SIMON. Well, I was not talking about the budget process as far as setting priorities. First of all, if we had, as I illustrate, a relatively small surplus, this would generate quite large savings in our economy, No. 1.

No. 2, we are looking right now at tax means to increase capacity in this country for many industries, steel, et cetera, that have a basic problem in their capacity. Even when automobile production was dropping precipitously as a result of the embargo, the steel operations were going all out at that time which was an indication of the tremendous demand.

Senator CRANSTON. In terms of the budget deficit that we presently are confronted by, is that not more due to the state of the economy and decline in expected revenues than to expenditures?

Secretary SIMON. No, I do not think so. Whether measured by either standard, the unified budget deficits as well as the additional Federal credits, if you will, as per the table in my testimony, the deficit comes from expanded spending. Revenues are not keeping up with the expanded spending. Really that was highlighted during the period 1965 to 1969—during the guns and butter period—when we attempted to finance the war without raising taxes.

Senator CRANSTON. Revenues are not keeping up with spending.

Secretary SIMON. No, sir.

Senator CRANSTON. In terms of the investment, tax credits of various sorts you suggested to stimulate production and investment, Senator Scott placed some material in the Record on July 30 which suggested among other things, that the interest paid on all forms of personal savings of $20,000 or less be made tax exempt. Do you think that would be a speculative——

Secretary SIMON. I would have to look at what the revenue impact would be and whether there might be a better way to skin a cat. I have found that during noninflationary periods in this country you do get a growth in savings. The first step we have to take is to break down this tremendous inflation rate.

Senator CRANSTON. Of course, now, savings and savings accounts either in banks or savings and loan institutions are not the best investment.

Secretary SIMON. Not at 5¼ or 5½ percent with double digit inflation. No, sir.

Senator CRANSTON. The figures that you give in your statement of the consequence of the borrowing the Government does from Fannie Mae, Ginnie Mae, Home Loan Bank System, and Export-Import, et cetera, et cetera, are pretty staggering. Do you feel we should take a look at those or because of the purposes for which they are designed do you think we have to carry them on at the present level?

Secretary SIMON. Senator, I think it was in 1967 there was a Kennedy commission on budget concepts that I believe made a very firm recommendation against financing outside of the budget, that is, by means of the so-called participation certificates used at that time and the financing techniques which account for much of this proliferation today. I have testified at least 15 or 20 times prior to coming to Government on just this practice. If you wish to establish priorities in this fashion then we have to recognize what consequences there are in the financial markets and the damage that we are doing to many of the industries in this country, large and small, and many more small than large, by squeezing them out of the marketplace. If we wish to do this then the least we could do is put them all in the budget so we know exactly what we are doing.

Senator CRANSTON. Beyond that, we do know what we are doing, if you look carefully. Do you feel that, to take an example, the Export-Import borrowings, which are tremendous, should be considered as one place to cut back in order to get what would then be a more balanced budget?

Secretary SIMON. Well, I feel that exports are very good for many reasons. And the major ones are: (*a*) Balance of payments considerations, especially today with the increase in our oil bill, (*b*) they create jobs here in the United States, and (*c*) allow industries to expand when the market is perhaps saturated in this country for the particular widget that they are producing. Export credits, or an interest rate break, if you will, enables many of our industries to compete with the foreign companies, because all the other governments of the world provide such assistance. Of course we have to constantly look at the specific areas receiving Ex-Im loans and we in the Treasury do so, while working very closely with Ex-Im on establishing the priorities.

Senator CRANSTON. Of course, the same good things can be said about Fannie Mae and Ginnie Mae technically since they try to help the housing industry.

Secretary SIMON. They do help the housing industry.

Senator CRANSTON. You look at each of these and where do you find the places to cut?

Secretary SIMON. I am not suggesting we do away with those programs at all. I suggest it might be a good idea if we put them in the budget and then we get a real look at the impact of the entire Federal operation.

Senator CRANSTON. I want to differ with you on one word you use. In your statement you say "Since 1965 we have got the worst peacetime inflation in our history." I think "peacetime" is not a very accurate description of that period since 1965 is the year we plunged into Vietnam, the year when the inflation really commenced that has been plaguing us ever since though it has been getting worse for many, many years. We have had an ongoing arms race all this time, huge defense budgets. Do you not think that word "peacetime" may not be exactly a good description?

Secretary SIMON. I will take it out of my next testimony. I agree with you. [Laughter.]

Senator CRANSTON. In terms of trying to balance the current budget or at least reduce expenditures, I gathered from the prepared statements that various administration spokesmen have presented to us and

from President Ford's own statements since he became President, there is not any real conviction on the part of the administration that the current budget, 1974–75, can be balanced. We hear possibly maybe cutting the $305 billion to $300 billion, but very little talk about actually squeezing it down to $295 billion. Is that true?

Secretary SIMON. I would say that there are different judgments on that. There are different judgments and forecasts as to the economic impact of attempting to balance, not to mention the political and practical ability to balance the budget. I think that we should move in that direction and I would like to work on that exercise. I would like to work on it and move as close to balance as we can. If we can achieve balance, and can agree on the specifics, and if that is what President Ford wishes to do, that would make me very happy. We should move toward this and the minimum step of moving to $300 billion I think is definitely attainable. And definitely we should move toward the balance in 1976.

Senator CRANSTON. Do you think it would be possible to balance the budget without some cuts in defense since 62 percent of the discretionary spending on the chart presented to us this morning by Mr. Ash is defense spending.

Secretary SIMON. Well, we are going to have to talk to the President as far as the priorities that he might have for the defense budget and other priorities in the budget as well. I think that there are undoubtedly efficiency cuts that could be made in the defense budget but there are compelling reasons why on the hardware side for national security reasons with the defense budget in excess of 30 percent below what it was in 1968 dollars that we ought to avoid doing something that would not be in our best interests. But that is a hotly debated topic up here and down there as well, Senator.

Senator CRANSTON. I am delighted to hear your response because you are the first administration witness that has not given the impression that the defense cut suggested by the administration is sound fiscal policy but defense cuts proposed by the Congress is wildly dangerous and threatens national security.

In regard to taking care of or trying to help those injured by any unemployment that stems out of budget cuts or stems out of other efforts to deal with inflation, your only suggestion is that we make improvements in our system of unemployment compensation which is a very—is very necessary and yet it is not necessarily the best answer. It certainly is not something that contributes to productivity. Secretary—Mr. Burns has suggested public service employment as a step to be taken. Would you comment on that?

Secretary SIMON. Senator Cranston, I have stated that I am intrigued by the idea of a trigger mechanism—whether it be triggered in at 6 or 6¼ percent, we should study this carefully. Public service employment would be one mechanism that could be put into place. I think we have to put up safeguards for the casualties of, potential casualties of, a disinflationary program. Otherwise the demand and the hue and cry that will occur after a while will be for more and premature stimulative policies. We have seen that happen before and then we are right back in the soup again, so, therefore, I would like to make sure that we take care of the social injustice part of this program

and then let us have a firm resolve once and for all to deal with this problem on a long-term basis.

Senator CRANSTON. In your statement you used some figures which Senator Dominick used also yesterday. I would like to call the Senator's attention to one other set of figures that goes with those. You mentioned the fact that it took us 185 years to get to the $100 billion mark in Federal spending, 9 years later we are up to $200 billion and 4 years later we are now up to our $300 billion. It seems to me that should be taken in the context of the gross national product. Mr. Ackley pointed out yesterday that that was $100 billion in 1941, $200 billion in 1944, $300 billion in 1951, 1954, 1955, 1956, and then getting to the figures that you and Senator Dominick referred to it was $500 billion in 1961, at which point our budget was roughly $100 billion, it doubled to a trillion by 1971 and we had doubled the Federal budget to $200 billion by then and it will be a trillion and a half in 1975 and again we are going to have—we are going up to $300 or $330 by then. So actually do you feel that the increases in the Federal budget are excessive in terms of the accompanying growth in the national product?

Secretary SIMON. I think it is, of course, useful to compare it to the total size of our GNP, Senator Cranston. I attempted to illustrate how dramatically spending had grown and I prefer to concentrate on the fact that our revenues are not growing that fast and the inflationary impact that these subsequent deficits have had.

Senator CRANSTON. I agree with you and Senator Dominick that those figures on the budget growth are staggering but when you do place them in the context of GNP, I agree, it seems to me that there is a slightly different impression. I agree with you also, however, that we certainly should take into account what is happening in terms of revenues.

I have just one last question. This is not my thought but it has been suggested that we return to the gold standard to deal with inflation. Would that have any positive or negative impact in your view in terms of inflation and the economy generally?

Secretary SIMON. Well, through 2 tedious years of intricate international monetary reform it has been generally agreed, Senator Cranston, that the logical thing to do would be to remove gold from the center of the monetary system and treat it just like any other commodity and create a strong special drawing right, SDR, as its replacement. I do not share the philosophy that returning to a gold-based system would assist in our battle against inflation, no, sir.

Senator CRANSTON. Thank you very much.

Thank you, Mr. Chairman.

Senator DOMINICK. Thank you, Senator.

Thank you, Mr. Secretary. That is all we have today. The hearings will adjourn until Wednesday morning in room 1114 at which time we will hear from Dr. Burns and Mr. Walter Heller.

The hearing is adjourned.

[Whereupon, at 1 p.m., the committee was adjourned, to reconvene at 10 a.m., Wednesday, August 21, 1974, in room 1114.]

THE FEDERAL BUDGET AND INFLATION

WEDNESDAY, AUGUST 21, 1974

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 9:40 a.m., in room 4200, Dirksen Senate Office Building, Senator Edmund S. Muskie (chairman), presiding.

Present: Senators Muskie, Magnuson, Moss, Mondale, Hollings, Chiles, Cranston, Biden, Dominick, Fannin, and Dole.

Also present: Alvin From, Lee Lockwood, and Lucinda Dennis, staff of Senator Muskie.

Senator MUSKIE. The committee will be in order.

I take it that we can proceed without any opening statements by the committee. We have two outstanding witnesses this morning. I am sure the committee will have many questions. So I would like to welcome an old friend and distinguished public servant who has been concerned about this problem in a persistent way, notwithstanding the fact that he has those that disagree with him as well as those who agree. For that persistence I compliment him, because I think we need that kind of commitment to a common objective, especially from the Chairman of the Federal Reserve Board, if we are to mobilize public opinion behind us.

So I welcome the Chairman of the Federal Reserve Board, Dr. Arthur Burns. Please proceed with your testimony.

STATEMENT OF DR. ARTHUR F. BURNS, CHAIRMAN OF THE FEDERAL RESERVE BOARD

Dr. BURNS. Thank you very much, Senator. It is a very real pleasure for me to meet with this committee as it undertakes its momentous responsibilities under the Congressional Budget Act of 1974. In recent years, Federal spending has risen swiftly, deficits have become chronic, and the public debt has mounted. Our present grave problem of inflation stems from many causes, and inadequate fiscal discipline is prominent among them. You and your congeners in the House of Representatives therefore face a great challenge, but you also have a unique opportunity to reestablish order in our Nation's finances.

The budget that the President recommends to the Congress at the beginning of each session is the product of a systematic process aiming to establish an overall limit on outlays in relation to expected revenues, and to determine priorities within the totality of outlays. This process, as you know, has hitherto had no counterpart in the Congress. Instead, congressional decisions that determine the ultimate

shape of the budget have been taken by acting separately—or at times by taking no action—on a hundred or more entirely independent measures. It is only after separate votes are cast on housing, education, defense, welfare, and whatnot that we put the pieces together and discover what kind of a budget has emerged.

Thus, year after year, Members of Congress have been voting for or against larger benefits to veterans, for or against better schools, for or against cleaner air, and for or against a host of other good things that Government can help to provide. But the Congress has not had the opportunity to vote on what total outlays should be, or whether an appropriation for a particular purpose is needed badly enough to raise taxes or to make offsetting reductions in other appropriations.

This fragmented congressional consideration of the elements that make up the budget has contributed materially to the almost uninterrupted succession of budget deficits. Since 1960, we have had a deficit in every fiscal year except 1969. True, some of these deficits occurred because of efforts to use the Federal budget as a means of stimulating a lagging economy, but for the most part we have allowed deficits to happen without plan or purpose. Machinery for putting effective ceilings on expenditures, and for establishing priorities among alternative uses of Federal revenues, has simply not been available.

By passing the Budget Act of 1974, the Congress has established a framework for exercising this much needed control, and has also indicated its firm resolve to do so. The Budget Act is a milestone in the reassertion of congressional authority and self-discipline. There is now real hope that we can avoid the massive increases of Federal expenditure and the persistent deficits that have plagued us in the past.

The immense importance of your committee's new responsibilities may perhaps be more fully appreciated by reflecting on what has happened to the Federal budget over the long sweep of our Nation's history. Total expenditures did not reach the $100 billion level until fiscal 1962, or nearly 200 years after the founding of the republic. By fiscal 1971, 9 years later, Federal spending had risen another $100 billion and thus passed the $200 billion mark. In the budget as now projected, the $300 billion mark will be passed this fiscal year. Clearly, the pace of Federal spending has been accelerating rapidly, and a pause for taking stock of where we are is overdue.

One result of the sharply rising curve of expenditures is that Government has been assuming an ever larger role in the economic life of our people. In 1929, Federal expenditures accounted for less than 3 percent of the dollar value of our total national output, and expenditures at all levels of government—Federal, State, and local—amounted to about 10 percent of the national product. By 1950, the share of national output absorbed by Government had risen to 23 percent. Since that time, governmental involvement in the economy has increased further; last year, Federal expenditures alone accounted for 22 percent of our national output, and the combined expenditures of all governmental units accounted for 35 percent.

A significant increase over the past four decades in the role of Government in economic life was inevitable. A growing population, and the increasing complexity of modern urban life, gave rise to new and expanded governmental activities. This was also a period in which the United States came to occupy a position of leadership in international political affairs and in world economic development.

Some part of the rapid upward trend of Federal spending, however, is attributable to widespread acceptance of the theory that social and economic problems can generally be solved by quick and large expenditure of governmental moneys. We have tried to meet the need for better schooling of the young, for upgrading the skills of the labor force, for expanding the production of low-income housing, for improving the Nation's health, for ending urban blight, for purifying our water and air, and for other national objectives, by constantly excogitating new programs and getting the Treasury to finance them on a liberal scale before they have been tested.

The result has been a piling up of one social program on another, so that they now literally number in the hundreds and practically defy understanding. Not a little of our taxpayers' money is being spent on activities of slight value, or on laudable activities that are conducted ineffectively.

Another result of the rapid growth of Federal spending has been a larger tax burden borne by our citizens, and a blunting of economic incentives. Business capital investment in recent years has certainly been inadequate for a nation that is eager for rapid improvement in the general welfare. There is thus reason to believe that governmental spending and taxing may have gone beyond prudent limits.

Where the line should be drawn between governmental and private use of resources is, in the final analysis, a matter of judgment and of social values. However this question is resolved, it should be clear to everyone that Federal spending, whatever its level, needs to be financed on a sound basis. Deficit financing by the Federal Government can be justified at a time of substantial unemployment, but it becomes a source of instability when it occurs during a period of high economic activity, such as we have experienced in recent years. The huge Federal deficit of the past decade added enormously to aggregate demand for goods and services, but they added little to our capacity to produce. They have thus been directly responsible for a substantial part of our present inflationary problem.

The current inflation began in the middle 1960's when our Government embarked on a highly expansive fiscal policy. Large tax reductions occurred in 1964 and the first half of 1965, and they were immediately followed by an explosion of Federal spending. New and substantial tax reductions followed in 1969 and 1971, and so too have massive increases of expenditures. In the last 5 fiscal years, that is, from 1970 through 1974, the public debt—including obligations of the Federal credit agencies—has risen by more than $100 billion, a larger increase than in the previous 24 years.

In the fiscal year just concluded, the condition of the Federal budget failed to improve sufficiently. True, the reported budget deficit declined about $3½ billion—a much smaller deficit than in the 3 preceding years. But in a year of such powerful inflationary forces the Federal budget should have been in surplus. Moreover, when off-budget outlays and the expenditures of governmentally sponsored agencies are taken into account, as I believe they should be, the total Federal deficit reached $21 billion last year, which is not much lower than the extraordinary deficits of the 3 previous fiscal years.

Senator DOMINICK. Doctor, what do you mean, if I may interrupt, by off-budget outlays?

Dr. BURNS. These are outlays, which I believe were initiated in fiscal year 1972, for certain governmental agencies that have been taken out of the unified budget. The Export-Import Bank is one of these agencies. Its outlays are not included in the budget.

Senator DOMINICK. Thank you.

Dr. BURNS. And there are at least two or three other such agencies.

Senator CRANSTON. What are you referring to, Fannie May, Gennie Mae?

Dr. BURNS. No. No. I am referring to Export-Import Bank, and the Rural Electrification Administration, the Rural Telephone Bank, and there are one or two others. I can locate those agencies later on or place the names of these agencies in the record at a later time.

[The following information was subsequently furnished by Dr. Burns:]

Currently, the off-budget agencies in operation are the Export-Import Bank of the United States, the Postal Service, the Rural Electrification and Telephone Revolving Fund, and the Federal Financing Bank. The United States Railway Association also has been authorized as an off-budget agency.

Senator MUSKIE. If I may make a point, simply for the record—under the committee's mandate, section 606 of the law, the Committees of the Budgets of the two Houses are required to study on a continuing basis those provisions of the law which exempt agencies of the Federal Government or any of their activities or outlays from inclusion in the budgets of the United States.

Dr. BURNS. I think that is a very wise provision in the new Congressional Budget Act.

If I may continue, the financing of these huge Federal deficits has contributed powerfully to the upward pressure on interest rates and the tension in financial markets, which have been so troublesome of late. The disturbing effect of Federal borrowing on the flow of funds was illustrated dramatically earlier this month, when the Treasury went to the market to refinance some maturing debt obligations. Long lines of people formed at the doors of the Treasury and the Federal Reserve banks to bid for the new securities offered by the Treasury. Half of the total of $4.4 billion sought by the Government was obtained through noncompetitive bids—that is, from relatively small investors. A large share of these funds undoubtedly came out of deposit accounts, and thus further reduced the ability of our financial institutions—particularly savings banks and savings and loan associations—to support homebuilding activities.

Senator MUSKIE. What issue securities was that?

Dr. BURNS. Well, there were three issues. One of about 2½ year notes, the second of 6-year notes, and the third consisted of long-term bonds. The last issue amounted to $400 million and the first two issues between them amounted to $4 billion. It was the first of these issues, the 2½-year notes, which the public took up in very large amounts.

Senator MUSKIE. What was the interest rate?

Dr. BURNS. The coupon rate was 9 percent on the two note issues; but since there was competitive bidding, the yield was brought down to a little over 8½ percent.

Senator MUSKIE. How does that compare with the interest rates on savings deposits?

Dr. BURNS. Well, it is about 3-percent higher than on passbook deposits.

Senator MUSKIE. Would you say that is the attraction?

Dr. BURNS. Why, of course.

Senator MUSKIE. The reason I put the question and raised the issue is because there is some criticism of the Government for offering those issues at those rates, with the effect of drawing off the capital available in the private market. I don't know whether that criticism is justified or not, as I am not expert in those matters. Was there any choice, Dr. Burns?

Dr. BURNS. The Treasury had to raise the money and had to pay the market rate of interest. The Treasury had no choice in this respect. I think the Treasury could have however, instead of issuing these notes with a minimum denomination of $1,000, issued notes with a minimum denomination of $10,000. This was done in some previous instances.

Senator MUSKIE. That would have had the effect of retaining small deposits.

Dr. BURNS. That would have kept the very small savers away from the Federal Reserve banks trying to buy these issues. But, of course, you have here a very difficult problem, Senator, as well recognize. The small saver has not been getting a break. The man with money is able to get in today's money market 8½, 9, 10, 12 percent, depending on the kind of paper instrument he purchases, but the small saver is pretty well confined to his savings and loan association or a commercial bank. He is definitely discriminated against. That doesn't result from an evil intent on anybody's part but from the fact that we have a ceiling on the interest rates that can be paid by our thrift institutions. The reason we have that ceiling is that these institutions are in a weak position. They are loaded down with morgages with low yields, and are not in a position to pay significantly higher interest rates.

Senator MUSKIE. The whole problem is a direct product of the monetary policy which is invoked in the name of controlling inflation.

Dr. BURNS. Well, if—I would like eventually to say something about that. I will have to disagree with you, Senator.

Senator MUSKIE. Well, I put it in the form of a question.

Dr. BURNS. Well, I can take that up now or perhaps finish my statement.

Senator MUSKIE. I will take it up in my question period and you complete your statement.

Dr. BURNS. I can finish my statement and get this paper out of the way or we can turn to your question and forget about these remaining pages.

Senator MUSKIE. Why don't you finish your paper and then I will raise the question again in my questions.

Dr. BURNS. Thank you very much.

Despite such concrete evidence, it is sometimes contended that the Federal deficits of recent years have been only a minor source of economic or financial instability, since the amounts are small relative to total borrowing by the private sector. This is a faulty argument. To be sure, the rate of private credit expansion has substantially exceeded the rate of Federal borrowing. But we must never confuse the power or responsibiilty of private citizens with the power or responsibility of government. Business firms and consumers have no way of acting in

concert to prevent an inflationary expansion of credit, and their private responsibilities may conflict with national objectives. The basic responsibility for economic stabilization lies with the Federal Government. Unless our Government exercises that function better than it has in the past, there will be little hope for restoration of stability in the general price level.

The central purpose of the Congress, besides providing for the Nation's security, is to help find the way to a better life for the American people—among other things, reasonably full employment, a widely shared prosperity, and a stable purchasing power of their currency. None of these objectives will be achieved over any length of time without far stricter fiscal discipline than we have exercised in recent years. That is why your committee, together with the Budget Committee of the House, has such a great and unique opportunity to serve the Nation's welfare.

I recognize that you have a good deal of preparatory work to do before you can begin exercising fully your responsibilities under the Congressional Budget Act of 1974. The importance of this preparatory effort should not be underestimated. A highly competent and thoroughly objective staff will need to be assembled to carry out the functions of the Congressional Budget Office. Good working relations will need to be established between your committee and the House Budget Committee and between both committees and the Office of Management and Budget. Procedures will have to be worked out for implementing the intricate steps in the budgetary process set forth in the Budget Act. Some flexibility is needed in congressional management of our enormously complex Federal budget, and the Budget Act properly provides opportunity for waiver of procedures and deadline requirements. But unless the Congress undertakes its new responsibility with a firm determination to reserve the waiver privilege for unusual circumstances, the Budget Act may turn out to be a well-meaning but illusory gesture.

Full implementation of the new budgetary procedures, I understand, will begin in fiscal 1977—or 2 years from now. We dare not wait 2 years, however, for the additional fiscal restraint that is so urgently needed in the present inflationary environment. Strenuous efforts should be made immediately to pare budget expenditures in fiscal 1975 and to balance the budget in fiscal 1976.

I recognize that this committee is not yet in a good position to recommend to the Congress where expenditure cuts would be most appropriate. Nevertheless, in view of the special responsibility that has been assigned to you by the leadership of the Senate, you can justly use your good offices to press for restraint on Federal spending. This is the most important single step that can now be taken by the Executive and the Congress to curb inflationary pressures and to restore the confidence of our people in their own and the Nation's economic future.

Thank you, Senator Muskie, for giving me the privilege to read this statement.

Senator MUSKIE. Thank you very much, Dr. Burns.

There is, as usual, and I hope it is a growing habit, good attendance on the part of the committee. For that reason I will invoke the 10-minute rule on questions. It is a little frustrating to the questioner

who is on the track of a possible fruitful line of questioning but we will undertake it in any case.

Why don't we turn to the question that I put to you during your statement. To put the question in a more objective way, Can you give us the relationship between what is happening with respect to the transfer of funds from deposits of savings, and so on, into the most recent Federal issue of securities? My impression was that because of the high interest rates that were offered an attraction had been generated which drew those savings out of the private sector, out of savings deposits, into Government securities. That is the question I want to put, because it is important for us to understand the implications of monetary policy as well as fiscal policy. I thought I would put the question in that form.

Dr. BURNS. Well, thank you, Senator.

It is undoubtedly true that interest rates in general are now at about the highest level in our Nation's recorded history. Interest rates throughout the world are at extraordinarily high levels. In fact, our interest rates, high though they be, and outrageous though they appear, are below interest rate levels in most industrial countries around the world.

Now, why are interest rates so high? Why have they risen as they have in this country and elsewhere?

The fundamental reason is that the demand for credit has grown much more rapidly than the supply of loanable funds.

Take this year, when the Federal Reserve is widely reputed, and with some justification, to be following a restrictive monetary and credit policy. In the first quarter of this year business loans, that is, loans to commercial and industrial enterprises by our commercial banks, in the aggregate, rose at an annual rate of 22 percent in the first quarter, at an annual rate of 23 percent in the second quarter, and at an annual rate of 20 percent in the month of July. These are extraordinarily high rates of increase.

The monetary authority, that is, the Federal Reserve System, has not been starving the economy for money and credit. Money and credit have continued to grow, and have continued to grow at a rate that is well above the long run historical average, but the demand for credit has grown so much faster than the supply that interest rates have inevitably risen.

Now, your question, Senator, if I may say so, implied that the Federal Reserve System sets interest rates. Perhaps I am not putting that fairly. Your question might have been interpreted to imply that the Federal Reserve sets interest rates or is solely responsible for the high interest rates that have been experienced of late.

Senator MUSKIE. May I say I didn't supply the interpretation. I supplied only the question.

Dr. BURNS. I know. I am taking the liberty, Senator, of putting an interpretation, not reading your own thought into it. I want to deal with the issue because that is often believed by very sincere and thoughtful citizens. The fact of the matter is, at least as I see it world or as I know the financial system, that if we at the Federal Reserve accelerated the rate of growth of the money supply, that would indeed have some easing effect on interest rates in the very short run. But this would also be interpreted by the financial world as evidence that in-

flation would soon proceed at an even faster rate. Both borrowers and lenders, anticipating a more rapid rate of inflation would, between them, in the process of shaping markets, then raise interest rates to still higher levels than they originally were. That is the way markets work.

You will find, historically, in individual countries and across the world, that periods of inflation are accompanied by very high interest rates. As the rate of inflation increases, market rates of interest also rise, and the reason is not difficult to grasp. As far as the lender is concerned, anticipating inflation or inflation at a faster rate, he will expect to be compensated for the decline in the purchasing power of his money a year later or 2 years later or 5 years later. He therefore will hold out for a higher nominal rate of interest. And the would-be borrower, expecting to repay the loan in a depreciated dollar, is ordinarily quite willing to assume the burden of a higher rate of interest. Let us look at interest rates today—take the prime rate. The prime rate is 12 percent. Now, is that a high rate of interest or low rate of interest? Viewed as such, it is an extraordinarily high rate of interest, the highest ever experienced in nominal terms. But when you remember that the inflation rate in the first quarter of this year was 14 percent and in the second quarter, 12 percent, and now is probably at about the same level, then the real rate of interest is either zero or a negative magnitude.

Now, these are the facts of life.

Senator MUSKIE. In order to try to focus on the difference between monetary policy and fiscal policy as a way of dealing the inflation—is it roughly true that monetary policy is a way of influencing the pace of private spending?

Dr. BURNS. Influencing what?

Senator MUSKIE. Is monetary policy a way of influencing the pace of private spending and budgetary policy a way of influencing the pace of governmental spending at the Federal level?

Dr. BURNS. I think that is fundamentally true, yes.

Senator MUSKIE. Could I ask you this question. On page 7 of your statement you refer to the total Federal deficit of $21 billion a year. That includes, I take it, not only spending for the day to day operations of Government programs but it reflects also the Federal Government's need and use of capital investment for governmental purposes. And that total is referred to as deficit spending that exceeds revenues.

To put that in focus over the same period, what was the pace of deficit spending, that is, capital borrowing, in the private sector?

Dr. BURNS. I can't give you the figure offhand but it was very much larger, Senator.

Senator MUSKIE. Very much larger. And you also have consumer deficit spending.

Dr. BURNS. Oh, yes. That is, the total, as I remember the figures, borrowing by private nonfinancial firms in the first half of 1973 proceeded at an annual rate of $185 billion. That was reduced in the first half of calender year to an annual rate of $165 billion.

Senator MUSKIE. I take it that that $165 billion of private borrowing can be as inflationary as the $21 billion.

Dr. BURNS. No——

Senator MUSKIE. Not to the same degree, but can it be?

Dr. BURNS. No question about it. But the critical point, as I see it, is that the Government has a certain responsibility that private citizens do not have. Under the Employment Act of 1946, and for that matter we began doing this in the 1930's, the Federal Government has undertaken the responsibility of serving as the balance wheel for the economy. And, therefore, when private borrowing is going wild, as it has recently, Government borrowing, instead of rising, should be reduced. In fact, Government should then be pouring money into the capital markets, should be running a surplus, to offset the inflationary effect arising from the private sector. It would thereby not only be serving to check the rate of inflation but also serving to check the rate of interest.

Senator MUSKIE. My time is up, Dr. Burns, but I want to come back to this theme if we have time because I am interested.

Dr. BURNS. I would like very much to pursue these questions with you, Senator, because the questions that you have asked are fundamental. They go to the heart of our problem.

Senator MUSKIE. Thank you very much.

I yield to Senator Dominick.

Senator DOMINICK. Dr. Burns, welcome to the committee and thank you for, I think, a very helpful statement that you have given us on the background of the problem we are in.

It so happens that everybody always thinks a statement is good if you agree with them and I agree with you. But it is extraordinary, and let me ask you maybe a $64 question. I have given quite a few talks on inflation problems, not as erudite as yours, over the past year and, you know, as soon as you start talking about inflation, your audience's eyes get glazed. Half of them go to sleep. Most of them yawn. They are not as interested in the reasons, as they are in knowing how to stop it.

Now, if you are asked how to stop it, what would you recommend other than balancing the budget.

Dr. BURNS. I would certainly recommend a continuation of a moderately restrictive monetary policy and I would——

Senator DOMINICK. By that you mean the expansion of the money market?

Dr. BURNS. Expansion of the money supply and overall credit. I would, of course, as I have indicated, and as you well know, recommend budgetary restraint.

In addition, I have long recommended that some attention be given by the Government to the fact that we live at a time when there are abuses of economic power by private groups, and abuses by some of our corporations, and abuses by some of our trade unions. Some kind of cost of living council or council on wage and price stability, I have favored over the years. I continue to favor that. I hope that the agency that the Congress is now voting on, and voting favorably as I gather, I hope that agency will prove helpful.

If I had to do it, I would have given that agency some additional powers, but never mind that since this is not the will of the Congress. If that agency has a vigorous head, and if that agency will use the powers about to be given to it by the Congress, particularly to hold

public hearings—that is the most effective instrument of that new agency—I think that this agency could prove helpful. We will all have to watch and learn.

Next, I would take another good look at our antitrust laws and how they are being enforced. I have the impression—I may be mistaken—that our antitrust laws are not being enforced as vigorously as they might be. I certainly have the impression that the penalties for violation provided by existing law are inadequate. The violation of antitrust law should be regarded as a very serious crime and treated that way by our courts.

Now——

Senator DOMINICK. Doctor—excuse me. I didn't mean to interrupt you. Go ahead.

Dr. BURNS. Well, I am almost finished. I think that we need larger investment in this country. We need larger investment particularly in some of our raw material producing industries. We have had very significant bottlenecks in those industries. We have had great shortages in the past 2 years. In fact, there are still shortages of many materials and component parts which are holding industry back. And I think some attention to this problem by the Congress, through some revision of our tax laws, would be constructive.

We ought also to take a very careful look at various of our laws, such as the Davis-Bacon Act, and the Minimum Wage Act, which interfere with the workings of markets.

I believe that there is considerable evidence to support the thesis that our minimum wage laws have had the unfortunate consequence of not only serving to raise prices here and there, but also, and this is more serious, of keeping many of our young people out of jobs by pricing them out of the labor market. I have long felt that an exception or a separate treatment should be made in our minimum wage legislation to look after the proper interests of our young people who need jobs.

Well, these are some of the directions in which I would travel.

Senator DOMINICK. I wish you had been on the floor of the Senate when I was advocating that and I wish you could have voted. We needed it.

Doctor, Senator Fannin had to leave and he was interested in one particular statement which you made when you were talking about the off-budget outlays. The general public gets the theory that we are only in a deficit of $31/2 billion, although why they think that is a minor thing I don't understand, but they do. And according to your statement here, if you take in off-budget outlays and the expenditure of the governmentally sponsored agencies, it is closer to $21 billion.

What he would like and what I think would be helpful to the committee, if you could give us some kind of chart showing the breakdown of those figures for the past 2 years, maybe we will say 3 or 4 years, if you could?

Dr. BURNS. I will be very glad to do that. That is very simple.

Senator DOMINICK. I think that would be extremely helpful to us.

[The following information subsequently was furnished by Dr. Burns:]

FEDERAL OUTLAYS FOR THE UNIFIED BUDGET, OFF-BUDGET FEDERAL AGENCIES, AND GOVERNMENT-SPONSORED ENTERPRISES

[In billions of dollars]

	Outlays		
	Unified budget	Off-budget Federal agencies [1]	Government-sponsored enterprises [2]
Fiscal year—			
1965	118.4	----------	1.2
1966	314.7	----------	1.9
1967	158.3	----------	—2.9
1968	178.8	----------	1.7
1969	184.5	----------	4.3
1970	196.6	----------	9.6
1971	211.4	----------	.3
1972	231.9	0.1	4.1
1973	246.5	.6	10.8
1974 (estimated)	268.3	2.4	15.0

[1] Includes the Export-Import Bank, the Postal Service fund, the rural electrification and telephone revolving fund, and the Federal Financing Bank.

[2] Includes Federal home loan banks, Federal Home Loan Mortgage Corp., Farm Credit Administration, Federal National Mortgage Association, and Student Loan Marketing Association (Sally Mae). Net outlays by these agencies are approximately equal to their net borrowing less their investment in Federal securities. These agencies are privately owned.

Source for historical data: The Budget of the United States Government, fiscal year 1975, p. 32.

Dr. BURNS. Perhaps, in answering that question, I might be helpful to the committee if I went a little beyond the question that you have just put to me. I will tell you why. I looked over Secretary Simon's excellent testimony before this committee and he had a figure of 20.3, I believe——

Senator DOMINICK. That is right.

Dr. BURNS [continuing]. Which is very close to my figure of 21. But his figure of 20.3 has a very different history than my figure of 21. He and I looked at the budget somewhat differently and to set those facts out without argument might perhaps be helpful to your committee as you keep working on these problems.

Senator MUSKIE. We will be delighted to have that.

[The following information subsequently was furnished by Dr. Burns:]

Secretary Simon and I both presented information which expanded the Federal deficit to include activities normally excluded from the budget. While the figures we presented for the most recent year, fiscal 1974, were very similar, the two concepts of the enlarged Federal budget are very different. As shown below the numbers are not as similar in earlier years.

ENLARGED FEDERAL DEFICIT

[In billions of dollars]

	Burns concept	Simon concept
Fiscal year—		
1971	23.3	39.8
1972	27.4	41.2
1973	25.7	29.9
1974	20.9	20.3

The items included in the concept employed by Chairman Burns are as follows: [1]

(1) The unified budget deficit.

(2) Outlays of all "off-budget" agencies.

(3) Outlays of all "government sponsored" agencies.

The concept used by Secretary Simon includes the following items.[2]

(1) The unified budget deficit.

(2) Borrowing of two "off-budget" agencies—the Export-Import Bank and the Postal Service.

(3) Loans that are guaranteed or insured by the Federal government.

Obviously the major differences between these two concepts are: (1) the activities of privately owned government sponsored agencies, such as the Federal National Mortgage Association (FNMA), are included in my concept of the Federal sector and excluded in Secretary Simon's concept; and (2) unlike Mr. Simon's concept of the enlarged Federal budget my concept excludes privately placed loans that are guaranteed or insured by the Federal government.

Senator DOMINICK. Doctor, a friend of mine was running a small business with a few other people, successfully, for the past 3 or 4 years. They were hoping to expand it and they went to every finance association they could think of with their good record. And they found they could get no money. Insurance companies, banks, real estate companies, and so on, just wouldn't loan them anything because they said they didn't have any money.

Now, one of the things that was suggested by them and also by some of the bankers was that we put a tax credit or some kind of tax proposal in which would benefit those who save. The effect would be putting more into the savings institutions.

Do you have any comment on that thought.

Dr. BURNS. I have just two comments. First, proposals of this kind that I have seen, in my judgment, tend to exaggerate the beneficial effects. The argument runs in terms of the effect on total saving, but the kind of legislation that is proposed would simply move or largely move saving from one channel into another.

Second, I think that this is an area that does deserve attention and study, but I would be a little unhappy to see the Congress move at this time in a direction that would erode even to a limited degree our revenue base.

Some tax changes may be desirable. But if tax changes are made by the Congress, if there are reductions in some areas, through tax credits or otherwise. I would like to see offsetting increases, so that the total revenue would not be diminished at this time.

Senator DOMINICK. My time is up unfortunately because I have a lot of other questions, so I will just wait.

Thank you Mr. Chairman.

Senator MUSKIE. Thank you, Senator Dominick.

Senator Magnuson.

Senator MAGNUSON. Doctor, we have heard a great deal about balancing the budget. But Congress has consistently appropriated under the requested budget amounts. Congress has been responsible for cutting down on Federal spending. But do you believe the budgets themselves are bloated? Are they too high? The last figure I have, Congress

[1] Historical data for off-budget agencies and government sponsored agencies is presented on page 32 of the budget document for fiscal year 1975.

[2] Data for borrowing by "off-budget" agencies and for guaranteed and insured loans are found in Tables C–5 and E–5 of the Special Analysis of the Budget for Fiscal Year 1975.

will probably be close to $9 or maybe $9½ billion under the President's 1975 budget.

Now, would you say that budgets themselves have been too high?

Dr. BURNS. I would make two comments in response to your question.

First, I think that the budgets submitted to the Congress in recent years have been bloated. That is my judgment.

Senator MAGNUSON. I don't like to use the word "bloated," but too high.

Dr. BURNS. Too high. Very well. That is a much more neutral word and I join you in preferring it.

But I would make a second observation. As I have studied——

Senator MAGNUSON. Too fat.

Dr. BURNS. As I have studied the activities of the Congress, I find that your characterization of the activity of congressional appropriations committees is entirely right. But I believe that the appropriations committees at the present time cover only about 45 to 50 percent of the total spending that is permitted, with the rest being done by the legislative committees. Therefore, I would say that the appropriations committees have done, year by year, consistently—you have spoken of the past 5 years, Senator, and I believe you could have spoken of a longer period—they have done consistently a fine job of pruning expenditures below Presidential requests. But the legislative committees of the Congress have moved in the other direction.

Senator MAGNUSON. Well, I think we do even a little better than that. I am about ready tomorrow to mark up the HEW Appropriations bill. That is the big one, next to Defense. We find that only 32 percent of the items are controllable. The rest is uncontrollable and can't be cut.

Now, I am very hopeful that when we talk about balancing the Federal budget that some credit is given to committees that are responsible for the direct appropriation of money.

Dr. BURNS. I think that the appropriations committees of the Congress have done an excellent job year in and year out. Now, they might have done still better, and a financial conservative like myself would have been pleased if they had done a little better, but I agree that they have done, on the whole, an excellent job, Senator.

Senator MAGNUSON. Now, the budget has been nearly in balance for the past few months. But it will slip back because of estimated revenues. So we will still have—the best figure we got from Roy Ash was $295 billion in revenues and expenditures will be $305. So there is $10 billion in between. I think the Congress will cut that much. Talking about balancing the budget is a difficult thing as you know very well. We don't really operate on a fiscal year budget between July 1 and July 1. When you look in the till at midnight on June 30, that becomes the budget or surplus deficit figure. But the funding and operation of Federal programs spill over so June 30 may not give an accurate picture. But I think the Congress this year is going to be very close to giving the administration a balanced budget.

Dr. BURNS. That is entirely possible.

Senator MAGNUSON. I want to ask you one question. You deal in figures and we try to, too, but part of Federal expenditures relate to jobs.

Dr. BURNS. Relate to——

Senator MAGNUSON. To jobs.

Dr. BURNS. Yes, sure.

Senator MAGNUSON. You have unemployment caused by a cut in the budget of x number of dollars. When a man is thrown out of a job he becomes a dollar burden on the Government and the body politic. We are trying to get figures how much a cut, say $5 billion, would mean in increased Federal Government expenditures. That is a sensitive point we have got to watch, too. So I am glad to hear you say that Congress has been fiscally responsible. With the help of this committee, next year we will do even better.

Senator MUSKIE. Thank you, Senator Magnuson. Incidentally, Dr. Burns, in your closing pages you made reference to the need for this committee to move even more rapidly than the timetable provided in the legislation. I think we will be undertaking a trial run next year on the process even though the new fiscal year doesn't take effect until the fall of 1976. We may not be able to try a full trial run next year but hopefully we will do what is necessary to prove ourselves sufficiently to engage the confidence of the Congress and the country.

I yield to Senator Dole.

Senator DOLE. Thank you, Mr. Chairman.

Many of us share in part your view concerning the budget but we hold different points on what impact a $5 or $10 billion cut would have on inflation.

I asked the question recently in this committee and the indication was that such a cut would not really have any impact at all. So if I don't have any, why is it so necessary?

Dr. BURNS. Well, I think the answer will vary with the individual and I wish I could say to you that I am qualified to give you a truly scientific answer to your question. I am not.

Senator DOLE. Give me one I can give to satisfy my constituents in Kansas. [Laughter.]

Dr. BURNS. I will give you an answer but you will have to judge whether or not it is useful to you.

Economists—many economists these days—I am not one of them but I have great respect for my professional colleagues—have developed mathematical models of the economy. They try to answer a question such as you put on the basis of what the mathematical model indicates.

Now, when I ask members of my staff a question like that and when they turn to their mathematical model, they will grind out an answer that runs something like this: A $5 billion cut in expenditures will lead to a reduction in the inflation rate of anywhere from one-tenth to two-tenths of 1 percent.

When I get that answer I am apt to say, well, that is unbelievable. What do you mean? Then I am told that the model indicates this is the result that you would get at the end of 1 year. And I then ask a second question, well, what would be the result at the end of the second year according to your model? The reply is, oh, it will be greater. Two years later, it will be somewhere between three-tenths

and four-tenths of 1 percent. And then I ask the question, well suppose we look ahead to the third year. Oh, it will be greater still is the answer.

Now, next, if we put the question to the model of having a $5 billion reduction in one year from the original target, doing the same the second year, doing the same the third year and the fourth then the reduction in the inflation rate is no longer negligible on the basis of this arithemetic. The initial mere one-tenth of 1 percent begins to mount.

Now, all this runs in terms of trying to get a mathematical equation to answer questions about human behavior. But all that a mathematical equation can do is to describe, through a certain technique, average experience over a given period.

The problem that presents itself to lawmakers and to governmental regulators is not average experience but what do we do, being where we are, today? I believe that today, when the inflation problem has become so serious, and is judged by citizens across the country to be of far greater concern to them than any other problem, that at a time like this an anti-inflation policy that is devised by the Government must at least be credible. It must be understandable as well as sound. And let me elucidate what I mean by that.

Take the policy pursued by the Federal Reserve. You may like it or you may dislike it. You may feel we are on the right track, you may feel we are on the wrong track, but as far as the average American citizen is concerned, he doesn't understand monetary policy. It is too complicated. It is too technical. If he accepts it, it is because he has faith in the Federal Reserve System. If he doesn't accept it, it is because he lacks that faith.

But there is one thing that the average citizen can understand, and understand very clearly, and that is that when the Federal Government reduces the level of its spending, then the pressure of demand for goods and services is smaller. Upward pressures on prices are reduced. The average citizen can also understand that when a government runs its finances at a surplus, then the Government will be pouring money into capital markets instead of drawing money out of those markets. The average citizen can understand that when the Government, in a year such as just concluded, runs its operations at a deficit of $21 billion, then the Government is competing actively against private citizens for money in capital markets, and therefore is serving to lift up interest rates.

I think also the average citizen can understand the kind of council on wage and price stability that the Congress is about to legislate. He may want a council that would have greater powers but he can understand all that.

Now, what I am trying to get at is this. If the Congress, together with the Executive, proceeded to cut the budget for fiscal 1975 well below the $305 billion figure, and if conviction that this is being done spread over the country, then confidence of business people, and of heads of our households, that the inflation problem will be brought under control would be greatly enhanced. In this new psychological environment, our trade unions may not push quite so hard for a large increase in wage rates, since they would no longer be anticipating a

higher inflation rate. And in this new psychological environment, our business people would not agree to large wage increases quite so quickly. Therefore, these indirect effects of a cut in the Federal budget of $5 or $10 billion can in such an environment be vastly larger than what the mathematical models which purport to describe average experience suggest.

Now, I have not given you the precise mathematical answer that you might have expected of me, but I have given you the best answer I know how.

Senator DOLE. Mr. Chairman, I share your expressed views. The mathematical precision or the detailed answer is not necessary. I do believe confidence is a key factor and I do believe that is what the Congress has in mind in some of their budget cutting efforts. Apparently, our new President has this in mind because he indicates the necessity of a balanced budget.

My time has expired?

Senator MAGNUSON. Mr. Chairman, I am going to have to go and I——

Senator MUSKIE. Did you have another question?

Senator DOLE. Well, I have another question but there is inadequate time for the answer.

Senator MUSKIE. Well, go ahead, Senator. Senator Magnuson had a——

Senator MAGNUSON. I want to ask one question. My State has a law that any loans over 12 percent interest are usury. How high are interest rates going to go? Are we going to have to repeal that criminal penalty?

Dr. BURNS. Well——

Senator MAGNUSON. I mean, in your opinion. I see my friend Dr. Heller in the audience. He is a Washington State resident—he is a neighbor of mine now. Maybe the two of us are going to have to wrestle with that 12 percent State usury law when we get home.

Dr. BURNS. I think most of our usury laws are at a time like this impeding the flow of credit to business firms and consumers within the individual State. Money then tends to go elsewhere.

Senator MAGNUSON. Here is a bank that is charging 8½ percent and making money, making all kinds of money. But the minute some other bank goes up to 9 percent, they follow. Why does that happen? Why don't they stay at 8½ if they are making money?

Dr. BURNS. Well, I can see—I can give you a reason why that will frequently happen, yes. If you are charging 9 percent and I am charging 8½ percent, then I will not only have my customers but your customers will come to my bank as well. But I cannot take care of all of them, my resources being what they are. Therefore, I am faced with the need of restricting demand. I love new customers but I cannot accommodate all of them, and so the price has to go up.

Senator MAGNUSON. Yes, but why should he charge his customers 9 when he is making money on 8½?

Dr. BURNS. Because he is engaged—let me repeat. You are a banker and I am a banker. You are charging 9, I am charging 8½. You are running a business. You are doing well and I am doing well. But now you having gone to 9, your customers flock to my bank because they

can borrow money at my bank at a lower rate of interest. I cannot take care of all of them.

Senator MAGNUSON. Well, could he just say, well, we cannot take care of you, we have not got the money. I mean, it does not take one hour for every bank in the country to follow suit.

Dr. BURNS. Well, that is the way competitive markets work. [Laughter.]

Senator MAGNUSON. Well, you answered my question but it is still a "puzzlement" to me.

Dr. BURNS. Well, all that I can say is that——

Senator MAGNUSON. I mean, the bankers, not you.

Dr. BURNS. No. I do not think that should be a puzzle to you. If you wanted to run a bank on non-market principles, then you could do just what you have described. But the average banker, like the average businessman, tries to run his bank on a market basis. He wants to treat all his customers in much the same way.

Senator MAGNUSON. But the broad, universal actions in common make it appear that there is no competition left in banking.

Dr. BURNS. Oh, on the contrary.

Senator MAGNUSON. They all charge the same.

Dr. BURNS. Oh, no.

Senator MAGNUSON. Of course, some of them give——

Dr. BURNS. Now, look when you have a uniform price in a market, this is a point in elementary economics, it may arise from collusion or monopoly, or it may arise from active rivalry among thousands and tens of thousands of business people and would-be buyers. A uniform price will emerge in a perfect competitive market, and it will also emerge in a monopolistic market. That is why you and I, too, may have difficulty distinguishing between the two. When you have a uniform price, does it arise from monoply or does it arise from the forces of competition? However, in the case of the banking industry, and I am not an apologist for the banks, I have been a stiff regulator, in the case of banking we have one of the most competitive markets in the world and certainly one of the most competitive markets in this country.

Senator MAGNUSON. Of course, some of them give free trips and more prizes and ice boxes and things like that. That is the way they are getting customers in now. I would not be surprised if they had a drawing: "If you deposit in our bank or savings and loan for a period you will get a piece of the bank after 10 years." [Laughter.]

Thank you, Doctor.

Dr. BURNS. Thank you.

Senator MUSKIE. There is one other question that ought to follow from the one that Senator Magnuson put. I think it has always been the popular impression that a competitive market produces lower prices, not higher prices, and the example that Senator Magnuson puts is an example of higher prices resulting from competition. Could you make that distinction for the record so you can clear up another "puzzlement"?

Dr. BURNS. Let conditions of supply be unchanged and let demand increase, then in a competitive market you will have higher prices, in the short run. Now, over the longer run, as adjustments are made on

the side of capacity, and so on, the price may well move lower. But the short run effect will be, given these conditions, a higher price.

Senator MUSKIE. Senator Dole, I think we interrupted you and you still have a minute of time if you would like to use it.

Senator DOLE. I want to ask a question and the answer can be furnished for the record.

Chairman Burns indicated the Appropriations Committees of the Congress deserve rather high marks but he made some reference to legislative committees not being in that category. And I assume because of some of the legislation we passed. I may talk to you about the merit of the livestock bill, you indicated that was not a monumental piece of legislation but in any event, are there some examples that we could have for the record where you believe the legislative committees have failed in their responsibility to sound fiscal policy or budgetary policy?

Dr. BURNS. Well, I did not mean to be critical of the legislative committees. To the extent that criticism was implied by my remarks, the criticism applied to congressional procedures. The authority of Appropriations Committees has shrunk. There was a time, I believe, when Appropriations Committees handled practically all of the spending legislation but that authority has eroded. Under the new Budget Act there will again be a certain uniformity of procedure that the Congress can follow. But at present, legislative committees report out bills that involve spending, and the Congress votes on these bills. The difficulty with all that has been that the Congress has voted money to spend without relating a particular expenditure to other expenditures or revenues, precisely the defect that the new Budget Act will correct.

Senator DOLE. Thank you.

Senator MUSKIE. Senator Moss.

Senator Moss. Thank you, Mr. Chairman.

Dr. Burns, of course, if the Congress passes a bill it is signed by the Executive with the exception once in a while of an override, and so it is a combined factor there——

Dr. BURNS. Always.

Senator Moss [continuing]. That you are talking about.

Dr. BURNS. And the President, one could justly say, is the most important single legislator.

Senator Moss. Yes. His one vote can account for two-thirds—at least it take two-thirds to override him.

I wanted to ask a question. If the chief advantage of a budget cut would be psychological, which I understood you to say, would not a comprehensive program of jawboning, with the threat of vigorous antitrust action, serve the same purpose?

Dr. BURNS. I would say that jawboning, based on knowledge of the facts and strict respect for antitrust laws, could be helpful. I favor these devices. But if the Congress at this time failed to show evidence that it was in a mood to practice greater economy than in the past, the country, as I understand its mood, would be greatly disappointed. The psychological effects that I for one seek, and that I think can be so salutary would hardly be forthcoming.

The public wants to be convinced, I think, that the Congress is in a mood to restore, or to establish better order in, our Nation's finances.

Senator Moss. But will not a cut of that magnitude really increase unemployment? It is, what, 5.2, or 5.3, now, and will this not increase unemployment?

Dr. BURNS. Well, many will argue that way. I would argue differently. I believe that if this Congress were to vote this day or this week a cut of $10 billion in spending, the stock market would revive promptly, the bond market would revive promptly, and that short term interest rates would move down promptly even if we at the Federal Reserve did not change our policy in the slightest degree. Forces, therefore, would be released within the private sector that would in time make for more jobs for our people. I may be mistaken in that judgment but I am answering your question to the best of my ability.

Senator Moss. Well, General Motors recently announced an increase of $500 an automobile in price and at the same time sales of cars are down about 20 percent. Now, how can that come about other than just a plain monopoly situation?

Dr. BURNS. I cannot answer that question. Before I could answer that question, I would have to examine the finances of that company with very great care. I was not happy when General Motors announced that price increase, but I am not ready to criticize General Motors on the basis of the little that I know.

Senator Moss. How do we release more capital for the housing industry? According to recent figures, starts in July are down almost 40 percent from last year and joblessness in the homebuilders, in the trade, is about 10 percent. Even with mortgage rates of 10 percent the savings and loan companies cannot provide the mortgage money.

Dr. BURNS. Unfortunately, when market interest rates rise, our thrift institutions are immediately in difficulty because they are unable to pay interest rates to their depositors that match the very high interest rates that are available in the market. The result is that the inflow of funds to thrift institutions dwindles and they, therefore, are not in a position to expand their mortgage commitments. In fact, they must contract their mortgage commitments and home building suffers.

Whenever you have a period of monetary restraint, of rising interest rates, the homebuilding industry suffers. That has been true in our country throughout history. It is true of every industrial dountry. This may surprise you, Senator, if you have not had the opportunity to look into the matter, the homebuilding industry suffers great instability even in socialist economies. I am not referring to Sweden. I am referring to the Communist nations around the world.

Now, this is a problem that has engaged the attention of economists for very many years and it happens to be a problem that I began studying 50 years ago. One of the very first things I did when I joined the Federal Reserve Board was to start a massive investigation of how this problem might be dealt with. The time to deal with problems is not when a crisis is upon you but when you still have time.

I think we made some very useful recommendations. If Congress had paid more attention to our report, perhaps better suggestions would have emerged. But Congress is very busy, there are so many things to do, and that report is gathering dust on the shelves.

Housing now finds itself in critical difficulty. Our home builders are in very serious trouble. The high interest rates that I refer to are interest rates that are paid by prime borrowers. Homebuilders, land developers, are not prime borrowers as a rule. And they will not pay 12 percent for their money. They will pay 15 percent or even more these days, and that is a terrific burden.

Some relief to that industry in view of the uneven impact of monetary policy, I think, is only good sense, is only a matter of equity. Around May 10 of this year the President announced a three-part program whereby governmental funds would be available on a rather liberal scale to help support that industry. Well, much of that money has been used up, and I do believe that the time is at hand when some supportive legislation for that industry will be needed.

Now fortunately, the Congress after very long and uncomfortable delays has just passed the Housing Act and that piece of legislation will be at least——

Senator MUSKIE. Could I interrupt just a moment, Mr. Burns? There is a quorum call. Senator Dominick and I would leave at once, and you leave when you think we have to get there, Senator Moss, and we will try to minimize the gap if possible.

Dr. BURNS. That legislation will be at least marginally helpful to the industry.

President Ford is now seeking counsel on this problem. What recommendations he will make to the Congress I do not know. But I would be surprised if some recommendations are not forthcoming from the President on this issue.

Senator Moss [now presiding]. How do you answer the argument made by some that high interest stimulates inflation by depressing capital investment in plants and machinery and thus restricts supply?

Dr. BURNS. It is undoubtedly true that high interest rates will have a restrictive effect. I do not attempt to answer that argument. The real question is do we not need a restrictive policy at certain times?

Senator Moss. Well, if we are trying to increase supply in order to stem inflation, would not lowering the interest rates then be an advantage?

Dr. BURNS. Well, if I may, I would rather speak of lower interest rates than a lowering of interest rates. If you had lower interest rates, lower interest rates to be sure will stimulate more investment in fixed capital. That factor by itself will work in that direction. But lower interest rates, in the process of stimulating more investment in fixed capital, will also stimulate a larger demand for goods and services and thus bid up prices and increase tensions in labor markets.

Now, 2 or 3 or 5 years down the road, depending on the length of the construction period, greater supply of industrial capacity will become available and this will be a force working in the direction of lowering prices. But the short run effect will be in the direction of raising prices and that short run effect may last a year or 2 or 3.

Senator Moss. Well, does our current inflation come primarily from low supply, that it is too much purchasing power against lack of goods? Or is there some other factor that dominates it?

Dr. BURNS. Well, I think that our current inflation has been due to a variety of influences. We have had a number of powerful special factors operating on the price level. The dominant factor over the

long run is undoubtedly too much money or too large governmental deficits in relation to our capacity to produce in a physical sense. But recently we had bad harvests in 1972, around the world. We had a very sharp increase, nearly quadroupling in the price of oil, and that has had an enormous effect on price level. We had two devaluations of the dollar. We had a worldwide boom. All these special factors have left their impress on our economy.

Over the longer run, it is the supply of money and the state of Federal finances that will determine the general price level. But special factors may dominate in any given year or 2 or 3.

Senator Moss. I understand labor productivity has been practically nil in growth recently, and this means that big wage increases are not being matched by labor output increases. Would not an economic slowdown make the situation worse, by forcing factories to operate at less than full capacity?

Dr. BURNS. Well, normally, if you study the behavior of productivity, meaning by productivity output per man hour, the typical behavior over the business cycle is something like this.

In the early stages of an expansion, output per man hour rises very rapidly. As the expansion lengthens, the improvement in productivity slackens. Toward the end of an expansion which lasts over a protracted period, productivity will no longer improve or will in fact begin declining.

In the early stages of a recession, productivity will decline, but after the recession has run a few months, productivity tends to pick up again. That is the normal pattern in the behavior of output per man hour in the American economy.

Senator Moss. Would you expect that to happen in this situation if we get through this depresssion?

Dr. BURNS. Well, I would approach this situation on the basis of typical experience, yes. I would want to be sensitive to special developments which are always occurring.

Senator Moss. I must go now, because I can just make the vote. We will be in recess for 5 minutes or less and the other Senators will be back. I would appreciate it if you would remain.

Dr. BURNS. Thank you, Senator.

[A recess was taken.]

Senator MONDALE [now presiding]. Chairman Burns, I guess I am supposed too carry on here until the chairman returns.

In order to conserve time and since we have Dr. Heller coming up, I do not plan on taking my full 10 minutes.

I think everyone agrees that great sacrifice is needed in American society by everyone to restrain inflation and to deal with the other dreadful problems of the economy. But what bothers me a great deal is that virtually all the remedies underway and those being officially proposed are remedies which place a disproportionate and often cruel burden on persons of moderate and low income and offer vast profits to others who least need them.

For example, in taxes, as wages go up because of inflation, people move into higher tax brackets. So not only is the dollar worth less but it is taxed more. If one looks at the payroll tax which is a flat per-dollar tax which has been rising impressively, that is taking another

serious bite, and yet the proposals we hear are for more tax relief not for the families suffering so much but for selected areas of business.

Similarly, inflation strikes hardest at this same group and the real wage of the average American I think is below that of 6 or 7 years ago.

Then in the budget proposals we not only are sure that these budget cuts will result in further unemployment but as I understand the President, as I review your testimony this morning, all the pressure on cuts is to be directed at the very same people who are suffering the most, in health, in education, in environment, housing and the rest.

Dr. BURNS. I have not said a word about that, Senator.

Senator MONDALE. Well, I read your statement and the programs that you single out as doubtful, dubious, inefficient, were in education and health. You did not mention defense.

Dr. BURNS. I did not——

Senator MONDALE. Show me where the——

Dr. BURNS. I did not mean to convey that thought.

Senator MONDALE. Maybe you can show me the word "defense" in your list of areas that you criticized. I did not see it.

Dr. BURNS. I did not—I was not attempting to be critical of any specific program. Where I made a criticism it was general, that we have some ineffective programs. We can all agree on that.

Senator MONDALE. In all areas. That is right. In any event, the other evening when the President spoke he seemed to be saying do not touch that defense budget but sock it to education and health, and so on. And then we get into the credit field and I think it is also true that as credit rates rise, it is perhaps the most regressive of all actions. It strikes hardest once again at the same families. It strikes hardest at small business, at housing which is in a depression—not a recession—now, at essential consumer credit, student loans and the rest, which families need to care for their problems, and in many ways it actually contributes to concentration of economic power because the smaller competitors that might be getting into the business are hopelessly outclassed with these high rates.

Now, as we look at the set of priorities in each of the remedies, must we not also include the credit instrument in our evaluation of possible priorities? Why, when we consider taxes or the budget, should we say it is proper to consider priorities but when you get into the field of credit it should be just the market itself that determines the allocation of credit? As you know, Congressman Reuss has introduced a bill in the House, I have introduced a companion measure here, to suggest the Fed should have varying reserve requirements and based on priorities so that we might get assured and more reasonable rates of credit in the high priorities areas. Would you respond to that?

Dr. BURNS. Yes, I will be glad to. I responded at length in a letter to Congressman Reuss but let me just make one or two brief remarks.

Professor—Congressman Reuss—really, sometime he is a professor, and a good one—Congressman Reuss's legislation deals solely with member banks of the Federal Reserve System. It does not deal with the credit that is extended by nonmember banks. It does not deal with the credit that is extended by a great host of financial institutions that we have in our country.

Now, giving the Federal Reserve this power, would mean what? Let us say that we set reserve requirements in a manner which is less favorable to business firms. Very well. Then they can go to nonmember banks. They can go to life insurance companies. And the larger corporations can go to the public market. Therefore, the advantages that we can see are very marginal, and we can see some serious disadvantages.

The point is a little technical but our control over the money supply would be seriously diminished and, therefore, you would have a less effective monetary policy. The policy might be right or wrong, but whatever the policy is, we ought to be in a position to carry it out. Our power to do so would be diminished.

And there is another objection that I, for one, take very seriously. When it comes to setting national priorities in the allocation of credit, or the allocation of governmental revenues, I think this is the high prerogative of the Congress. I do not think that a body such as the Federal Reserve should be entrusted with that responsibility. I do not think we are qualified to discharge it. We have certain technical competence, but I do not think we ought to be setting national priorities with regard to the use of credit.

And while Congressman Reuss tried to deal with that problem in his legislative proposal, he did not go to the heart of this problem.

I think that if the Federal Reserve were given this authority, before too long the Federal Reserve Board would be politicized and that would be an unhappy result for our country.

Now, there are other ways of going at this problem. I have tried to think it through. We have had some experience. I can visualize a national instrumentality for credit allocation, not through the Federal Reserve but through another agency, let us say.

How would it operate? Well, if such an agency were established, I would assume that the Congress would exclude credit going to prospective homeowners, at least those who would be purchasing modest homes. They would not need certificates of necessity. I would assume that small bnsinesses up to a certain figure would also be excluded. And then this authority would allocate credit to all other firms, to all other users.

Now, the knowledge that would be needed to do that is enormous. The interrelations among business firms are so complex. For example, one automobile company comes in with a request to issue bonds for $100 million. Well, you say yes to that company after investigating its condition and market and making a judgment about the utility of that kind of credit. Then a second automobile firm comes in and, well, you may say, no. Why? Because the automobile industry has been taken care of through the first. Is that a good way to try to operate the economy?

Moreover, the automobile industry is related to thousands, tens of thousands, of suppliers all along the line. To make sure that the credit allocation goes in the right amounts to all of the suppliers, and the suppliers of the suppliers, would not only require a vast bureaucracy but I do not really think that it can be done as well as the market does it.

Now, does that mean that we should not have any credit allocation? I think the Congress has recognized the need for special credit facilities in certain areas. We have special institutions dealing with agricultural credit. We have special institutions dealing with housing credit. We have special institutions dealing with credit for small business firms.

Now, existing legislation needs constant review and modernizing. That is the area to which I would look for improvement rather than entrusting a nonpolitical body like the Federal Reserve with an authority that it could discharge only poorly and which might impede its efforts to control the money supply and credit.

Senator MONDALE. Thank you very much.

Senator MUSKIE [now presiding]. Senator Hollings.

Senator HOLLINGS. Thank you very much, Dr. Burns.

Senator Dominick was describing his talks around the country and I have described you as a Dutch boy at the dike. Symbolically your stance at that table is almost like a witness in a foreign country. However, you now have the ear of the American people finally, and of this Congress. When you use the term "to effectuate a greater discipline," and that is what we are trying to do, I wonder why we cannot try for the $10 billion cut rather than the $5 billion that President Ford has spoken of—in the light of what is going on just now. In other words, at the moment we are discussing the Defense appropriations bill and the subcommittee and full committee came out with a $5.1 billion cut. That is what Senators Jackson and Stennis and Thurmond and everybody else agreed on. I just mention them because no one is going to accuse them of being anti-defense or having our country as a "Mr. Avis." So we can cut on the Senate side, and it looks like we will save about half of that target figure right here. In addition, we have cut from transportation some $256.5 million. Yesterday the full committee marking up State-Justice-Commerce cut about $190 million from the budget request of January. It is not so impossible, and it is so attractive the way you describe it. You said if we could cut from $5 or $10 billion that the impact would be larger than the mathematical models indicate and you listed the various things if we could cut $10 billion now, about the stock market reacting, the bond market going down, the short term interest rates ameliorating some.

I am also saying why do you not take my 10 minutes and go get on the phone and get the President. He is coming up here at 2:30. I know he is on a social visit but he will make some significant remarks. We do not know yet whether he really is going to support that $5 billion defense move. We know he is not fighting it, but one of the spokesmen for the White House and Wall Street Journal is quoted as saying he is opposed to it. We do not like to cut. But if that is the situation, why can we not act more like a State government? Here we talk of, even in your testimony, sort of let the discipline go. If Dr. Rush comes up—Kenneth Rush—and says that $5 billion is one-tenth of 1 percent, if Mr. Ash comes up and says with a big chart you cannot get there from here, it is all uncontrollable, and the atmosphere of futility and then when the Dutch boy at the dike even comes and talks about balancing the budget in fiscal 1976, if we were Governors, if Governor Muskie were in Maine he would not be sitting around

waiting for 1976 talking to the State legislature in 1974. We would have to go back home and they would have hold of us right away. And since the Congress in its good mood of conciliation is working and understanding and now that you, namely, have some assistance, could not it be that we could get some assistance out of the administration, particularly on this defense cut and then try to go for this $10 billion and then, which is going to be my real question, because that is what my constituents want to know, then cannot Dr. Burns let some of the money go?

In other words, if you came up in your testimony and said, gentlemen, look, if you go for $10 billion, and that is not unrealistic, then I can let, release and ease credit restrictions as of November 1st. Then you have got a deal because if we do not accept the deal we go back home and the housing market is wrecked and they will get us and after all, we are a bunch of politicians and as you say, what this committee is charged with doing is trying to bring about a stricter discipline, a far stricter fiscal discipline, as you characterize it.

Dr. BURNS. Senator, you made a very admirable and very persuasive statement. As far as I am concerned, I would much prefer to see a $10 billion cut made in our expenditures. I prefer 10 to 5. I would prefer 5 to zero as well. I would much prefer to see $10 billion cut. And I am sure it can be done.

It would require a great deal of work on the part of the Executive and the Congress to work out the details. As for our Military Establishment, I do not think we can afford sacred cows in our country. There is money to be saved everywhere. I have been in this town for a number of years and I do not know of a place where economies cannot be achieved.

Now, the second part of your question relates to the Federal Reserve's policies. If a cut in the budget of significant magnitude took place, why, of course, we at the Federal Reserve would take that into account in setting our own policies. But I must go on to say, Senator, that I cannot give you—you want me to be honest . . . that is my job—I cannot give you a promise. The reason I cannot give you a promise is simply that in monetary policy, we have a highly flexible instrument. Fiscal policy is very important to us in determining monetary policy. There may be special factors of a kind that I cannot foresee which still might, even if the Congress carried through a cut of, say, $10 billion, prevent us at that point from easing monetary policy. But that it would greatly influence our thinking, you can be quite sure of that.

Senator HOLLINGS. Well, very good, sir. It is going to be difficult to get to the actual $10 billion. We are cutting our HEW. This will be the first time in history that HEW has come from the House, and instead of increasing it we have decreased it. It could be even perhaps decreased a little bit more. And the best estimate right now—the working political guess—is about $78 billion. But even if we got to the eight, then these fellows with oil, you know, could sell a little bit more, but we could get almost to that $10 billion figure.

Quickly, on the matter on the one hand of talking investment credits and the other, the expression you used, not liking to see Congress move to erode our revenue loss, since we are talking of discipline and we

withstood the idea of individual tax cuts early in May, I just do not see big business around here helping us trying to balance the budget. They are fiddling around fighting with a little old consumer agency and I have got a feeling they are lying in wait in the eaves now ready to come forward after Labor Day for that investment credit.

You said if there is a loss it would have to be made up of tax revenue. If we start to move on investment credit then we start to move with tax increases to make up for the loss, then we start with all the lobbyists, then we start with tax reform and then—now what is going to come out of that is to break the entire dam.

Is the administration going to recommend investment tax credit just when you have got the Congress moving down the road to cuts and holding the line on tax decreases?

Dr. BURNS. I have no idea what tax proposals the administration will come up with. I have not heard of any definite moves.

My own view on tax legislation this year is very simple. I would do two things. First, make some minor changes in the capital gains tax with a view to encouraging small investors particularly to reenter the market. And second, I would balance that by increasing the minimum tax from its present 10 percent level to something like 20 percent, possibly 25 percent. I would not know the precise number. But I think that would be desirable in the interest of protecting the revenue and it would be desirable in the interest of equity as well.

Nothing will make a people more unhappy, more frustrated, give them a feeling of injustice, than the fact that there are some individuals in the country, a small number to be sure, who have very large incomes but who pay very little in taxes and meet the cost of Government.

Senator HOLLINGS. Thank you very much. My 10 minutes are up already. Thank you very, very much and I commend you for what you have been doing over the years for this Government.

Senator MUSKIE. Senator Cranston, before you begin, may I announce that we will go right through Dr. Burns' testimony and Dr. Heller's. It will be more convenient for him. So if the Senators would like to break for lunch or any purpose on an individual basis I think this would be the most expeditious way to proceed. So we will go right through until we finish both witnesses which at the present rate of questioning might conceivably be 1:30 or so. I just announce that so that we all know.

Senator Cranston.

Senator CRANSTON. Mr. Burns, in addition to the capital gains minimum income tax offset of the sort you suggested, Chairman Mills asked you some weeks ago to study this proposal, to raise the 7 percent investment tax credit to about 10½ percent, to stimulate capital investment and to offset that by raising the 48 percent corporate income tax to 50 percent.

Have you had any opportunity to come to a conclusion in regard to that proposal?

Dr. BURNS. Yes, and I wrote Wilbur Mills on this subject and I would be glad if you would care to have me do so, to submit my reply for the record.

Senator CRANSTON. Yes. I wish you would.

[The letter referred to follows:]

AUGUST 1, 1974.

Hon. WILBUR D. MILLS,
House of Representatives,
Washington, D.C.

DEAR WILBUR: At the House Ways and Means Committee Hearing on July 15, you asked for my thinking on the desirability of raising the corporate income tax from 48 to 50 percent, and using the revenue gain to raise the investment tax credit from its present level of 7 percent to a higher percentage. Among other things, you asked whether this shift would leave the business community better off.

In general, industries that have larger than average investments in eligible machinery and equipment per dollar of profits would be better off; other industries would be worse off. The effects on individual industries vary greatly. Using past data as a guide, the greatest beneficiaries would be the transportation industries (especially railroads, airlines and pipelines), electric and gas utilities, coal mining and mining of nonmetallic minerals, and some branches of manufacturing—such as the paper, petroleum refining, and the primary metals industries. On the other hand, firms engaged in wholesale trade, retail trade, and finance would be worse off. Also, firms whose profits have declined to such an extent that they cannot now take advantage of allowable investment tax credits would receive no relief. A number of firms in the public utilities sector might fall into this category.

Considered as a permanent feature of the tax structure, I believe the proposed change would be undesirable. A higher permanent level for the corporate income tax would be a drawback, since the higher the rate, the weaker are the incentives for efficiency in business enterprise. I also would be cautious about raising permanently the average level of the investment tax credit, since this would accentuate the discriminatory features of this device—that is, the tendency to favor industries that invest heavily in machinery and equipment over those that invest in other ways, or that are generally less capital-intensive.

There would be some advantages, however, to considering a temporary change of this kind in the structure of business taxation, for—on balance—I believe the proposal would encourage additional outlays for machinery and equipment. The incentive to increase investment would apply to all firms with profits regardless of whether or not they benefit from the two-pronged change in tax rates. There would, however, be a considerable time lag—probably a year or more—before any material benefits would be realized in the form of increases in productive capacity.

These short-run benefits would be of some value, but probably not of major significance in the battle against inflation. And it might be that this change in the tax structure could not be achieved in a timely fashion. It is therefore not clear to me that it would be worthwhile to expend much energy in trying to get this proposal through the Congress. I would be glad to reevaluate my opinion when the tax bill gets closer to passage.

Sincerely yours,

ARTHUR F. BURNS.

Dr. BURNS. I came out feeling lukewarm about that proposal.

Senator CRANSTON. What?

Dr. BURNS. I came out feeling rather lukewarm about that proposal.

Senator CRANSTON. If you would supply your reply to him I would appreciate it.

Dr. BURNS. Thank you.

Senator CRANSTON. Some economists have argued that a policy of too rapid a rate of growth and the tight money supply between 1970 and 1973 in particular, was a major contributing factor to today's inflation.

Dr. BURNS. Too rapid growth of——

Senator CRANSTON. Of the money supply.

Dr. BURNS. Oh, yes.

Senator CRANSTON. In 1970 and 1973 in particular, was a contributing factor to our present inflation. Would you comment on that charge or statement?

Dr. BURNS. Well, that is a view that is held by a large segment of the economics profession. I cannot say that it is entirely wrong. If I could relive history I think that I would try to achieve a somewhat slower rate of monetary growth. But it is my considered judgment that the difference that would make would be quite small.

I have tested this in various ways. I spoke a little critically of mathemathical models before and I am not going to praise them now, but I will tell you what the mathematical models show. One of our Federal Reserve banks has a rather strict monetarist model, that is, one that emphasizes the role of the money supply in determining economic activity and price levels. I have tested the workings of that model by assuming the precise rate of growth of the money supply, quarter-by-quarter, that we have had since 1971. On the basis of that model, the increase in the price level in the first half of this year should have been about 3½ percent rather than the 12 to 14 percent that we actually had.

I also tested this theory concerning the role of the money supply by using another model, one devised by one of our large banks, again a monetarist model, that is a model that emphasizes the role of the money supply. And by using that model I found that the rate of advance of the price level should have been 3.1 percent in the first quarter of this year.

Well, clearly other factors, if you trust these models, have been very important. In my studies over the years, I have never neglected the role of money. But over short periods I have paid less attention to the stock of money than to the willingness of people to use the existing stock, in other words, the rate of turnover of money. The rate of turnover of money is highly variable whereas the existing stock is fairly stable. Over long periods of time the monetary stock gains in importance. Over a short period, the willingness to use the existing stock is far more important.

Senator CRANSTON. Thank you very much.

I was pleased to note your statement in early August to the Joint Economic Committee proposing a $4 billion program of public service employment that you estimated could create some 800,000 jobs in State and local government. It has been estimated, and this estimate was by the Labor Department, Bureau of Labor Statistics, by economists when they were testifying before the Manpower Subcommittee of the Labor Committee in 1972, that expenditures for public service employment will result in savings and welfare payments and unemployment insurance and increased tax revenues of about 40 cents for every dollar actually spent. In addition, based upon Bureau of Labor Statistics data, it has been estimated that for every 10 public service jobs created, 4 private sector jobs will be created immediately and that eventually over the next 18 to 24 months another 6 will be generated from the gross national product increase resulting from those 14 jobs.

Would you comment on that? Do you accept roughly those figures as what can be expected to occur as a consequence of public service jobs and that, therefore, we should take that into account when we are calculating the actual net cost of such expenditures?

Dr. BURNS. I have not seen that study and I am glad you called it to my attention. That there will be indirect effects in the direction that

that study indicates, there can be no doubt. But I cannot now express an opinion on the magnitures arrived at.

Senator CRANSTON. I will supply you with the details of that study and I would be very grateful to get your written reply to it.

Dr. BURNS. Thank you very much.

Senator CRANSTON. Using your figure of $4 billion, on the 800,000 job program, we are talking about 200,000 jobs per billion dollars. The National Planning Association in a recent joint statement, however, estimates, an initial expenditure of $750 million to $1 billion to produce 100,000 public service jobs. Do you have any idea of why the difference in those figures?

Dr. BURNS. Well,——

Senator CRANSTON. They do not expect as many jobs as you do, apparently.

Dr. BURNS. Yes. The difference must be that I have assumed a lower cost, a lower wage cost on the average per employee than did the other study. And that is also a difference between Senator Javits' proposal and mine. Senator Javits, I think, has submitted legislation calling for, under certain conditions, just as my suggestion does, a $4 billion expenditure on public service employment. He had an estimate of 500,000 jobs. He assumed an average cost per employee of $8,000. I assumed an average cost per employee of $5,000.

Senator CRANSTON. $5,000.

Dr. BURNS. And I want to explain rather than argue the case for the $5,000 figure.

The explanation is that, as I see it, the Government has a certain responsibility, particularly when it pursues a restrictive policy, to look after that sector of the economy that will suffer most from its restrictive policy. But we should not make these public service jobs so attractive to individuals that they will tend to stay in them. We should rather use them as a device for helping people to tide over a period of personal or family difficulty. Individuals should have the incentive to seek a regular job in industry or a regular job in Government.

Senator CRANSTON. You indicated that—suggested that the program should only go into effect if we hit nationwide unemployment of 6 percent. You stated in response to a question earlier, that we should deal with problems before they become a crisis. Do you not think that proceeding with this now would insure that we would not have suffering as a result of higher unemployment rather than waiting until it comes and then have a long lag?

Dr. BURNS. I think that is precisely the way to proceed. I think that legislation should be on the books now. It is a contingency plan.

Senator CRANSTON. Well, should not perhaps the employment program—we have a very small, modest public service program at the present time.

Dr. BURNS. This is a question that is not easy to answer. Actually, when my mind first turned in this direction, the plan that I was going to recommend ran in terms of a triggering device at a 5½ percent unemployment rate. That is, if over a 3-month period the unemployment rate averaged 5½ percent, that would trigger a public service employment expenditure in the amount of $1 billion, and then when the trigger hit the 6 percent unemployment rate, an additional $3 bil-

lion would be allowed. There are variations here that reasonable men seeking the same objectives will differ on. I am not tied rigidly to the six percent proposal. It seems better to me now than the 5½ percent triggering point, but this is not a question that I could take a very strong position on.

Senator CRANSTON. Thank you very much.

Senator MUSKIE. Senator Chiles.

Senator CHILES. Dr. Burns, I think your testimony has been very helpful. I was particularly interested in your testimony in which you carried us through the model, one-tenth of 1 percent, but that did not quite translate into human nature and what the psychology would be and the reason for that psychology.

You mentioned that you thought that we needed a rigid enforcement of our antitrust laws. I wonder if you would give me your opinion as to whether you think our antitrust laws now are sufficient. In particular, I wanted to direct your attentions to the fact that when most of these laws were passed, we did not have conglomerates. We did not have holding companies. As I understand, most of the pattern that we look to or look to now is to determine whether 15 percent of a particular market is being—at least that much of the market would be taken up by some merger.

Well, that might be dealing with a particular thing like tires or it might be dealing with some other particular commodity. But now what about when we are dealing with holding companies that are purchasing another company or merging other companies completely unrelated but still are making tremendous vertical holdings that way? We do not seem to have any thing on the books in that regard.

I would like to have your comments.

Dr. BURNS. Well, I wish I knew more about this area than I do. I think that you are entirely right in saying that our antitrust laws were passed in an earlier era and the economy has changed very radically since the passage of those laws.

I am told by some of my attorney friends that one difficulty with existing antitrust laws is that business firms are uncertain as to just what is expected of them in the way of behavior. Now, such ambiguities in the legislation, to the extent they exist, ought to be cleared up. I think this is a subject that the Congress might want to hold extensive hearings on, and review existing legislation with a view to its application to modern conditions and also with a view to stricter enforcement and stronger penalties for violations—such as I referred to.

Senator CHILES. We——

Dr. BURNS. If I may say a personal word, Senator, you and a number of your colleagues were most helpful in stimulating this Government, first the Congress and then President Ford, to plan a summit meeting. Antitrust legislation might be another good area for you and some of your energetic colleagues to go to work on.

Senator CHILES. Thank you, Doctor. You were very instrumental in stimulating us to come up with the proposal for the domestic summit.

Now that it appears that we are going to have a domestic summit, that the President says he is going to Chair that summit and now as I understand from reading today's paper, that he wants to set up a steering group first, made up with some members of the administration

and also some Members of the Congress, what are some of the things that you would advise that steering committee to try to set as an agenda for bringing into being the domestic summit, the things that they should be talking about?

Dr. BURNS. Well, there is a danger that the summit meeting will try to cover the waterfront. I think fences should be put around the agenda. I think the summit meeting would have a large enough task if it focused upon the inflation problem and what can be done about it, and hear on this subject from legislators, from our labor leaders, business leaders, and financial leaders. They should present their best thoughts and we can see whether a consensus emerges. I am rather hopeful that in a town meeting of that kind, and with the good feeling that now seems to exist over the country and the eagerness to get ahead and make progress on this front, that a consensus may emerge.

Senator CHILES. You envision, then, that that would be a consensus in which labor leaders and business leaders and the Congress—that would have to be sort of a consensus in which everybody would have to be willing to sacrifice some of their interests, would they not?

Dr. BURNS. Sacrifice some of their interests in short run.

Senator CHILES. Short term.

Dr. BURNS. Yes. Short run benefits often prove to be illusory as well as short term.

Senator CHILES. Do you think that at that summit—you said we should deal, focus primarily on the question of inflation. Are we not locked in at the same time with the specter of the recession which could go into a depression that is a part of that problem?

Dr. BURNS. Well, there is always that possibility. I think the way I would approach it would be to consider, first, the policies that are needed to bring inflation under control. Second, recognition would need to be given to the fact that the policies that are needed to bring inflation under control will cause not only inconvenience to many people but also some hardships. In view of that, some ameliorative actions on the part of Government are essential and housing is one area where ameliorative steps are clearly needed. I would say the public utilities industry is another area where ameliorative steps are needed. And I would certainly say that unemployment is a third area.

Senator CHILES. What was the third?

Dr. BURNS. Unemployment. And that is why a contingency plan for dealing with unemployment through public service jobs which can be triggered in and triggered out rather speedily, and also triggered in and triggered out in individual areas where unemployment is heaviest, that kind of a program I think is sufficiently flexible to be helpful in dealing with the problem.

In other words, to repeat, let us attend, first, to what can be done about inflation, and second, what can be done to mitigate the harsh impact of restrictive policies on important sectors of our economy.

Senator CHILES. Then, you would hope to see that the summit would try to come up with a game plan?

Dr. BURNS. Well, that would be ideal and I would want to approach it in a hopeful spirit. But if no consensus emerges, and that may be the case, then the President and the Congress will at least have had the benefit of a candid, and I hope thorough, exchange of views on different approaches to the problem.

Senator CHILES. I had a conversation with Mr. Meany—it happened to be the day that President Ford assumed office—and at that time asked him about his feelings about such a conference. He indicated that he would be perfectly willing to sit down and that labor would be willing to sacrifice if other people were willing to sacrifice, but he did not feel that labor was going to do any more sacrificing if they were the only ones to do it.

Dr. BURNS. Well, that is entirely reasonable.

Senator CHILES. I think that again talks to the spirit that you talk of of harmony that we have right now and the opportunity, therefore, that we have right now trying to come up with something.

Thank you very much.

Senator CRANSTON [now presiding]. Senator Biden?

Senator BIDEN. Thank you.

Dr. Burns, every time I listen to you, and it has been several times I have had the privilege of doing that, being on the Banking Committee, I am more impressed. You are almost to reasonable. You know, I am not used to reasonable people. And one of the things that has cropped up in the hearings we have had thus far is the evidence that nobody has a plan. Nobody has a plan. Even the people that come up here to tell us about a plan do not have a plan. We ask administration spokesman who have been up here, for example, the President's counselor, Mr. Rush, unless I am mistaken in my understanding of what he said, and I tried to repeat it several times, there was really no plan as to how we are going to get after the issue we all term the No. 1 issue, that is, inflation.

You know, this domestic summit which Senator Chiles and others did instigate and some of us cosponsored, I hope that somehow some kind of concensus come out of that or if not, the administration, and if not and at the same time this committee and/or the Congress as a whole at least present the American people with a plan.

I remember your sitting in my office warning about the Cost of Living Council and its demise. We are considering that in the Banking Committee. I am not sure whether you said it or I said it or who said it but we both agreed at that time, if my recollection is correct, that what we allowed to happen in the Congress last, what, April 1, April 30, whenever it was, by letting it go out of existence, we announced to the American public we give up. We essentially said to the American public we do not have a plan, we do not know how we are going to deal with it, and we will worry about it maybe later. Maybe we can blame it on the Republican President for what he got us into and that is a good way to talk about it.

Now, you seem to have indicated when asked by Senator Dole—and I kind of like Senator Dole—and I kind of like Senator Dole's directness—he said what can you tell me to say between now and November—I am not up for another 4 years, but I would like to be able to have something to say and I think you have suggested something to us, and correct me if I am wrong, if I have got it incorrectly. You said, first of all, balancing the budget has a present psychological effect with which I, not being an economist, would totally agree and you predicted some things that would occur if that happened immediately. You said balancing the budget has a long-term effect that may be geometric. You are not sure, though. Each year, though, the effect would be greater.

Then you talked about the Cost of Living Council and you made your views clear on that and I think they are particularly pertinent in light of your reputation. If anything, your reputation is that of being slightly conservative. I say that advisedly.

Then you went on to talk about antitrust laws and you then mentioned the revision of certain tax laws. You talked about Davis-Bacon and minimum wage and you talked about unemployment and actually a Government employment program. And then you talked about increasing, somehow, the production side of the raw material shortages we have.

Now, that is the first time someone has sat before this committee that I know of—I missed one day of hearings and maybe the staff or someone can correct me—it is the first time I am aware that anybody has come with some concrete proposals. Everybody else has been, well, the way we are going to lick inflation is we do not trim the defense budget, balance the budget, have high unemployment, keep high interest rates and it goes on down the line which is a brilliant scenario for disaster, it seems to me, at least, in terms of the one thing we all talk about, that is, the confidence of the American people.

Enough ceremonizing. Now to the question.

First of all, did I understand——

Senator CRANSTON. Your time is up. [Laughter.]

Senator BIDEN. I bought this new little watch that has a stop hand on it because I found, Dr. Burns, when you are the last guy to get the time to ask questions, those keeping time, hold you strictly to it. I am going to keep my own time since the chairman is not here and I am sure that—I am only kidding about that. Anyway, I just wasted a minute of my time.

Okay. But anyway, moving to tax reform, balancing the budget, I do not see why we always look at just one side. We just look at the expenditure picture and we are not really looking at the revenue picture and everybody says as my eloquent friend from South Carolina, Senator Hollings, you all can't get into that, you know, because it is going to bring all those lobbyists up here, and that is true, and somehow we say because of that we are not going to talk about it because the lobbyists are going to descend upon us.

You made a concrete recommendation and I am glad to hear it because I introduced a bill. You said increasing the minimum tax which would bring in not a great deal but it would bring in some significant amounts of money and in the proportions we are talking about it would certainly go a long way in being the area depending on the figure you pick upward to $1 billion, anywhere from $200 million on up depending on the figure you pick if any figures are correct, and then you said something about capital gains change.

Now, I want to see capital gains changed but I am never too sure what kind of gains we are talking about. Would you explain to me what you mean by capital gains change?

Dr. BURNS. Well, my thinking on that is very simple. The changes that I believe would be very helpful in bringing small investors back into the equities market are as follows.

No. 1, let the rate of the capital gains tax vary inversely with the period over which the asset is held so the longer you hold the asset the lower will the tax rate be.

Second, at the present time an individual can deduct capital loss from ordinary income, in any one year, only in the amount of $1,000. Now, that is a provision of law that I believe goes back to the 1940's. Professor Heller is here. He knows all these things far better than I do and he may want to correct my statement, but that is my impression. I think that amount should definitely be raised. Now, whether you raise it to $2,000 or $2,500, I would not know, but it ought to be raised.

These are simple changes. They would not involve, in my judgment, any appreciable loss of revenue, certainly not in the first year. Over the longer run, there would be some loss. Being jealous of our tax revenues at the present time I would try, as I indicated earlier, to balance these tax reductions with an increase in the minimum tax.

Senator BIDEN. Doctor, I have only got about 3½ minutes, if I am right, left, and I want to talk to you about home building and unemployment but that has been touched, and if we get to go back to it I will. If not, I would like permission to be able to contact you as you let me do in the past and sit down with you and talk about those two areas. One that really scares the heck out of me, because I do not know about it, I guess—I hope that is the only reason—is that members of the banking community, primarily, I guess because if you are on that committee they come to you, are becoming increasingly conpotential mild recession on the other side of the picture but about a disaster, and there has been a lot of speculation about the stability of the financial institutions around the world, not just the United States.

The Washington Post had a long story on August 4 in which, among other things, it quoted David Rockefeller, the president of Chase Manhattan, as saying: "The situation is uncertain enough that one should not discard the possibility of a panic."

Now, do you believe there is a serious problem worldwide involving the stability of financial institutions and even nations, and if so, what is the cause of that?

Dr. BURNS. Well, we have gone through a period of very rapid economic expansion around the world. We have experienced a great boom in this country and elsewhere. During a period like that, euphoria often develops and there will be some financial carelessness here and there.

Also, as you know, the international monetary system has undergone a change and we no longer have stable exchange rates. Exchange rates are now floating. The shift from stable exchange rates to floating exchange rates excited the imagination of some financial people. They saw a new opportunity for making profits. But then, as so often happens in life, while some experienced profits, others experienced losses.

Moreover, this is an area where you may start speculating and then turn to something that can more accurately be described as gambling, and this may here and there merge into swindling. We have a little of that.

We have also had an important bank failure in Germany. We have had several well-publicized banking difficulties in England. One of the large Swiss banks has experienced foreign exchange losses. In our own country the difficulties of Franklin National have been widely publicized. All this has led to rumors, uncertainty, tension, in financial markets.

My own conviction is, and I hope I speak from knowledge, that our banking system is entirely sound. We do have some soft spots, but they are not numerous. And I think these rumors are greatly exaggerated.

But there is one difficulty that is very real and it is a difficulty that applies more to countries than to banks. The quadrupling in the price of oil has resulted in enormous increases in the dollar value of imports of countries around the world, an enormous flow of funds to the oil exporting countries. The less-developed countries in the world are in very serious difficulty and some industrial countries are in difficulty as well. I have felt from the beginning that the hike in the price of oil has released financial forces on a scale that is simply unmanageable. I believe that this is the most important threat that the world financial system faces at the present time.

We in this country will come through reasonably well. I have no doubt about that. But what happens elsewhere is bound to have an effect on our economy and also on our political position in the world.

At the beginning of the oil crisis we reacted intelligently. We put through a conservation program. But we and other countries around the world have been getting back to the lazy ways of doing business as usual, and our conservation program is now much weaker.

Again, at the beginning of this crisis the administration announced a new program, Project Independence. I think it was a proper response. But so far, at least as far as my knowledge goes, Project Independence has been more rhetoric than substance. I think that is a serious mistake.

And third, at the February conference held by our State Department, a decision was reached that the oil consuming countries would try to get together on a common policy just as the oil exporting countries have. Efforts in this direction have not prospered thus far. I cannot think of any problem that is more important for the world financial system and the world economy than attending to this one.

Senator BIDEN. I agree wholeheartedly. I have used up 15 minutes and learned the art of asking the most complicated question last so they do not interrupt you. So thank you very much.

Senator MONDALE [now presiding]. Thank you very much, Mr. Chairman, for your most useful contribution. Some of the members of the committee would like to submit questions in writing if you can respond——

Dr. BURNS. Yes.

Senator MONDALE [continuing]. For the record.

Dr. BURNS. Yes, sir.

Senator MONDALE. Our next witness is Dr. Walter Heller, from Warren Magnuson country, and from the University of Minnesota.

If you will proceed.

STATEMENT OF DR. WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

Dr. HELLER. Mr. Chairman, partly I am going to draw on my prepared statement in these opening comments and partly I am going to spend some considerable time in answering some of the points made by the esteemed Chairman of the Federal Reserve Board who is just leaving us.

Usually over the years I have been a defender of Mr. Burns as Chairman of the Federal Reserve Board. But today I am going to emphasize the points of difference on a number of things that he has said, including the $21 billion deficit number that he asserts, including the points he makes about the budget really having more psychological impact than economic impact, including the impact of our domestic economic policies on these foreign countries for which he just expressed such grave concern in the oil explosion. I thought I ought to telegraph those punches because I will be dealing with those and not just the points in my statement.

Let me say at the outset that I consider it a privilege and an honor to be part of these first hearings under the historic Budget Reform Act of 1974. That act promises for the first time to give Congress not just the tools and procedures but the perspective to be a full partner in setting the Nation's economic and fiscal policies and its overall budget course. I remember all too well the defective and abortive 1947–48 reforms, which tried to do the same thing but did not have really the tools for it. In contrast, the 1974 reform really provide a solid foundation for budget decisionmaking that will be both responsive to the country's needs and responsible as an instrument of fiscal policy and that is badly needed.

Now, you clearly have your work cut out for you on this committee. The budget reforms are being launched in heavy economic seas. Indeed, badgering the budget is coming to the fore as the favorite indoor sport in a Washington that has been liberated from Watergate but is still besieged by inflation. In part for lack of better target, policymakers at both ends of Pennsylvania Avenue, not to mention Constitution Avenue, seem to have turned on the budget as the inflationary culprit. In our frustration about the inflation problem the budget is becoming the whipping boy. It is becoming the punching bag. We have to be very careful to make rational budget decisions and not base them on an emotional surge against the budget for lack of knowing what else to do in trying to beat back this accelerated, dangerous and divisive inflation.

Now, just as fighting recession is no excuse for spending money on unsound programs, so fighting inflation is no excuse for slashing sound programs. If recession and inflation just had the decency to occur at separate points in time we would be able to give a much clearer set of signals. You could, say, speed up programs in recessions, slow them down in inflation. But when the two occur together as they do in this year's stagflation, or slumpflation, there are no simple economic ground rules for overall budget policy.

Now, whether it is reasonable under these circumstances to cut the budget as an anti-inflationary measure—getting away from the rhetoric and the purple passages—depends on, first, how big a payoff in lower inflation are we going to get in exchange for any given budget cut, and second, how big a price are we going to have to pay for such a cut in lost jobs, lost output, lost profits, the very things you were mentioning in some of your questions to Chairman Burns.

In the last analysis, the economist cannot give you a definitive answer to this because you have to make a value judgment on behalf of the country as to the tradeoff, as to the benefit-cost ratio between

the inflation abatement benefits we gain and the employment and output costs, that we incur. I cannot give you any precise formulas, but I think it might be useful to examine the evidence on the causal relationship between the budget and inflation, to look at the probable effects on the level of prices and the level of economic activity that a substantial budget cut might have, and then finally, to consider the broader role that budget policy can play in either aggravating or alleviating the inequities of inflation.

Now, in the past we know perfectly well there have been instances where the budget has been the engine of inflation. In World War II and in the Vietnam war, when we did not match expenditure increases with tax increases, it was the budget that generated inflation. We also have the clean-cut example of the early sixties when it was not. The big tax cut in those days obviously did not generate inflation. During the 4 years when I was Chairman of the Council, to which I fondly refer in these circumstances, inflation averaged 1.2 percent a year while we were cutting taxes substantially and increasing expenditures. Clearly, budget increases do not necessarily generate inflation. Under those circumstances they could be reflected in higher output, more jobs, and higher profits, and not in higher prices.

Digging beneath the surface, what has been the role of the budget in relation to inflation today? Looking at the evidence, I think a fair appraisal simply does not support the proposition that the Federal budget is the root of all inflationary evil or even almost all evil. I look at it from two points of view.

One is the nature of the 1973–74 inflation. I do not need to belabor this committee with the proposition that most of the inflation has nothing to do with the budget. There was little that congressional budgeteers could do about the worldwide food price explosion or about the ransom demanded by the oil cartel or by the excessive devaluations that boosted prices of imports, and so forth. These were cost-push and supply-squeeze factors. Sure, they were compounded by excess demand in 1973. But basically, there was just not much the budget could have done about it. Budget policy was not the major culprit in the 1973 inflation.

Some rather careful studies have been made of this, by the way. William Nordhas at Yale has analyzed the sources of 1973's inflation and has shown that the budget is a miniscule part of the 1973 inflationary surge.

Now, in 1974, with supply squeezes easing and excess demand ebbing, inflation is rapidly maturing into a new self-propelled price-wage spiral. It is all too reminiscent of 1969–70 and those successive "game plans" that never worked. We are putting in the same game plan now but calling it the "old time religion." I do not think a change of labels is going to make it any more effective. And we found that that kind of inflation, a price-wage spiral, is highly resistant to further turns of the monetary and budget screws.

Second, let us look at the budget performance in the face of this inflation. The budget may be the whipping boy, but as the economy boomed and inflation zoomed in 1973, Federal budget policy was actually very responsive. It came hard about. After being somewhat too stimulative in 1972, the budget turned restrictive in 1973–74 and

much as I decry the way it was cut—to the injury of inflation was added the insult of cutbacks of social programs—I have long said that Mr. Nixon's fiscal 1974 budget represented sound economic policy.

Measured in terms of a high-employment economy—and regardless of the requiems being sounded for the full employment or high employment budget concept, it is still the best single shorthand way of measuring the economic clout of the budget—it turned from a $2 billion deficit in fiscal 1973 to a $10 billion surplus in fiscal 1974. That shift is the real measure of budgetary restriction. Even if you used a higher-than-4-percent definition of full employment, say 4½ percent, a budget swing of over $10 billion toward restriction occurred in 1 year. Now, you cannot say that that is irresponsible or inflationary—on the contrary.

And as Gardner Ackley pointed out before this committee a week ago, if you take Federal, State, and local budgets and put them all together, we have been running a surplus in those three budgets in real terms, not just in the full employment budget. There is just not much inflationary pressure in them thar hills and we should not be flagellating the budget for something that is not its fault.

Let me turn at that point, Mr. Chairman, to Mr. Burns' reference to that $21 billion deficit figure. That leaves me puzzled. He is adding to the regular budget the things that have been taken off the budget like Fannie Mae and other similar financing agencies. If I understand correctly, he takes their net lending, treats it as additional spending, and says implicitly that we ought to finance it by additional taxes.

One wonders whether Mr. Burns has forgotten his long and distinguished service to the National Bureau of Economic Research when he helped Wesley Clair Mitchell and Simon Kuznets perfect the national income accounts. Those accounts specifically do not count lending operations and credit operations as part of the goods and services transactions of the Government. Those are asset transactions. You are trading one asset for another asset. And, therefore, they are not plugged into the numbers for the Federal budget on the national income accounts basis. And that was absolutely sound reasoning.

With all due respect to Arthur Burns—and I have enormous respect for him—he is now mixing apples and oranges. Is he really suggesting that we should match the net lending of the Government and off-budget agencies with taxes, that if there's a net lending of $21 billion we should increase taxes $21 billion? Then if there is a net repayment of, say, $30 billion, should we reduce taxes $30 billion? Granted, I am sort of lampooning his proposal. But I hate to see that $21 billion deficit thing entered on the record, with the prestige and probity and profundity of Mr. Burns behind it. I do not regard it as sound budget economies.

Senator MONDALE. Mr. Chairman, may I interrupt?

Senator MUSKIE [now presiding]. Yes, of course.

Senator MONDALE. The theory is that when we increase appropriations, we stimulate demand by increasing aggregate consumption in this country.

Dr. HELLER. Right.

Senator MONDALE. Are you saying that that is true of a direct appropriation which we spend, say, for education or health or defense, but when you lend in exchange for an asset, it is not true?

Dr. HELLER. Let me make this distinction as clearly as I can. What I am saying is that the off-budget lending, for example, by Fannie Mae (which is now a semiprivate company whose stock is traded on the New York Exchange) is not part of the budget expenditure total to be financed by taxes. It is part of the overall mix in terms of the impact on employment, on economic activity, GNP, output, profits, all the rest, should be taken into account in setting U.S. budget policy. But such policy should not single out one set of lenders and say we ought to match their net lending with increased taxes, which is the clear implication of what Mr. Burns is saying.

You put them all together, you look at how much excess demand is being generated by the economy—what the excess of private investment over private savings (or deficiency) might be—and then you set your budget targets accordingly. Suppose there were $20 billion of net lending by the off-budget agencies. Suppose that it just offset net repayments by others to other financial institutions. You know, so that it was all awash. Still, under the implications of this rule, you ought to go ahead and increase taxes $20 billion to finance it. That is just not sound fiscal policy, and I reject it.

Am I responding to your question?

Senator MONDALE. There have been three or four witnesses all from the administration that have made this point, that you really must look at the $21 billion and when you do, the budget is outrageously inflationary and you must consider the $21 billion as you pursue a policy of cutting the budget. You reject that.

Dr. HELLER. Absolutely. I am not rejecting the proposition that it has a bearing on economic activity in the United States, just as the lending and credit operations of the banking system, of the savings and loans, of the insurance companies, and so forth, but that is where it belongs. It belongs out there with those operations and that is why it was taken off of the budget. Well, there may have been some political motivation, too. But when the politics of shrinking the budget numbers is based on sound economics, one should not object. Interestingly enough, you remember, the Budget Reform Committee led by David Kennedy as I recall recommended that these things be taken off the budget and that only the subsidy elements, which involve a purchase of services by the Federal Government, be included in the budget.

Let me add that the national income accounts budget shows that last year we were running a modest deficit of about $4 billion—actual, now, not full employment—toward the end of the year about $2½ billion, and I bet it is very close to balance right now.

The credit activities are much more in the realm of monetary policy than fiscal policy but Mr. Burns is throwing them back to you. It is worth reiterating that I am not saying that they have no impact on the economy, they do. But they belong in a different basket.

On reflection, I should add that it is almost as illogical to single out the off-budget State-local surpluses for assimilation with the Federal budget position as it is to single out the off-budget lending agencies. I say "almost," first because the State-local surplus or deficit arises out of a balancing of purchases of goods and services against inflows of current revenues (not including credit transactions) and, second because the recent State-local surplus is directly related to rapidly growing grants that help generate the Federal deficit. Nonetheless, for Fed-

eral fiscal policy purposes, State-local budgets are basically part of the "rest of the world" just as are the off-budget agencies to which Dr. Burns refers. So I'll strike a a bargain with him: I'll withdraw my point about State-local surpluses if he'll withdraw his about off-budget agency deficits.

Let me go back now to budget policy as such. Important as it is to get the economic record straight on recent budget policy, the committee's more pressing task is to grapple with the economic implications of the fiscal 1975 budget and the guidelines for the prospective 1976 budget. And there you have to ask, do budget cuts of $5 or $10 or even $15 billion make sense in terms of a rational calculation of program needs balanced against the net effect of such cuts on the economy?

The $30 billion spending increase proposed for this year has been cited as evidence that the budget is out of control and that Congress would be loosening the pull of the budget reins on inflation. Again, I do not think the evidence supports that.

Just take a quick look at the facts. After one subtracts $19 billion of mandatory increases under existing programs and after deducting the projected rise in Federal pay scale under rules adopted by this Congress, and after deducting the proposed increase in defense outlays—the Pentagon managed to protect itself against inflation and put in a 5.8-percent real increase in its baseline total obligational authority, which will lead us to something like $113 billion of total military expenditures by 1980, according to a Brookings study—but after you take out these mandated increases, only $4 billion is left for relatively discretionary domestic programs. The proposed increase for the social grant programs is only 2 percent, far less than the rate of inflation. So we are actually squeezing those programs down while we are pushing defense up.

Now, one can question the priorities but having looked at the budget as a whole, the $30 billion, whether relating it to past commitments, or the advance in money GNP, or the rise in prices, or the rise in revenues, is not a wild or excessive increase by any past standards that we have applied to the budget.

Turning to the second half of the question, is it nonetheless, pushing the budget to an inflationary postion? I noted that the budget moved over $10 billion in a deflationary direction from fiscal 1973 to 1974. Does this now push it in an inflationary direction? The answer is "No." Even without taking into account the big acceleration in inflation over and above the administration's projections, which will boost revenues relative to expenditures, the high-employment surplus rises to $14 billion in the first half of next year. So the budget as Mr. Nixon proposed it, with its $305 billion of expenditures—and I am not saying this to say there is not some fat in that, that there are not some cuts that ought to be made—but measuring it objectively in terms of its impact on the economy, that budget represents an increase in budgetary or fiscal restraint, not a decrease. We start from that point.

The next question is: how effective would budget cutting be in taking some of the steam out of inflation? Here I find a point of agreement with Chairman Burns. We should not take the numbers that are ground out by a computer as gospel. But I do not jump from the mathematical model all the way to psychology and psychoanalysis. I think, there is economic commonsense somewhere in between those two things.

Nothing we know on the basis of commonsense economics—the kind of things that you can figure out on the back of an envelope—supports Mr. Burns' assertion that there is going to be a sudden surge of confidence if you cut the budget. The cold fact is that if you reduce the demands for the products of American industry by a $10 billion budget cut, all the evidence available to us tells us that it is going to cut back the level of economic activity in the United States.

I do not doubt that there is some symbolic significance, but I do not put nearly as high a value on it, certainly not enough to offset the real inroads on economic activity that would be involved.

On this question of what is the tradeoff between budget cuts and inflation, perhaps the judgments of administration policymakers are the least suspect. Late in June, Roy Ash was reported as estimating that if spending were reduced by $5 billion inflation would be cut by this same one-tenth of 1 percent. That brings to mind that staff study done late last year by the OMB which said that a $5 billion tax cut would not add significantly to inflation though it might save as many as 250,000 jobs. That was a study that somebody in the indefatigable press wormed out of the OMB, but there it is.

Senator CRANSTON. How would it save those jobs?

Dr. HELLER. I beg your pardon?

Senator CRANSTON. How would it save jobs to have that tax cut?

Dr. HELLER. To have a tax cut? By increasing the funds available, especially to the lower income groups, for expenditure in areas where there is now growing excess capacity. It would use some of that excess capacity and keep people on the job, or would add people to the job rolls.

Let me now turn to the cost side of the ledger. What price would we pay for these limited inroads on inflation? Again, I do not need to belabor the committee with the grim data on current and projected levels of economic activity. Even before Mr. Nixon resigned, and increasingly in the welcome candid approach in President Ford's administration, policymakers have been admitting that under present policies we are in for either no growth or very slow growth and sharply rising unemployment. And just wait until the forecasters come home from their vacations. When they take a new look at economic prospects under excruciatingly tight monetary policy and tight budget policy, they will, I am willing to wager, lower their forecasts of economic activity in the quarters to come. A continuing drop in GNP is not ruled out.

I felt a certain air of unreality about the discussion in these chambers this morning. We are letting inflation fill our whole field of vision. There has been little or no talk about the sad state of the economy. The stagnation in this economy brought on by the oil price explosion, by tight money, and by tightening budget policy is a very threatening thing, both in human terms and in the financial and business crunch that is resulting.

Mr. Burns, in answer to Senator Biden's very last question, expressed alarm about the ability of the rest of the world to handle the explosion of oil prices. He said we can get by, but the rest of the world is thrown into financial jeopardy.

Well, it seems to me that the other side of that coin is that if we continue to squeeze the life out of our economic recovery and out of

our economy, and thereby shrink American markets for the rest of the world, we are compounding their problem. That dimension did not come into his discussion, yet it is a dimension we have to weigh in striking this balance between the necessary fight against inflation and the costs of pushing that inflation fight too far. A cutback in U.S. economic activity is surely going to take it out of the hides of the rest of the world. We are their biggest single market for export goods. If we squeeze them down, the worldwide problem Mr. Burns pictured in answer to your question, Senator Biden, is going to be enormously increased. Economics is simply not simple. We always have to figure in the tradeoffs, the costs balanced against the benefits of any given policy. Under these circumstances, to generate even more slack and unemployment and world financial problems by cutting the budget below $305 billion in exchange for negligible effects on the inflation rate is a bad economic bargain and a bad human bargain.

That brings me to President Ford's pledge of a balanced budget in 1976. That has the right ring, I admit. It is the appropriate symbol for belt tightening for an America that is beleaguered by inflation. But if the Budget Committee is to carry out its new responsibilities, it also has to judge the overall impact of the 1976 budget on the U.S. economy.

There are two circumstances that would make a balanced budget for 1976 good economic policy. The first is if we were moving strongly toward full employment so that balanced budgets in the actual unified budget would not imply a huge full employment surplus. And the second is if Congress could persuade its creature, the independent Federal Reserve System, to balance overly tight fiscal policy with an easing of monetary policy. That is the very question Senator Hollings, I believe, raised, about a sort of quid pro quo.

One of the great advantages of your new congressional budget procedure and mechanism is that it gives Congress the tool it needs for coordination of its fiscal policies with the Fed's monetary policies. The two have to work in harmony. I thought Chairman Burns' appearance here this morning was a promising omen of this new relationship. Let me repeat that you should be sure that there is a policy quid pro quo in this relationship. If Congress under your guidance, cuts the budget, you should be sure that the Federal Reserve will in exchange back away from its too tight monetary policy. If you cannot get that agreement in public, get it in private.

Senator Hollings, in other words, was right on target on this point and I could not emphasize too much that new interrelationship that can be managed much more effectively.

Well, let me turn finally to a balanced fiscal approach to inflation. I would say that based on available budget evidence and economic analysis and economic forecasts your committee should avoid advocating drastic slashes in the current budget. It should be very wary of rigid pledges of budget balance in 1976, however great the symbolic appeal. The balance you should seek instead is between the benefits and burdens of inflation and to this you can really make a notable contribution. The great need is not simply to exorcise that devil, inflation, no matter how much economic and human devastation is involved. Rather, within the bounds of a restrained fiscal monetary policy, every effort must be made to redress the grievances of inflation while gradually disinflating the economy.

In terms of comprehensive budget balancing, this does not call for net cuts in the budget. Instead, the probing for soft spots and pruning of unneeded and wasteful expenditures should be offset by more adequate measures to compensate the victims of inflation, especially the lower income groups and the working man who have been hit so hard by the skyrocketing fuel and food and housing costs. And further steps should be taken to cushion the blows of unemployment and pinched incomes on the victims of the fight against inflation, the victims of tight money, the victims of budget cuts, et cetera.

What I am suggesting is that one of the central tasks in fighting inflation is to overcome the social injustices and inequities that are generated by the kind of inflation we have experienced in 1973–74, and by the kind of policy we have used to attack it.

Senator Mondale was very eloquent on this in questioning Chairman Burns and I think that has to be plugged into anything that claims to be a compassionate anti-inflationary program. It would embrace public service employment, more generous provision for unemployment benefits, food stamps, and housing allowance on the spending side, and relief from payroll taxes on the working poor, and boosts in personal income tax exemptions and low-income allowances on the taxing side.

I have testified at some length before various committees on these proposals and so I will not take time to note any more here than to say that the time to enact a greatly expanded public service employment program is now.

Chairman Burns said, put it in on a standby basis. No point in putting it in on a standby basis. Put it in. Do not wait for a trigger. With all due respect to the Congress, by the time you have got that thing passed, the economy will be there. Shortly, we will be in 5½ percent plus unemployment, on the way up to 6 and beyond. Given the inevitable lags in congressional action, and then in putting the program into motion, there is just no time to lose in moving on this front. That is my answer, Senator Cranston, to the question you put to Chairman Burns. Get going right now. Put it on the books and put it in operation.

Now, let me underscore, and I have to because it is easy to be misunderstood with the kind of approach that I am taking, I am not proposing that we should be soft on inflation. What I am proposing is that we should be hardheaded in striking a balance between benefits and costs in charting budget policy. I want to be hard on inequity, hard on unemployment, but not soft on inflation. If we fail to strike a sensible balance in this process and fail to reduce the sense of alienation and undermining of social cohesion that inflation brings in its wake we may go well beyond the bounds of social and political tolerance in our battle against inflation.

Now, I have not dealt with other methods of tackling inflation. I covered these in my recent Wall Street Journal article in the form of an open letter to President Ford [1] and I hope the committee will permit me to add that as an appendix to this statement.

Senator MUSKIE [now presiding]. By all means.

Dr. HELLER. Now, the final question one has to face is whether the tax and spending moves briefly listed above ought to be made even if

[1] See p. 268.

the total budgetary cost exceeds the amount of fat that can be trimmed from the budget plus the amount of revenue that can be recouped from tax reform. On net balance, given the present prospects of abortive economic recovery and rising unemployment and given the minor, even negligible effects of modest budget changes on inflation I would have to opt for going ahead even if the net effect is a temporary increase in the actual deficit and a reduction in the size of the high unemployment surplus. The benefits in increased equity and a modest stimulus to the economy would decisively outweigh the miniscule effect on inflation. Our combined monetary fiscal posture would still be one of restraint but it would be more tolerable restraint, the kind that would enable us "to stay the long course."

Thank you.

Senator MUSKIE. Thank you very much, Dr. Heller. I apologize for the fact I was not present when you began your testimony but I returned as rapidly as I could.

I think we will also invoke the 10-minute rule since we have some five Senators here, all of whom have some questions to be put.

As I understand your position, it is first, that a cut in the budget—which could be anything from $5 to $10 billion—would have an insignificant effect on the rate of inflation. How do you respond to Dr. Burns argument that this might be true in the literal sense in the first year but that the benefits would accumulate over a 2 or 3 year period?

Dr. HELLER. Well, Senator, I would say, first, that there is some evidence that the impact would gain in strength as time went on, though the gain is not infinite by any means. Further, it is worth emphasizing that the losses on the employment side and the output side and profit side would also accumulate. So that it does not change the balance of costs and benefits. It simply changes the time span within which you look at them and you still have to face the value question: Is that gain worth the loss, the price in terms of jobs and production?

Senator MUSKIE. That is the point I hoped you would contribute.

Indeed, to get the 3-year benefits on the rate of inflation, it would mean committing ourselves 3 years in advance to a restrictive policy not only with respect to the budget but in other ways commit ourselves to a decline in growth. Is that accurate?

Dr. HELLER. Yes, and given the very pessimistic and uncertain outlook for the economy, you should not lock yourself in on that policy.

Senator MUSKIE. With respect to the other side of the coin—the impact on employment and growth—what would be the order of magnitude of those consequences if we were to cut the budget $5 or $10 billion?

Dr. HELLER. Well, as I cited the figures for the OMB, they suggested that a tax cut would generate or protect a quarter of a million jobs. One can turn that around and say a $5 billion budget cut would cost that many jobs. I think that is an excessive estimate. It is very hard—it depends on what multipliers you plug in.

In testifying before the Joint Economic Committee a couple of weeks ago, Prof. James Duesenberry said on the basis of his calculations you could probably use a multiplier of nearly 3, if I recall correctly. If you get a bonafide $10 billion change, that would in due course translate into a change of $25 to $30 billion in gross national product. That may not seem much compared to a $1,400 billion GNP

total. But if you're talking about the annual advance, it would knock a couple of percentage points off the annual advance in GNP in money terms. A cutback of 2 percent in GNP implies a loss of about half a million jobs under Okun's Law (that employment drops about 1 percent for every 3 percent drop in GNP). That could make a difference between slight progress in the economy versus recession in the economy. So I think we are talking about substantial magnitudes.

Senator MUSKIE. Does the magnitude of these consequences vary at all depending on what programs are cut or whether you are cutting muscle or fat?

Dr. HELLER. Well, I think that has more of a qualitative than a quantitative effect as to the kind of jobs you cut out.

Senator MUSKIE. What I am really getting at——

Dr. HELLER. I am tempted to get into the military budget in response to that question. In fact, I will. One of the things that seems to be way off target was Secretary Schlesinger's suggestion last February, that about $5 billion of that military budget was designed to fight recession. Well, that is just about the worst way to fight recession. The kind of jobs created by additional military expenditures tend to be, first of all, slow in coming. They tend to be high-paying skilled jobs. And instead of providing vital social services or building up social capital, they build up overkill capacity. And so I think one has to look at the qualitative aspect and the timing aspect as much as at the ultimate effect in quantitative terms.

As economists, we have tried sometimes to classify the various types of budget expenditures and the various type of taxes and differentiate their multiplier and job effects. But when all is said and done, except for things that are way off at one end that are really asset transactions or way off at the other end in the form of transfer payments to lower income groups which are immediately translated into jobs, except for sort of the extremes it is very hard to disentangle and say this will create more jobs and this will create less jobs.

Senator MUSKIE. This is a question I would like to put to you. It is apparent that Congress is going to cut the budget, at least reduce appropriations below the levels requested by the President. Putting aside the question of whether or not those cuts would be offset in any degree by increases in interest payments or other declines in revenues or other uncontrollables, would the kind of cuts that Congress is seeking to make—that is, cutting out fat, cutting out low-priority programs, and cutting out unnecessary defense spending or excessive defense spending—be likely to have an unfavorable economic impact?

Dr. HELLER. Are those cuts, even though desirable in themselves, likely to have an unfavorable impact on the level of economic activity? Yes, they are, if they are not balanced out by an increase in the public service jobs program or more generous unemployment compensation or by relieving the working poor from payroll taxes, and so forth. There is no question if you cut the budget $295 billion as against $305, that $10 billion will show up in less demand for American goods and services, products of American business and labor, and in a weak economy I would have to say that we cannot afford such a falloff in economic activity. If we really had excess demand, Senator, essentially a demand-pull inflation, my answer would have to be quite different. I would then have to say if you cut off $10 billion of demand, most of the

impact will go into relieving pressure on prices, not pressure on jobs and output. But in the present circumstances when we have had two consecutive drops in GNP, and when we are headed for at best a flat economy—sort of a plus-minus economy and at worst maybe further drops—this would just push the economy down still further. There is nothing that has been shown—in spite of the psychological point that Chairman Burns brought out, there is nothing that has been shown to contradict that a reduction in demand causes a slowdown in economic activity.

Senator MUSKIE. What I am really trying to get at, for the record, is the instinctive feeling of most Americans that at a time of such pressure, we ought to be more prudent in spending taxpayers' dollars.

What you are saying means to most of us eliminating wasteful or unnecessary spending. What you are saying is that sure we definitely ought to do that.

Dr. HELLER. Absolutely.

Senator MUSKIE. We ought to eliminate wasteful and unnecessary spending, but in the interests of economy we have got to find a useful and effective way to spend $305 billion.

Dr. HELLER. Or to offset the cuts. Suppose you were to cut to $295. Maybe $5 billion should go into these cushioning programs, that is, to provide some cushion for people you are knocking out of jobs in fighting inflation, et cetera. Maybe the other $5 billion ought to go in the form of compensation in lower taxes for the middle and lower income groups, through an increase in personal exemptions and low-income allowances, and as I say, the payroll tax adjustment, to compensate them for the beating that they have taken under the food, fuel and housing price explosions.

So that—in other words, I am saying the budget position as it stands is about right. It is a restrictive budget. It is putting downward pressure on the economy. I do not think that pressure ought to be expanded. But I will make one final comment again, that all of this should be worked out in close collaboration with the Federal Reserve Board. You know, if you could really get them to commit themselves to dropping interest rates—and they can do it—in exchange for some of the budget cutting, then you ought to plug that into the formula. That is another alternative.

If I have a chance I want to say something about Dr. Burns' argument about the fact that 12-percent inflation rates are not all that high. Out where we come from, Senator Mondale, people think those are high interest rates.

Senator MONDALE. They do not know any better.

Senator MUSKIE. I hope my colleagues pursue the point Dr. Burns raised in his testimony that the Fed does not set interest rates. I would like to have that point pursued but I yield at this point since I have used my 10 minutes.

Senator MOSS. I would like to pursue that. Don't high interest rates in and of themselves, cause a degree of inflation by restricting money that can go into productive capacity?

Could you address that for me?

Dr. HELLER. Well, there are a lot of interrelationships, of course, between interest rates and inflation. Obviously, the high cost of money discourages the use of money and consequently in that sense reduces

inflationary pressure. Clearly, for many businesses, and again serving on the board of a modest bank as I do out in Minneapolis, I see this in terms of some of our borrowers, it is a cost factor which is not yet pushing them to the wall—I certainly hope not in terms of our loans—but which is causing them to raise their prices. That is somewhat of an offset. But the first effect is the biggest; namely, discouraging the use of money.

What you are raising is a third question what about this increase in capacity and the modernization and the automation that we need to increase productivity and to break these bottlenecks? Undoubtedly if we choke off expansion and hold back the economy, that will have a negative effect on the willingness of business to put money into plant and machinery and equipment. And again, if we concentrate simply on reducing overall business and consumer demand we forget what happens as a secondary effect from choking the economy so hard with tight money that it becomes less interesting, less attractive because of the high cost of money, to invest in expanded capacity and modernization.

Business capital spending thrives in an atmosphere of expansion and withers in an atmosphere of stagnation. That will be one of the longer run costs, a counterproductive effect of our present anti-inflation policy, if indeed we strangle a good part of capital spending by these excessively high interest rates and the resulting reduced rates of growth in the economy.

Along with that also is the fact that you choke off the benefits you get in productivity advances. One of the things we have always relied on to offset some of the big gains in wages in an economic recovery was an increase in productivity per man hour. I thought the most chilling number that came out in the second quarter was the fact that unit labor costs rose 13 percent in the private economy. That was mainly because productivity fell at the same time that wages were zooming.

Now, if we choke the economy down too much, we will deny ourselves those increases in productivity that come from a larger volume of output with the same amount of plant and machinery and basic labor force. That will be self-defeating.

I am very glad you raised that question because I do not think those things are plugged into the Washington calculus today on the fight against inflation.

Senator Moss. How does the Fed affect the interest rates? What can they really do about them?

Dr. Heller. Well, they do it primarily, in the last couple of years, by management of the supply of money and the total of bank credit. They set themselves targets on the interest rate, particularly in the "Federal funds rate." Through the operations of the New York desk, the New York Federal Reserve Bank, they are learning to hold those pretty much within the range that they specify. The Federal fund rate went somewhat beyond what they wanted, 13, 13½ percent. They pulled them down to 12¼ for several weeks running. They have their eye right on that interest rate target and they influence it by their willingness to pump money into the market if it gets too high, primarily by buying Treasury bills and then by pulling money out of the market by selling bills when it gets too low. So they have their finger

on that interest rate level much more than the modesty of Mr. Burns might suggest.

Senator Moss. How far down could they pull those interest rates if they just targeted for them?

Dr. HELLER. If they just what?

Senator Moss. If they targeted for them, could they pull it down to 6 percent or is it possible to do that?

Dr. HELLER. It would not be sound to pull it down that far. I am not advocating cutting interest rates in half in this present inflation experience. I am just trying to substitute moderation for extremism. and I would think they could pull them down from the present—where are they, about 12 percent, prime rate?

Senator MUSKIE. Dr. Burns said 12 percent this morning.

Dr. HELLER. Down to maybe 9 percent within a couple of months. I do not think there should be any pellmell rush. I am not suggesting that we simply take our foot off the brakes and step on the gas. We should gradually take our foot off the brakes—and the more you put your foot on the budgetary brakes by cutting the budget, the more Mr. Burns ought to take his foot off of the monetary brakes. Otherwise, this economy is in for a long tough, grim period. In the making of policy, a balanced perspective is terribly important.

Senator MUSKIE. That should be a simultaneous operation?

Dr. HELLER. Absolutely. And as I said earlier, if it cannot be done—I do not know whether you were here, Mr. Chairman—if it cannot be done in public it should be done in private.

Senator Moss. If one of the principal causes of inflation lies in anticipatory price and wage demands, we should be focusing on ways to dampen that. How can we get business and labor to exercise restraint?

Dr. HELLER. It is tough. But we have an unparalleled opportunity with President Ford coming in on a surge of good will and support and bipartisanship. We have an unparalleled opportunity to appeal to both labor and business, to reach some kind of economic detente, what I sometimes call an economic disarmament agreement. One should not expect miracles, but it does seem to me there is responsible business and responsible labor leadership that can be appealed to. If labor in particular can be made to feel that this is no longer an anti-labor, probusiness, proreaction administration—and Mr. Ford has a marvelous opportunity to reach out to labor and convince them of that—if that kind of an appeal can be made and at the same time to business, and they could be brought together during this era of goodwill and good feeling, the chances are rather good that one could serve the interests of the country as a whole. With the conviction that the credibility gap has been closed, that there is integrity in Washington, and in the White House, there is a real chance of making some progress on this front I do not think that is just pie in the sky. It is a real possibility, given some determined moral and economic leadership by the President of the United States.

Senator Moss. And you think that can really have an effect on the inflationary rate that we are experiencing.

Dr. HELLER. Not an immediate and dramatic effect, Senator, but it could help us back up this new monitoring agency, for example. How are we going to make that work when it has no powers? Well, during the Kennedy administration and Johnson administration I like to

think our wage-price guideposts had some impact but that was partly because they appealed to the commonsense of the parties. We had guidelines that they chafed under, but I think they responded reasonably well to them. And I think a good deal can be accomplished by holding, grasping or gouging behavior up to public light and ridicule, and by appealing to a sense of the public interest. There is something in the American spirit that has not been appealed to in a long time—a willingness to do a few things in the common interest, to think of the other fellow. But that spirit has not been appealed to for about 6 years and I hope President Ford will shift our sights in that respect and perhaps go back to a little "ask not" and a little bit of "reasoning together".

Senator Moss. Is there anything we in Congress can do other than hope that the President will do as you suggest?

Dr. HELLER. After all, if you express this kind of approach and cooperate the way you have just now in giving him exactly what he wanted on the wage-price monitor front, it seems to me you create a predisposition. He is listening to Congress, I assume. He has lots of friends up here and even if it is not done in the form of some dramatic action by Congress, I would think the lesson could be pounded home by any number of Senators and Congressmen who have access to the White House these days and I think—I feel that with respect to inflation in particular, there ought to be bipartisanship. Borrowing a phrase from another great Michigander, you know, bipartisanship should stop at inflation's edge, and perhaps with President Ford we could realize that.

As to specifics, I have covered those in my open letter to President Ford, appended to my statement—such things as giving the price-wage watchdog some clout, reenacting some credit allocation authority for the Federal Reserve, putting in a public service jobs program, and so forth.

Senator Moss. Thank you, Dr. Heller.

Senator MUSKIE. Senator Mondale.

Senator MONDALE. I think in your Wall Street Journal article, your open letter to the President, you said we need not only a political reconciliation. We need an economic reconciliation. I think I feel the same at this point and I wholeheartedly endorse that objective and I hope the new President will realize how essential that reconciliation is, especially to the kinds of programs he wishes to pursue. I think the present policies are loaded against the average family and their problems, whether you look at tax policies, credit policies, absence of an incomes policy, the unbelievable deference shown to oil companies, particularly the multinationals, who just raped this country, and now the tremendous pressure on the budget portion which deals with human problems, health, education, housing and the rest, and I do not think there is any chance of getting the country behind a policy which has that double standard nor do I think it is good economics. It assumes apparently that we are in a period of surplus demand basically and that is causing inflation. Apparently it is not the case at all, and demonstrably not the case, yet the rhetoric we heard from Mr. Burns and certainly the other evening from Mr. Ford is that that is the problem, the big spenders in Washington, so that if they are not careful they are going to pursue a policy of budgetary restraint which

will only aggravate the adverse consequences of inflation without doing much, if anything, about inflationary factors. Indeed, it might throttle the increase in productivity which in the long run I assume is our best source of anti-inflationary efforts. I gather that is your thesis and that is your hope.

Dr. HELLER. Precisely.

Senator MONDALE. And I agree wholeheartedly with it.

One of the problems I have in trying to envisage how this committee works, can work, really to handle the global questions that we have been charged with handling, is the credit site—the public and private borrowers. It took me a decade to understand aggregate demand. I think I have finally got it. And the relationship of public spending and private spending in the economy. And we included in this bill something that I suggested, I guess others came up with the same idea, from Stan Surrey, that we ought to include tax expenditure concepts as well as appropriation concepts.

Might we well consider a credit expenditure concept as well, see if we can pull spending, taxes and credit into a single calculation? It that that possible?

Dr. HELLER. If you are talking about aggregates, that was implicit in what I was saying about the close coordination between the Congress and the Fed.

Senator MONDALE. Yes, but how do we get hold of it? In other words, the credit side is so slippery. The Federal Reserve Board I think like a good lawyer speaks in Latin, so then you cannot understand them, except to believe and trust them, and so much of the credit side seems——

Dr. HELLER. Well, through the Federal Reserve System you have a really very powerful instrument of influence or control over the aggregate amount of credit. Obviously the reach of the Federal Reserve System is not complete by any means. In other words, there are lots of financial institutions and operations that are outside of their reach. They influence it by what they do in the quantity of money and level of interest rates. But what they do not do is influence the quality of credit. What they work on is the overall quantity and they do not exercise, as of the present, any selective rationing over the channels into which credit is routed.

Now, they could, it seems to me, affect the allocation of resources favorably by more selective devices. I realize there is a lot of controversy about this. Some of my colleagues in economics think that money is too fungible, that the reach of the Fed. is too limited. But others, like Governor Brimmer, feel that the Federal Reserve should go into selective credit allocations. They should press down speculative uses of credit. In a period of inflation like this, it really seems unconscionable to let huge amounts of credit flow into foreign exchange speculation, inventory speculation, grain speculation, land speculation.

Senator MONDALE. Is there any way we can get figures on where credit is going and the changing application of credit?

Dr. HELLER. You should have asked the previous witness, Senator.

Senator MONDALE. What?

Dr. HELLER. You should have asked Chairman Burns that.

Senator MONDALE. Is there any chance he would have answered it?

Dr. HELLER. He suggested that you should submit questions and I urge you to submit that one to him.

Senator MONDALE. Would you help me write it?

Dr. HELLER. Surely, but I will tell you, I will be excommunicated by his staff. His staff members are being worked to a frazzle answering questions from Members of Congress as well as doing their regular job, so they are working until midnight most nights.

Well, perhaps they can work until 12:30 and answer this question.

There is a fair amount of information on this. I cannot rattle it off but there is a fair amount of information on the channels into which credit is going. But it is by no means perfect because of the fungibility of money. You can control, push down, one particular use of money here and it will pop up over here where you cannot control it. So I do not mean to overstate the possibilities of selective credit control. But in a period like this when we ought to be putting our money into productive investment to fight inflation rather than speculative investment that worsens inflation, in a period like this we surely ought to investigate every possible way of influencing the channeling of credit.

Senator MONDALE. One final question. The chairman said he thinks there ought to be selective tax reductions on business investment, that that is what we need for productivity. Do you agree with that or do you agree with others who, as I understand it, say the real barrier to business expansion now is questions about the market, whether it is going to expand, where there is consumer buying power there. If you had your choice as to what would most contribute to investment in productivity, would it be another tax preference or even larger preference or would it be expanded purchasing power in the hands of the average consumer?

Dr. HELLER. Well, it certainly would not be the first. When most of the beating of inflation and weapons used against inflation is being meted out to lower income groups, it seems to me pretty anomalous to propose tax breaks for upper income groups. Mr. Burns also suggests tightening up the system here and there.

Senator MONDALE. With a minimum tax.

Dr. HELLER. With a minimum tax, and one thing that we certainly should not let go by in the year 1974 is those oil profits. Unbelievable that they should not already be taxed and there it is not just the administration's fault. I can point a finger elsewhere and suggest that you just have to move. After all, impeachment is out of the way; Mr. Nixon is out of the way; get going.

Senator MONDALE. We tried. We were short of votes.

Dr. HELLER. Well, maybe—I cannot deliver those for you—but——

Senator MONDALE. Well, you are close to the big oil companies. Why can you not——

Dr. HELLER. I am? Well—so I certainly am very chary. In a balanced program, Senator, if we were able, let us say, to make some budget cuts, if we were able to provide some recompense, almost you might say, reparations to the groups we have hit so hard, then as a part of a balanced program I would, for example, be fairly sympathetic to using an overall instrument like the investment credit. If we can get a quid pro quo, and that quid pro quo would have to include a lot of tax reform, I would not be averse to raising the investment

credit to 10 percent as part of a balanced package because I do think we need general investment stimulus, side by side with an expanding economy. All the tax gimmicks in the world are not going to stimulate much investment if the general economic environment is a constrictive one. That is why I frankly admit I am an expansionist. But I am not an inflationist. There are ways of threading a reasonable balanced path between the two.

I do have to take exception to Chairman Burns' proposal of that gradual reduction in capital gains rates as you hold an asset longer and longer. All those years that you have been escaping capital gains taxes while you had not realized capital gains and then at the end you should be rewarded by having a lower capital gains rate? And you should stimulate people to hold their assets longer and longer and cut down on the liquidity and mobility of capital markets by giving them an incentive to hold those assets longer, those stocks? He was right, we did once have that kind of a system. I was against it then, 34 years ago, and I am against it now. I suppose that shows a certain stubborn streak.

Senator MONDALE. Thank you very much.

Senator MUSKIE. Senator Cranston.

Senator CRANSTON. Do you have any suggestions for any methods this committee could follow in seeking to develop a capacity to measure the impact on inflation and the impact on productivity and other key economic factors of various expenditures that are proposed?

Dr. HELLER. Well, that is a very tough one. It cuts across a lot of economic research that has been done, but precise measures of differential inflationary and productivity effects are hard to come by. It is the kind of problem, by the way, that Brookings might tackle. I think it might be put to the Brookings Panel on Economic Activity. That panel is in charge of realists, not slaves to the computer and mathematical models, economists like Okun and Perry and Peckman. In short, I am suggesting passing the buck to the people who really have the tools to do it. I do think that I agree entirely with the implications of your question, that tradeoffs—inflationary versus other impacts of the budget—deserve a lot more study than they have received.

Senator CRANSTON. Do you consider spending for military purposes more inflationary than many other forms?

Dr. HELLER. I consider them more objectionable but not more inflationary in the short run. It is a rather widely accepted proposition and I think a fallacy that somehow or another expenditures for things that you blow up, that do not come back into the economy, are more inflationary than expenditures on civilian goods and services. In the short run, Senator, I do not think there is much difference between the inflationary impact of an additional dollar of defense spending and an additional dollar of civilian spending, provided they are both financed the same way. Where the chickens come home to roost is in the long run impact on productive capacity and productivity. If we spend, let us say, $13 billion on the Trident submarine—let me interrupt myself to say that we could do it for $3 billion, by retrofitting the Poseidon and then going directly to the Narwahl, skipping the Trident entirely. Informed military critics say it would be a much sounder program, one that can save $10 billion in the Federal budget over a period of years. But if we put $13 billion in the Trident, there is no long-run increase

in productivity, no increase in manufacturing capacity, whereas if we put it into civilian services like education or into private capital spending and public capital spending, there is such a long-run payoff.

Senator CRANSTON. Since the Trident does not produce any goods or services that the people can purchase with the wages they received to help build the Trident, does that not set that amount of money chasing other goods and services?

Dr. HELLER. I would like to be able to say yes, because I would welcome an additional count against the Trident. But I am sorry I have to hew to good economics. The real question is, do you match it with additional taxes? Generally, if you match the additional expenditure with additional taxes it is not inflationary and if you do not, it is. But the story is quite different in the longer run. If you make bad expenditures in terms of the country's resource uses they do not help you fight inflation and expand the economy in the longer run. If you put them to good uses they do, and in that sense it has an important long run impact on inflation but the short run impact depends on the way in which you in Congress and in the White House balance taxes against expenditures.

Senator CRANSTON. What about that $21 billion that is outside the budget? If we are talking about, say, Ex-Im and Ginnie Mae, is that sort of expenditure or borrowing inflationary because it sets up higher competition for funds on the marketplace?

Dr. HELLER. Well, you have to ask first of all, if that were a net addition to the funds available to the housing market, for example, and related markets, yes, it would be an expansionary or inflationary force depending on whether you are talking about a weak economy or fully employed one. Actually, a lot of it displaces other, lending and spending, so you do have to look at that $21 billion in the context of the total lending and repayment of debts in the non-Federal economy. And if the $21 billion is superimposed on other very expansionary borrowings, then you would have to plug it in as part of the inflation problem, not plug it into budget calculations and match it by taxes but take it into account in monetary and fiscal policy generally.

Senator CRANSTON. In the manner of seeking to work out some sort of a trade with Federal—if we cut the budget so much they ease credit that much, what should be the objective—say, we cut $5 billion. What should we expect to see in lowered interest rates, by how much of a percentage? Or $10 billion should mean how much of a cut in interest rates?

Dr. HELLER. Well, in a sense I suppose you are asking an unanswerable question because it would depend on the course of the economy. If the economy continues to slide, and we have a very bleak economic picture, you ought to demand a bigger pound of flesh, of monetary flesh, in exchange for the fiscal austerity than if the economy starts to move up. So it is hard to give you a specific figure. But the idea that there ought to be a quid pro quo measured in terms of the condition of the economy at the time is absolutely sound, and it seems to me some discussions with the Federal Reserve ought to be an integral part of the budget-cutting process of the Congress.

Senator CRANSTON. Do you think the Fed should be as independent as it is of both the executive branch and the Congress if it chooses to exercise its independence?

Dr. HELLER. Senator Cranston, I came to Washington in 1961 as an advocate of ending the independence of the Federal Reserve Board and I went away from Washington in 1965 pretty well convinced that we ought to maintain its independence in but not of the administration and the Congress. There really is some merit in not having it under the thumb of the White House. Let me illustrate the dangers in terms of allegations in a recent newspaper article that Arthur Burns, under White House pressure, pushed for excessive monetary ease in 1972, to help assure Mr. Nixon's election. I think that does Mr. Burns an injustice in the sense that an expanding money supply was good policy in the weak economy that we had in 1971–72, and I do not know the truth of allegations that he was responding to the White House pressures. But that illustrates the kind of thing that we ought not to let happen over at the Federal Reserve.

Second, I do feel that while Congress attitude toward the budget is obviously changing somewhat, it is a good idea to have a fairly independent watchdog on inflation over there in an inflation-prone economy. Mind you, economists have been saying this for years—Senator Proxmire sometimes gives us a bad time saying we did not forecast inflation. Sure, we blew it in 1973 in predicting inflation about half as high as it turned out to be. But most of us as economists, can show you statements we made years ago saying that as we pushed up to sustained high employment, this was becoming an inflation-prone economy. Inflation is going to be endemic and occasionally break out into epidemics in the U.S. economy. In that circumstance, it's not bad to have an agency, an independent agency that is consistently biased against inflation.

Senator CRANSTON. I would like to ask for a written response to my last question, if I might. In regard to public service employment, how many more jobs will be created through the multiplier effect, over what period of time, for each public service job that is directly created, and second, what are the offsets in welfare payments and unemployment insurance and the costs that are eliminated and the offsets in increased tax revenues for every dollar spent, both in terms of what you get in those respects from the jobs directly created and what you get from those that are created by the multiplier effect?

Dr. HELLER. I do not happen to have my computer with me.[1]

Senator CRANSTON. That is why I asked for a written answer. Thank you very, very much.

Senator MUSKIE. Thank you very much, Dr. Heller. I think it has been a very useful morning and part of the afternoon. As always, we welcome your contribution, both enlightening and illuminating. We appreciate it.

Dr. HELLER. Thank you.

[The prepared statement of Dr. Heller follows:]

PREPARED STATEMENT OF WALTER W. HELLER, REGENTS' PROFESSOR OF ECONOMICS, UNIVERSITY OF MINNESOTA

It is a privilege to be part of these first hearings under the historic Budget Reform Act of 1974—an act that promises, for the first time, to give Congress not just the tools and procedures but the perspective to be a *full* partner in

[1] Given the limitations of time and lacking a staff to grind out the data, I regret that I cannot respond to this request. But I believe that Congressman Reuss and Senator Mondale, as authors of the earlier legislation, will know of Joint Economic studies and hearings that will shed light on the job effects and budget savings.

charting the nation's overall budget course and guiding the nation's fiscal policies. Unlike the defective and abortive 1947–48 reforms that sought the same objective, the 1974 reforms provide a solid foundation for budget decision-making that will be both responsive to the nation's needs and responsible as an instrument of economic policy.

You clearly have your work cut out for you. The budget reforms are being launched in heavy economic seas. Indeed, badgering the budget is coming to the fore as the favorite indoor sport in a Washington that has been liberated from Watergate but is still besieged by inflation. In part for lack of a better target, policy-makers at both ends of Pennsylvania Avenue seem to have turned on the budget as the inflationary culprit.

The danger is that the budget will become a scapegoat, bearing the brunt of our inflationary frustration in the form of deep across-the-board cuts instead of the prudent selective pruning that would meet the need for measured budget restraint.

Just as fighting recession is no excuse for spending money on unsound programs, so fighting inflation is no excuse for slashing sound programs. If recession and inflation had the decency to occur at separate points in time, one could make a persuasive case for speeding up selected programs in recession and slowing them down in inflation. But when they occur together, as in our 1974 stagflation, there are no simple economic ground rules for overall budget policy.

Whether it is advisable under these circumstances to cut the budget as an anti-inflationary measure—and if so, by how much—depends on (a) how big a payoff in reduced inflation we get in exchange for any given budget cut, (b) how big a price we have to pay for such a cut in lost jobs, lost output, and lost profits, and (c) our value judgment as to the trade-off, the benefit-cost ratio, between the two.

Although I can offer no precise formulas to determine these costs and benefits, it may contribute to clear thinking on the subject to consider (1) the evidence on the casual relationship between the budget and inflation; (2) the probable effects on the level of prices and the level of economic activity a substantial budget cut might have; and (3) the role that budget policy can play in either aggravating or alleviating the inequities of inflation.

THE BUDGET AS A SOURCE OF INFLATION

When the Federal Government pumps money into a fully employed economy via large deficits as it did in World War II and the Vietnam War, the budget is the engine of inflation. But when the Federal deficits pumped money into a slack economy, as in the early 1960's, the major impact was to expand jobs and output, not to raise prices. The 1973–74 inflation, on its face, offers us no such clearcut verdict.

We have to dig beneath the surface of inflation, of the budget, and of today's slack economy to determine whether our present disruptive inflation can largely be laid at the door of budget profligacy and whether budget-cutting is a promising solution.

A fair appraisal of the evidence simply does not support the proposition that the Federal Budget is the root of all (or almost all) inflation evil:

It is widely agreed that the explosion of food, fuel, and other commodity prices—forces that, while poorly handled by U.S. policy and magnified by excessive dollar devaluation, were largely outside of our control—accounted for the great bulk of our 1973–74 inflation. Though compounded by excess demand in 1973, inflation even then was more a supply-squeeze and cost-push phenomenon than a product of demand-pull.

In 1974, with supply squeezes easing and excess demand ebbing, inflation is rapidly maturing into a new self-propelling price-wage spiral all too reminiscent of 1969–70 and, if history is any guide, highly resistant to further turns of the budgetary and monetary screws.

As the economy boomed and inflation zoomed, Federal budget policy came hard about. After being somewhat too stimulative in 1972, the budget turned restrictive in 1973–74. Much as I decry the *way* it was cut—to the injury of inflation was added the insult of cutbacks in social programs—I have long said that Mr. Nixon's Fiscal 1974 Budget represented sound economic policy. Measured in terms of a high-employment economy (and regardless of the requiems being sung for the full-employment or high-employment budget concept, this is still the best shorthand measure of the budget's economic impact), the budget turned from a $2 billion deficit to a $10 billion surplus. Even if one prefers to use 4½% rather

than 4% as a measure of high employment, the *shift* in the budget position—and it's *shift* that counts most in the impact on overall levels of economic activity—was still over $10 billion toward restraint.

If one broadens the concept of budget impact on the economy to include all levels of government, as Gardner Ackley did in his testimony before this Committee a week ago, one finds that federal, state, and local budgets combined were an even more restrictive force on the economy. The combined budgets ran an actual surplus of $3.6 billion in 1973 and have been running an estimated surplus of $2.5 billion in 1974 (on a national income accounts basis). There is not much inflationary pressure in them that hills] (It's interesting to note, that even if high employment is defined as 4½% instead of 4% of the labor force unemployed, the combined federal-state-local budgets for the past 5 calendar years have averaged a $5.5 billion high-employment surplus.)

THE FISCAL 1975 AND 1976 BUDGETS AND THE ECONOMY

Important as it is to get the economic record straight on recent budget policy, the Committee's more pressing task is to grapple with the economic implications of the fiscal 1975 budget and guidelines for the prospective 1976 budget. Are proposed budget cuts of $5, $10, or even $15 billion warranted in terms of a rational calculation of program needs balanced against the net effect of such cuts on the economy? Let me take up the component questions the Committee has to face in making its decisions on this score.

Does the $30 billion spending increase for fiscal 1975 mean (a) that the budget is out of control and (b) that the Congress would be loosening the pull of the budget reins on inflation?

On the first half of this question, a quick look at the facts shows that Mr. Nixon was not being profligate in proposing the $30 billion increase, even though Congress might differ on priorities:

After subtracting $19 billion of mandatory increases under open-ended programs, the proposed increases in defense outlays, and the projected rise in the Federal pay scale, only $4 billion is available for "relatively discretionary domestic programs."

Indeed, the budget for social grant programs is exceedingly tight. Only a 2% increase, far less than the rate of inflation, is proposed between fiscal 1974 and 1975. In real terms, education and community development would barely hold their own, while manpower programs and community action would be substantially cut. Meanwhile, total obligational authority for baseline defense forces (adjusted for fiscal 1974 add-ons) would increase by about 6% (presaging a steady real rise in baseline defense expenditures throughout the 1970's, to a total of $103 billion, in constant dollars, by 1980, according to Brookings estimates).

Turning to the second half of the question, the budget data show that, in spite of the $30 billion increase in expenditures, the fiscal 1975 budget would continue the shift toward greater restraint on the economy. Even without taking into account the sharply higher-than-expected rates of inflation in recent months—which will boost revenues more than expenditures—the high-employment budget position was programmed to become considerably more restrictive, reaching a surplus of about $14 billion (annual rate) by the first half of calendar 1975. This would be the tightest fiscal policy the country has experienced since the early sixties. No signs of fiscal irresponsibility here!

The next question is: How effective would budget cutting be in taking some of the steam out of inflation?

On this question, perhaps the judgments of Administration policymakers are the least suspect. Late in June, The New York Times reported an estimate by Budget Director Roy Ash that inflation would be cut by only one-tenth of one percent if Federal spending were reduced by $5 billion. This was consistent with a staff study done late last year in his agency, the OMB, which said that a $5 billion tax cut would not add "significantly" to inflation—though, as the study pointed out, it might save as many as 250,000 Americans from unemployment.

Other studies based on the University of Michigan and Data Resources models conclude that the impact on inflation would be even more negligible, but that the employment effects would also be smaller.

Another way of looking at the problem is to consider budget cuts as an antidote to the inflationary pressures arising from such outside forces as world-wide agricultural shortages and the economic ransom demands of the oil cartel. To have offset the upsurge of food and fuel prices last year and still hold the overall inflation rate to 4% would have required a *drop* of 3% in all other prices com-

bined. To accomplish this through fiscal policy would have required such drastic cuts in the budget that the country would have been plunged into a massive depression.

That brings us to the cost side of the ledger: What price would we pay for the very limited inroad on inflation?

I need not belabor the Committee with the grim data on current and projected levels of economic activity. Even before Mr. Nixon resigned—and increasingly in the more candid approach of the Ford Administration—Administration policymakers have been admitting that under present policies we are in for either no growth or very slow growth and sharply rising unemployment. A continuing drop in GNP is not ruled out. Given the lags between the tightening of fiscal and monetary policy and the contractionary effect on the economy, we are condemned to a sluggish economy for several quarters to come. Under these circumstances, to generate even more economic slack and unemployment by cutting the budget below $305 billion in exchange for negligible effects on the inflation rate is a bad economic bargain and a bad human bargain.

That brings me to President Ford's pledge of balance in the fiscal 1976 budget. I have no doubt that it has right ring, that it is the appropriate symbol for belt-tightening to an America beleaguered by inflation. But if the Budget Committee is to carry out its new fiscal policy responsibilities, it also has to judge the impact of the 1976 budget on the U.S. economy.

Two conditions could make a balanced budget the right economic policy for 1976:

The first is that the economy be well on its way to full employment by 1976—otherwise balance in the actual unified budget will imply a large and repressive surplus in the high-employment budget.

The second is that the Congress can persuade its creature, the independent Federal Reserve System, to balance overly tight fiscal policy with an easing of monetary policy.

In that connection, let me note that one of the great advantages of the new Congressional budget procedure and mechanism is that it gives Congress the tool it needs for coordination of its fiscal policies with the Fed's monetary policies. The two must work in harness. Chairman Burns' appearance here this morning is a promising omen of this new relationship.

Returning for a moment to President Ford's budget promise, I am reminded all too vividly of President Kennedy's pledge in the summer of 1961 to bring in a balanced budget the following January for fiscal 1963. That too had a fine ring. But when 1962 rolled around, the economy was still way below par. A balanced budget was patently the wrong economic medicine. To avoid choking off recovery, the goal of a balanced budget had to be abandoned. Will history repeat itself?

A BALANCED FISCAL APPROACH TO INFLATION

Based on available budget evidence and economic analysis, your Committee should avoid drastic budget slashes in the current budget and be very wary of rigid pledges of budget balance in fiscal 1976, however great the symbolic appeal. The balance you should seek to serve instead is between the benefits and burdens of inflation. To this balance, Congress can make a notable contribution.

The great need today is not simply to exorcise that devel, inflation, no matter how much human and economic devastation is involved. Rather, within the bounds of a restrained fiscal-monetary policy, every effort must be made to redress the grievances of inflation while gradually dis-inflating the economy.

In terms of comprehensive budget planning, this does not call for net cuts in the budget. Instead, the probing for soft spots in the budget and pruning of unneeded or wasteful expenditures should be offset by more adequate measures to compensate the victims of inflation—especially the lower income groups and the working man who have been hit terribly hard by skyrocketing food, fuel, and housing costs—and to cushion the blows of unemployment and pinched incomes on victims of the fight against inflation. What I am suggesting is that one of the central tasks in "fighting inflation" is to overcome the social injustices and inequities generated by the kind of inflation we have experienced in 1973–74 and by the kind of policy we have used to attack it.

A compassionate anti-inflationary program would embrace public service unemployment and more generous provision for unemployment benefits, for food stamps, and for housing allowances on the spending side and relief from payroll taxes for the working poor and boosts in personal income tax exemptions and low income allowances on the taxing side.

Since I have testified at some length before other committees on these proposals, I will take time here only to note that a greatly expanded public service employment program is needed *now*, without waiting for a 6% unemployment trigger. Given the discouraging direction in which the economy is clearly heading, together with the inevitable lags in putting such a program into motion, there is no time to lose in moving on this front.

Let me underscore that what I am proposing is not that we should be soft on inflation but that we should be hardheaded in striking a balance between benefits and costs in charting budget policy. If we fail to strike a sensible balance in this process and fail to reduce the sense of alienation and the undermining of social cohesion that inflation brings in its wake, we may rather quickly exceed the bounds of economic and political tolerance in our battle against inflation. (While I have not dealt with wage-price restraints and other non-budgetary steps to curb inflation, I have covered these in a recent Wall Street Journal article in the form of "An Open Letter to President Ford." I hope that the Committee will permit me to submit this for the record as an appendix to this statement.)

The final question one has to face is whether the tax and spending moves briefly listed above ought to be made even if the total budgetary cost exceeds the amount of fat that can be trimmed from the budget plus the amount of revenue that can be recouped from tax reform.

On net balance, given the present prospect of aborted economic recovery and rising unemployment and given the minor or even negligible effects of modest budget changes on inflation, I would have to opt for going ahead even if the net effect is a temporary increase in the actual deficit and a reduction in the size of the high-employment surplus. The benefits in increased equity and modest stimulus to the economy would decisively outweigh the miniscule effect on inflation. Our combined monetary-fiscal posture would still be one of restraint—but it would be more tolerable restraint, the kind that would enable us to "stay the long course."

An Open Letter to President Ford

(By Walter W. Heller, Regents' Professor of Economics, University of Minnesota)

(As published in the Wall Street Journal, August 12, 1974)*

As you enter the presidency, the Number 1 problem in your domestic docket is inflation. In tackling it you have an opportunity that has come only once in the lifetime of this republic, one that enables you to make a New Beginning, backed by the will, the support and the hopes of the vast majority of Americans.

It's an odds-on bet that the present corps of economic advisers—Messrs. Rush, Simon, Greenspan and Ash—will recommend that you use this priceless opportunity to maintain unflinching adherence to the "old-time religion," to the catharsis of tight money and budget cutting.

But before you accept that counsel and the appealing Rock of Gibraltar image it implies, you should take a fresh hard look at the inflation problem, bearing in mind the new options that open up as you restore credibility and integrity to the White House. No one expects you to find a quick, magic cure for inflation—there are none. But people rightfully expect you to ask the tough, searching questions that will reveal the true risks and rewards of present policies and point the way to a broader and better balanced anti-inflation program.

A nagging question pops up at the outset: Why should the economic game plan that failed so miserably in 1968–71 work in 1974–75? Tightening the fiscal and then the monetary screws generated 6% unemployment and the recession of 1970, yet failed to subdue inflation. But, you will be told, that's because "we failed to stay the long course."

At that point, it's fair to ask how deep a valley of disinflation lies ahead of us under present policy. What the President, the Congress and the public need is a candid calculation—free of self-delusions and false optimism—of the projected benefits and costs of monetary-fiscal austerity:

How much inflation will it squeeze out of the economy, and by when?

How much will it cost in lost jobs, output and profits and in business and financial failures?

---

*A number of typographical errors that occurred in the process of transmitting the "Open Letter" to the WSJ by phone have been corrected in this "reprint."

A PARTIAL, CHILLING ANSWER

Careful econometric studies by James Tobin (in the latest Brookings Papers) and by Otto Eckstein of Data Resources provide a partial and chilling answer. They agree that the cost of simply adhering to severe monetary and fiscal restraint to check inflation will be sustained and heavy unemployment. Mr. Eckstein calculates that it would take at least two years of 8% unemployment to beat inflation back to a 4% rate. I think you will agree with him, Mr. President, this would be "overkill" and that the financial system would collapse before we cracked inflation.

That raises a closely allied question: Given the kind of inflation we are suffering today, are demand-suppressing measures enough? Are they the right medicine for this inflation? I don't mean to say that understanding how the inflation genie got out of the bottle necessarily tells us how to get it back in. But surely the medicine—and the dosage—should be different if inflation is merely a lingering legacy of demand-pull forces than if specific supply crunches and cost-push forces are the villains.

The plain fact is that 1974 inflation, born of 1973's combination of excessive demand and commodity crunches, is rapidly maturing into a new spiral of wages chasing prices and prices chasing wages—into a self-propelling price-wage spiral all too reminiscent of 1969–70 and all too resistant to a monetary-fiscal squeeze. The result? Further turns of the monetary and fiscal screws will wring less and less inflation and more and more life blood out of our economic recovery.

This is becoming painfully evident as the first-half slide turns into second-half torpor. Every day new cracks are appearing in the facade of economic strength behind which the ordained optimists have been hiding. A first step toward more realistic policy must be to recognize the 1974 slump for what it is: Not merely an "energy spasm", "a shortages economy" or a pause that refreshes, but a costly stagnation arising out of a shortfall in aggregate demand.

Let's drop the debate over whether it deserves the label "recession" and redirect our attention to the real problems: How far below our output and employment potential are we prepared to drive the economy by policies to cut demand? And in view of the limits of demand management policy in subduing the new inflation, what measures to curb cost-push pressures and to improve supply management should now be considered?

Here, above all, Mr. President, you are in a unique position to de-escalate the inflationary spiral. Labor, justifiably aggrieved about the erosion of its real earnings, is stepping up its demans. Business, also pointing to inflation inroads and citing huge capital needs, is pushing up prices and profit margins. Now is the time, backed by a floodtide of goodwill, to practice not just the politics but the economics of reconciliation. Now is the time to bring business and labor together in a dialog, leading under your guidance to economic detente for the benefit of the American consumer.

That will mean reaching out to bring labor back into the fold. It will require evidence that the strong pro-business bias of recent White House economics will become not a pro-labor but a pro-public bias. And it will also require a liberal (or even conservative) dash of the "reasoning together" and "ask not . . ." spirit that seems to underlie your early words and actions as President.

NOT AN EASY TASK

Translating this new mood into specific initiatives to defuse the price-wage spiral won't be easy, especially after the unfortunate discrediting of wage-price controls under the inept freezes and phases of recent history. But without some kind of a wage-price watchdog and a new set of even-handed wage-price guides—backed not just by powers of inquiry and publicity but by powers of suspension (and in outrageous cases even by roll backs)—the outlook for inserting a circuit-breaker in the new round of cost-push inflation will remain bleak. Building on the base of the Bentsen-Nixon proposals for a wage-price monitoring agency, the White House and Congress can forge this missing link in the anti-inflation chain.

This may go against your free-market instincts, Mr. President. But it shouldn't. Monitoring would be focused on those powerful unions and business units that wield excessive market power, those areas of the economy where competition is a poor policeman; in other words, the government presence would be a stand-in for the forces of competition.

For the longer pull, much of the relief from stubborn inflation must come from the supply side. An intensive review of government policy to enlarge critical supply capacities, increase productivity, and monitor emedging supply crunches is long overdue.

In light of our traumatic experience with shortages in the last couple of years, you should call for a thorough exploration of the potentials for supply management. This should range all the way from better information devices like shortage alerts and prompt export reports or even licensing to the use of special financial aids (without building new tax shelters) and the milder forms of credit rationing.

Rationing of credit by price alone is channeling too much of our limited financial resources into speculative investment in land, inventories and foreign exchange to the detriment of investment in productive capital. And, as always, super-tight credit is squeezing small business, housing and municipal borrowers. To curb such inequities and channel more credit into productive uses, Federal Reserve policy should, where feasibly, apply more selective methods of supplying credit.

And a gradual phaseout of the Regulation Q ceiling that shortchanges small savers and distorts the flow of financial resources is clearly in order. These moves would facilitate the gradual retreat from excessive tightness that is needed to permit a moderate economic expansion.

A government that is dead serious about fighting inflation ought also, at long last, under your leadership, to put an end to the laws, regulations and practices that make government an accomplice in many cost- and price-propping actions. They run from over-regulation of transportation rates and under-enforcement of antitrust laws to fair trade laws and the Davis-Bacon Act—not to mention maritime subsidies, import quotas and the Buy American Act. Such actions will step on the toes of articulate well-heeled pressure groups—but now is the time to take those political risks.

SUPPLY SIDE OF EQUATION

While dealing with the supply side of the equation, let me emphasize how important it is not to undermine some of our natural defenses against inflation by stopping expansion dead in its tracks. For if we do, we would deny ourselves the short-run productivity offsets to rising costs that we normally reap from a rising volume of sales and output. The longer we stunt productivity by choking off recovery, the more likely it is that lower productivity growth and hence higher unit costs will be built into conventional markups.

Further, remember that investment, innovation and risk-taking thrive in an atmosphere of expansion and wither in an atmosphere of stagnation. Super-tight credit undermines the health of equity markets, pushes money costs skyward, and threatens profits and financial stability. In the face of a policy of calculated stagnation, no program of tax gimmicks or special incentives will be able to induce the increases in capital spending the nation needs to boost productivity, expand supplies and ease price pressures.

Finally, Mr. President, in formulating your anti-inflationary program, be sure to take it out of the narrow context of economic gains and losses into the broader perspective of its social impact, of the inequities and unfairness that it could generate. Out of these inequities grow a sense of grievance and alienate an undermining of morale and social cohesion that may be inflation's greatest cost.

A telling reason why so many segments of our society have rejected current policies—have indeed felt they add up to an anti-them instead of an anti-inflation program—is that they are its victims rather than its beneficiaries.

Monetary policy boosts their housing costs. Budget policy has been squeezing social programs while enlarging defense outlays. And tax policy has thus far shown too little concern for those who are being shortchanged by inflation.

DISTRIBUTING BENEFITS AND BURDENS

A truly balanced attack on inflation would couple the restraints of fiscal and monetary policy with measures to redress the grievances of skyrocketing fuel and food prices. I urge you to consider as an integral part of a compassionate anti-inflation program not only more generous unemployment benefits, food stamps and housing allowances but relief from payroll taxes for the working poor and increases in personal income tax exemptions and low income allowances. Distributing the benefits and burdens of economic policy more fairly will facilitate a more sustained battle against inflation.

If we simply declare total war against inflation without weighing the resulting devastation of the human and financial landscape, experience tells us that we will invite an eventual public backlash. This is a plea, not to be soft on inflation, but to strike a sensible balance between benefits and costs in your anti-inflationary program, thereby staying within the bounds of economic and political tolerance rather than risking repudiation of the battle before it is won.

Just one final thought: I realize that if you follow the foregoing counsel, it will enhance the prospects of your continuation in the presidency after 1976. But in the belief that partisanship stops at inflation's edge, that's a risk I'll have to take.

Senator MUSKIE. The committee will recess——

Senator CRANSTON. Mr. Chairman, before you recess, could I ask you about one thing we discussed yesterday briefly?

Senator MUSKIE. Yes, of course.

Senator CRANSTON. Since that discussion I have talked to the two California members of the Budget Committee about the idea of having a session in California with economists and business leaders and labor leaders and consumers and others who are interested in inflation and on the impact of the work that this committee will do and generally what might be done about inflation to precede the summit conference on inflation that will be held here, to pick up some ideas in the community or State atmosphere as against the Washington atmosphere which might be productive for the work of this committee and might also be productive as something we could feed through this committee to the conference that the President has called at the suggestion of Senators. I would like to ask if you might not urge that upon other members of the committee as a way to add to the great value you have gotten out of these hearings. I think they have been tremendously productive and this sort of a thing locally could add to our——

Senator MUSKIE. Yes. I would urge that, realizing as I told the Senator yesterday, that at this point I do not have staffing or other resources to do that in the usual way. But I would certainly encourage members of this committee to use this vacation or recess period to stimulate that kind of dialog in the States, in an informal way, incurring no cost to the committee until we know what we are going to have in budget resources. I think it is an excellent suggestion. I compliment the Senator from California for offering it. And I commend it to my colleagues if their recess plans are not already fixed.

Senator CRANSTON. Thank you very much. I intend to do it in California on the 3d, 4th and 7th. I will report back on the results.

Senator MUSKIE. I look forward to hearing about it.

Thank you again.

[Whereupon, at 1:50 p.m., the committee was recessed, to reconvene at 9:30 a.m., Thursday, August 22, 1974.]

THE FEDERAL BUDGET AND INFLATION

THURSDAY, AUGUST 22, 1974

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, D.C.

The committee met, pursuant to recess, at 10:15 a.m., in room 1114, Dirksen Senate Office Building, Senator Edmund S. Muskie (chairman) presiding.

Present: Senators Muskie, Moss, Mondale, Abourezk, Chiles, Biden, Dominick, and Javits.

Also present: Alvin From, Lee Lockwood, and Lucinda Dennis, staff of Senator Muskie.

Senator MUSKIE. The committee will be in order.

The first requisition, I guess, should be for a gavel.

The committee will be in order. It is a pleasure to welcome our first witness this morning, Prof. F. Gerard Adams of the Wharton School of Finance and Commerce. This is something on the order of an educational process in which we are engaged, Professor Adams, so you can treat us as a class until you get to our questions, and then you ought to treat us as an adversary.

Senator JAVITS. Mr. Chairman?

Senator MUSKIE. Yes.

Senator JAVITS. May we, and I think it goes for all of us, explain to the witnesses that if any of us leaves, it is only because we have other commitments. For example, shortly I will have to go to Foreign Relations on the floor, and so forth, and in no way should these gentlemen who are kind enough to give us their knowledge fear that we are slighting them.

And I thank you, Mr. Chairman.

Senator MUSKIE. Thank you very much, Senator Javits.

I hope we will have a minimum of interruptions. I must say that I have been delighted over the attendance of the committee. I do not know if it is just the case of a new broom sweeping clean, or a reflection of a very real interest. I think it is the latter, and I am delighted to have a committee that is so representative and so concerned, and so hardworking.

May I welcome you, Professor Adams, and ask you to present your testimony.

STATEMENT OF PROF. F. GERARD ADAMS, WHARTON SCHOOL OF FINANCE AND COMMERCE, UNIVERSITY OF PENNSYLVANIA

I appreciate the opportunity to speak to the committee and however, I do not think there is any need to view the committee as a class. You have, I believe, all of you received a copy of this testimony, and I will speak briefly and draw from it.

The new congressional machinery for managing the budget recognizes that the budget has important macroeconomic as well as microeconomic consequences. It is quite clear that budget decisions cannot be independent of decisions about economic policy. In fact, budget decisions are economic policy decisions.

For this reason, it is very important to have realistic information on the nature and magnitude of the impact of the budget on the economy, the need to know the connection between budgetary policy, employment, inflation, and economic growth, and let me stress at this juncture that it is not simply a matter of knowing that a smaller budget deficit is less inflationary than a larger budget deficit. It is very much a question of knowing how much, what is the magnitude of the impact of budgetary policy on the macroeconomic developments.

In this testimony I would examine how the Federal budget policy affects macroeconomic performance. I will report on the results of simulations of the Wharton econometric model to test the implications of alternative budget policies, and I will draw some inferences from this work for budgetary policy and the economic outlook.

I think it is particularly relevant to the work of this committee to recognize that the relation between budget figures and the performance of the economy is much more complex than is generally recognized. The aggregate budget summary statistics that we look at—total expenditures, total receipts and the deficit or surplus—are really only shorthand measures. They are useful as a broad means of budgetary control but they are quite imperfect indications of the economic impact of budgetary decisions. The total economy must be studied (one way of studying it is by econometric model simulations), and in some detail, in order to appraise the economic impact of alternative budget proposals.

I will turn now to a discussion of our calculations of the macroimpact of budget policy. In order to evaluate some relatively simple alternative budget choices I chose a number of simple alternatives. We have carried out a series of simulations with the Wharton econometric model of the U.S. economy. This econometric model is the model which we regularly use, and have used over a period of 10 years in order to predict and analyze the economic outlook of the U.S. economy. It is a model which is widely recognized as a reliable tool, as reliable as these instruments are, for studying the economy. We have taken what we call our Wharton control forecast, the last one which was dated August 1, and we have compared to it alternative budget scenarios.

Now, this basic forecast—well, let me call your attention to table 1 which follows:

TABLE 1.—MACROECONOMIC EFFECTS OF ALTERNATIVE BUDGET SCENARIOS

[Calendar year 1975]

		Changes from 1975 control forecast	
	Wharton preliminary control forecast, Aug. 1, 1974 1975 forecast	Alternative 1: $10,000,000,000 decrease in purchases of goods and services	Alternative 2: $10,000,000,000 decrease in transfers to persons
GNP (billions of dollars)	1,525.5	−19.5	−7.3
Percent change 1975/1974	8.7	−.9	−.4
GNP (bill of 1958 dollars)	832.5	−5.4	−2.8
Percent change GNP	.4	−.3	−.2
GNP deflator	1.83	−.01	(1)
Inflation rate (percent)	8.2	−.5	−.11
Personal consumption expenditure deflator	1.761	−.01	(1)
Percent change PCE deflator	8.8	−.6	−.2
Unemployment rate (percent)	6.3	+.4	+.1
Compensation per man-hour (percent change)	8.4	−.9	−.2
Productivity (percent change)	−.2	−.1	−.2
Disposable income per capita (1958 dollars)	2,851.7	−15.8	−23.1
Corporate profits (before tax, billions of dollars)	140.7	−3.6	−4.2
Federal Government deficit (−) (billions of dollars)	−22.0	+5.3	+6.6
GNP (billions of dollars)	−8.7	−11.3	−15.2
Percent change 1975/1974	−.5	−.4	−.6
GNP (billions of 1958 dollars)	−3.6	−1.6	−.8
Percent change GNP	−.3	0	+.2
GNP deflator	(1)	−.010	−.2
Inflation rate (percent)	−.1	−.4	−.8
Personal consumption expenditure deflator	(1)	−.01	−.1
Percent change PCE deflator	−.2	−.5	−.6
Unemployment rate (percent)	+.2	+.3	0
Compensation per man-hour (percent change)	−.2	−.8	−.8
Productivity (percent change)	−.1	+.1	+.2
Disposable income per capita (1958 dollars)	−26.8	+12.0	−10.4
Corporate profits (before tax, billions of dollars)	−3.9	+.3	−1.3
Federal Government deficit (−) (billions of dollars)	+8.3	−3.2	−3.7

[1] Less than 0.01.

This table compares the alternative budget scenarios to the Wharton preliminary control forecast, August 1, 1974; on the left hand side we show the values of our forecast for 1975, and then on the right hand side of the table and on the second page of the table we show the differences between the control forecast and the impact of alternative budget scenarios.

In order to illustrate that, let me simply say that the first number on the top, on the left, says that our present control forecast, shows a GNP for the year 1975 of $1,525 billion, and then the alternative with a $10 billion decrease in purchased of goods and services shows a number of $1,506 billion which is just $19.5 billion less.

Let me comment first on the base control forecast. This forecast assumes a budget expenditure total on a unified budget basis of $303 billion in fiscal 1975, and $339 billion in fiscal 1976. It assumes what I would call moderate growth of the money supply at a little over 6

percent per year, and I want to alert you to the fact that it assumes a small tax cut worth about $7 billion in mid-1975.

The broad picture of the economic outlook that results is an entirely flat economy over the next four quarters. The growth rate of real output averages out to zero over this four-quarter period. This represents an extended period of increasing slack. Pressures of demand are fast fading in this economy.

On the other hand, the base forecast shows inflation continuing at a rate of near 10 percent as measured by the GNP deflator during the remainder of 1974, and it shows continued inflation at historically high rates of 7 to 8 percent in 1975.

Let me stress that the character of the inflationary phenomenon is rapidly undergoing change in the sense that the inflation in the course of the past year has been a demand-pull inflation, an inflation which results from lack of capacity as compared to the demands of our and other economies, and that we are now fast switching into a cost-push inflationary phenomenon where prices are continuing to rise, even though spare capacity is available, and unemployment level is increasing.

This leads me to the next point, that our forecast shows a gradually increasing unemployment vote to more than 6 percent in mid-1975. Our forecast also assumes substantial budget deficits in fiscal 1975 and in fiscal 1976.

It is very clear from these calculations that a balanced budget in 1976 is not a realistic objective. Now, the details of these forecasts, of this base forecast and all of the other alternatives have been made available to the committee. I will talk here only in terms of the 1975 annual numbers, but the impacts of alternative policies develop gradually over time. The alternatives which we have considered correspond to the headings of table 1.

Alternative 1 represents the sharpest effect, a $10 billion reduction in purchases of goods and services. That coresponds to a Federal budget of roughly $295 billion in fiscal 1975, and approximately $330 billion in fiscal 1976.

The other alternatives show somewhat different impacts. Alternative 2, we are still talking about a $10 billion decrease in budget expenditures, but in this case, the decrease has been imposed on transfers to persons. I want to stress as you can see from these numbers, that the economic impact of altering transfer payments is quite different from the economic impact of lower purchases of goods and services.

Senator MONDALE. Could I interrupt here?

Why would that be, because the one calls for the production of goods and so on and the other simply reduces?

Professor ADAMS. Yes, because one represents immediately a change in demand for goods and services. The other increases the consumer's flow of disposable income, but he does not spend all of that increase. Some of it goes to savings, and it also takes him some time to adjust his spending patterns to the higher income flow.

What is interesting is that by and large in a very broad sense a change in transfer payments is in broad sense similar in impact to a change in taxes, which is our alternative 3.

Senator MONDALE. If you reduce income transfers, I assume that means social security, pensions, that sort of thing.

Professor ADAMS. Yes.

Senator MONDALE. Do those income transfers not go to generally speaking low-income people who spend 95 or 98 percent of their income, so that in effect that would show up rather quickly in the form of purchasing power for consumer goods, or is that not the case?

Professor ADAMS. That is the case. It is important to recognize that the impact of the budget upon the economy needs to be looked at in specific terms. I do not want to downgrade the importance of having some overally aggregates of the budget performance and budget numbers in order to scale things by, but it is quite clear that the impact depends upon the specific changes that are made.

Let me indicate the following thing. It is quite clear that if we made a change in transfer payments going largely to people at the lower end of the income distribution, it will have a somewhat larger effect and a somewhat quicker effect, as you point out, than if it hits people at the upper end of the distribution. The same thing is true of taxes. Our tax change assumption was of a balanced change in taxes with an equal cut in corporate taxes as a percentage rise as in personal taxes. Clearly it would be somewhat greater with the personal taxes directly.

The third alternative, as I pointed out, is a change in taxes.

The fourth alternatve is a change in purchases, a cut in purchases and in taxes, what sometimes is called the balanced budget multiplier.

And finally, the fifth alternative represents a cut in purchases of $10 billion, with an attempt to see what would happen if we had an offsetting public employment program, $3 billion worth, about 400,000 in public employment.

Senator JAVITS. Could I ask a question at that point.

Senator MUSKIE. Yes.

Senator JAVITS. Why did you pick the $3 billion when the bill which we have, Senator Nelson and I and others is $4 billion at a 6-percent trigger, estimating 500,000 jobs, and the figure that Arthur Burns came up with is 800,000, which would cost $4.8 billion. He figured $6 billion a year, or $6,000 a year per job.

Was there a reason? I do not say this challengingly. I am interested why your group picked the $3 billion figure, 400,000 jobs. Question A.

Question B, we now have provision for 100,000. Does the $3 billion and the 400,000 jobs include or exclude the—what we had?

Professor ADAMS. The answer to your first question is that the size of the program was an arbitrary choice. The $3 billion rather than $4 billion was arbitrarily. We can easily calculate at $4 billion, and we will be happy to do so.

The translation of $3 billion into 400,000 was not arbitrary. That represents our estimate that once you allow for the overhead costs which are involved in such a program, that we simply could not accept a number as large as the one that Dr. Burns proposed in terms of the number of jobs.

Senator JAVITS. Well, what about the accumulative nature of the figure?

Professor ADAMS. It is in addition to everything that is now.

Senator JAVITS. Thank you.

Professor ADAMS. Now, in considering these alternatives, I think the best thing to do is simply to summarize the conclusions that we draw from them.

It is quite clear that changes in expenditures and taxes have an impact on the dollar flow of the Nation's product. Notice that the multiplier of Government purchases is approximately two, meaning that after 1 year has passed, a $10 billion change in purchases gives you approximately $20 billion—$19.5 billion is the exact number—as the effect on GNP. The impact of transfer payments is less, as we would expect, and similarly, the impact of tax changes is less. Also, noticeable but in a lesser amount is that a $10 billion spending cut would reduce the Nation's real output by approximately $5 billion in 1958 dollars. This is a little more than six-tenths of 1 percent.

Now, that is not surprising because precisely $10 billion out of a GNP of $1½ trillion is again somewhere around 6 tenths of 1 percent.

The thing I should stress, but I think has been stressed before this committee before, is that the impact on the inflation rate is very modest. A $10 billion reduction in spending reduces the annual rate of inflation, but it reduces it from 8.2 percent in our control forecast to 7.7 percent in the spending cut simulation.

The effect on unemployment of a $10 billion change in Government purchases is approximately four-tenths of 1 percent in 1975. It has an unemployment rate of 6.7 percent as compared to the 6.3 percent. I believe that figure of four-tenths of 1 percent is some what on the larger side as compared to some other estimates.

I think that realistically speaking, four-tenths of 1 percent or three-tenths of 1 percent gives you an order of magnitude. I do not think we can be too precise in how big that impact will be. There will be an impact. However, there will also be an impact on personal disposable income per capita, the impact of a $19 billion decrease in purchases for goods and services is about $16 in 1958 dollars in personal disposable income per capita in the year 1975, and I stress that because we already have seen in the course of the past year a decline in personal, real personal disposable income per capita. This would be a further decline.

The budget deficit is reduced by spending cuts, but as you can see from these numbers, the reduction generally is less than the $10 billion change, and that, of course, is because as we get lower levels of economic activity, we also get reduced tax collections; $10 billion of spending cut reduces the deficit by only some $5 billion.

Finally, let me say that we have worked out in our simulation 5 a public expenditure program, and it is indeed true that a public expenditure program of approximately the magnitude that we have indicated here would go a long way toward offsetting the employment impact of a $10 billion spending cut, and it turns out, in fact, that we would get a reasonably favorable result on the inflation rate as well.

Let me turn now to the last part and make some comments about our appraisal of the implications of these results on budget policy and inflation. To a very substantial degree, inflationary pressures have been built into our economy. The present inflation reflects forces and policies of past years. I think we are all aware of the commodity inflation which is a result of worldwide shortages of food and primary materials. The inflationary boom in the United States and abroad has built inflationary impetus into the economy even though extraordinary demand conditions themselves are fast fading.

I think we should stress a point that I understand Walter Heller made yesterday when he said that the Federal budget alone is not

responsible. It is not alone responsible for our inflationary figure. I would like to suggest that it is time that we treat inflation somewhat the same way as we are beginning to treat insurance and, I guess, divorce. It is time we took a no-fault view of the inflation problem and proceeded accordingly.

For the near term we continue to forecast a substantial price catch-up as business firms seek to pass on cost increases and wages with escalator clauses move up.

The simulations with the Wharton Econometric Model suggest that moderate changes in the budget have only a moderate impact upon inflation over a 2-year period. This is not to say that ultimately in the case of 4 or more years a policy of demand deflation will not curb inflation, but it would do so at a very high cost in foregone output, high unemployment, and reduced social and economic mobility.

I want to stress the high cost of economic stagnation. It is not simply a matter of foregone output, the loss in the output of the people who would be working. We have to remember that a buoyant economy creates job opportunities. It creates upward mobility. It is a stimulus to technological innovation. We cannot ignore these considerations in dealing with the kinds of social and economic problems that we have in the U.S. economy at this time.

Now, after saying that, I want to also say that we cannot safely ignore excess demand conditions which are caused by budget deficits. But the present economic outlook has all the earmarks of a slowing economy, one in which demand pressures are rapidly abating, and one in which inflation is turning from demand pull to cost push. In this framework, aggregate demand policies have little effectiveness in dealing with inflation. A spending cut is not a quick cure, perhaps not even a quick aspirin for the inflation problem, and I think we must realistically recognize the limitations of macropolicy in dealing with the present inflationary situation.

Senator MUSKIE. Thank you very much, Professor Adams.

I for one can concede that in order to really explore the implications of this very useful data you have presented to us, I would have to know more about the subject than I do. But, in any case, I will undertake to begin some questions. Because several members of the committee are here, we will again adopt the rule of limiting each member to 10 minutes on the first round. That does not limit you. If a member asks a question at 9 minutes and 60 seconds into his time, by all means answer it adequately.

With respect to your assumptions—you have chosen five alternatives. Do any of those five constitute a sensible or sound policy, given our present situation?

Professor ADAMS. Well, I suppose that I would myself actually choose a sixth alternative. We really need an alternative that does not have an expenditure cut, but an alternative that does have a public employment program, because our forecast does indeed show an increasing slack over an extended period, and unemployment rates that are rising to levels that are becoming very uncomfortable.

On the other hand, I think the thing to stress is that budgetary decisions and expenditure decisions must be made in light of what are the Nation's needs. This is a case, at a time where we have developing slack and where we can weigh the needs of the Nation somewhat more

heavily than we can the details of the budget balance or surplus. And it is in the light of that that I would think I would not opt for a budget cut for inflationary reasons.

I would opt for economy yes, but I would not make the macropolicy considerations dominant in the budget decisions.

Senator MUSKIE. With budgetary cuts made with sound reasons, you would have the same economic impact as with budgetary cuts made for unsound reasons, would you not?

The $10 billion that you cut in some of your assumptions would produce the same economic results, whether those cuts represented the elimination of genuine waste or unnecessary programs, or whether they eliminated justifiable programs. The economic impact would be the same?

Professor ADAMS. Yes.

Senator MUSKIE. What puzzles this layman is that $305 billion did not mean anything to anybody until a President announced it as his budget ceiling, and now it becomes the focus of disagreement between those who believe in budget cutting to deal with inflation and those who do not.

But what makes $305 billion magic? Was it the result of sound economic judgment on the part of the President's advisers when they chose if, or did it become accidentally the benchmark for sound budgetary expenditures in terms of the state of the economy? Why did it become that magical and now become the focus of all our attention?

Professor ADAMS. Of course the $305 billion is, as you pointed out, a result of a long process, and a result of a process that did not altogether disregard economic considerations.

In the first place what these calculations suggest to me is that from the point of view of inflation policy, it really does not make that much difference whether that number is 300 or 305 or 310, or 295, and that we ought to look closely at what types of programs does it support and what are the needs of the economy.

And I find it very hard to justify a cut from 305 on the basis of macroinflation policy. That is as far as I can go with it.

Senator MUSKIE. You find it hard to justify. What are your reservations about cuts below $305 billion?

Professor ADAMS. My reservations are that cuts in the budget will have little effect on inflation at this time. They will, however, have an effect on GNP and on unemployment.

Senator MUSKIE. Let me address myself to a point made by Dr. Burns yesterday.

He argues—and I certainly cannot put his argument as effectively as he can and I do not pretend to—that there is a psychology about this all, that the American people are disturbed, they are fearful that they are in the grip of uncontrollable economic forces, including an enormous Federal budget, and that evidence of the determination of Congress to exercise discipline in this respect by means of a $10 billion cut would have a sizable, even though unmeasurable at this point, economic consequence.

It is clear that that point of view is having its effect on the Congress. Every appropriations bill represents substantial pruning by the Appropriations Committee. The Senate yesterday approved the cut of $5 billion in the defense budget. It is clear that the Congress, pro-

ceeding under its present momentum, could cut from $5 to $10 billion, that those cuts will represent a consensus as to where waste and unnecessary spending, whether for defense or for other purposes, can be postponed or eliminated.

Are those wrong kinds of judgments to make at this point?

Professor ADAMS. Well, I think, Senator, there are two considerations which you bring out.

One of them is the question of psychological impact. A cut that is symbolic of our feeling for economy and it is very hard to evaluate psychological impact, I hardly believe that the American public will be greatly swayed by a cut which represents 3 percent on a budget of $300 billion plus.

The other question, the other aspect, I am inclined to agree with you if in fact it can be shown we were cutting fat rather than cutting muscle. Then I am all in favor of cutting fat. And then I think the calculations suggest that there are programs, specifically a public employment program, which will offset any macroeconomic impact of such a cut, then I would be in favor of it.

Senator MUSKIE. Would the new programs have to offset the cuts in your judgment?

Professor ADAMS. Well, it would help to offset the impact of unemployment, for instance.

Senator MUSKIE. In your tables you have mentioned the cumulative effects on the inflation rate of the various alternatives.

What are the cumulative effects related to unemployment?

Professor ADAMS. What do you mean, sir?

Senator MUSKIE. I am going again to Dr. Burns testimony yesterday where he said that in the first year, the impact of a $10 billion cut on the rate of inflation might be on the order of a reduction of that rate by one-tenth of 1 percent, according to his figures. The second year that reduction could go up to 0.2 or 0.3 percent, and so on. He commended that cumulative effect as the benefit to be derived from that kind of a cut in the budget. He did not address himself to the cumulative effect on unemployment that might result, and I thought perhaps we could get some insight from you on that point.

Professor ADAMS. The inflation rate impact does also accumulate somewhat. Another way our calculations were done, we imposed the changes on budget policy for fiscal 1975 and for fiscal 1976 meaning in effect, imposed them immediately over the whole eight quarter forecast. The numbers I have given you on the economic conditions are for calendar year 1975, meaning that we have some months for this policy to begin to have an impact on the economy. As we look further ahead, there is some accumulation of the impact, but the accumulation of the impact on unemployment is not nearly as big.

In fact, I note here in looking at the numbers that by the time we get out to mid-1976, and second quarter of 1976, we show an unemployment rate of 6.8 percent for our base solution and 7.2 percent for our solution with a $10 billion decrease in purchase of goods and services.

So you see that has not really accumulated at all. That is the same 0.4 number which is the ninth number in the alternative 1 column. So that does not accumulate any further.

On the other hand, as we go out the inflation rate does come down somewhat more and by the time we get 2 years out to mid–1976 the inflation rate is a full 1 percentage point less under alternative 1 as compared to a half a percentage point.

Senator MUSKIE. I think my time is up, Professor Adams, so I will yield to Senator Dominick.

Senator DOMINICK. Thank you, Mr. Chairman.

Professor, I have always had a great respect to the Wharton School of Business and I read your statement here with some amazement.

Would you classify yourself as a pessimist?

Professor ADAMS. I wish, sir, that I could classify myself as a pessimist.

Senator DOMINICK. Well, if you do not, then what you are saying to us is that it does not make any difference what we do here in Congress, any kind of a cut in the budget is bad for the economy, bad for unemployment, does not affect inflation and does not do any good. Is that not the net effect of your statement?

Professor ADAMS. I would say that a budget cut is an economic policy at this time which is likely to have little impact.

Senator DOMINICK. Well, then, why should we not have a $500 billion budget, then? Let us spend some more money.

Professor ADAMS. I do not think you would want to swing with extreme numbers. This is clearly a measure of the impact, given the relatively small range of changes that we are talking about.

If we were now suddenly to impose on the economy an extremely large sudden program of another $300 or $500 million on the budget, you would see quite perceptible macroeffects.

But when we are talking about magnitudes which we are considering now, the effects are not very discernible, particularly since we have an economy where we have and are developing some spare.

Senator DOMINICK. Under your statement, however, any cut that we make will increase unemployment, will reduce GNP and will have no effect on inflation.

Professor ADAMS. It will have some effect on inflation, very little.

Senator DOMINICK. If that is your thesis, why would not increasing the budget thereby helping unemployment, increasing the GNP and presumably do something with inflation, I do not know what your thesis would be on that.

Professor ADAMS. One alternative I think one could validly consider at this time would be the alternative of a modest tax cut, directed at precisely those people who have suffered greatly from the pressure of declining real income, and I might well argue that psychologically and in terms of inflationary pressures and pressures on demanding higher wage increases, a small tax cut might have some positive payout.

Senator DOMINICK. I was not asking you about a small tax cut. I was asking you about an increase in expenditures.

Professor ADAMS. All right. I think that if the needs of the economy at this time, the public program needs, require an increase in spending and an increase in spending on sectors of the economy that are soft, it might well have a favorable impact.

Senator DOMINICK. Now one of the soft areas is lack of investment capital, is that right?

Professor ADAMS. Yes. Although for the moment, the real investment sector, the construction of plant and equipment, is the one sector of the economy that does have great strength. The funds are not available but in terms of the backlogs and the strains on production capacity, investment happens to be the one sector that is still moving ahead quite strongly.

Senator DOMINICK. Well, if funds are not available, how does it move ahead, except by internal funds which means the consumer pays for it?

Professor ADAMS. Well, partly by internal funds and partly by the ability of the industry to bid funds away from alternative uses.

Of course, the clearest example of that is the abysmal weakness of the housing market.

Senator DOMINICK. Well, the abysmal problem of the housing market, which we would all agree is a rough field, is because they do not have enough money to lend out at rates that people can afford to pay. And as I understand your statement, a cut in our budget would not help at all inflation. It would not do anything on the interest rates and it would create unemployment, and would not do any good as far as GNP is concerned. So I am presuming that housing is built in, is that right?

Professor ADAMS. Yes. You could well do with some loosening of monetary policy, particularly a loosening of monetary policy which might direct more funds into the housing market. That is a slack area.

Senator DOMINICK. So you are saying we ought to be printing more money, is that right?

Professor ADAMS. No, I would hesitate to say that.

Senator DOMINICK. Well, put it another way. We do not have any metallic limitation on the amount of money that can be issued any more, so presumably we could print as much as we wanted and what you are saying is, if I understand it correctly, that Dr. Burns ought to be easing money policy and thereby getting more money into circulation.

Professor ADAMS. Well, the only response I can make is that I am basically not a pessimist. I view myself as relatively conservative in some of these issues. I do not think we should swing wildly. I do not think that we should print vast quantities of money but I think we should look at the needs of the economy and we should realistically recognize that the macronumbers on the aggregate of numbers on the budget, whether it is 305 or 310 or 295, or whether the budget deficit is $10 or $15 billion, that alone does not help very much with the inflation problem and we should be guided in our choices by, to a substantial degree, by what are the the pressing needs of the economy, keeping in mind at all times that the economy, what is necessary, and the waste must be avoided.

Senator DOMINICK. Secretary Simon said that the financing of the Government debt now absorbs 62 percent of the total money that is available for the private industry, for borrowing and so on.

If we incease, as I understand it, the spending bill, it would be good for unemployment but it obviously is also going to increase the debt and thereby necessitate even further inroads on the available funds for financing the debt.

Now, how do you get around that problem?

Professor ADAMS. That raises some difficult questions for monetary policy. I do not believe that we should print money recklessly. It is clearly not a good policy. On the other hand, the Federal Reserve is well able if it wants to to accommodate a modest increase in the debt and that a policy of 6-percent growth in the money supply at a time when current dollar GNP of the economy is rising, the level of transactions if you like is rising at 10 percent, is clearly a very restrictive policy and there may well in the slackening economy be room for some greater expansion in the money supply and accommodation by the Federal Reserve to deficits.

Senator DOMINICK. My time is up. Mr. Chairman?

Senater MUSKIE. Senator Moss.

Senator Moss. Thank you, Professor Adams, for your presentation. I do not know whether I would get a very high mark in your class. I am having a hard time absorbing what you have been saying but I do have two or three questions I would like to ask. On page 8 your table shows that a $10 billion cut in Government spending for example on defense would have four times the anti-inflation impact as a cut on the transfer programs such as social security, and also costs about four times as much in unemployment.

Are there certain areas where budget cuts could have a greater impact upon inflation without having greater impact on unemployment?

Professor ADAMS. I am not sure whether we can conclude that. The two things are closely linked. You see, the cut in goods and services is a cut which impacts in real terms immediately on the economy.

It is a cut which also impacts on elements of the economy that we normally associate with it.

For instance, on inventory, goods in process inventories and Government orders are not translated immediately into goods. It takes time, as the orders are processed, and as the work is carried out until the goods are delivered, and this shows an upsurge as a result in inventory investment and in various ways.

Consequently the demand for goods and services is more stimulated when the Government orders goods and services directly than when we simply have an increase in transfer payments and the consumer allocates his spending or saves some of it and allocates the rest along a series of goods where the tightness of capacity is not so strong. The inflationary impact is very closely linked in this framework and I think in the economy too the real impact of the change on demand and economic activity and it is quite clear as you point out that the impact on real GNP of the $10 million cut on expenditures and purchases is $5 million, about twice as much as in 1958 dollars as the impact of the reduced transfer payments.

And I do not think that there is much opportunity for redirecting activities in such a way as to maximize the inflationary impact and minimizing the impact on output.

It is an interesting question though.

Senator Moss. Suppose we were able to offer tax relief to those in the lower brackets and match the lost revenues by increasing the loopholes area. What would be the impact on inflation on jobs?

Professor ADAMS. Well, certainly there would be some positive impact. I am not prepared to give you a quantitative answer off the top of my head but there would be some quantitative impact in terms of

increasing real output and jobs. You would be drawing from sectors of the economy which do not spend so much out of their current income and you would be redirecting funds toward people who would tend to spend all or much of the tax relief that they would obtain. You would get some positive impact on real output. You would get some positive impact on unemployment. I think in the present world you would get very little inflationary effect.

Senator Moss. Is the reason that you say there will be only moderate changes in the budget and moderate impact on inflation over a 2-year period because of the relative size of the Federal budget with the GNP, that it is not big enough in the whole GNP to have that much impact?

Professor ADAMS. That is only one reason and you are quite right, that is one reason. We are talking about $10 billion in a large world.

The other reason is simply that in this phase of the business cycle, as we see a slackening of economic activity, it does not transfer quickly into lower prices. The inflation process is a cost push process that is fueled by price increases in the past. We would not expect the reduced pressure on capacity to be quickly translated into a slackening of inflation.

In fact, one of the problems is that as the economy slacks we find that we lose productivity. The same work is spread over a larger number of people and then businessmen through their accounts discover that productivity has dropped and unit cost has increased and they come back and say now we have to increase prices. Consequently there is some of this reverse effect. As the economy slows down the loss in productivity also tends to translate into higher prices and you have an economy where prices are very much determined.

Senator Moss. Are we now in what you call a soft economy?

Professor ADAMS. I would say that we are very rapidly going into a softer economy. It is a very unbalanced economy. The investment sector is still quite strong, but there are many soft sectors of the economy, housing, automobiles, durable goods of various kinds.

Senator Moss. And on page 2 you are saying in a soft economy increased spending may promote real economic expansion.

Would that indicate that rather than exacting the cuts that we are making now in all of the Federal budgets we ought to be considering budgeting the full amounts or even increasing them?

Professor ADAMS. Yes, as I said earlier, I would hesitate to swing wildly. I would want to put a limit on overall spending but an increase in expenditures, if it is required by the underlying needs of the economy, probably would be little harm and might provide a stimulus in certain areas. It is not something that I would like to propose but it is not something that should be entirely ignored.

Senator Moss. Do you think we have fallen into maybe slogan thinking, thinking you just cut the budget and thereby reduce inflation and everything will come out all right? Do you think we are making a mistake in that regard?

Professor ADAMS. Yes.

Senator Moss. Thank you. Thank you, Mr. Chairman.

Senator MUSKIE. Senator Javits.

Senator JAVITS. Mr. Chairman, I am very much interested in the projections, Mr. Adams, which you have made, and find the alternative No. 5 very much, very congenial to my own thinking.

Alternative No. 5 which you developed is the reduction of $10 billion in Government purchases combined with a public employment program worth $3 billion.

I gather you are figuring $7,500 per job, is that right?

Professor ADAMS. Yes. However, that is not $7,500 of wages paid out. That involves really the assumption that there is some overhead.

Senator JAVITS. I understand.

Professor ADAMS. So we are talking about $5,000 or $6,000 per job.

Senator JAVITS. But the rate of Government expenditure would be at the rate of $7,500 per job so we can move them up or down in that order. I think that is a good figure and I accept that. It is more than Dr. Burns' figure and a little bit less than mine, which is $8,000.

Now, assuming then that I like your alternative No. 5, and generally speaking I feel that it is the direction of policy we ought to take, I would like to crank two other things into it. One is a 10 cents per gallon tax on gasoline or a similar tax raising measure. I wish we did have time for effective tax reform on an overall basis to more equitably distribute the burden of taxation but I doubt that is possible currently and quickly, so the surest and quickest way would be to increase the tax on gas as I am deeply devoted to a conservation program anyhow, and that would discourage consumption, which is good, and to pay that off with a tax cut for the lowest income groups who are the most heavily impacted by inflation.

So many millions of people in the country whose wages and salaries nobody is collectively bargaining for except we in the Congress and question, which may be a rough question to ask you, but nonetheless you have worked and you are kind of playing with this machine all the time, maybe you could give us some guidance.

Assuming that we are going to cut the budget and we are, and I think our chairman is absolutely right and Senator Dominick, it is just unthinkable that we will not, whatever may be good or bad those are the facts of life, it is like telling me you know, controls woud be a good idea right now, well, there ain't gonna be none.

So what I would like to ask you is this. Expanding your alternatives with the inclusion of a tax on something like gas, and an accommodation to what for the millions who are not subject to collective bargaining, for what collective bargaining is going to do for other millions who are, will you have any opinion on how that equates out in terms of rationality and benefit in the fight against inflation or would you like to take it back and give us an answer?

Professor ADAMS. I guess I can comment on what is indeed a rough question, and I suspect that in terms of macroeconomic impact—and you know, one of the advantages of working with the model as we do is that you do either quickly learn something about the responses, and you ask yourself whether the economy does respond realistically to the changes that you make; that you develop some judgments about the nature of the responses that will occur—and the answer is that the macroeconomic impact of such changes, in the short run, you are offsetting an increase in the gasoline tax with a change in taxes on lower income groups; the effect on overall output, is likely to be small.

Let me raise one note of caution—two notes of caution. The first note of caution is a 10 cent increase in the price of gasoline will show up as an increase in the CPI, and not only will it show up as an in-

crease in the CPI, but it will translate into an increase in wages through escalator clauses. So that it is distinctly inflationary in its own right—how much is a matter of calculation—but it will show up in the CPI. And then we will have a subsequent effect through the impact of higher living costs on wages. And a second caution is that that means that it is likely to be a very arbitrary change. It is arbitrary in the sense that those of us who are driving old, gas-guzzling cars, those of us who live in the parts of the country where we are dependent upon cars, will be more affected than others. It is arbitrary, also, in the sense that those people who are upon price-wage escalator clauses will be able to offset this increase with substantial impunity through the automatic operation of this mechanism, and that would make it very difficult to find the tax formula which will set the impact on the specific lower income groups that are doing to be affected.

But to answer your first—to go back to the first point in terms of macroeconomic impact, it is one way of handling the budget without a substantial macroimpact, except for the inflation.

Senator JAVITS. Do I take it, then, that the Consumer Price Index figures do not reflect the overall total in the cost of living? Because in your note of caution, you omitted a reduction in consumption. In other words, if an individual is earning $200 a week, and if that individual is paying 65 cents for gas instead of 55 cents, and that individual uses less gas, do we reflect it in the CPI, or do we reflect it only in the fact that the individual gallon costs more?

Professor ADAMS. Correct.

Senator JAVITS. That is the distortion, that figure; that the figures may be cockeyed, but the facts will not represent an additional inflationary force, except that the words and letters of the collective-bargining contracts do not reflect what is the actual increase in the cost of living. They only reflect the percentage increase at a particular price.

Is that not correct?

Professor ADAMS. That is substantially correct.

Senator JAVITS. In other words, if a fellow stops using his car to go down to the corner drugstore for an ice cream cone, that is not reflected in the CPI; and yet that is the vicious thing that we have got right now, when we have so quickly forgotten what happened to us only a few short months ago.

Is that not correct?

Professor ADAMS. Yes. The CPI has a fixed base index, and the CPI will immediately translate this into higher consumer prices, and that in turn will go into the price estimate.

Senator JAVITS. So if we went the gasoline route, we should couple it with a massive Federal drive for conservation, like we did in the early days of this year, and we should do something about dealing with its effect on the CPI. After all, we can change the CPI in the same law in which can pose a tax, can we not? The Bureau of Labor Statistics is bound by law, is it not?

Professor ADAMS. Yes. I do not believe they are bound by law in the formula for the CPI, but it is not an unreasonable formula. Perhaps one should add that calculations of response of consumers to higher gasoline prices show that the response in the short run is quite small. This is only realistic if we visualize that a consumer is substantially

stuck in terms of gasoline consumption by the size of the vehicle which he drives, particularly at the low income end of the distribution. The consumer is not in a position to quickly shift from a large, old car that uses lots of gas to a small, efficient new car.

So that indeed, if the consumer is going to use less gasoline, he is going to have to use less gasoline by walking to get his ice cream cone, rather than by driving, as you point out. Now, that does impose a burden on the consumer, and one that the statistics seem to indicate he does not want to assume.

Senator JAVITS. Mr. Chairman, my time is up. I would just like to observe that we could accomplish the same result by excess profits taxes on the old companies, if they were big enough, and that would not be in the CPI.

Mr. Chairman, as I shall not be here for the other witnesses—I read their statements, and they are excellent—I ask unanimous consent that I may submit them some written questions which, when replied to, should be made part of the record.

Senator MUSKIE. Without objection.

Senator Mondale?

Senator MONDALE. I wish to commend you for a very perceptive and helpful approach to this whole problem. It underscores the complexity of the absence of a simple solution.

I just have one question. It seems to be that from your analysis, public service employment stands out as a powerful tool both to help cure inflation and unemployment, and that the pickup of revenues make it a fairly inexpensive strategy as well.

Is that correct?

Professor ADAMS. Yes, that is correct. In terms of the number of jobs per dollar, public service employment is a very effective tool. As an economist, I would like to add that we want to be quite sure that public service employment does not turn into a WPA; that these are indeed useful jobs, that they are jobs that perhaps have potential for training and development of the individuals involved. But as programs go, per dollar of money spent, the payout is quite considerable.

Senator MONDALE. What did you calculate the cost of those payments to be?

Professor ADAMS. The cost of such a program?

Senator MONDALE. Per job.

Professor ADAMS. $7,500 per job.

Senator MONDALE. If I read the table on page 9 of your statement correctly, alternative 5 is a $10 billion spending cut in purchases, with an add-on of $3 billion for public service jobs. But it shows a net decline of some Federal revenues of $3.7 billion. Should that not be a net increase in revenues of $3.7 billion?

Professor ADAMS. That translates into a change in the deficit, and that last number there is a plus $3.7 billion. The deficit will be $3.7 billion less than it would in our base solution. You see, we have a $10 billion cut in spending, and you offset that with a $3 billion increase in the public expenditure program; and then, of course, some other endogenous changes. And the end result of this combination of circumstances is a budget deficit which is $3.7 billion less.

Senator MONDALE. Thank you.

Senator MUSKIE. Senator Abourezk.

Senator ABOUREZK. You said that we had gone from a demand pull to a cost push type of inflation. I wonder if you might be able to say exactly, or roughly, when the demand pull started, and what caused it; and at what point did it shift to a cost push type?

Professor ADAMS. Of course, the timing of these phenomena is difficult to pin down, because it is a wage-price spiral. It is a highly interrelated situation. Some economists trace this back to the late 1960's, and the Vietnam war expansion; and I think one can well trace it back to that. But if you look at the inflationary numbers that we are facing this year, it is all a very different order of magnitude. It is all a very different order of magnitude as of last year. Most economists did not predict this present inflation. In a very substantial extent, it is attributable to the circumstances that are beyond our control the peaking out of the business cycle the world over, the very sharp increase in demands for primary materials, the failure of harvests at a time when consumer demands and expectations were rising all over the world, including the Soviet Union; the effort by the Middle Eastern countries to put us over a barrel, so to speak, with regard to oil prices. All of these elements are really not elements for which one can fault present or past administrations. I am not saying things could not have been handled differently, but these are problems that are outside of the economy. There are others that have not been mentioned—the impact of the devaluation of the dollars—and these factors have been built into the economy in the past year; our own demand situation, our use of capacity rose very high, investment demands were very high, and all of these forces came together, I would argue, with the third quarter of 1973. And the remnants of these forces are with us now.

I cannot pinpoint precisely when the cost push element became dominant. In some fields, the cost push element is dominant now. Take the automobile industry. In other fields, there is still demand pressure, but these demand pressures are beginning to fade, and they are gradually shifting from a situation where the cost push element of inflation has become dominant.

Senator ABOUREZK. Well, if the cost push element is not dominant, what would the effect now of a tax cut on the lower income levels, or a cut in payroll taxes—that might be an indirect cut for these people who were given more income—the effect on inflation, that is what I mean.

Professor ADAMS. It depends a little bit on where you put it. Our alternative here, the cut in taxes, does not show much effect, but that is an alternative that assumes a broad based cut in taxes; some on corporate, some on personal. An alternative on what I think you are saying is that, suppose you cut the tax on the employer's contribution to social security. I think that would have a quite explicit impact on inflation. It would reduce labor costs, and would in fact tend to reduce the need to markup. You see, it works both ways. The recent increase in the minimum wage—many of us would support that, but nevertheless, realistically speaking, an increase in the minimum wage does increase labor costs, and passes along higher prices. In many cases, if you at this time cut the employer's contribution to payroll taxes, you might have some greater impact on inflation than his impact in this kind of connection.

Senator ABOUREZK. What about then, if that would have a beneficial impact, what of cutting the employees' share of payroll taxes?

Professor ADAMS. Well, that would also have an impact, but I suspect not as much, not as direct. It would have an impact, basically, really, in increasing the employee's purchasing power, and his ability to buy goods. In that sense, it would stimulate activity somewhat. I do not think it would have much effect on inflation. The only possibility which one might well consider is in the context of this social compact that people have talked about, talking to labor leaders and saying, we, in exchange for moderation in your wage demands, we will try to ease the pain of inflation by reducing some payroll taxes on the employee, for instance. And I think, in that sense, it might be helpful.

Senator ABOUREZK. Well, would you say—would it be fair to say that, since cost push factors are now dominant, that that kind of increase in disposable income would not increase inflation?

Professor ADAMS. That is correct.

Senator ABOUREZK. Now, one other question. If you had the power to decide for the Government, for Congress, and for the administration, what ought to be done about inflation to stop it, what would you say should be done?

Professor ADAMS. At this phase of the cycle, I would try to be much more active in what economists would call microeconomic policy; that is to say, I would counsel moderation in the definition of the budget, I would counsel moderation in monetary policy. I would argue——

Senator ABOUREZK. In what respect, when you say moderation? Would you moderate the restraints, as they are now being done?

Professor ADAMS. Some easing, yes; and because, I think marcropolicy, at this time, does not have much impact on inflation, I would turn in the direction of much more specifically oriented policies. One is the proposal for a monitoring agency on wages and prices. I understand the days of wage and price controls are past, but some monitoring agency certainly is appropriate. And then I would ask, what other elements are there in our economy of a micronature that tend to inflate prices? One of them is farm policy. A significant question needs to be asked about whether we need export controls on farm products; and even more significant is the question of whether we need import controls when the prices begin to sag. That is an area where we are saying——

Senator ABOUREZK. You are saying the question is always there. But what would you do about it? How would you answer the question on farm policy, for instance?

Professor ADAMS. I would answer the question in the direction of temporary export controls on farm products, and a total relaxation of impact restrictions.

Senator ABOUREZK. And what else would you do?

Professor ADAMS. I would examine very closely our regulatory policy with regard to its inflationary impact. Regulatory policy, for instance, on the airlines, trucks, public utilities.

Senator ABOUREZK. You would have more free competition in regulated industry?

Professor ADAMS. Yes.

Senator ABOUREZK. Anything else?

Professor ADAMS. Yes. I might add the easing of interest rate policy and monetary policy would also help somewhat favorably, in terms of the interest of cost consumers.

Senator ABOUREZK. You mean you would lower the interest rates?

My time is up, but I thank you.

Professor ADAMS. May I add one comment?

Senator ABOUREZK. Please, go ahead.

Professor ADAMS. I would like to add briefly only that I would go ahead and take a very careful long-run view of where are the capacity shortages, why did they arise, where is the pay-out from additional technological developments, and I would try to develop policies by, perhaps, selective treatment of our credit flows, perhaps by a tax incentives to see expansion, to push supply in those areas—energy being one of them—where supply is likely to be short, where stimulus for technological development might pay off.

Senator ABOUREZK. Thank you very much.

Senator MUSKIE. Senator Chiles.

Senator CHILES. You were telling us that we were shifting now from a demand pull to a cost push.

Professor ADAMS. Well, because slack is beginning to appear, the pressure on the demand is easing.

Senator CHILES. Well, now, you are telling me—but why?

Why is it beginning to appear? Why is it slack?

Is it the inflation, the double-digit inflation?

Is it the interest rates? Why?

Professor ADAMS. Well, we have had, in the course of the past year, quite a restrictive economic policy. We have had very tight money policy. The Federal budget has not been stimulative to the economy.

Now, in a somewhat more complex way, I would also argue that—and this is a result, as we know of double-digit inflation—we have had some shift in the income distribution away from the consumer. This is the first time in a generation that we have had a real decline in per capita consumer income.

Senator CHILES. Well, you could not run forever in the demand-push inflation, could you, without having some effect when you get into double-digit figures of inflation?

Professor ADAMS. No, our past experience has illustrated this on numerous occasions, that you get to a phase in the cycle where the demand-pull gradually is translated into a cost-push situation, which is characteristic of this stagflation kind of a period.

Senator CHILES. Now, you said that the economists did not predict this, that this slipped in this year.

Why would the model not show this?

Professor ADAMS. The model shows a good deal of the domestic interrelationships in the economy. The model really is a tool which must be used by an experienced economist; it is not a replacement for reality. And a model does not really recognize the foreign sector. It is at present still an element which is, using our word, exogenous; it is outside the model system. The estimates of foreign prices are outside this system.

We did predict the rapid rate of inflation; but it is these outside forces which have had a very substantial impact on inflation which the model does not predict. The analyst has to evaluate them and put

them in. I am afraid that most economists were in the same boat. We really did not appreciate how strong, how rapid these inflationary elements would be.

Senator CHILES. Well, that gives me a little concern, because if we could go all the way from—if we could change completely the cycle and nature of the inflation, as well as the rate, then I am concerned about the model that you give me today that says if we do this and we get this picture, and if we do this, we get this picture. Next year, you know, you might be back here telling me that there is something else that we missed.

Professor ADAMS. Well, I hope not. But I will grant you that if tomorrow the Arabs quadruple the price of oil, that would be a certain element that we have not taken into consideration. But there are external forces which buffet the economy, and we try to foresee these external forces as well as you can. Your basic tool describes the internal workings of the system and, given some reasonable assumption about these external circumstances—and there are indeed such assumptions behind this forecast of alternatives. Except for one thing, the assumptions are the same for the control and for the five alternatives, given that set of assumptions.

Senator CHILES. Now, you mentioned to Senator Dominick's question—he was talking about if you stimulated spending, and you got into whether the needs would be there to stimulate it or not.

But, regardless of the needs, just what would the model show if we increased our deficit this year by another $25 billion? What would the model show; or $15 billion?

Professor ADAMS. The answer is that the model would show an expansion of real activity, an expansion of current dollar change peak, and some impact on inflation, but not that large a one until you begin to give me a budget deficit number, or an expenditure number, that has got to be so large where we would again impose pressures on capacity and employment.

What our forecast, essentially, tells us is that there is slack. And the impact on inflation will not be so large until more of that slack begins to be absorbed.

Senator CHILES. I am trying to understand that. You mean that until you have enough money stimulated that you went back on the demand-push?

Professor ADAMS. Yes.

Now, it is a matter of degree. But that is right. If we came in now and begin to impose upon the economy again the kind of demands that we imposed in 1965, 1966, we would certainly find ourselves back on that same inflationary track.

Senator CHILES. Then we would still have inflation. it would just be back to what it was before?

Professor ADAMS. Well, it would be more.

Senator CHILES. What steps could we take, if any, to change the inflationary rates? Your figures are showing, you know, like 1 percent; if we wanted to change that rate to 4 percent, or reduce it 4 percent, what should we do?

Professor ADAMS. I am not sure that we have that option in the short run. Unfortunately, this is a very intractable problem, and it is one where, even if we went full speed ahead with deflating the economy and turning toward the kinds of measures that I talked about, I doubt

that you could really have that much impact on the inflation rate in the short run.

The only way you could achieve that kind of objective is by really interrupting the wage-price spiral—I am not advocating this—by imposing controls or by, possibly, something that has not been considered, by possibly imposing some limitations on the price-wage escalators. Only by doing that could we really slow down the inflation rate to the degree that you suggest.

Senator CHILES. How would that slow it down, taking your other kinds of calculations into consideration, that when you reduce these other factors you reduce GNP and you reduce tax revenues, and, therefore, you have these kinds of effects?

Professor ADAMS. Well, we would begin, I suppose, by deflating the economy. We would get smaller dividends in terms of a reduced inflation rate out of that, but we would then proceed to all of the micropolicies, and we would get some improvement. Then, I am not sure that we would to do that, but we would presumably impose additional constraints, wage limitations, or say, escalator clauses are permitted but only if, instead of giving the wage increases 1 percent for every 1 percent increase in prices, maybe we will only let people have one-half of 1 percent or one-fourth of 1 percent for every 1-percent increase in prices.

If we imposed that kind of policy—it is doubtful that we would want to do that—it might get a quicker reduction, but it might not be worth the price.

Senator CHILES. Why does alternative 5, which has a $3 billion public employment program along with a $10 billion budget cut give you a lower inflation rate than alternative 1 which is a straight $10 billion budget cut?

Professor ADAMS. I am glad you mentioned that. That is a mixed phenomenon. That is to say, I would not take that difference between the, I think it was, 0.5 in alternative 1 and 0.8 in alternative 3, I would not take that too seriously. It is perfectly correct, but it is a result of the fact that in alternative 3, the Government sector, and specifically the Government sector with employment at a low rate, is represented somewhat more heavily than in alternative 1. You might note that one number down, the impact on the personal consumption inflator is the same in both of these alternatives. You can see it is 0.6 in both case No. 1 and case No. 5.

So I would not take that difference too seriously. It is a matter of the way this particular deflator is calculated, and a change in rates.

Senator CHILES. Thank you.

Senator MUSKIE. Senator Biden.

Senator BIDEN. Thank you, Mr. Chairman.

I, from your testimony, Professor Adams, it seems as though inflation is really not our major problem that you are concerned with. It is how do we readjust the impacts on the economy of inflation, the inflationary picture which you are in effect saying we are not going to be able to really do much about, and so why do we not worry about where that impact is going to be, and maybe make adjustments accordingly, and I think it is a very sensitive consideration. One is obviously on unemployment, and the sector of the economy that gets hurt most by this continued inflation.

Is that accurate, or generally accurate?

Professor ADAMS. I am not prepared to put it quite that way. I focused the testimony deliberately on the macroissues on the budget, in view of your being the Budget Committee, and I think what I would put first, before joining what you said, I would say that macropolicy right now is not a good tool, and that we should surely examine all of the micropolicy alternatives that are open to us, but then after that, I would agree with you that a certain amount of this inflation is inevitable, and we will need all tools.

Senator BIDEN. As a practical matter, in your estimation in the model that you have constructed, there is no realistic possibility in the very near future, in the next 2 or 3 years, that we are going to move from double digit inflation down to 4, 5, 6 percent, is there?

Professor ADAMS. By the end of 1976, by mid-1976 we do get to a point where the inflation rate is 5 and 6 percent, which is a significant improvement from where it is now. By our present standard, that is great. By the standard that we imposed in the 1960's, that is still a very high level of inflation.

Senator BIDEN. What is the unemployment rate at that point?

Professor ADAMS. Excuse me?

Senator BIDEN. According to your projections, what will be the unemployment rate at that point?

Professor ADAMS. The unemployment rate would be at that point—I can give you a number here. We come out with somewhere between 6½- and 7-percent unemployment.

Senator BIDEN. Now, on page 4 of your testimony you paint a bright picture, you say. It sounds like recession to me, on a flat economy, inflation at 10 percent, unemployment over 6 percent, and budget deficits, and then you go from there and give us your alternatives.

Now, in light of that you further say, as I understand from your testimony, that a budget cut is not appropriate. As a matter of fact, it may be counterproductive to have a budget cut. As a matter of fact, you do not say may. You say it will be, and then we get into the thing that Senator Dominick raised earlier that is slightly perplexing to me, and that is if in fact budget cuts will have the opposite impact we are looking for with only a slight gain in terms of catching up on the inflation picture, does it make sense—you have been asked this question several times—but does it make sense for us to spend more Federal dollars in order to deal with what to me looks like a recession which with the flat economy, inflation at 10 percent, unemployment at 6, does spending more money do more good than spending less money at this point?

And I know you cannot quantify it for me exactly, but generally, is that correct?

Professor ADAMS. By and large, spending decisions ought to be made in the light of what are the needs of the economy.

Senator BIDEN. Now, I am not sure what you mean by that. When you say the needs of the economy, do you mean the needs in terms of liquid inflation or the needs in terms of social needs?

Professor ADAMS. No. Quite specifically I mean in terms of social needs, infrastructure needs and so on.

Senator BIDEN. If you wish, I think we could spend $500, $600 billion easily.

Professor ADAMS. Well, obviously you have to consider the alternatives. We have in our control solution forecast not an increase in ex-

penditures to stimulate the economy, but we did put in in mid-1975 a cut in taxes of about $7 billion. That is part of the base forecast, and that reflects in part an evaluation of since we are making a forecast, an evaluation from what might develop under the circumstances, but in part also it reflects a feeling that by mid-1975, as the inflation rates rise over 6 percent, that means that we might well be prepared to provide some stimulus, and we put it in the form of a tax cut. It could well go in in the form of an increase in expenditures, if there are appropriate purposes for which the funds might be spent.

Senator BIDEN. Does it not also reflect a lack of distinction—maybe there need be none—between deficit spending and spending? It does not really matter in terms of the model, does it, whether or not we spend $300 billion, and that we have a deficit of $20 million, or we have a balanced budget?

Does balanced budget mean a darned thing in terms of your model?

Professor ADAMS. It does, but it is really a question of a quantitative impact.

Senator BIDEN. It is minuscule, is it not?

Professor ADAMS. It is small.

Senator BIDEN. It is obvious you did not write President Ford's speech.

Now, the one thing—and I have only got 5 minutes left here—the one thing I would like to get into, and I tried to raise it yesterday, and I notice the Wall Street Journal raised it today also, and that is, it seems to me that one of the things that maybe we are incapable of determining the impact of, and I think or we are ignorant of its existence, and that is the international, the implications, the international implications of our domestic policy and conversely the domestic implications of international monetary policy and trade policy generally, particularly with regard to oil and agriculture.

Now, your model, understandably—I do not know if I should say understandably—apparently does not take into consideration the world monetary situation, or does it, and was that not—have not the recent moves in terms of the international monetary situation over the last 2½ years played a significant part to our inflationary picture?

Professor ADAMS. Yes, it has, and the devaluation of the dollar simply means that foreign goods are more expensive, and that does enter into our model. The whole change of the United States, particularly U.S. agricultural markets that used to be substantially insulated from world markets, are much greater. Our much greater involvement in world markets at this time is a part of the inflationary stimulus that we have had, and the whole international monetary picture is troublesome. It does not enter, as you say, as a monetary picture, it does not enter into the model directly. What does enter in is the exchange rate for the dollar, and the cost of foreign goods relative to our products. That has a significant impact, but while these things are not explicitly in the model, they are not left out of consideration, and our appraisal of the validity of——

Senator BIDEN. The immediate impacts are put into your model, though, are they not, the immediate impacts, that is, the variation rate of exchange, the increase.

Professor ADAMS. They do impact, but the general monetary picture, does not impact explicitly, but it is certainly taken into consideration

in appraising whether this is a realistic picture of the economic outlook. We are very careful to view it in this kind of a way.

Now, I will say that these international financial developments do limit our domestic policy to some extent. We cannot afford to let the inflation rate get out of hand relative to where it is going in the rest of the world. We are probably limited to some extent in our interest rate policy with respect to monetary policy and interest rates abroad. We need, and I think there is a psychological element here, we do need to assure the foreign countries and the holders of some of these large quantities of cash that are floating around in international markets, that we have a stable economy.

Senator BIDEN. Well, I have a minute left and I have a number of other questions. I would like to ask permission of the chairman to be able to submit them in writing rather than taking the time now, and I would like to finish up with one question I asked yesterday, and that is that there has been a good deal of speculation about the stability of our financial institutions, and you have been talking today about the investment sector being strong, and it is healthy, and in the Washington Post in a long story about this on August 4, which among other things quoted David Rockefeller as saying that "the situation is uncertain enough that one should not discard the possibility of panic."

Do you believe there is a serious problem worldwide involving the instability of our financial institutions, and for that matter, the financial stability of other nations?

Professor ADAMS. I wish we could formulate our forecasts like a weather forecaster who has a 10-percent probability of rain. You cannot go wrong that way, and I think that this kind of a question must be answered in those terms. The risks of probabilities of failure, of panic, the risk of the solvency of the Italian Government has serious financial problems. The risks are much greater this year than they were a year ago. That does not mean that I anticipate such failures, but I would be conscious of the risks.

One of the elements is—and this is one of the elements that I factor into my suggestion earlier, that we moderate the stringency of our monetary policy. The risks of difficulties like that are much greater than they used to be, and I would rather play it safe and avoid those risks.

Senator BIDEN. My time is up. Thank you very much.

Senator MUSKIE. Thank you very much, Dr. Adams, for your very interesting testimony.

All members of the committee obviously have other questions in mind, and I am sure that there will be no objection to the submission of questions to you, provided you have the time and the willingness to provide answers for the record.

Our next three witnesses constitute a panel this morning. The Honorable Paul C. Warnke, Assistant Secretary of Defense, Prof. Murray L. Weidenbaum of Washington University, former Assistant Secretary of the Treasury, and Alice M. Rivlin, senior fellow at the Brookings Institution.

Good morning. Welcome to you all.

I think it might be helpful of we invite each of the witnesses to present their written statements before we embark on questions. Otherwise I can foresee our being here late into the evening. Let us begin

with Mr. Warnke and then proceed through Mr. Weidenbaum and Ms. Rivlin to carry the anchorload.

STATEMENT OF HON. PAUL C. WARNKE, ASSISTANT SECRETARY OF DEFENSE; PROF. MURRAY L. WEIDENBAUM, WASHINGTON UNIVERSITY, FORMER ASSISTANT SECRETARY OF THE TREASURY; AND ALICE M. RIVLIN, SENIOR FELLOW, BROOKINGS INSTITUTION AND FORMER ASSISTANT SECRETARY OF HEW

Mr. WARNKE. Mr. Chairman, members of the committee, I have submitted a written statement. I assume that that can be printed in the record, and I will just summarize my views quite briefly.

Senator MUSKIE. All right, without objection, it will be printed at the conclusion of your oral statement.

Mr. WARNKE. Thank you very much, Sir.

I feel that this new committee does give the Congress an opportunity for the first time to view the issue of national priorities from a broad perspective. It has been, I think, fairly difficult in the past for any committee to deal in this kind of a broad framework because of the fact that necessarily the various departments and agencies that present their budget proposals do so as advocates, and do so from their own more narrow viewpoint.

Now this does give us the opportunity for the first time to balance competing needs. I think that this is particularly important on the issue of national security because, as has been pointed out very eloquently by Dr. Arthur Burns, we have to view national security as meaning something more than military hardware and military personnel. What really provides for the security of our county is the fact that we have a governmental system that is able to satisfy the aspirations of its people and to bring about a degree of economic and social cohesion which has served us so well in the difficult days through which we have just passed.

Also, particularly in dealing with the Defense budget, there has been an understandable reluctance on the part of the Congress as a whole to second guess the specialized committees which review the Defense requests. After the Armed Services Committees of the House and Senate, and the Defense Appropriations Committees have completed their work, I think there is a natural deference that comes from the fact that the Senate and the House as a whole have not been able to assemble the kinds of staff and have not been able to build up the degree of expertise that would enable them to review on a weapons program by weapons program basis or mission by mission basis the various proposals that the armed services have presented.

I think it is therefore very important that a committee such as your committee is able to assemble the kind of a staff that can review these military requests and weigh them in comparison with the competing demands for the Federal budgetary dollar. In my opinion it is necessary that the Congress begin to exercise a restraint on militar spending. The trend at the present time is up. The excuses that have been given for this are in many instances quite persuasive, but I think we have to recognize that if we continue to pour more and more money into more and more expensive weapons programs, we will only do so

at the sacrifice of other conflicting needs that are in my opinion at least equally vital to our national security.

The reason why I feel it is so important for this committee to look into this area is that otherwise we will keep dealing with the Defense requests on a year-by-year basis, and even if there is a temporary period of reduction, it will not last because of the fact that the military services—and I do not criticize them, this is their job—quite naturally endeavor to keep going all of the programs in which they have an interest. So that they can tighten their belts for 1 year, but there is no stop to the initiation of the various weapons programs that over a period of 5, 10, 15 years can mean increases in many, many billions of dollars. It has been estimated, for example, that if the current weapons programs, the ongoing ones and those in the R. & D. stage, all proceed to their conclusion, it will mean an additional $50 billion investment. Strategic programs alone, if they proceed on the basis on which they have been proceeding, will in a period of something like 10 years add in constant 1974 dollars something around $6.5 billion to the national defense budget.

So that means we face at the present time, unless something is done, a budget which could be as high by 1980 as $140 billion.

Now, I am certainly not an expert on what the optimum level is of Federal expenditures. I do not know to what extent an unbalanced budget or continuing deficits spark inflation. What I do know is that if there is a desire on the part of the Congress to cut Federal expenditures, then I see no way in which this can be done with any equity unless there are very substantial cuts in the Federal Defense budget.

It has been pointed out by some that Defense expenditures constitute a steadily declining percentage of the Federal budget, but what that ignores, I think, is the fact that much of the Federal budget is in funds that are not disposable by the Congress. They are the so-called trust funds, primarily social security, in which the Government acts as an insurance company, collecting premiums and then paying benefits. These are not general tax revenues which are allocable by the Congress of the United States.

When it comes to the disposable income of the Federal Government—that controlled by Congress over the short run—Defense spending accounts for something between 60 and 70 percent. Now, what that means is that at the present time if it is felt that it is necessary for our general economic health that the Congress cut something like $5 billion in outlays, and if that were to mean something like a $10 billion cut, approximately, on appropriations, if you do not cut the Defense budget, you are going to be cutting that $5 billion in outlays and $10 billion in appropriations out of something like 30 or 35 percent of the total Federal budget, which means that the impact will be exponentially much higher than it appears if you just quote the overall figures.

I think also it is now time for the Congress to consider whether or not increasing the Defense budget is an effective, useful way of stimulating the economy. There has been some debate about this. There were suggestions earlier this year that the Defense budget had been increased because of the feeling that this would be a stimulus to an economy that otherwise might be sluggish. But the figures that have been assembled by the Government itself demonstrate that increasing

Defense expenditures is a poor way to generate jobs. For example, $1 billion in Defense expenditures is estimated by the Bureau of Labor Statistics to generate something like 75,000 jobs. An equivalent amount of money spent at the State or local level for education generates over 100,000 jobs. Not only that, but as Gardner Ackley has pointed out, and as is pointed out in a recent newsletter of the First National City Bank of New York, putting money into Defense as a means of stimulating the economy suffers from a number of defects. In the first place, you cannot really determine when the impact is going to be felt because there is a lag, obviously, between the appropriations process and the actual use of those funds.

Not only that, but it generates money, it puts more money into the economy without sopping up demand because the products that are produced are not consumer products, so that they do not utilize consumer dollars.

So that I do feel it is extraordinarily important that the budget committees of the Senate and House consider the Defense budget and do so over a long range basis.

Recent proposals of the Committee for Economic Development suggest that the Congress ought to review Defense programs on the basis of a 5 year rolling program so that Congress could determine not only what the impact is during any current year, but also could determine what the effect will be of procurement decisions that are made now as far as the economy is concerned some 5 years from now.

In that connection, in my statement what I propose is that the committee give very thoughtful consideration to the way in which it will divide its activities. I think it might be quite risky if it were to divide its activities on the basis of functions, as has been the case with other committees. If there were to be a subcommittee, for example, dealing with Defense, I think you would find over a period of time that it would acquire a particular tenderness for Defense expenditures which might make it less effective in its work.

So if the committee is to break down its functions, I would hope that the breakdown would be along lines other than the traditional lines of the various functions, and instead that the breakdown might be in terms of consideration of current effects, a subcommittee, for example, that would concentrate on the current budget, with another subcommittee that might consider a 5-year program, and perhaps another subcommittee that would deal with the question of taxes and revenues.

I believe that that sort of a breakdown would enable the committee to deal more effectively with the overriding issue of priorities. I would hope also that the committee would impose a degree of discipline on the manner in which the military budget is presented, and in my paper I have made certain specific recommendations along those lines.

I think that it is important, for example, that the military budget be presented on the basis of the various missions, which is the case, of course, with O. & M. and with personnel, but is currently not the case with procurement. So it is difficult to analyze the overall financial demands of such programs as Strategic Forces, or as the regular conventional forces.

I would also hope, Mr. Chairman, that as the committee continues its work, it would be able to intervene in the military budget process

at quite an early stage, and could serve a purpose in monitoring the development of the military budget.

I have felt for some time that one of the reasons why our Defense costs continue to run so high is that we have developed no mechanism by which we can genuinely determine what it is for which we have our military forces. I think it is important that we determine a Defense policy which is geared to a coherent foreign policy, and that decides what are the contingencies in which the United States should be prepared to go to war. I think were we to do this that we could determine a force structure that would be adapted both to the needs of the waning years of the 20th century, and also to the economic stringencies under which we find ourselves.

Thank you very much.

Senator MUSKIE. Thank you very much, Mr. Warnke. I am sure what you said will stimulate a lot of questions.

[The prepared statement of Mr. Warnke follows:]

PREPARED STATEMENT OF PAUL C. WARNKE, ASSISTANT SECRETARY OF DEFENSE

It is a distinct pleasure to participate in these first hearings of the Senate Budget Committee. I am confident that this will be a first step in a continuing process that can do a great deal to establish for our country a sensible and responsible set of priorities in Federal spending.

It is only the Congress of the United States, the peoples' branch of our government, that has the perspective from which it can view national needs in their entirety. The departments and agencies that spend the tax dollars are necessarily advocates for their own positions and competitors for a greater share of the available funds.

Moreover, it is only through the process established by the Congressional Budget and Impoundment Control Act that Congress can bring to bear the totality of its information in determining what areas of Federal concern need support and at what level in comparison with all the other areas.

In the pursuit of its task, it is of cardinal importance that the Budget Committees of the Congress direct searching scrutiny to the Defense Budget. Until now, the principal effective Congressional control over the cost of defense has been exercised by the Armed Services Committees and the Defense Appropriations Subcommittees. They have brought to their job both the experience accumulated over the years and a sincerity of purpose to see that money for defense is spent for purposes that contribute to our military capability. They have, however, lacked perspective that exists in a committee that must reconcile military requests with other needs that equally involve our true national security. And when these Defense Committees have completed their work, there has been an understandable reluctance on the part of their colleagues in the House and in the Senate to second-guess their judgments on the weapons and manpower structure required for our military capability. The Budget Committees of the Senate and House can acquire the information necessary to exercise a balanced judgment on defense needs and also can consider and adjust for the long-range impact of the programs and force structure requested for any one fiscal year.

It is, in my opinion, imperative that the Congress begin at once to exercise a restraining influence on our military expenditures. Not only is this restraint consistent with our national security; in my opinion it is vital to the preservation of that national security. Our free society cannot be preserved if we fail to meet the legitimate aspirations of our people and if we fail to maintain substantially full employment, broad educational and occupational opportunities and the standard of living which has become our proudest boast. In this regard, not only is it necessary to fund the Federal programs that are directed toward these objectives but also it is necessary to avoid Federal expenditures that may contribute significantly to an inflation which threatens to deprive those in the vital center of American life of their expected share of comfort, recreation and financial security.

I can pretend no special expertise on the optimum over-all level of the Federal budget or in the impact of Federal expenditures on inflationary pressures. I have, however, devoted a good bit of time both in government service and in private life to the question of our national defense. I am fully persuaded that, rather

than the increases in defense appropriations and spending which have been proposed by the Executive Branch, our national security can be fully assured from the standpoint of defense by a level of spending which is significantly lower. I would hope that I might persuade the Committee to review the Defense Budget, both in its current manifestation and in terms of its long-range implications, with a view toward reducing it now and controlling its future growth.

In this connection, I would hope that President Ford's statements with regard to government spending do not foreshadow a view that, while other parts of the Federal budget should be reduced, defense requests are somehow sacrosanct. In his speech to Congress, the President stated:

"To restore economic confidence, the government in Washington must provide some leadership. It does no good to blame the public for spending too much when the government is spending too much."

At the same time, however, he suggested concern about any reductions in the Defense Budget. In the past few days, moreover, he and other officials of the Executive Branch have made efforts to persuade the Congress that even the modest cuts thus far proposed are somehow imprudent and even risky. Certainly no significant cut in Federal expenditures can be sound and equitable without meaningful cuts in the Defense Budget and, in President Ford's own words:

"Good government clearly requires that we tend to the economic problems facing our country in a spirit of equity to all of our citizens in all segments of our society."

Despite earlier efforts to obscure the fact by so-called "readiness" supplements which are sought to be charged against the 1974 budget but would buy new arms in the current fiscal year, the fact is that the amount requested for military purposes in fiscal 1975 is greater, in constant dollars, than previous years. Moreover, it is necessary that the Congress take full account of the fact that, in terms of appropriations that are controllable by Congress this year, the cost of all military functions constitutes about 65%. Accordingly, any decrease in Federal spending must significantly involve the military budget unless 100% of the impact is to be visited upon that 35% of the budget which includes all domestic non-military programs.

There are those who insist that defense costs are a declining burden. I believe, however, that is misleading to refer to a smaller percentage of the Federal budget represented by defense demands when that percentage is based on a total which includes Social Security and other trust funds. These are monies collected and earmarked for specific purposes, not general tax revenues.

Nor is it meaningful to defend higher military appropriations on the thesis that they represent no higher percentage of our Gross National Product. Our present GNP is swollen by such things as the higher costs of services in an inflationary period. Determining our defense budget by the application of some fixed percentage of GNP would suggest that our international peril increases as our domestic economy booms. And certainly proponents of high defense expenditures would not be comfortable with the assumption that an economic recession means that the threat of foreign aggression has lessened.

I also find no merit in the view that high defense expenditures somehow protect against economic recession. The economic letter published by the First National City Bank of New York noted, in its issue of last April:

"It has seldom proved good economics to give an economy a fiscal shot in the arm by upping defense outlays."

The Defense Budget pumps money into the economy for creation of products which no consumer either can or would want to purchase. Gardner Ackley, former Chairman of the Council of Economic Advisors, has stated:

"The important cases of demand inflation, result from government expenditures, especially those that relate to war preparations."

An increase in the current defense budget, moreover, has less effect on current outlays than it does on future years. As described by the First National City Bank:

"The fiscal push would not come until after the forecasted upturn from the recessionary trough."

Congressional acceptance and funding of the various new programs proposed by the Defense Department would involve an investment of some $50 billion. Along with the all-volunteer army and higher manpower costs, the Defense Budget would be increased to over $145 billion by the late 1970's.

Faced with these prospects, the Congress should insist that the military budget cannot be exempt. It must absorb its fair share of any Federal budget cutting. If the target is a $5 billion cut in outlays for the current fiscal year, this would require about a $10 billion reduction in appropriations. Inasmuch as military

functions consume about 65% of the appropriations controllable by Congress, a fair share to be absorbed by the Defense Budget would be $6.5 billion. Accordingly, it is unfair and impractical for the Executive Branch now to complain about the $5 billion cut proposed by the Senate Appropriations Committee.

Far more than a $5 billion cut, or a $6.5 billion cut, could be made without sacrifice to our national security. A report in which I participated defined some $15 billion that might safely be trimmed from the current military requests.* The major items, listed in millions of dollars of requested budgetary authority are listed below:

General purpose forces:	
Asia committed forces:	
SEA incremental force	463
Demobilize 3 divisions and 8 air wings	1,900
Deactivate 15th carrier	100
Drop expansion of Diego Garcia	29
Streamline the reserves	600
Procurement:	
Cancel AWACS	770
Halt F–14 and Phoenix missile	856
Stretch procurement of SSN–688 (2 instead of 3)	100
Slow tank procurement	206
Stretch procurement of DD–963 (3 instead of 7)	264
Slow procurement of patrol frigate	200
Halt funding of war reserve stocks for Asian allies	530
Miscellaneous	300
Military efficiency:	
Reduce military support personnel 15 percent and trim excess nonmonetary benefits	2,000
Reduce civilian slots 15 percent and cut wasteful operation and maintenance costs	2,000
Strategic forces:	
Counterforce programs	300
Trident submarine	1,400
B–1 bomber	500
Strategic defense	300
Southeast Asia military assistance: Reduced aid to South Vietnam (MASF) Cambodia (MAP) and Laos (MAP)	1,400
Military assistance program:	
Grant assistance	775
Foreign military credit sales	315

Any realistic assessment of the valid purposes of military power in today's world would justify the deletion of these items. Only one other power has the capability of posing a military threat to us. As seen by the Secretary of Defense, this power—the Soviet Union—has been a "prudent and sober power" internationally and its aggression against Western Europe is "unlikely." We can retain the ability to deter any Soviet aggression against the United States or those whose security is integral to our own with an annual Defense Budget well below any of the figures that we have discussed. Despite the lessons of recent years, there is still a tendency to equip ourselves for some global military mission. But our role in preserving world peace cannot be discharged by military force. The experience of the Middle East and of Cyprus demonstrate that enlightened diplomacy can achieve useful results where American military intervention could produce world disaster.

The Congressional Budget and Impoundment Control Act will facilitate the work of the Congress in ensuring that our military force structure is consistent with our true defense needs.

The Budget Committee is in a novel position to take a comprehensive, long-range look at Federal fiscal matters. The provision for consideration of spending and revenue projections over a five-year period will enable Congress to assess trade-offs, to determine the consequent budget implications and thus to provide more flexibility in budgeting.

In order to take greatest advantage of the opportunity to gain a fresh perspective on the budget process, the Committee and its staff might consider an

*"Military Policy and Budget Priorities—A Report to Congress." Project on Budget Priorities, 1974.

alignment which embodies analytical and deliberative processes distinctly different from those common to the functional budget categories now operating in the Executive Branch and among the authorizing and appropriating committees of the Congress. The vertical functions such as housing, transportation, health, education, public works, defense, etc. might be avoided. Instead, since the primary objective of the Committee is to determine Congressional budget priorities, subcommittees and staff could be organized along horizontal lines which parallel the duties of the Committee and incorporate all budget categories. In order to consider budget trade-offs and priorities on an on-going basis, the following subcommittees might be appropriate:

1. *Long-term Budgets.* This subcommittee would be concerned with expenditures over a five-year period. It would develop expertise in all the major functional categories and would assess the fiscal and program implications of various budget options.

2. *Immediate Year Budget.* The primary focus of this subcommittee would be the allocation of total budget authority and outlays levels in the concurrent resolutions (and reconciliation bill, if necessary) reported each year. It would take into account the work on long-term projections for both revenues and spending. In addition, this subcommittee could perform the budget scorekeeping function and monitor recessions, impoundments and deferrals. The staff should have expertise in all the functional budget categories and their relationship to agency program classifications.

3. *Revenue and Taxation.* The work involving revenues, taxation, debt and economic conditions both in the immediate year and over the long-term would be assumed by this subcommittee.

All of the subcommittees would be concerned with improving the budget process and make periodic recommendations. Hearings prior to the first concurrent resolution would be conducted by the full Budget Committee.

In the context of this organizational scheme, I would suggest certain measures for dealing more readily with the military budget request.

1. Military budgets, both for the immediate year and over the five-year period, should be presented in a more uniform and detailed manner.

a. The major budget functions (national defense, agriculture, commerce and transportation, etc.) should be revised to reflect relevant programs. For example, AEC civilian programs are now in the national defense function whereas veterans programs are omitted.

b. The present breakdown of Department of Defense budget according to appropriations categories should be changed (e.g., "procurement, Army;" "operation and maintenance, Navy."). A more meaningful delineation would be by mission and program (e.g., strategic forces, general purpose forces, etc. by service and type of expenditure).

c. All military budget items should be expressed in terms of levels of budget authority, obligations, obligated and unobligated balances and outlays.

2. Information regarding the lag time from granting of budget authority to use as obligations and outlays should be obtained for each budget item. The Committee should use this information as a basis for implementing more effective control of programs and outlays.

3. The Committee should monitor the military budget process within the Administration in order that missions and programs can be assessed in terms of perceived needs and capability requirements over the long term.

4. Annual funding priorities and alternative funding levels for particular budget items should be determined especially over the long term. Options for immediate budget year funding should be developed in case budget authority and outlays requests must be altered to any degree necessary for a concurrent resolution or reconciliation bill.

5. Means should be developed to prevent the distortions inherent in the current use of supplemental requests and reprogramming of unobligated balances of budget authority.

Any field of human endeavor can benefit from enlightened criticism. The Defense Budget is no exception. From its unparalleled perspective on our national needs, this Committee can protect our true national security from the erosion of excessive defense expenditures.

Senator MUSKIE. Following our scheme of today I will proceed to Mr. Weidenbaum.

STATEMENT OF MURRAY L. WEIDENBAUM

Professor WEIDENBAUM. Thank you, Mr. Chairman and members of the committee. I have prepared and presented to the staff a 25-page paper going into detail on these issues and I will confine myself orally to a short summary of that. And I would of course appreciate it if you would include my full paper in the record.

Senator MUSKIE. Of course. Without objection it will appear at the conclusion of your oral statement.

Mr. WEINDENBAUM. Thank you Mr. Chairman.

Professor WEIDENBAUM. Mr. Chairman, the need for better control over the budget and slowing down the rise of Federal spending is clear and urgent. The massive inflation that faces the United States had its origin in excessive government spending; it continues to be fueled by Federal deficits. Between 1965 and 1973, Federal spending more than doubled and the cumulative deficit exceeded $100 billion, and it continues to grow.

The inflation has been accelerated and extended by a variety of other factors, ranging from oil embargo to food shortages. Nevertheless, so much of the responsibility for inflation remains at the doorstep of the Federal Government, and the budget process is the key decision mechanism for the Congress. The Federal budget exercises an inflationary effect in at least six ways. (I warn the committee that the econometric models that we have been listening to do not fully reveal these real world impacts.) Here they are:

One, an excess of Government outgo over income increases the purchasing power in the private sector, and this is inflationary. There is no reason for ignoring it. Two, deficit spending often requires the Treasury to sell debt to the banking system. This is also inflationary because it provides for multiple expansion of the money supply. Three, when the deficit is financed by selling government securities to individuals and nonfinancial institutions, the Treasury debt may replace private borrowing that can reduce the amount of funds available for investment in the productive capacity needed to increase the supply of goods and services. Four, through subterguges such as credit subsidies and off-budget agencies, the amount of fiscal stimulus is underreported. Five, to the entent that taxes to pay for the Federal spending reduce the funds available for investment, the Nation loses the anti-inflationary benefits of a larger supply of goods and services. Six, when the Government's own fiscal house is out of order, the credibility of any national anti-inflation program is sharply reduced. A toughminded effort to control Federal spending is essential to developing public support for fighting inflation. Telling business and labor to exercise restraint when Congress is unwilling to do its part is just not demonstrating leadership.

It is in that spirit of enhancing congressional initiative over economic and fiscal policy that I offer the following program for controlling the budget in reordering national priorities.

One, adopt a program approach to the Federal budget and national priorities. I analyze such a program in my paper. It is unreasonable to expect the Congress as a whole to make rational choices among the many hundreds of programs, agencies, and activities which it must review each year during the budget process. In order to truly assert the power of the purse, Congress needs to shift its attention from the bits and pieces to the central issues involved in enacting the budget.

The solution is to adopt a Government-wide program budget to permit decisionmakers to compare alternative programs of different agencies which contribute to achieving a given national goal.

Such an approach would introduce a healthy degree of competition among Government spending programs. It would focus the budget process on strategic choices—such as public works and investments in human resources, grants-in-aid and income transfer payments, military and civilian needs.

Two, set a zero real growth target for Federal spending for fiscal years 1975 and 1976. There is no excuse for increasing the budget faster than the rate of inflation. Some individual areas of Federal spending must need to expand more rapidly than the average. But not everything is equally important. The essence of reordering priorities is to cut the lower priority areas, military and civilian. A zero real growth would still permit Federal spending to rise substantially, by $27 billion, from $268 billion in fiscal 1974 to $295 billion in fiscal 1975.

Three, control the "uncontrollables." Too many expenditure items cannot now be effectively controlled because of the restrictions in basic statutes. These fiscal "sacred cows" should be put to pasture by eliminating the legislative barriers to effective congressional control through the budget process.

Some agencies virtually escape the scrutiny of annual review while others are completely controllable. Congress should eliminate the subsidies of the 1930's and 1940's by amending the legislation setting up these permanent appropriations and other fixed charges.

Four, put the off-budget agencies back into the budget. The recent phenomemon of "off-budget" Federal agencies is expanding too rapidly. These agencies are entirely federally owned and staffed by civil servants. The only thing that separates them from the agencies in the budget is legislation which arbitrarily removed their financial transactions from the budget. As a result, the reported total of Federal spending is lower than it really is.

Five, halt new extrabudgetary credit programs. Credit programs are a second type of governmental activity excluded from the budget. This is done by means of loan guarantees and federally sponsored enterprises. So long as they are excluded from the budget. there is a strong incentive to convert Federal spending to these indirect techniques. and it is being done on an increasing scale, Fannie Mae, Ginnie Mae, Sally Mae, Fanny Rae, ad infinitum. These have a very real impact on the economy. They exert strong upward pressures on interest rates. A moratorium should be declared on new Federal credit programs during this inflation. Existing credit agencies should be held in check.

Six, modernize the military procurement process. I want to turn to the very real problem of holding down defense spending without hurting our military capability. It is paradoxical that just when the Russians have been expanding their military strength, many Americans have developed a critical or negative attitude toward our military. Any objective analysis shows that an important shift has been taking place in the balance of military strength between the two superpowers. We can debate whether we or the Russians are ahead today. But it is clear that the Soviet Union is making a determined effort to catch up and overtake what earlier had been an indisputable American lead. The new military budget responds to this situation by the traditional method—we should spend more money—while others,

strangely enough, are urging unilateral reductions on the part of this country.

I suggest an alternative: streamline the Military Establishment to increase its effectiveness at minimum cost. As a former defense industry executive, I believe that the present method of closely controlling the defense companies just does not work. Too much of their effort is devoted to paperwork and reporting rather than to the job of producing military hardware.

I will skip over it but in my formal paper I give a series of suggestions of modernizing, streamlining, reducing the expenditures without reducing the effectiveness of military procurement.

To conclude, controlling the Federal budget to fight inflation and to improve the return on the taxpayer's dollar is not easy. I have not advocated anything as simple as a 5 percent across-the-board cut. That would be an abdication of congressional responsibility. Congress has to decide where it wants to cut the budget.

But the public needs to learn the essential difference between cutting the requested budget and actually reducing Government spending. We are not talking about slashes and cutbacks. Realistically, we are concerned with slowing down the rapid rate of growth of Federal expenditure during a period of severe inflation.

There is a positive side to all this. As Congress improves its tools of budgeting, it gets into a better position to reorder priorities under a variety of fiscal conditions. Even at the present time, there is no need for a stagnant budget policy but rather a sensible balancing of selective expansions and hard-nosed reductions all within a self-imposed ceiling of fiscal restraint. Thus, an effective budget process will permit Congress simultaneously to deal with some of the most pressing side-effects of inflation, rising unemployment and reduced availability of investment capital, while combatting the inflation itself.

Mr. Chairman, this is not a simple plea on my part for the old time religion. There are many other things to do in order to bring down the inflation and restore a healthy, fully employed economy. It includes measures to increase the capacity to produce goods and services and steps to make a more competitive economy. But the budget is the place for the Congress and for this committee to begin.

Thank you.

Senator DOMINICK [presiding]. Thank you, Professor. I think that is an extremely valuable statement. I appreciate it very much.

We have a vote on, which is why no other committee members are here, and as soon as the chairman comes back, I am going to have to leave, and we might as well go ahead.

[The prepared statement of Mr. Weidenbaum follows:]

A PROGRAM FOR CONTROLLING THE BUDGET

PREPARED STATEMENT OF MURRAY L. WEIDENBAUM, FORMER ASSISTANT SECRETARY OF THE TREASURY

The Need for Budgetary Control

The need for better control over the budget and slowing down the rise of federal spending is clear and urgent. The massive inflation that faces the United

States had its origin in excessive government spending; it continues to be fueled by federal deficits. Between 1965 and 1973, federal spending more than doubled and the cumulative deficit exceeded $100 billion.

The inflation has been accelerated and extended by a variety of other factors, ranging from the oil embargo to food shortages. Nevertheless, so much of the responsibility for inflation remains at the doorstep of the federal government. The federal budget exercises an inflationary effect in at least six ways;

1. An excess of government outgo over income increases the purchasing power in the private sector. For technical reasons, even a balanced budget tends to be mildly stimulative.

2. Deficit spending often requires the Treasury to sell debt to the banking system. This provides a direct basis for the multiple expansion of the money supply.

3. When the deficit is financed by selling government securities to individuals and non-financial institutions, the Treasury debt may replace private borrowing that can reduce the amount of funds available for investment in the productive capacity needed to increase the supply of goods and services.

4. Through subterfuges such as credit subsidies and off-budget agencies, the amount of fiscal stimulus is underreported. The amount of fiscal restraint is overreported by using outmoded or inappropriate measures such as the full-employment budget.

5. To the extent that taxes to pay for the federal spending reduce the funds available for investment, the nation loses the anti-inflationary benefits of a larger supply of goods and services.

6. When the government's own fiscal house is out of order, the credibility of any national anti-inflation programs is sharply reduced. A toughminded effort to control federal spending is essential to developing public support for fighting inflation.

It is in that spirit that I offer the following program for controlling the budget and reordering national priorities.

HOW TO CUT THE BUDGET

1. Adopt a program approach to the federal budget and national priorities

It is unreasonable to expect the Congress as a whole to make rational choices among the many hundreds of programs, agencies, and activities which it must review each year during the budget process. In order to truly assert the power of the purse, Congress needs to shift its attention from the bits and pieces to the central issues involved in enacting the budget. The solution is to adopt a government-wide program budget to permit decision-makers to compare alternative programs of different agencies which contribute to achieving a given national goal.

Such an approach would introduce a healthy degree of competition among government spending programs. It would focus the budget process on strategic choices—such as public works and investments in human resources, grants-in-aid and income transfer payments, military and civilian needs.

The proposal for a Program Planning Budget attempts to deal with the most fundamental shortcoming in government budgeting—the failure to treat the budget process as a series of choices among alternatives.

"Would an added dollar be more wisely spent for education or for highways?" "For job training or for income maintenance?" These fundamental questions are not even raised in the budget process at the present time, much less are any answers sought.

The current emphasis rather is on deciding whether to increase or decrease the funds to be allotted to the specific projects within each of these categories. Furthermore, the choices are usually restricted to those which can be made within each of the many agencies involved in education or income maintenance or any other specific functional area.

What is needed is a Program Planning Budget for the entire Federal Government. This would permit if not require decision-makers to compare alternative programs of different agencies which may contribute to achieving a given basic national goal. Hence, I would base such a budget on the fundamental objectives for which the various government programs are carried on. Merely for purposes of illustration, I have identified four such basic end purposes in Table I—national security, public welfare, economic development, and general government.

Let us reconstruct the federal budget in this framework and thus see for ourselves what the implicit priorities really are. The key term of course is implicit.

When we examine the budget and appropriation hearings over the years, we find little if any systematic attempt to appraise the wisdom or desirability of these overall choices in the allocation of government resources. Some of the results of such a reconstruction of the budget are obvious. Public welfare, rather than national security, receives by far the largest share of the budget.

What may be more surprising, and maybe also disconcerting to some, is the overwhelming dominance of civilian spending by income-maintenance expenditures over investment outlays. A puny portion, about 13 percent of the total budget, is comprised of the various investment and economic development efforts. That is, the bulk of civilian spending is devoted, not to increasing the size of the nation's income pie, but to rearranging the slices.

It is mere conjecture of course to wonder to what extent the allocation of government funds would have been different if the individual appropriation requests had been developed and reviewed in the overall context of priority decisions such as presented here. We can gain some added insight to the possible program choices that can and might be made in this budgetary framework by making a deeper analysis of the content of each of the four categories.

Table 1.—Hypothetical Government-Wide Program Planning Budget, Fiscal Year 1973 (in billions of dollars)

Category	*Amount*
National security:	
U.S. military forces	82.4
Foreign economic aid	4.4
Scientific competition	3.4
Foreign military aid	1.7
Psychological competition	0.3
Total	92.2
Public welfare:	
Social insurance and retirement	60.8
Health services	20.1
Veterans benefits	12.4
Public assistance	11.0
Aid to farmers and rural development	5.7
Housing and community facilities	3.7
Antipoverty programs	2.7
Specialized welfare activities	2.5
Total	118.9
Economic development:	
Transportation facilities	10.4
Education and research	8.0
Natural resources and regional development	6.3
Manpower development	4.4
Health research and development	3.6
Business aids and subsidies	1.3
Total	34.0
General government:	
Interest on debt	21.2
General aid to states and localities	5.3
Government operations	3.7
Judicial and law enforcement	2.1
Foreign relations	.5
Intragovernmental transactions	−7.1
Total	25.7
Grand total	270.8

The bulk of the national security budget is devoted to the U.S. military forces. A little over one-tenth of the total is comprised of programs that promote the national security through other means, such as foreign aid. This approach lends itself to raising and answering questions such as the following: "Would national security be improved by shifting some of the $6 billion of foreign aid to our

own military establishment?" "Conversely, would the national security be strengthened by moving a proportionately small share of the direct military budget, say $200 million, to the U.S. Information Agency or to the arms control effort and thereby obtaining disproportionately large increases in these programs?"

This kind of detail also permits cross-comparisons of government programs which are not now made. For example, the $4.4 billion of foreign economic aid far exceeds the $2.7 billion devoted to the formal domestic anti-poverty efforts. Would some trade-off between the public welfare and the national security areas result in a net advantage to the nation? This type of analysis is an attempt to raise quantitatively the fundamental question. "Would an extra dollar (a billion in the case of the government) be more wisely spent for program A or for program B?"

Transportation facilities—mainly highways—account for the largest single share of the Economic Development category. When combined with natural resource development and business subsidies, these investments in our physical resources dominate the category. Education, manpower training, and other investments in human resources receive a lesser priority. A government-wide Program Planning Budget could focus attention on questions such as, "Would a shift of funds from physical to human resources be advisable?" "From highways to job training?" Raising these questions need not be taken as expressions of value judgments—although I do wonder why highways have become our chosen instrument to foster economic growth and development. The point of course is to develop new patterns for government decision-making so as to identify the areas of government spending that could yield greater returns to the nation and its taxpayers—as well as those areas that yield smaller returns on our national investment and which could be cut back.

If this analysis were incorporated into the annual budget document, it could result in growing Congressional and public concern and awareness of the problems of choosing among alternative uses of government funds. In the absence of an automatic market mechanism, such an approach might introduce a healthy degree of competition among government spending programs.

The underlying theme of this program approach to government budgeting is the need to array the alternatives so that deliberate choices can be made among them. This does not require sophisticated methodology. It has its counterparts in the private sector. Many families rush out and spend the Christmas bonus on a new car. A more prudent family may carefully, although subjectively, consider the relative benefits of a new car, a long summer vacation, or remodeling the basement. Similarly, a well-managed company would not impulsively decide to devote an increase in earnings to raising the dividend rate. Rather, it would carefully consider the alternative uses of the funds—embarking on a new research program, rebuilding an obsolescent manufacturing plant, or developing a new overseas operation.

2. Set a zero real growth target for federal spending for fiscal years 1975 and 1976.

There is no excuse for increasing the budget faster than the rate of inflation. Some individual areas of federal spending must need to expand more rapidly than the average. But not everything is equally important. The essence of reordering priorities is to cut the lower priority areas. Anybody who believes that we can fight inflation painlessly is deluding himself or herself.

A zero real growth target for federal spending will hurt. But any approach that will not hurt surely will not be effective. A zero real growth approach would still permit federal spending to rise significantly, from $268 billion in fiscal 1974 to $295 billion in 1975.

3. Control the so-called uncontrollables

Too many expenditure items cannot now be effectively controlled because of the restrictions in basic statutes. These fiscal "sacred cows" should be put to pasture by eliminating the legislative barriers to effective Congressional control through the budget process.

Many expenditures are in practice immune from change during the appropriations process. A large share of the budget authority requested each year is in the form of trust funds, permanent or indefinite appropriations, and fixed charges. The size of these types of appropriations is determined by factors outside of the budget process.

Some agencies virtually escape the scrutiny of annual budgetary review, while others are completely controllable. An interesting contrast can be drawn between the two agencies with the largest budgets, the Department of Defense

and Health-Education-Welfare. Almost all of the defense budget, but only 12 percent of HEW's, is susceptible to effective annual review through the appropriations process (see Table 2). This fact may help explain why the defense budget goes through cycles of expansion and contraction while HEW outlays increase sharply every year.

Several key reforms in the area of increasing the controllability of government spending need to be instituted in order to make the annual budgetary process more effective.

Table 2.—Controllable Share of 1973 Agency Budgets

	Percent
Justice	100
Executive Office of President	100
HUD	98
Defense—Civil	98
Defense—Military	95
Commerce	91
State	91
Judiciary	84
Legislative branch	82
Funds appropriated to President	55
Agriculture	51
Labor	33
Other agencies	31
Transportation	26
Veterans' Administration	21
Treasury	18
HEW	12
Interior	0
Average for Government	46

Source: Murray L. Weidenbaum and Dan Larkins, The Federal Budget for 1973, Washington, American Enterprise Institute for Public Policy Research, 1972, p. 52.

First, it is important to differentiate between naturally uncontrollable items and artificially uncontrollable items. For example, interest on the national debt is a natural uncontrollable, because the amount depends on the types of Treasury securities outstanding and on money market conditions. These are not the kind of factors that can be determined in the review of the Treasury budget.

It would be far more useful, in the direction of efficient government, for the Congress to rivet its attention on those areas which are artificially uncontrollable—programs made uncontrollable by statute, but which the Congress could adapt to annual review. For example, one program in the "artificial" category stems from a 1935 act which provides that 30 percent of annual customs receipts must be automatically funneled to a permanent fund to be used for the "removal of surplus agricultural commodities." The common factor in all such artificially uncontrollable items is that there is no relation between the amount appropriated and the current requirement for the money. Annual budget review is needed for these items in order to correct the situation.

In many cases, reform will mean amending the legislation that authorizes the permanent and/or indefinite appropriations, the fixed charges and the trust funds, so that annual review by the appropriations committees could be possible. With respect to the trust funds, the Congress should reexamine each of them and preserve only those which are most in keeping with the idea of a trust, i.e., money administered but not owned by a fiduciary. For example, the civil service retirement and disability fund is a logical candidate for a trust fund, but the highway program is not. Spending money for highways is more similar to spending for ordinary government operations than it is to the fiduciary concept. In fact, this program was financed out of general revenues until 1954 when it was shifted to trust fund status.

Second, the Congress should examine permanent and indefinite appropriations to make sure that their amounts are not greater than the existing need. Some permanent and indefinite appropriations may be superfluous in terms of today's conditions. Other artificial fixed charges should be restored to annual review through substantive changes in the basic statutes.

Third, to avoid the problem of large relatively uncontrollable appropriations to continue construction projects that start off with a modest initial appropria-

tion, the Congress should carefully assess the full costs of construction projects and other long-term investments at their inception. The "full funding" technique in which total costs are considered at the outset should be extended to all such long-term schemes.

Fourth, the Congress needs to emphasize the most effective point of effective control over government spending—the proposal stage when the legislation is being considered, prior to its enactment. Provisions to require annual budget review should be included in new legislation, so that future problems of uncontrollability will not arise.

If these steps are taken, the obstacles to efficient budget review would be substantially reduced. Moreover, the Congress would then be in a better position to finance new initiatives in response to changing national priorities, without having to increase taxes, consider new taxes, or postpone necessary public activities.

4. Put the off-budget agencies back into the budget

The phenomenon of the "off-budget" federal agencies is of recent origin. The term was first introduced in January 1974 in the Federal Budget for the fiscal year 1975. It deserves some attention, because it is weakning the effectiveness of the unified budget as a comprehensive indicator of federal finance.

First of all, this category does *not* include many items which would seem to fit the title. It does not cover the government-chartered enterprises, such as the Federal Land Banks and the Federal National Mortgage Association, which have become privately owned in recent years. Since 1967, when the Federal Government adopted the recommendations of the President's Commission on Budget Concepts, these privately-owned albeit government-sponsored enterprises properly have been excluded from the federal budget.

In contrast, this new category of "off-budget agencies" contains and is limited to enterprises which are entirely federally owned and controlled. That is, the "off-budget agencies" are truly part of the Federal Government. They generally are staffed by civil servants and subject to all other federal operating procedures. The only thing that separates them from the agencies that are included in the budget is that Congress has passed laws which arbitrarily move their financial transactions out of the federal budget.

The result is clear: the total of federal expenditures and the resultant budget deficit are both lower than they would be if this arbitrary change had not occurred. It is noteworthy that when the Treasury reports the Federal Government's total borrowings from the public, the financial requirements of these off-budget agencies are added back in!

One characteristic that seems to accompany the achievement of "off-budget" status is that of expansion. For example, the first off-budget agency was the Export-Import Bank, which was excluded by statute as of August 17, 1971. In the fiscal year 1972, its lending totaled $249 million. The volume more than doubled to $630 million in 1973 and is estimated to exceed $1.3 billion in 1975. This upward trend is in striking contrast with another wholly-federal enterprise which has remained in the budget, the Tennessee Valley Authority. TVA's net outlays declined from $448 million in 1972 to $367 million in 1973 and are estimated at $458 million in 1975.

Since 1972, the Post Office (now the Postal Service) and the lending activities of the Rural Electrification Administration (now the Rural Telephone Bank and the rural electrification and telephone revolving fund) were removed from the budget. In fiscal 1973, the REA's net outlays were $528 million. By 1975—now outside of the budget—its net lending is estimated to reach $784 million; in addition $19 million of administrative costs continue to appear in the budget.

Several new wholly-federal activities have been established since 1972, and their finances will be "off-budget"—the Environmental Financing Authority, the Federal Financing Bank, and the U.S. Railway Association. Except in the case of the Postal Service, the excluded outlays of the off-budget agencies are for loan programs. These programs are similar in all substantive effects to the direct loan programs which are in the budget.

Another characteristic of this new category of agencies is that it is more difficult to obtain detailed information about their current and prospective operations than is the case of agencies which continue to be included in the budget. Table 3 pulls together the data on off-budget agencies which currently are dispersed over a variety of special analyses which accompany the budget document. When the Railway Association gets underway, it is likely that its disbursements will push the total outlays of the off-budget agencies well beyond $3 billion a year.

Table 3.—Estimated Net Outlays of Off-Budget Federal Agencies (fiscal year 1975, in millions of dollars)

Agency:	Amount
Export-Import Bank	$1,250
Postal Service [1]	733
Rural Electrification Administration	463
Environmental Financing Authority	240
Rural Telephone Bank	135
U.S. Railway Association	([2])
Federal Financing Bank	([2])
Total	2,821

[1] Net after receipt of subsidy of $1,533,000,000 from budget funds.
[2] Being organized; estimates not yet available.

If any forecast on federal finance can be made with some confidence, it is that the number of the "off-budget agencies" and the size of their outlays will continue to grow rapidly in the future. Unless Congress sees the danger of this apparently painless way of government financing, the unified budget will become a less complete measure of the total flow of revenues and expenditures between the federal government and the public. Unless Congress senses the danger of this subterfuge, much of its effort to curtail federal spending will be vitiated by moving more spending programs out of the budget.

5. Halt new extrabudgetary credit programs

Credit programs are a second type of governmental activity excluded from the budget. This is done by means of loan guarantees and federally-sponsored enterprises. So long as they are excluded from the budget, there is a strong incentive to convert federal spending to these indirect techniques.

Of course, there is always justification for these governmental efforts. However, we must realize that when a national government enters financial markets, it possesses advantages not available to private borrowers. To a considerable extent, it transfers some of these governmental attributes to the ostensibly private organizations such at Fannie Mae, which are empowered to issue obligations backed by the U.S. Treasury. Thus, increasing portions of available investment funds are being preempted by government credit agencies and are not available to truly private borrowers. Let us face it, this means an increasing socialization of our capital markets, which are such a basic element in the strength and durability of a private enterprise system.

Moreover, it is not hard to see the reasons for the growing popularity of these Federal programs extending governmental credit. Most of them are not included in the formal Federal budget; hence, they seem to be a relatively painless way of achieving national objectives. Moreover, the segments of the society to which the specific programs are directed receive a benefit at the expense of the rest of us. For example, the operation of Federal credit programs in the fiscal year 1970 alone will result in ultimate interest subsidies to the direct beneficiaries of these programs of over $5 billion. About $1 billion of the subsidy benefit was received in the first year of these loans, with the remaining benefit to occur during the rest of the life of the government-assisted loans extended in that one year. Of course, hidden subsidies such as these have many supporters.

What should be done? First of all, the various Federally-sponsored credit programs need to be reviewed together in the government's own budget process and their respective costs and benefits compared. This in turn should lead to the adoption of some strong controls over the total volume of Federally-assisted credit extended. Just because most of these programs are no longer included in the Federal Budget, they should not be treated as free good. The amount of investment funds generated in our economy in a given period of time is limited and giving specific categories of borrowers special preference should be restricted.

A comprehensive analysis of federal priorities must take account of these credit programs. They have a real impact on the economy and exert strong upward pressures on interest rates. A moratorium should be declared on new federal credit programs during this inflationary period. Existing credit agencies should be held in check.

6. Modernize the military procurement process [3]

The proposed Department of Defense budget of $86 billion for the fiscal year 1975 has stirred up a substantial debate. But only extreme alternatives seem to

[3] This section draws heavily on my new book, The Economics of Peacetime Defense (New York, Graeger Publishers, 1974).

get attention: (1) the "hawk" versus "dove" controversy over whether the United States needs to strengthen its military arsenal or already possesses "overkill" and (2) the more economic argument over whether this Nation can afford more military spending. A variation of the latter point contends that a higher level of defense spending may be essential for the health of the American economy.

This paper tries to develop a reasonable and responsible middle ground and, in passing, to raise the information level. In essence, five key points are made:

1. If necessary for the national security, the United States can afford a substantially higher level of military spending. In any measurable sense, the economic burden of military spending has been declining.

2. The health of the American economy does not require any particular level of defense spending. In fact, there is an "opportunity cost," in terms of the civilian programs that are foregone when resources are devoted to military purposes.

3. The international environment poses continued and severe threats to the national security. The disenchantment with the military establishment in some quarters of our society contrasts sharply with the present, massive Soviet armament effort. There is no sensible rationale for a reduction in the U.S. military posture.

4. But the changing international environment often means that our military allies become our political and economic competitors. The strength of our internal social and economic structure thus becomes a key element in our total national security posture.

5. Hence, important pressures are present to truly economize on the resources devoted to military purposes. This does not mean simply to cut military budget requests. Rather, it requires seeking out methods of achieving the necessary level of military effectiveness at lower costs. Drawing on my recent book, the *Economics of Peacetime Defense*, much of this paper shows how a streamlined military establishment can be achieved. Many of the proposals involve reducing the excessive degree of control over military contractors, but simultaneously cutting back the government subsidies that they receive.

A great deal of controversy attaches to the balance of military forces between the United States and the Soviet Union. A detailed examination of available information on the respective armed forces is inconclusive; the United States leads in some categories and lags in others. By the middle of 1973, the Soviets had 1,527 ICBMs, while the United States had only 1,054—the latter was the same number as in 1967. This, of course, can be pointed to as evidence that the Russians have pulled ahead (see Table 4).

On the other hand, the U.S. strategic bomber fleet of 506 airplanes dwarfs the Russian fleet of 140. Also the great bulk of our ICBMs are solid-fueled (quicker firing and hence more likely to survive a first strike by an enemy). These latter comparisons are emphasized by those who do not believe that the Russians are ahead. The total of 656 submarine-launched ballistic missiles reported by the Department of Defense is only marginally larger than the rapidly rising USSR inventory, which now totals 628—thus pointing to an inconclusive result.

TABLE 4.—THE STRATEGIC BALANCE: UNITED STATES AND U.S.S.R.

Year	ICBM's		SLBM's		Long-range bombers	
	United States	U.S.S.R.	United States	U.S.S.R.	United States	U.S.S.R.
1963	424	100	224	100	630	190
1964	834	200	416	120	630	190
1965	854	270	496	120	630	190
1966	904	300	592	125	630	200
1967	1,054	460	656	130	600	210
1968	1,054	800	656	130	545	150
1969	1,054	1,050	656	160	560	150
1970	1,054	1,300	656	280	550	150
1971	1,054	1,510	656	440	506	140
1972	1,054	1,527	656	560	506	140
1973	1,054	1,527	656	628	506	140

Source: International Institute for Strategic Studies, "The Military Balance for 1973–74," and "Federal Budget for the Fiscal Year 1975."

But how do we equate an invulnerable submarine with a land-based missile silo or with a subsonic bomber? It is difficult to come up with a measure of equivalency or of sufficiency. What is clear is that the United States does not

now possess that overwhelming strategic/nuclear power that it did five or ten years ago. Paradoxically, during this period when the American society has been developing a more critical attitude toward its defense establishment, Russian military efforts have been expanding.

It does seem clear that an important shift in the relative balance between the two military superpowers has taken place during the last several years. The USSR is now in a relatively stronger position vis-à-vis the armed strength of the United States. It can be debated whether they are ahead as of any given present or prospective point in time, but it does seem clear that they are making a determined effort at least to catch up, if not to overtake what just a few years ago was a secure lead on the part of the United States.

In any measurable sense, a shift in the world balance of power has been taking place in the last several years—a shift that is not favorable to the United States. Nevertheless, this Nation continues to possess a tremendous military arsenal and superiority in many military areas and at least equality in others. Perhaps more fundamentally, the nature of the challenges facing our society is changing—and the change is toward greater complexity. The newer challenges are intensifying and show great potential of becoming as serious as any military threat, if not more so. I am referring to the basic stability of our internal society and the social, ecological, and political strains which have become increasingly severe in the last several years. The domestic and international aspects cannot be viewed in separate, watertight compartments. Measures to make ours a more attractive and respected society can bolster our international position. The tremendous increase in the destructiveness of modern weapons has, paradoxically, resulted in the decline of raw military power as an effective instrument of national policy. Because of their awesomeness, nuclear weapons are reserved for an apocalyptic situation—which thankfully has not arrived. Future conflicts among nations are likely often to be resolved through means which are primarily non-military, such as economic and technological competition and propaganda and similar maneuvering within the framework of the international political community. This is a difficult environment for the United States to learn to live in successfully, in part because the power relationships are changing. The assured availability of energy sources may become more important than the precise number of ICBMs in place. Our military allies often become our economic rivals; Japan and Western Europe are two striking cases.

Despite all of the recent talk about declining military budgets after SALT and Vietnam, the trend of U.S. military spending is upward. The fiscal 1975 budget for the Department of Defense requests appropriations of more than $13 billion over the 1971 level. The Pentagon budget is likely to exceed the $80 billion annual level during the 1970's and perhaps to reach $90 billion a year during the latter part of the decade. Total requested appropriations for all national defense programs for the fiscal year 1975 are $95.0 billion. As a harbinger of things to come, carryover balances of unexpended defense appropriations are estimated to rise from $35.9 billion on July 1, 1973 to $50.1 billion on June 30, 1975.

The shift toward a volunteer armed force only exacerbates the existing economic and financial pressures on the military budget. In theory, of course, there is some pay scale that should be high enough to attract the numbers and skills of manpower needed. Nevertheless, we must recognize that every incident of recruits landing in the hospital with kidney ailments as a result of foolish training procedures makes the task more difficult. So do the racial antagonisms among servicemen.

If we wish to see the military meet its manpower requirements short of paying baseball star salaries, then a military career must be made more attractive. That is likely to take more than beer in the barracks. It will require developing attitudes that are based on the recognition that the new crop of enlisted men are there and will only remain there in the final analysis if they are motivated to do so. Personnel are a scarce resource whose use needs to be "economized".

There is a pressing need for increasing the effectiveness and reducing the cost of new weapon systems. The multiplicity of problems do not lend themselves to a single panacea or to a pat solution. To a considerable extent, simpler weapons may also turn out to be better as well as cheaper. Cost considerations need to be incorporated into design requirements, as well as contractor selection.

The present method of relying on a host and variety of ways to closely control the operations of defense contractors—to make them behave more like government agencies—just does not work. Some have urged a variation of the old arsenal approach, that the degree of government control over weapon system

design and production be increased even further, even to the point of nationalizing the companies doing the work. That just seems like more of the same—the hair of the dog. If we do not have the benefit of market competition now, we certainly would not secure it under an arsenal system.

This is a plea for a new departure—let us try private enterprise. We really have not given it a chance. Defense contracts are awarded to ostensibly private companies. But the contracts themselves require the companies to behave like arsenals. So many of their efforts are devoted to a proliferation of paperwork; rather than doing, the contractor spends his time reporting on all sorts of schedule, financial, and technical matters. Thus, the nation does not get the benefit of the innovation and efficiency that is expected from the private sector.

Paradoxically, the defense contractors are not likely to favor an abrupt shift from the status quo. It would mean that they lose much of the subsidies they now receive—free factories, free production equipment, and free working capital. But the defense industry would be better off in the long run to forego the advantages of military subsidies in order to shake loose from the red tape and interference with the prerogatives of management that inevitably accompanies these aids.

If, contrary to the present situation, these basic changes attract a greater number of companies to compete for defense work, then the dependence on defense work will decline for many of them. Thus, the government will no longer have to fear that, if it drives too hard a bargain with a contractor performing poorly, it may lose through bankruptcy a major part of the military's industrial base. Rather, following this suggested free enterprise route provides the hope and possibility of cutting costs with the introduction of traditional commercial market incentives. This new approach would go a long way toward reducing that close and continuing relationship between a small group of companies and the Pentagon which is at the heart of the concern over a military-industrial complex.

Important Technical Matters

There are some of course who react to the entire budget control problem by shifting the debate to the so-called full-employment budget. Even after allowing for the $3 billion of federal spending by the off-budget agencies, this measure of federal finance would still show a comfortable and comforting $5 billion surplus in fiscal 1975. But here account must be taken of two key shortcomings of this series: (1) the four percent unemployment assumption and (2) the impact of inflation.

One assumption universally underlies both the official and the private computations of the full-employment budget—that full employment is to be defined as 96 percent of the civilian labor force, or an unemployment rate of 4 percent. However, under present labor-force conditions, it does not seem reasonable to expect that the American economy can achieve that level of full employment in peacetime short of unacceptable inflation. But the choice of unemployment assumption can be critical to determining whether the full-employment budget registers a surplus or a deficit for any given time period. This is the case because revenues are far more sensitive than government spending to changes in the level of economic activity.

Using the traditional 4 percent assumption, the Federal Budget for fiscal 1975 shows an estimated surplus of $8 billion. But at 4.5 percent unemployment, the full-employment budget would register a $4 billion deficit (see Table 5). If "full employment" were defined at 4.8 percent—which might be a reasonable figure under present circumstances—the government would be operating at an $8 billion full-employment deficit.

Clearly, the higher the level of unemployment which is assumed to represent a relatively fully employed economy, the more difficult it is to achieve a balance of revenues and expenditures.

TABLE 5.—SOME ALTERNATIVE FULL-EMPLOYMENT BUDGETS

Unemployment assumption	1975 full-employment budget (billions)		
	Revenues	Expenditures	Surplus (+) or deficit (−)
4 percent	$311	$303	+$8
4.5 percent	299	303	−4
4.8 percent	296	304	−8

A more recent line of attack on the usefulness of the present method of calculating the full-employment budget follows from the recognition of the role of inflation in increasing revenues faster than expenditures. Thus a balanced full employment budget can be achieved rather easily—and not be too meaningful.

To simplify matters, we can use the estimates in the January 1974 *Economic Report* that full-employment revenues rise 1.1 percent for every one percent increase in inflation and that full-employment expenditures rise only 0.5 percent, in the short run. This estimate of the income elasticity of revenues (the proportional increase in revenues in relation to a percentage increase in the GNP) is considerable lower than earlier estimates. Yet it is quite reasonable in view of the changing federal tax structure. The rapid growth of social security taxes (with a relatively low income elasticity, in the neighborhood of 1) offsets the higher income elasticity of income taxes (usually estimated to be at least 1.2).

On the expenditure side, although many programs are "indexed" to overall price movements, they usually react with a lag. Thus, in the short run, an increase in inflation above that assumed in preparing the budget estimates generally will mean declining real outlays for many programs operating under relatively fixed appropriations.

On the assumption of a 7 percent rate of inflation for the year ahead, the Administration has estimated an $8 billion surplus in the full-employment budget. But what would the full-employment measure have looked like, if inflation were held down to the more traditional rate of 3 percent? As shown in Table 6, revenues would be substantially less, and only a modest $2 billion surplus would be registered.

TABLE 6.—MORE ALTERNATIVE FULL-EMPLOYMENT BUDGETS

Inflation assumption	1975 Full-employment budget (billions)		
	Revenues	Expenditures	Surplus (+) or deficit (−)
7 percent	$311	$303	+$8
3 percent	299	297	+2
0 percent	290	292	−2

To see what the total effect of inflation is on the full-employment budget concept, we can compute the figures that would result from no change in price levels—i.e., to convert this measure into "real" terms. A $2 billion deficit would replace the $8 billion surplus currently estimated for the full-employment budget in the fiscal year 1975.

The purpose of this analysis is not to question the realism of the 7 percent inflation assumption actually used in the new Federal Budget. But we need to recognize the consequences of inflation: the more rapidly that the level of prices increases, the smaller the deficit or the larger the surplus that is registered in this budget series. Thus, grave doubt is cast over the validity of using the full-employment budget numbers as presently computed as an indicator of fiscal restraint during a period of substantial inflation.

Opponents of fiscal restraint point to the large surpluses of state and local governments which have been reported in the national income accounts in the last several years. These accounts, which underly the Gross National Product and other important aggregate measures of the economy, are designed for and are extremely useful in gauging the economic impact of the various sectors of the economy. However, they are not intended to be measures of financial condition.

Thus, this report has focused on the Federal Budget, and not on the Federal sector of the national income accounts. The data which are most comparable to the federal budget are those contained in the reports of the Governments Division of the Bureau of the Census, using data supplied from state and local accounting systems. A very different picture emerges from an examination of the Census reports than is generally appreciated (see table 7).

In the fiscal year 1971, rather than the surplus of $2.3 billion shown in the national income figures, Census reported a cumulative deficit of $4.7 billion by state and local governments. In the fiscal year 1972 (the latest period for which data are available), the Bureau reported a surplus of $300 million for all state and local governments, compared to the $8.6 billion surplus shown in the national income accounts. The notion of states and localities enjoying huge fiscal bonanzas turns out to be a statistical artifact and not indicative of their actual financial condition.

TABLE 7.—TWO VIEWS OF STATE AND LOCAL FINANCE

[In billions]

Fiscal year	NIA surplus (+) or deficit (−)	Census surplus (+) or deficit (−)
1971	+$2.3	−$4.7
1972	+8.6	+.3

Source: "Economic Report," January 1974; U.S. Bureau of the Census, "Government Finances in 1971–72."

Conclusion

Controlling the federal budget to fight inflation—and to improve the return on the taxpayer's dollar—is not easy. I have not advocated anything as simple as a 5 percent across-the-board cut. That would be an abdication of Congressional responsibility. Congress has to decide where it wants to cut the budget.

But the public needs to learn the essential difference between cutting the requested budget and actually reducing government spending. We are not talking about slashes and cutbacks. Realistically, we are concerned with slowing down the rapid rate of growth of federal expenditure during a period of severe inflation.

There is a positive side to all this. As Congress improves its tools of budgeting, it gets into a better position to reorder priorities under a variety of fiscal conditions. Even at the present time, there is no need for a stagnant budget policy, but rather a sensible balancing of selective expansions and hard-nosed reductions all within a self-imposed ceiling of fiscal restraint. Thus, an effective budget process will permit Congress simultaneously to deal with some of the most pressing side-effects of inflation (rising unemployment and reduced availability of investment capital) while combatting the inflation itself.

STATEMENT OF ALICE M. RIVLIN

Senator DOMINICK. Ms. Rivlin, you can give your oral statement at this time.

Ms. RIVLIN. Fine. My statement is short, but I will shorten it still further and try to give you very, very briefly the main points that I would like to make.

I did want to start, as we all have, by expressing the extreme pleasure that I feel that this committee does finally exist, that the Congress has given itself a way of looking at the budget as a whole. And I am delighted to be among the first witnesses of this committee.

I am a little less happy about the way the question was put to me. If I may paraphrase what the chairman said to me in his letter, it was how should the Congress cut the nondefense spending in fiscal year 1975 in order to control inflation? And my short answer is that it should not. I think the question implies that the current inflation is primarily caused by high Government spending and that cutting back such spending would ease the inflation.

Unlike Mr. Weidenbaum, I do not think that is right, and I would like briefly to develop three points.

The current inflation is not primarily caused by Government deficits, but by a wage-price spiral set off by several accidental stocks to the economy, some of which has been discussed this morning; the food price increase, devaluation, oil. Cutting back the fiscal 1975 budget by feasible amounts like $5 million is unlikely to make a significant dent in the inflation, but almost certain to make unemployment worse. Cuts in the domestic budget, which were what the chairman asked me to focus on, would hurt those who suffer most from inflation and unemployment.

Let me skip over the first two points because you have heard them developed by others, and move to the third one.

Senator DOMINICK. I am going to have to go. If you will excuse me, and I suggest we just stay in recess until the chairman gets back.

[A brief recess was taken.]

Senator MUSKIE [presiding]. I do not think we will be interrupted again by a vote, so why do we not proceed. Senator Dominick tried to minimize the gap by spelling me. I take it, Professor Weidenbaum, you are through with your prepared statement?

Professor WEIDENBAUM. Yes. Ms. Rivlin was in the middle of hers.

Ms. RIVLIN. I had started, Mr. Chairman, by saying that I would skip over my first two major points, namely, that I do not think this current inflation is primarily caused by Government deficits. I think it is largely attributable to a wage-price spiral as a result of outside shocks to the economy. And the second point, that cutting the fiscal 1975 budget by feasible amounts is unlikely to make a significant dent in the inflation and almost certain to make unemployment considerably worse.

I would like to skip over those points because I think you have heard them developed before by Walter Heller and by Gardner Ackley and this morning by Professor Adams, and move to a more particular point which you had addressed specifically to me, namely: what would be the effects of cuts in the domestic budget? I think they would be bad.

They would hit those who suffer most from the inflation. I would like to develop that point a little bit.

As Roy Ash pointed out last week, it is extremely difficult to cut Federal spending in the short run because commitments have been made and benefit levels established in law. But even if quick cuts—and by that I mean fiscal 1975—were possible, it is difficult for me to see where they could be made in the domestic budget without causing additional anguish to those who are already suffering heavily from the impact of inflation. Roughly, $208 billion was allocated to domestic programs, and by that I mean not defense or space or foreign affairs, in the President's budget for fiscal 1975 as submitted in February. Of this amount about $131 billion or 63 percent goes for direct benefits to individuals either in cash or in kind. Cash payments alone will be approximately $98 billion, almost all of which goes to poor, disabled, or retired persons. Benefits in kind such as medicare and medicaid, housing subsidies, food stamps, amount to about $33 billion and also go almost entirely to very low-income people.

Inflation, particularly the kind of inflation we have right now, hits hardest at low income people who spend a high proportion of their income for necessities, especially food, and people who cannot benefit from the rising wage levels, especially the retired and the disabled. Unemployment also hits hardest at minorities and those without firm attachments to the labor force. It would seem unconscionable to add to the current hardships of low income groups by singling them out for reductions in Federal benefits. If additional Federal budgetary restraint is desirable—and I do not agree that it is—it would be much more equitable to achieve it through across-the-board tax increases paid by everyone than by slashing the incomes of the poor and the elderly.

That leaves the other third of the domestic budget, much of which goes to State and local governments to finance services of various sorts. Approximately $18 billion, less than 9 percent of the domestic budget, goes to support social programs such as education and health service delivery. Many of these services are directed at helping the poor and, again, it seems unjust to single them out for reduction in the name of fighting inflation. Moreover, this portion of the budget has not been rising as fast as the price level; the Federal Government's real level of support for social services has been declining.

An approximately equal amount, about $17 billion, goes to State and local governments for investment in physical resources, including transportation and environmental protection. These programs have more general benefits and one might worry less about cutting them on equity grounds, although I do not think that statement applies to mass transit. But stretching out the completion of physical projects can be extremely inefficient and can lead to the higher cost to Government in the long run.

That leaves revenue sharing as a candidate for cuts in the domestic budget. One might make a case for cutting revenue sharing—if one thought cuts were desirable—on the grounds that the State and local fical crisis appears to have abated and that revenue sharing, by definition, supports the general services of State and local government, not programs for the specially needy. However, cuts in revenue sharing and, indeed, cuts in other Federal grants to State and local governments might be merely a kind of bookkeeping transaction. State and local governments, in the aggregate, have been running surpluses for the last several years. In fact, if you look at the three levels of government together, you find they are not in deficit, they are in surplus. A cut in Federal grants to State and local governments might merely mean that you have less of a surplus in the State and local sector and very little impact on total Government spending.

If the Congress really wants to balance the Federal budget in 1975, it would be much quicker and more equitable to accomplish this end by raising income tax rates than by cutting domestic spending.

I want to make clear that I am not recommending this course of action, since I believe that in the present state of the economy a tax increase would reduce consumer spending, would retard investment, and it would increase unemployment without having an appreciable impact on inflation. It would, however, have been more equitable and more feasible than a comparable cut in domestic spending.

Those of us who counsel against quick budget cuts as a remedy for inflation are certainly not saying that the current level of Government spending is in any sense ideal or that the budget now reflects the most appropriate priorities. That indeed is the set of questions that this committee was created to look into, and I would urge that you do so and that the way to do so is to look ahead into fiscal 1976 and 1977 budgets, not to try to change priorities in the fiscal 1975 budget, because it is too late.

It is my personal belief that it would be much in the national interest to shift public resources gradually from defense to domestic programs. I also believe that the threat of inflation will be with us for many years to come and that it is important to reorient domestic priorities so as to reduce the hardship that both inflation and unemployment

bring to low income people. Our economy has inflationary biases built into it and we can expect that there will be other shocks like those of the last year or so that will set off inflationary spirals difficult to bring under control. We should not abandon the effort to control inflation, but at the same time we should take steps to guard our most vulnerable citizens against its ravages.

We need to protect the recipients of Federal benefits from inflation-caused hardship by building in cost-of-living adjustments to benefit levels. We need to put a national floor under real income by enacting a welfare reform program whose benefits would rise with the cost of living. And we need flexible public employment programs to provide jobs and purchasing power for those thrown out of work by temporary crises in the economy.

I would urge the committee to turn its full attention quickly to these longer run priority questions among others and to begin now to discuss and lay out for the Congress as a whole major budget alternatives for fiscal 1976 and beyond.

Senator MUSKIE. Thank you, Ms. Rivlin.

[The prepared statement of Ms. Rivlin follows:]

PREPARED STATEMENT OF ALICE M. RIVLIN

Mr. Chairman:

This morning I feel something far stronger than the ritual pleasure normally expressed by a witness appearing before a Congressional Committee. I have spent a large part of my professional life worrying about ways in which both the Executive Branch and the Congress could improve their ability to make informed decisions about the federal budget and the national priorities it expresses. I have never understood how the Congress could get along without committees specifically charged with examining the budget as a whole and recommending appropriate fiscal policy and longer-run budget strategy. I am delighted that this committee finally exists and happy to be among its first witnesses.

I am less happy about the question you have asked me. If I may paraphrase the Chairman's letter, the question is: How should the Congress cut non-defense spending in fiscal year 1975 in order to control inflation? My short answer is: It shouldn't. The question implies that the current inflation is primarily caused by high government spending and that cutting back such spending would ease the inflation. I don't think that is right, and I would like briefly to develop three points: (1) The current inflation is not caused primarily by government deficits, but by a wage-price spiral set off by several accidental shocks to the economy. (2) Cutting the fiscal 1975 budget by feasible amounts is unlikely to make a significant dent in the inflation, but almost certain to make unemployment worse. (3) Cuts in the domestic budget will hurt those who suffer most from inflation and unemployment. After all that negative advice I would like to move to one thing I think you should be doing: Considering how to alter the longer-run priorities reflected in the budget so as to protect the groups who now bear the brunt of both inflation and unemployment.

There is no question that government deficits can start inflation and often have. In 1966–69, when unemployment was running below 4 percent the large government deficits used to finance the Vietnam War added to excess demand and helped push prices up. It is also clear that once an inflation gets started it has a tendency to continue. Workers demand wage increases to compensate for increases in the cost of living, past and anticipated, and businesses raise prices to compensate for rising costs, both past and expected.

But a wage-price spiral can be set off by outside shocks to the economy, even when demand is not excessive, and this appears to have happened last year. Several shocks occurred at once: The rapid rise of world food prices associated with poor weather and crop failures, the leap of fuel prices attributable to the oil embargo, world-wide escalation of raw material prices and the increase in cost of American imports that resulted from dollar devaluation. These shocks pushed the cost of living up rapidly—60 percent of the increase last year was attributable to food and fuel alone— and set off the current wage-price spiral.

Government spending does not appear to have played much of a role. The relatively small federal deficits over the last eighteen months are a result of the fact that the economy is operating at less than full employment, rather than the reflection of excess demand being added by the government. If we were to get back to 4 or even 4½ percent unemploment, federal revenues would be larger, some expenditures would be smaller, and the federal budget would be running a modest surplus. Moreover, as Professor Gardner Ackley pointed out before this Committee last week, federal, state, and local governments taken as a whole are exerting appreciable restraint on demand by taking in more than they are paying out. This fact suggests that cuts in federal grants to state and local government might be mainly a bookkeeping transaction—the surpluses would show up in the federal budget rather than in those of state and local governments.

The dreary statistics on employment and economic output that have been pouring out of government agencies during recent weeks certainly do not give evidence of an economy that is overheated or suffering from excess demand. The Gross National Product has declined for two quarters and even optimists see little prospect of growth for the rest of the year. Indeed, the economic forecasters are remarkably unanimous in foreseeing a real Gross National Product for 1974 that will end up slightly below that of 1973. Unemployment is generally expected to rise to around 6 percent, maybe more. High rates of inventory accumulation certainly do not suggest excess demand. In this situation cuts in federal spending seem likely to make weak demand even weaker, to cause production cut-backs and worker layoffs, while having little impact on inflation. It is hard to imagine a budgetary strategy that would be worse for the country's morale and well-being than one which added to unemployment without cutting inflation.

As Roy Ash pointed out last week, it is extremely difficult to cut federal spending in the short-run because commitments have been made and benefit levels established in law. But even if quick cuts were possible, it is difficult to see where they could be made in the domestic budget without causing additional anguish to those already suffering heavily from the impact of the inflation. Roughly $208 billion was allocated to domestic programs (i.e., *not* defense, space, or foreign affairs) in the President's budget for FY 1975 as submitted in February. Of this amount about $131 billion, or 63 percent, goes for direct benefits to individuals either in cash or in kind. Cash payments alone will be approximately $98 billion, almost all of which goes to poor, disabled, or retired persons (Social Security, Veteran's programs, federal retirement, and public assistance). Benefits in-kind (such as Medicare and Medicaid, housing subsidies, food stamps) amount to about $33 billion and also go almost entirely to very low income people.

Inflation hits hardest at low income people who spend a high proportion of their income for necessities, especially food, and at people who cannot benefit from rising wage levels, especially the retired and disabled. Unemployment also hits hardest at minorities and those without firm attachments to the labor force. It would seem unconscionable to add to the current hardships of low income groups by singling them out for reductions in federal benefits. If additional federal budgetary restraint is desirable (and I do not agree that it is) it would be much more equitable to achieve it through across-the-board tax increases paid by everyone than by slashing the incomes of the poor and the elderly.

That leaves the other third of the domestic budget, much of which goes to state and local governments to finance services of various sorts. Approximately $18 billion (less than 9 percent of the domestic budget) goes to support social programs, such as education and health service delivery. Many of these services are directed at helping the poor and, again, it seems unjust to single them out for reduction in the name of fighting inflation. Moreover, this portion of the budget has not been rising as fast as the price level; the federal government's real level of support for social services has been declining.

An approximately equal amount, about $17 billion, goes to state and local governments for investment in physical resources, including transportation and environmental protection. These programs have more general benefits and one might worry less about cutting them on equity grounds, but stretching out the completion of physical projects can be extremely inefficient and can lead to higher cost to government in the long run.

Finally, there is revenue sharing. One might make a case for cutting revenue sharing (if cuts were thought desirable) on the grounds that the state and local fiscal crisis appears to be past and that revenue sharing by definition supports the general services of state and local government, not programs for the specially

needy. As suggested above, however, such cuts might merely reduce state and local surpluses without having any impact on total government spending.

If the Congress really wants to balance the federal budget in FY 1975, it would be both quicker and more equitable to accomplish this end by raising income tax rates than by cutting domestic spending. I am *not* recommending this course of action, since I believe that a tax increase would reduce consumer spending, retard investment, and increase unemployment without having an appreciable impact on inflation. It would, however, be both more equitable and more feasible than a comparable cut in domestic spending.

Those who counsel against quick budget cuts as a remedy for inflation are emphatically not saying that the current level of government spending is ideal or that the budget now reflects most appropriate priorities. Up to now the Congress has not had a mechanism for explicitly considering these problems. Now it has. It is the job of this Committee to focus the attention of the Congress and the nation on questions such as: Is the federal government doing too much or too little? Would it be in the national interest to shift resources from defense to domestic programs? Should the mix of activities within major areas be shifted? But these big questions cannot be addressed if the Committee keeps its attention on the current fiscal year. Major changes on priorities and emphasis will only take place if the Committee turns serious attention to budget alternatives for next year and the two or three years after that.

It is my personal belief that it would be very much in the national interest to shift public resources gradually from defense to domestic programs. I also believe that the threat of inflation will be with us for many years to come and that it is important to re-orient domestic priorities so as to reduce the hardship that both inflation and unemployment bring to low income people. Our economy has inflationary biases built into it, and we can expect that there will be other shocks to the economy that will set off inflationary spirals difficult to bring under control. We should not abandon the effort to control inflation, but, at the same time, we should take steps to guard our most vulnerable citizens against its ravages. We need to protect the recipients of federal benefits from inflation-caused hardship by building in cost of living adjustments to benefit levels. We need to put a national floor under real income by enacting a welfare reform program whose benefits would rise with the cost of living. And we need flexible public employment programs to provide jobs and purchasing power for those thrown out of work by temporary crises in the economy. I urge the Committee to turn its full attention quickly to these longer-run priority questions and to begin now to discuss and lay out for the Congress, as a whole, major budget alternatives for FY 1976 and beyond.

Senator MUSKIE. We will undertake to use the 10-minute rule again. That is going to be difficult with three witnesses to cover.

Professor Weidenbaum, I did not get the benefit of your full testimony. I wonder, therefore, if I could just ask two or three specific questions that you may have answered, but which we have touched with every witness, and on which I would like your advice.

What is your view with respect to the full employment budget? I would assume that you reject the concept.

Professor WEIDENBAUM. I think under the current circumstances, and I have a section in the long paper going into that in detail, the full employment concept has fallen a victim of inflation. In an earlier period it was useful but in this period of double digit inflation, literally, the faster the rate of inflation, the better the full employment budget looks. And if the inflation is big enough, you go from a full employment deficit to a full employment surplus and think you have fiscal restraint just because the inflation is worse than you anticipated.

Therefore, I think it is just a very poor tool, a very poor guide for fiscal policy in this kind of a situation.

Senator MUSKIE. From your point of view we ought to be discussing surpluses and deficits in real terms.

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. Now is it your view that we should seek a balanced budget for fiscal 1975?

Professor WEIDENBAUM. I think that is a very highly desirable objective and the closer that the Congress can get to that objective, the better in terms of inflation, interest rates, and the economy as a whole.

Senator MUSKIE. I take it that you also are committed to the idea of a balanced budget in real terms in 1976.

Professor WEIDENBAUM. Yes, sir, because I believe the inflationary problem will still be severe in 1976.

Senator MUSKIE. As you look to the contribution of Government spending to the forces of inflation, do you think it is appropriate to consider it in terms of all three levels of government?

Professor WEIDENBAUM. Yes, I do and that is a subject I examine specifically in that larger paper. And I must say I came up with very different results than the previous people who have testified. The staff has a copy of the full paper.[1] On page 24 [2] I have a table where I go to the Census Bureau, which is a basic custodian of budget data for State and local governments, and this is the kind of data that is comparable to the Federal data. I believe there is a surprise there. In fiscal 1971, the national income counts, and that is what everyone has been using, showed a surplus for State and local governments of $2.3 billion. The census data showed a deficit of $4.7 billion. In fiscal 1972 the GNP data showed an $8.6 billion surplus. The census data, the budget data for State and local governments showed a modest $300 million surplus.

Unfortunately, we do not yet have the fiscal 1973 data, but the moral of the tale is clear: we have been looking, or I should say, frankly, they have been looking at the wrong set of data. It is not a $10.9 billion surplus that State and local governments have achieved during that 2-year period. It is a $4.4 billion deficit. And Mr. Chairman and members of the committee, I suggest that if you speak to State, and particularly, local governments, you will see they do not have money coming out of their ears.

The typical city, county, town is hard pressed to meet its fiscal requirements.

Senator MUSKIE. So that you support the census estimate of State and local spending?

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. Well, I do not know that I want to take the time at this point to get into the reasons for that. Are they explained in your paper?

Professor WEIDENBAUM. Well, not fully but basically the census data is comparable to the Federal budget data. These are budgetary statistics. The data that the economists use are economic impact estimates which are not on the same basis. I think if we are going to compare the Federal budget to State and local finance, we should compare budgets with budgets.

Senator MUSKIE. In Gardner Ackley's testimony last week, he has these figures.

Professor WEIDENBAUM. What page are you in, because Gardner sent me a copy.

---

[1] See p. 306.
[2] See p. 317.

Senator MUSKIE. It is page 6 of his statement.

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. Taking into account Federal, State, and local, all three levels, he showed in 1971 a deficit of $18.2 billion, in 1972 a deficit of $5.2 billion, in 1973 a $3.6 billion surplus, and in 1974, a $2.5 billion surplus.

The question I really want to put to you is this. I do not want to get into an argument about the accuracy of the figures, although anything you would like to submit to us on that point, we would be happy to receive. But if, on the basis of figures which you accepted, there were an overall surplus in the budgets of the three levels of government, would you accept that as a definition of fiscal restraint, notwithstanding the situation with respect to the Federal budget?

Professor WEIDENBAUM. Yes, but—and I hate to put it that way, Mr. Chairman, but I have to—yes, but providing those statistics include all of the expenditures and revenues of Federal, State, and local governments.

For example, we have got $3 billion of off-budget agencies, which is a subject I go into in some detail in my paper, which is Government spending which are agencies run by civil servants, which is part of the Federal Government, which does not show up in the budget.

Senator MUSKIE. Let me ask a question on this point because I think Dr. Burns raised the same question yesterday. He identified as the measure of off-budget spending the figure of $21 billion.

Now do you treat that in terms of serving budgetary policy? Do you consider that as a deficit attributable to operational programs? Would you, for example, require that other forms of Government spending be reduced by $21 billion in order to offset that kind of expenditure or would you urge that taxes be increased by as much as $21 billion in order to achieve budget balance?

Is that kind of a deficit the same as a deficit in the defense budget or a deficit in the spending for social programs?

Professor WEIDENBAUM. Not quite, and in my paper, on page 13, I deal with one important piece which is comparable and if you turn to page 13, table 3, you will not see those credit agencies like FNMA and GNMA, but bona fide agencies of the Federal Government which, like the Postal Service, provide services, which, like the Rural Electrification Administration, until recently, were a part of the agricultural budget.

These, I submit, are bona fide Federal activities which have the identical impact as the agencies in the budget and this $2.8 billion—yes, sir, I would without hesitation include that in an accurate measure of the Federal fiscal position.

Senator MUSKIE. So you treat the Export-Import Bank, in terms of its budgetary impact, the same way you would——

Professor WEIDENBAUM. The Farmers Home Administration, when they make loans, would show up in the budget. Yes, sir, I would treat them identically.

Senator MUSKIE. So in your judgment, in order to offset the spending of the Export-Import Bank, we ought to either raise taxes or cut other expenses.

Professor WEIDENBAUM. That is right.

Senator MUSKIE. And that is true of the Postal Service?

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. The REA?

Professor WEIDENBAUM. Amen.

Senator MUSKIE. Let's include table 3 of the long statement in the record at this point.

[The table referred to follows:]

TABLE 3.—ESTIMATED NET OUTLAYS OF OFF-BUDGET FEDERAL AGENCIES

[Fiscal year 1975, in millions of dollars]

Agency	Amount
Export-Import Bank	$1,250
Postal Service [1]	733
Rural Electrification Administration	463
Environmental Financing Authority	240
Rural Telephone Bank	135
U.S. Railway Association	(2)
Federal Financing Bank	(2)
Total	2,821

[1] Net after receipt of subsidy of $1,533,000,000 from budget funds.
[2] Being organized; estimates not yet available.

Senator MUSKIE. I have some questions of Mr. Warnke and Ms. Rivlin, but my time is about up so I will yield to Mr. Dominick at this point.

Senator DOMINICK. Mr. Chairman, I must say I enjoyed reading all three of the brief statements that were given, and listening to them, and it reminds me of a Senator that I was talking to a couple of days ago who said he did not listen anymore to any economists because they all said yes on one hand, no on the other, and he said he was looking for a one-armed economist.

I have some questions, Professor Weidenbaum, to present to you in writing from Senator Fannin, and I am sure you will have no trouble in answering them and I would appreciate it if you would answer them for the record.

Professor WEIDENBAUM. Yes, sir.

[The information referred to follows:]

ANSWERS TO QUESTIONS BY SENATOR FANNIN, SUBMITTED TO MURRAY L. WEIDENBAUM

Question 1. Prior witnesses have testified that we would not have a budget deficit if we consider all levels of government, i.e., Federal, State and local. Would you care to comment?

Answer. I believe they have been looking at an inappropriate set of numbers, the state and local "sector" of the national income accounts. These data are useful to indicate economic impact, but they are not measures of financial condition. As I show in the paper that I prepared for the committee (table 7), the Census Bureau data based on financial reports of states and localities do not show large surpluses. For example, in the fiscal years 1971 and 1972, state and local governments ran a cumulative deficit of $4.4 billion.

Question 2. Can you explain your recommendation relating to zero real growth for the Federal budget?

Answer. I thought that it would be useful to develop an approach to a spending ceiling that avoided pulling a figure out of the air. My recommendation for a zero real growth in federal spending in fiscal years 1975 and 1976 is in the nature of a target. It will be extremely difficult to keep within the target, especially in fiscal '75, but the effort certainly should be made.

Question 3. There was some confusion and conflicting statements relating to off-budget items and credit agencies in the testimony yesterday in the Committee. Could you shed some light on this conflict?

Answer. It is necessary to distinguish between off-budget items and credit agencies. Off-budget items clearly belong in the budget. They are wholly federally owned activities operated by civil servants. The category is not limited to credit programs, as it includes the Postal Service. These items have been arbitrarily moved out of the budget because of statutes, not logic. The credit agencies are a more complicated matter. They do not involve direct Federal spending, but rather use the government's credit power. They are not costless to the nation or to the government. These agencies reduce the amount of funds available to private borrowers. In the process they tend to raise interest rates, including the interest that the Treasury has to pay.

Question 4. What can the Congress do about high interest rates?

Answer. There is one obvious and direct contribution that Congress can make. By appropriating less in the first place, Congress can reduce the size of the federal deficit and thus reduce the amount of borrowing by the Treasury. Less borrowing by the Treasury will ease the pressure on interest rates.

Senator DOMINICK. Mr. Warnke, you and I have known each other for quite a long time and I understand your philosophical position on this, on cutting the defense budget, but for the record and serving on the Armed Services Committee as I do, I am not sure you are totally up-to-date on what we have been doing.

We have a series of subcommittees now which go in in some depth into weapons systems as to whether we should even get them started, one of them being the R. & D. Subcommittee, chaired by Senator McIntyre, which I have the privilege of being the ranking member on, and I think we have done quite a job on this. We are not just taking in as we used to do, maybe 15 years ago, everything the defense asked for and give it to them.

You make the statement on page 6 that, along with the all-volunteer army and the higher manpower costs, the defense budget will be increased over $145 billion by the late 1970s. I do not understand that statement at all, when, as a matter of fact, we have been cutting the defense budget for at least 3 years. We have cut a million men out of the armed services. We have, in fact, cut the actual amount down to a level below 1950, as far as procurement power is concerned, and we have substantially increased the pay for the all-volunteer service. At the same time that we have done that it is our intention, I think I should say that, to try and hold this down to some kind of a reasonable level.

Now you put a statement in here on page 7 in which you said that we should show the type procurement—and I am not sure whether the figures in the righthand side of that table are in dollars or in numbers of tanks. We are producing now about 300 a year, maybe a little under that. The Soviets, on the other hand, are producing 3,000 a year, as was shown in the Middle East war. There is a certain imbalance there which could create a lot of problems in the event that we ever had to use our own tanks somewhere.

Am I correct in believing that what you think is that we really do not have a national defense problem?

Mr. WARNKE. As you said, Senator Dominick, we have had the opportunity to exchange views on this subject before. I do not think that I will quite succeed in convincing you and I do not think you will quite succeed in convincing me, but I do not think our difference is as great as that you feel there is a national security problem and I feel there is not. I recognize that there is a national security problem. I also feel that the threats to our national security by military power are quite limited. We are not in the unfortunate position of the Soviet

Union. We are not surrounded by hostile communist neighbors. We have quiet borders and we have the advantage of oceans. That does not give us the opportunity of course to retreat to a fortress America concept. But I do not think we have to feel that we are a beleaguered outpost of freedom in a hostile world.

We have allies. We have friends. They are strong. They are faithful. We do not have rebellious satellites and I feel that we can secure our national defense, from any sort of military threat with a significant cut in the amount of money that we are spending.

I think that our problem is that we have not really assessed what the role is of American military power in today's world. I still find statements in the Secretary of Defense's posture statement for example, about the United States' global military mission.

Now, I regard that as being nonsense.

I say that with some hesitation, because he is a bright man, but I think it is time that somebody suggested that we do not have a global military mission, that we cannot keep world peace by making war and that our role as far as intervention in local or regional conflicts is concerned ought to be one of diplomacy rather than any sort of American military participation. And I think if we were to evaluate the missions that genuinely make sense that we could end up with a defense budget which would be something like $10 to $15 billion less than is proposed in the current fiscal year.

Senator DOMINICK. I talked to a man in the middle 50s, Mr. Warnke, that was very interesting. I talked to him at some length and he happened to be in the defense business, and he said that actually, you could spend your whole gross national product on military defense, and would you be any safer that way than you would if you did not do it? Or, he said, we could cut it in half, and would we be any better? So what are the numbers, he said, that are effective? I think it was a very provocative statement and I think yours is a very provocative statement, but let me ask you this. Would you or would you not, and if you had had the position and the power, have reinforced Israel during the October War?

Mr. WARNKE. I favored the supply of arms to Israel during the October War, yes. I think that we had a sufficient role in the creation of Israel so we cannot avoid responsibility for its survival. But I think American military intervention would surely have spelled the demise of Israel.

Senator DOMINICK. I did not ask for that, and neither did Israel, fortunately. But the interesting thing is, that during that we had to do it unilaterally. We got no help from our allies whatsoever, even on landing rights, except in Portugal.

Mr. WARNKE. That is correct.

Senator DOMINICK. So when you say that we have reliable, strong allies, we may have but the question is, where? And when? And under what circumstances?

Obviously, if they get attacked they are probably going to fight, in Europe I mean, but that does not necessarily mean that they are going to be able to, as you yourself have testified before, be able to restrain the Soviets if the Soviets decided on an attack on Europe.

I believe that you would agree with me that it is in our interest to keep Europe, Western Europe, part of the free world. And if we are

going to do that, then somehow or another we are going to have to have the mechanism, both to get people there and to have them be efficient when they get there.

Is that not correct?

Mr. WARNKE. That is correct, and none of the cuts that I have proposed would affect our posture in Europe. If you are looking at realistic threats to American military security, I think you have to put Western Europe as the No. 1 vulnerable area. That is the one area in which Soviet power might be applied to our detriment, because it would be to the detriment of the security of the Western Europeans. As a consequence, as you know, Senator, I have supported over some time, a substantial American military presence in Europe. I continue to support it.

Senator DOMINICK. Well, that is fine. I just do not think that we can go at this with the attitude that we are going to get all of our cuts such as they may be out of the military budget and we have not been doing that on the floor in the appropriations process.

So I hope that we will not do it that way, keeping in mind the value of the dollar at the moment.

Mr. WARNKE. That is why, Senator, I suggest in my statement that we ought to apply it on an equitable basis, and on that sort of a basis I think that the cut would be something like $6.5 billion.

Now I am delighted to see that the Senate has up to this point imposed a cut of some $5 billion. I would sincerely hope that that cut would be retained. I of course would have favored the further cut to a ceiling of $81 billion.

Senator DOMINICK. Well, if I remember correctly you and I were on the same side in saying that we should not guarantee the loan to Lockheed.

Mr. WARNKE. That is correct.

Senator DOMINICK. And I so voted.

That, however, would have caused, if I understand it correctly, a real economic collapse in this country on the terms of employment if Lockheed had gone down. Now what would we do about that?

Mr. WARNKE. Well, I must say, Senator, that I believe in the constitutional right of a poorly run business to go broke.

Senator DOMINICK. Thank you.

Mr. WARNKE. And I do not believe that the U.S. Government has got a responsibility to keep them afloat.

Senator DOMINICK. That is exactly right.

Mr. WARNKE. And I also feel that if that were to happen that you would find that the personnel and other assets would not disappear. They would end up in other hands and I think that the security of the country could very well survive that. Now, I am not saying that Lockheed is poorly run. I do not know. I have not studied the situation. But if they have to stay afloat by artificial Government props, then I submit that this is inconsistent with what I view as the free enterprise system.

Senator DOMINICK. I agree with you totally on all of those comments.

My time is up. It must be Senator Moss.

Senator Moss. Thank you, Mr. Chairman. I regret that I was absent during some of the direct statements that were made by the knowl-

edgeable people who are before us and I have read as quickly as I could or at least skimmed through those statements.

I will read them more fully. I have maybe just one or two questions. I would like to ask Dr. Rivlin a question.

The Wharton model which was presented, this model shows that certain categories of Federal outlays which involved spending for goods and services are four times as inflationary and four times as productive as in job size programs such as Social Security which involved direct transfer of payments. Is it possible for this committee to assign an inflationary unemployment quotient to a specific program?

Ms. RIVLIN. Well, I have not examined the Wharton model in enough detail to know whether those are right in terms of the exact numbers.

It certainly seems reasonable that some kinds of programs are more directly inflationary than others, and that where the Government is coming into the market and buying things there is a more direct effect than when they are giving money to people who in turn buy things. It depends partly on who those people are.

I think it would be very difficult to assign certain kinds of quotients but I would not discourage you from trying this and from getting the Wharton people and other experts together to see what they might say about the inflationary and unemployment effects of the different kinds of programs.

Senator Moss. Could we do the same thing do you suppose with tax programs, in determining which would increase employment or decrease in prices or level out prices?

Ms. RIVLIN. Yes. I think this again is subject to be approached with care, but some fairly clear differences exist certainly between whether you are cutting or raising taxes at the low or high end of the income scale. You expect that to have more effect on consumer spending if you are raising or lowering the low of the scale.

Professor WEIDENBAUM. Senator, you might want to see how good the track record of that model is and how badly burnt you might have been in the past if you had used it.

Senator Moss. I suspect we had better look at that to see. Dr. Rivlin, in your article in the Washington Post, Sunday, which is an excellent one, and I commend you for it, you said that to be successful a program of wage and price restraint would require congressional action on a new tax and spending policy.

Just what congressional action would encourage the wage and price restraint that you say should be the goal of Government policy?

Ms. RIVLIN. Well, I was talking there, Senator, about what the President might do right now to get both business and labor to moderate their wage-price demands. That seems to me to be the essence of what we do right now about this wage-price spiral. I was suggesting that the projected summit conference not be just a talk-fest but that it be a reflection of a bargain struck behind the scenes. I think it would have to take a lot of very skillful negotiation between the Government and representatives of business and labor in which both business and labor leaders would be willing to exercise considerable voluntary safe restraint.

But I was also suggesting that part of this bargain might well be involved with other things that the Government also has leverage on.

Now, some of my colleagues at Brookings have suggested, for example, that one way to insure higher probability of labor cooperation in holding down wage demands would be to make it part of a package deal in which you would offer some tax cuts at the low end of the income scale as part of a kind of social compact or bargain with labor that would say: we will take of part of perhaps the payroll tax in exchange for labor restraint. The payroll tax hits labor very hard and one might suggest that either a temporary or a permanent cut in the payroll tax in exchange for a considerable amount of wage restraint over the next few months might be a good way to hold down the inflation.

Senator Moss. A combination of jawboning and bargaining, then?

Ms. RIVLIN. Right. It would be a very delicate thing to do and it would have to be very skillfully managed and with cooperation from everybody, but this may be a moment in history when that kind of cooperation could be achieved.

Senator Moss. Dr. Weidenbaum, I do not think you agree with that.

Professor WEIDENBAUM. You are right, Senator. First of all, it is hard for me to see how any sensible union negotiator would settle for a lower wage demand just because taxes are being reduced, particularly on lower income people. We are talking about fairly middle income union employees and it certainly would not be a dollar for dollar reduction. I assure you if you get a 50 cent reduction in wage demands for a dollar reduction in taxes, the balance of that is inflationary.

I suggest there is a basis for an agreement and that is to convince hardnosed business and hardnosed labor negotiators that the outlook for the economy is less inflationary Senator, the way I believe you can convince them is to show that the Government is curtailing spending, is reducing the deficit and hence that there is less inflation in the future. That is the way to strike the bargain.

Senator Moss. Well, that is the name of the game we are trying to figure out, of course, and we appreciate the contributions that you make here.

I will relinguish the balance of my time.

Mr. Chairman?

Senator MUSKIE. Senator Biden.

Senator BIDEN. Thank you very much.

You will be relieved, Mr. Chairman, I am not going to be able to take my full ten minutes. I have to go. But I would like to ask one short question, prefaced by a short comment.

I understand what Secretary Warnke said and I agree with it. I do not know enough about what you two others said to know whether I agree or do not agree, and the reason I say that, I am not trying to be facetious, is that I do not know that anybody is talking about inflation.

Dr. Rivlin, there have been three or four witnesses we have had with whom I would probably be, from the tone of the testimony, in philosophical agreement with on social programs. And my voting record would reflect it. But, again, I do not understand you all because it does not seem as though you are really talking about inflation. It seems as though you are saying inflation is something you cannot lick and we are really not going to do much about it so what we should really concentrate on in this committee and in Congress and in Government in general is how we really are going to ameliorate the effects

of inflation on certain sectors of the economy, particularly the low and moderate income.

Now, I guess the specific question I have is, is there a difference between deficits and balanced budgets in terms of any effect on the economy, and particularly inflation, or is it just the aggregate amount of spending that is important?

Ms. RIVLIN. Let me start by saying I think inflation is terribly important and that we ought to do everything we can about it.

Senator BIDEN. I was not suggesting that you did not think it was important.

Ms. RIVLIN. And I think there are some things we can do about it, but it is important to know how the particular inflation you are dealing with started. There is some disagreement among economists about this.

It seems to me that the evidence points in the direction that this particular inflation was not started by Government deficit spending.

We have had inflations that were. We had one in 1966–69 that was very directly traceable to the fact that we were financing the Vietnam war by running a Government deficit. And this created excess demand for goods and services and it pushed prices up.

And I do not think there is any disagreement about that. The question now is whether we are in a comparable situation, and I do not think we are.

I think we are dealing with an inflation which did not come from excess demand, particularly excess demand created by the Government.

It got started by some shocks from outside the economy, things that could not really have been predicted, like the rapid rise in food prices which was partly just an act of God, and the oil embargo. Last year's Consumer Price Index went up very rapidly, but 60 percent of the increase was attributed to food and fuel. And there was not very much that the Government could have done about that.

Right now we are in a situation where a wage-price spiral, following on these initial increases in the cost of living, is occurring.

It is very difficult to do anything about that, especially when it is occurring at a time when we also have substantial unemployment and a very soft-looking economy and what I am saying, and Professor Adams was saying also this morning, is that in the situation you are in now, cutting Government spending, by $5 to $10 billion, is likely to make the economy softer and to increase the unemployment rate without doing very much to mitigate the inflation. And therefore I would counsel against it, and that I think is the connection.

Senator BIDEN. And how about the other side? Does the present situation call for increased Federal expenditure?

Ms. RIVLIN. Well the present situation is a very, very difficult one, if you are trying to manage fiscal policy.

Senator BIDEN. Even more difficult if you are in public office and have to explain it.

Ms. RIVLIN. At the time this budget was formulated it was a slightly restrictive budget, and I do believe that the full employment for surplus has some meaning. But it was a budget in which the Government was leaning slightly against the wind and in a slightly restrictive direction.

I think it was put together pretty sensibly from a fiscal policy point of view. Since the budget was presented by the President, two things have happened. The economy has gotten a lot softer, which by itself would indicate that we ought to have more stimulus rather than less. But the inflation has gotten worse, and there you have it. It is like a patient with two diseases and the treatment that helps one makes the other worse. It is a situation doctors face all the time. What do you do? I think right now I would be probably for a mild increase in the stimulus, which might take the form of a low income tax cut or might take the form of public employment programs or both, but the main thing is not to make the budget more restrictive.

Senator BIDEN. But do deficits play a role there for example? If we talk about the revenue side of the picture which we are supposedly going to address ourselves to in this committee, is it important that we assume for the moment that the stimulus needed is a tax cut for a certain segment of the economy, that segment which uses 90 percent or whatever, a very large percentage of their income on consumer products?

Is it a requisite that we make up for that lost revenue somewhere else or does that matter?

Ms. RIVLIN. Well, certainly it matters. It depends what you want to have happen. And if you believe that decreasing the deficit, increasing the surplus will have a deleterious effect on our employment and you are worried about that, and I am, then whatever you do you should not be increasing the restrictiveness of the budget.

Now you can play with both sides obviously and the great thing about this committee is that you have both within your purview for the first time. For purpose of changing the impact of the budget on the economy quickly, it is economically much more feasible to do that through changing tax rates. It may be politically more difficult.

Professor WEIDENBAUM. Senator, I do want you to appreciate that there are fundamental disagreements between these two economists.

Ms. RIVLIN. I think they figured that out.

Senator BIDEN. I am sure you appreciate the same kind of fundamental disagreement exists on the committee. Would you like to comment on anything the good Doctor just spoke to?

Professor WEIDENBAUM. Thank you, yes. I do think that there is a role for fiscal restraint, for slowing down the rise in Government spending as a way of fighting the inflation.

I do not think we can dismiss it.

Senator BIDEN. Do you think it is a role like Dr. Burns described yesterday which was sort of interesting? He talked more about the psychological impact of admitting that if you look at the models then the models would show that really there will not be much impact, but it was a psychological impact and he went on to say that if, and my colleagues will correct me if I am wrong, he went on to say that he thought there may be increased employment as a consequence of the fiscal restraint because of this psychological impact. Do you buy that argument?

Professor WEIDENBAUM. Senator, that is point 6 of the six points in my statement, as to how the budget contributes to inflation.

The other five are not psychological but they are very real.

For example, deficit spending means higher interest rates because the Treasury is going into the money market. I am sometimes surprised

why people, for example, are worrying that the Treasury is drawing money out of the savings and loans by issuing high interest bearing notes. There is a very simple way of dealing with that situation. Cut appropriations, reduce Government spending so the Treasury does not have to go into the money markets and draw funds out of the private economy.

Senator BIDEN. I think it would be very useful. I do not know, but it would be useful for me if sometime I could have several hours to get both of you together in the same room, and I mean that sincerely, because I am not accomplished enough to know the questions to ask each of you independently and half the time I am getting beyond the point, well, I am not beyond the point actually. I tend to be impressed by every expert that comes up here. I am getting like that two-armed economist. I don't know what the hell's going on, but if I can have you both, seriously, if I tried to set that up would you be kind enough to tutor me together, and to fight with one another in my presence?

Professor WEIDENBAUM. I will be glad to learn together.

Ms. RIVLIN. I would be delighted.

Senator BIDEN. Thank you very much. Mr. Chairman?

Senator MUSKIE. Senator Chiles.

Senator CHILES. Mr. Warnke, you talked about the trouble that Congress might have second-guessing the Armed Services and the Defense Appropriations Committees' military expenditures.

Is not this true in part because of the way that we structure and debate the defense budget? And all the other items of the budget, really, the bits and pieces and line items where you have to be an expert to even tell what you are talking about when you are talking about these line item figures.

Would not it help to restructure the budget and debate the end-purpose missions like strategic defense, close air support, free air defense rather than try to deal with each one of these line items?

Mr. WARNKE. I believe that is correct, Senator Chiles. As Senator Dominick has pointed out, the Armed Services Committees in my opinion also have been doing an infinitely better job in the past few years by going at it with much that sort of an approach and, as he points out, Senator McIntyre's R. & D. committee has gone at from the standpoint of missions. That is why I propose in my written statement that the military budget ought to be presented consistently in terms of missions. Part of it is at the present time, part of it is not.

You find procurement for example, broken down on a different basis than you do O. & M. or personnel. And I think that the Senate should consider it in terms of missions and then they would be able to exercise the kind of judgment which I think is called for to determine whether that mission is a sufficiently valuable or sufficiently valid one as to require the expenditure of the sort of funds requested.

Senator CHILES. Well the thrust of your testimony has been more the military. Does not that make sense in HEW the same way? If you are dealing with the dropout program, rather than have 16 different dropout programs?

Mr. WARNKE I would certainly think so, Senator Chiles. I cannot pretend to get involved in the economics debate that has been going on between my colleagues any more than, even less than Senator Biden.

I am sort of like George Plimpton in "Paper Lion;" it's fun to play in the pro backfield, but I am not going to score many points.

Senator CHILES. Part of the studies of the Government Procurement Commission having to do with the military or along the lines of trying to promote more effectve competition between how you went in to designate what a weapons system or any major system and how you were going to set that up, have you had, do you have any comments to make on that?

Mr. WARNKE. I am really not sure where the competition is that you would be addressing under the circumstances, Senator Chiles. Would it be competition as among defense contractors or among the services?

Senator CHILES. Well it looks like right now the military decides that they want a new weapons system, they go forward in house with much of the structure of what that system is going to be and rather than saying, initially, to your defense contractors, here is what we want this weapon to do. Give us your ideas and your cost and your design and how it would accomplish this.

They go in and in-house design this thing to the point when they put it out they are not asking for any kind of innovative competition.

They are only asking for whether you are going to use maybe one way or another or any perhaps that you have lower overhead than they do.

But you have lost all of your possibilities of any innovative competition.

Mr. WARNKE. I think that definitely is a problem, and I think that some of the weapons systems that we are currently having problems with derive in part from exactly that phenomenon.

I think that the people who are eventually going to have to build the particular weapons system should have more of a part in the actual design and I would agree with you that, if you could first of all get a focus on what the mission is, just what it is that you want a particular weapons system to do and why, and as against what sort of a threat assessment, you could then have that concept implemented by those who are in a position perhaps to bring it into practical operation more effectively and at lower cost than if it were done entirely within house.

I would certainly agree with that.

Senator CHILES. Then this question is for you or any other members of the panel that could respond, again along the lines of trying to have Congress set the guidelines of how the budget should be presented to us. The way it is now, we just accept this budget document that comes over. It is pages and pages and millions of items, and through that each committee tries to make some kind of sense out of it. But we do not have a program oriented budget. We do not have a mission oriented budget. There is no way we can see the priorities that the executive branch is placing on these items, and really while I think this would be helpful to us, it would also be very helpful to the executive branch, because I think at the early stages it would allow them to make the kind of decisions that they should be making.

I wonder if you could comment on that.

Professor WEIDENBAUM. Senator, I must say I am delighted to hear you say that because point 1 in my statement is to adopt a program approach to the Federal budget and national priorities. In the de-

tailed paper which I have submitted to the record, I showed a hypothetical Government-wide planning budget dealing I hope with just the point you raised, how to focus on the key alternative priorities rather than the bits and pieces. It is pages 2 through 6 of my detailed statement. I have a format there.

Ms. RIVLIN. May I say I am sorry Senator Biden has left because I would like him to see that. Professor Weidenbaum and I agree on some things, and I fully agree with that.

Senator CHILES. Thank you. The Government Operations Committee, which developed the Senate side of the budget legislation, also reported out a bill, S. 1414, that would provide Congress with the ability to seek this kind of information and make these kinds of requirements. That bill was later amended on the Budget Act on the floor, and some small semblance of that survived the conference, a very small semblance of that kind of authority that would have given the Congress the authority, but S. 1414 is still on the calendar, and maybe we will get to it.

That is all.

Senator MUSKIE. I know at least one of you is under some kind of time constraint, and I suspect all of you are, so I will not hold you for the range of questions that it would be interesting to explore.

I would like to focus your attention on this chart that was put in the record by Mr. Ash the other day. It is a chart that shows the composition of outlays in fiscal year 1975 budget, dividing them between mandatory spending and discretionary spending, for the purpose of suggesting some of the constraints that we face as we undertake to consider budget cuts.

Both Dr. Rivlin and Mr. Warnke talked about cuts or potential cuts, or the impacts of cuts in the domestic or the Defense side of the budget, and I wondered if you would be in agreement with the basic thrust of this chart. I see you have it before you. You notice that mandatory spending totals $225 billion of the $305 billion in the budget. I take it that that refers to spending that cannot be reduced without breaking commitments already entered into and/or legislative changes to reduce payments, transfers and so on.

Is that a figure that you would like to challenge at all, any of you?

Ms. RIVLIN. I for one would not be. I think one can break down the budget in various ways, but the mandatory or uncontrollable portion is very large. I think it is, however, less a legal matter than mainly a moral matter.

Now, when you are in the executive branch, as all of us have been, it is a legal matter. There are certain types of spending that cannot be changed unless a law is changed, and there is nothing the executive can do about it.

From the point of view of the Congress, that is not really true. If you want to cut social security benefits, you can cut social security benefits. You have the legal power to do so, and it becomes more a question of looking at the budget in terms of who would be hurt if you did cut various things, and what your moral commitments and political commitments really are. And there I think the story is very much the same. It is very difficult to cut spending in the short run, any kind of spending.

Senator MUSKIE. Well, I think the value, if that is an accurate or useful way of categorizing spending, has some utility for us because it highlights the kinds of changes that need to be made.

If you want to go into this area at all, like a cut on social security benefits, just to mention that is to suggest some practicability as well as from my point of view the immorality of it. But these are the kind of commitments that sort of freeze that $225 billion into place a little more firmly than the next category.

Do you disagree with that?

Professor WEIDENBAUM. As an old Budget Bureau hand, I have been through this exercise many times in the past quarter of a century, and this is accurate from the point of view of the discretion of the Budget Office, but as Dr. Rivlin pointed out, it is not quite the same from the point of view of the Congress. Some of these contractual obligations, like interest on the public debt, are true uncontrollables. Some of these subsidies, whether it is housing or some other area, are only uncontrollable because there is a law on the statute books which the Congress may not have had a good look at in a decade or two decades, and some of these programs in three decades. Hence, one of my recommendations, point 3, is control the uncontrollables.

I take a new look at the tremendous mass of legislation which restricts discretion of this committee and of the Congress and some of that restriction may not correspond to today's priorities, and needs to be lifted.

Senator MUSKIE. Do you have in your statement a list of those programs? No one has broken those out yet and it might be useful.

Professor WEIDENBAUM. I would be glad to supply such a list for the record, Mr. Chairman.

[The information referred to above follows:]

A TECHNICAL NOTE

Trust funds and the permanent and indefinite appropriations are clearly identified in the budget. This note lists those items which are "other fixed charges."

Legislative Branch—Senate:
- Compensation of Vice President and Senators
- Expense allowance of Vice President and majority and minority leaders
- Mileage of President of the Senate and Senators
- Payments to estates and widows of deceased members of the Senate

Legislative Branch—House of Representatives:
- Compensation of members
- Mileage of members and expense allowance of Speaker
- Members' clerk hire
- Payments to widows and heirs of deceased members of Congress

Judiciary: Salaries of Judges

Executive Office of the President: Compensation of the President

Department of Agriculture: Commodity Credit Corporation—price support and related programs

Department of Defense: Retired pay, defense

Department of Health, Education, and Welfare:
- Retirement pay and medical benefits for commissioned officers
- Grants to states for public assistance
- Payments to Social Security Trust Funds

Department of Labor:
- Federal unemployment benefits and allowances
- Federal workmen's compensation benefits

Department of State: Payment to foreign service retirement and disability fund

Department of Transportation: Retired pay

Department of the Treasury:
Claims, judgments and relief acts
Payment of government losses in shipment
Veterans Administration:
Income security
Readjustment benefits
Veterans insurance and indemnities
Service-disabled veterans insurance fund
Veterans reopened insurance fund
Veterans special life insurance fund
Civil Service Commission:
Annuities under special acts
Government payment for annuitants, employees' health benefits
Foreign Claims Settlement Commission: Payment of Vietnam and U.S.S. *Pueblo* prisoner-of-war claims
Interstate Commerce Commission: Payment of loan guarantees
Railroad Retirement Board: Payment for military service credit
General Services Administration: Payments, public buildings purchase contracts

Source: Murray L. Weidenbaum and Dan Larkins, *The Federal Budget for 1973*, Washington, American Enterprise Institute for Public Policy Research, 1972, pp. 55–57.

Senator MUSKIE. If changes in those areas require legislation, point that out. Readers of the record may not necessarily agree with your conclusions, but if you think there are areas for exercise of our legislative discretion and that we ought to examine, then I think we would appreciate it.

But at the moment, the fact that legislation would be required to change any of these programs is an obstacle that is not found with respect to discretionary programs, so that it is more difficult to break out savings or cuts in that mandatory spending area than in the other area. You all agree with that?

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. Would you agree with that, Mr. Warnke? Because there is about $23 billion of Defense expenditures in this category. Does that $23 billion include any of the spending that you have covered in your proposals for cuts in Defense spending?

Mr. WARNKE. No, none of it is.

Senator MUSKIE. What does that $23 billion include?

Mr. WARNKE. That would be principally veterans' benefits.

Professor WEIDENBAUM. If I may, there are two aspects of that. One, as Mr. Warnke says quite accurately, is retired pay of the Army. The larger part is expenditures for contracts already made, and here there is precedent, of course, for canceling, reducing contracts which are commitments, and clearly the Defense Department, the Government has the power and has upon occasion exercised it of altering the contracts. That is not a recommendation on my part. It is just a factual statement.

Senator MUSKIE. Mr. Ash made that point with regard to not only the Defense sector but also the non-Defense sector. This category includes contractual obligations that could be renegotiated, but he warned that the results would be minimal. I have no judgment on that.

With respect to discretionary spending, if we were thinking in terms of a $5 billion to $10 billion cut in the budget, this would be the overall area, I take it, in which our search should be most productive.

Of that area, Defense amounts to $57 billion. If we were to exclude Defense, as some would argue, and as several administration witnesses

have argued, then all the cuts would have to come out of the $35 billion in non-Defense areas.

Is that accurate?

In other words, if we were to make $10 billion in cuts in non-Defense areas, are we for practical purposes limited to the $35 billion as a base?

Professor WEIDENBAUM. As you stated, Mr. Chairman, but I think if there is anything that this whole panel agrees with, it is that we welcome the hardnosed attitude of the Senate in cutting the Defense budget by a reasonable amount, and I can only add personally I hope that the Senate and the Congress takes a similar hardnosed attitude on the civilian budget. There should not be sacred cows. I do not think there should be sacred cows, military or civilian.

Senator MUSKIE. I think Senator Magnuson said just the other day that he thought that when all the numbers were in the Appropriations Committee—and he expects them to be in by the end of this week—that total cuts in appropriations will amount to $7 to $8 billion. That, I take it, includes the $5 billion in the Defense appropriation bill, which the Senate acted on yesterday. So that obviously suggests another $3 to $4 billion, and I do not have the detail on that, in other areas.

Professor WEIDENBAUM. Now, not all of that will be cuts in expenditure in fiscal 1975, particularly in the military. Much of that is long leadtime procurement which will show up in lesser rates of expenditures in fiscal 1976 and 1977.

Senator MUSKIE. Well, I am talking in terms of the $305 billion. Is all of the $305 billion going to be spent in fiscal 1975?

Professor WEIDENBAUM. Yes, sir.

Senator MUSKIE. There are no——

Professor WEIDENBAUM. $305 billion is not the total appropriations to be enacted for fiscal 1975, but the expenditures out of both old money and new money.

Senator MUSKIE. What I am trying to get at is a number that you would apply against, say, $305 billion.

Are you saying that that the $5 billion that we cut from defense appropriations yesterday is not a reduction to that amount of $305 billion?

Professor WEIDENBAUM. I guess about half of it, offhand. I have not seen the detail, but as a rule of thumb, I would say no more than half of it, maybe $2 billion.

Senator MUSKIE. Is the $305 billion an outlay figure or a budget authority figure?

Professor WEIDENBAUM. It is an outlay figure.

And if there is a $5 billion cut in DOD, which is mainly procurement, that sort of an area, I doubt whether much more than $2 billion, even if that much, would show up in reduced outlays in this fiscal year. I would have to see the details to make a more informed judgment.

Senator MUSKIE. Maybe you can educate me on this point.

I understood that the Defense Department said that the budget estimates which were reduced by $5 billion were part of a $305 billion total budget.

Professor WEIDENBAUM. Not quite. The Senate, the Congress does not directly, unless it is acting on a ceiling, but when it is acting on the budget it is voting on appropriations. In the case of the military, par-

ticularly, military procurement and research and development, the appropriations that the Congress enacts in a given year are spent over a period of 4 to 5 years.

Senator MUSKIE. Let me ask you this. You add up the figures in this chart. You have $23 billion Defense in the mandatory spending category. You have $57 billion in the discretionary spending category. That adds up to $80 billion. Then in addition there is military assistance of from $7 to $8 billion. That adds up to $87 or $88 billion.

It is that number that was reduced by $5 billion, as I understood from the report on the Defense appropriation bill?

Professor WEIDENBAUM. But that is new money. That is budget authorizations or appropriations. It is not expenditures.

Senator MUSKIE. I have taken the figure out of this analysis which is an analysis of the $305 billion. This analysis comes up with the same numbers that the Appropriations Committee told us yesterday they were using in cutting $5 billion from the Defense bill. But you tell me that not all of that $5 billion is a cut.

Professor WEIDENBAUM. I would feel much more comfortable if I had a copy of the Senate's action.

Senator MUSKIE. Well, instead of belaboring the issue, the point I want to make for our benefit is to try to narrow the focus of the achievement.

If you cut $10 billion, you have the choice as to whether you are going to cut $10 billion from Defense and non-Defense items, or simply from non-Defense. You are in agreement on that point.

Let me ask you though, since you raise the point, Professor Weidenbaum—if you wanted to achieve a $10 billion cut in outlays—and you are the first witness, I think, to emphasize that point—what would you have to cut in appropriations to achieve it?

Professor WEIDENBAUM. There is not a specific number. In other words, it depends upon the appropriations you cut. If you cut salary and expense appropriations, the bulk of which are spent in the year of the appropriation, it is close, but not exactly, it is close to a one to one correspondence. But whether it is military or civilian, when you cut appropriations for construction or procurement of new long lead production items, a dollar cut in appropriations may not be much more than a 50-cent reduction in expenditures in that same year. So it depends on what you cut.

Senator MUSKIE. So what you are suggesting is a $10 billion cut in outlays, whether or not to achieve that would involve 50 percent more in cuts in appropriations.

Professor WEIDENBAUM. It is a target. I am very dubious of the Congress achieving the target, you understand.

Senator MUSKIE. There is no hope of achieving it if you are not specific about what the target is.

Professor WEIDENBAUM. On the average, given the overall size of the dimensions of government spending, it would take on the average of a $15 billion cut in appropriations to effectuate a $10 billion cut in expenditures this fiscal year.

Senator MUSKIE. Is that $15 billion a cut from the $305 billion?

Professor WEIDENBAUM. In order to cut the $305 billion $10 billion, you need to cut budget authority, which is different. This is not budget authority. Those expenditures were outlays.

Senator MUSKIE. This is $305 billion.

Professor WEIDENBAUM. If the staff has a copy of the President's budget and the tables, I will be glad to—or if you would prefer, I would submit——

Senator MUSKIE. Why don't you submit it. I am not as interested in debate as I am in getting the information.

Professor WEIDENBAUM. If I may, I will submit the information for the record.

Senator MUSKIE. We did not get into the question with Mr. Ash because time ran out on us, and time is running out on us now, too.

[The information referred to follows:]

In the mid-year review of the Federal Budget for fiscal year 1975, budget outlays are estimated at $305.4 billion, of which $85.8 billion is devoted to defense and military assistance. Total budget authority is estimated at $324.5 billion, of which $93.2 billion is devoted to defense and military assistance. A $5 billion reduction in defense appropriations for fiscal 1975 would mean a corresponding cut of that amount in budget authority for 1975. However, expenditures in fiscal 1975 would only be reduced by that portion of the $5 billion which would have been spent in 1975 (the remainder would have been spent in later years).

Senator MUSKIE. Let me ask one more question.

I would like to ask it of Mr. Warnke.

We have talked about cuts in Defense spending now, ever since the prospect of a Vietnam dividend, which disappeared almost before we knew it. In any case, there have been repeated efforts on the hill to cut the military and Defense budget. This year I think there has been a particularly good effort made, and I applaud it. But I am also conscious of the fact that there has been an escalation on one side of the budget, due to inflation and personnel costs, particularly the Volunteer Army.

Are we reaching the point of diminishing returns in cuts in Defense spending, if we are to maintain our real security requirements? Can you identify that point for us?

Mr. WARNKE. Certainly, Senator, no one could identify that point with anything like mathematical precision. My own feeling is that the Defense budget is sufficiently swollen at the present time so that a cut in the nature of $10 billion would not to any extent interfere with our ability to preserve our freedom and protect our national security.

Now, how much more than that we would be able to cut safely is something that would require, I think, very exhaustive studies. I think that there would still be a level below that to which you would be able to go safely. I think we would have to recognize that in making drastic cuts—and I think $10 billion is not drastic—in making drastic cuts you would have to make some sort of a reassessment of what the military role is of the United States, and you would have to make the kinds of decisions which are suggested in the Brookings Institution study on the budget. Do we really have to prepare, for example, for a protracted conventional war in Europe, or is that below the level of likelihood? Is that something that the Europeans would be so loath to support that it is ridiculous for us to budget the forces for that kind of a contingency?

But in making the suggestions that we have made in this statement and in the earlier report which was sent to the Congress on military budgets and priorities this year, what we have suggested is that there

are some contingencies which as far as I can see American foreign policy now eschews as being beyond the realm of those things for which we will go to war.

Now, one of those is the contingency of a ground war in Asia. Certainly the present situation in Asia is such that the only way in which China could represent a threat to the United States would be if we sought to invade China. Obviously we are not going to do that, so do we need the kinds of forces that we presently have allocated for an Asian contingency?

Another aspect of this is the current presumed planning goal of a 1½ war capability—well, what is the half war? I can understand what the one war threat is. The military threat that we face is that posed by the Soviet Union. And obviously we have to have the power which will deter any conceivable effort by the Soviet Union to attack us, either nuclearly or by conventional force. But how could that half war happen? I mean, do we really feel that American forces have to be employed in some sort of a brushfire situation against a foe with limited military capability? Is that not a return to the discredited idea of counterinsurgency operations? So if in fact our force structure is planned for one and a half wars, I suggest we drop off one half of a war and I am sure we could effect very substantial budgetary savings.

Senator MUSKIE. I wish we really had time to pursue that theme and that thesis.

We are going to have to go vote—but Senator Dominick has one question before we leave—I must say in closing that I think the questions about the mathematical precision of this testimony are useful. I wish we had time this morning to go into this question of the econometric models. When I see an analysis that projects nine-tenths of 1 percent decline in the gross national product of $1,500 million, an impact on the inflation rate of four-tenths of 1 percent, and an impact on unemployment of a similar fraction of 1 percent, I just wonder whether we are dealing with something that is that precisely measurable.

I wonder whether you think the behavior of human beings, in the words of Dr. Burns yesterday, can be that precisely anticipated. I suppose that kind of thing is done because economics is supposed to be a science, but is it, Dr. Rivlin?

Ms. RIVLIN. Oh, I think, Senator, you are being a little unfair because none of the econometricians would defend their models to the letter. They are trying to respond to a question that they thought you asked, which is what is your best guess? Tell us as well as you can what you think will happen. Everybody knows who has done it for any length of time that those guesses are often wrong, but the question still has to be answered.

Senator MUSKIE. I agree with that, but I would like them to defend their model in response to a hostile question as well as in response to a friendly question. We do appreciate the analysis. And my question was not put for the purpose of denigrating the result but rather to try to get you to put it in the perspective of what is really within the realm of possibility.

Is that guess—which was taken in response to some kind of technique, I assume—a real one? Is it something that fits into what we actually will face?

Professor WEIDENBAUM. Senator, I think you really put your finger on the limitations of a lot of those analyses, even if you agree with the assumptions, and that often is compelling. If you set the assumptions, you can almost predetermine the results of a lot of those analyses. The great precision that seems to come out of these models reminds me of my neighbor who estimated that the Mississippi River was 1,000,008 years old. I then asked him how he could be that precise, and he said, well, 8 years ago he heard a State geologist say it was 1 million years old.

Ms. RIVLIN. I would just like to add that people are always more skeptical of models when they come out with answers that they disagree with.

Senator DOMINICK. Professor Weidenbaum, I was delighted with your statement. As I am sure you would know, amongst other things, in talking about productivity, which I think is necessary, and some method of increasing this has got to be worked out, one of the things that has been bothering a lot of people is the lack of investment funds for businesses.

What would you feel about a tax credit for savings which would, by virtue of that, offset the higher interest rate that government was giving on its deficit spending financing, and would therefore lead people to put money back into their savings accounts?

Professor WEIDENBAUM. Senator, I am not sure that I advocate the passage of such a bill this year. However, I do think—and I am in the midst of completion of a major study of the problems of financing, capital investment for the 1970's and it is going to be a massive problem, I believe. I think we seriously have to consider additional incentives to savings and that strikes me as the most sensible suggestion of them.

I would suggest that the time is right for the Senate to start an organized analysis of the problem of financing capital investment, and the need to foster savings.

Senator DOMINICK. Thank you very much, Professor. We do have to go.

Senator MUSKIE. Thank you.

The committee will stand in recess.

[Whereupon, at 1:55 p.m., the committee recessed subject to the call of the Chair.]

APPENDIX

OFFICE OF THE DEPARTMENT OF PLANNING,
Pennsauken, N.J., August 16, 1974.

Hon. EDMUND S. MUSKIE,
Chairman, U.S. Senate, Committee on the Budget, Old Senate Office Building, Washington, D.C.

DEAR SENATOR MUSKIE: I am a planning aide, librarian and editor of the Camden County, New Jersey Planning Department quarterly newsletter, KALEIDOSCOPE, which is printed on totally recycled paper.

I am also an investigative reporter for THE CROSSINGS of Winslow Township, Camden County, New Jersey and THE HAMMONTON NEWS, Atlantic County, New Jersey.

I am also a research assistant to New Jersey Democratic State Senator Joseph A. Maressa (District 4-Burlington, Camden and Gloucester Counties), State Senator Maressa is Majority Whip of the 40 member New Jersey State Senate (29 Democrats, 9 Republicans and one Independent).

I am also a research assistant to New Jersey District 5 (Camden County) Democratic Assemblyman James J. Florio. Assemblyman Florio is Chairman of the 80 member (66 Democrats and 14 Republicans) New Jersey General Assembly Committee on State Government and Interstate and Federal Relations. Assemblyman Florio is also the Democratic nominee for Congress in New Jersey's First Congressional District (Camden and Gloucester Counties).

Pursuant to an August 14, 1974 telephone conversation I had with a member of your staff I shall sincerely appreciate it if you could arrange to have my research report entitled "INFLATION ALERT: BLUEPRINT FOR ACTION" inserted into the printed hearings record of the United States Senate Budget Committee 1974 hearing INFLATION AND THE BUDGET.

Please acknowledge by writing your reception of my research report and that it will see hearing record. Please send me four (4) copies of hearings.

Thank you for your cooperation in this matter.

Very truly yours,

FRANK RODIO, Jr.,
Planning Aide and
Editor Kaleidoscope.

"INFLATION ALERT: BLUEPRINT FOR ACTION"

(A Research Report Prepared for the U.S. Senate Committee on the Budget)

Mr. Chairman and Distinguished Members of the United States Senate Committee On The Budget:

President Gerald Ford has wisely proclaimed the economic cancer known as inflation "Public Enemy Number One," not only of his new administration but of the nation as a whole. President Ford in his first week practiced "jawboning" against the tentative General Motors price increase for 1975 cars.

"Jawboning" is a very useful tool used by Presidents against inflation and should be used more often. The United States simply cannot afford an unchecked spiraling rise in the cost of living and inflation rate. The United States is a nation of consumers.

Every American is a consumer and at one time or another has felt the pincers of the economic inflation cancer at one time or another during the last five years of "Nixonomics." "Jawboning" by Presidents is merely an extension of the Keynesian economic philosophy and policy of government intervention and regu-

lation of the erstwhile American free enterprise system devised by the New Deal Administration of President Franklin Delano Roosevelt.

Keynesian economics followed the "Great Depression" which grew out of the "laissez-faire" or let-it-alone policy and philosophy adopted by the United States Government since the foundation of the Republic at the fateful long, hot Philadelphia convention of 1787 which drafted the Constitution.

The genesis of today's worldwide inflation was in the 1960's. We are in 1974, one decade away from the momentous year of 1964 and one decade away from George Orwell's "Big Brother" year of 1984.

The late Lyndon Johnson instituted a "guns and butter" economic policy when he should have asked Congress to raise taxes. Former President Richard Nixon inherited a budget surplus in 1969 just as the inflation wheels were beginning to turn.

His "Nixonomics" known as Phases I, II and III of wage-price controls were instituted too late to be effective. They should have been instituted in 1969 instead of 1971. President Gerald Ford has acted wisely against inflation.

I support the national economic summit and the cost of living council. I am opposed to high interest rates. I feel Phase II of wage-price controls should be reimposed. I support the creation of Congressional Budget committees, the Act to Control Federal Expenditures and the General Accounting Office Act of 1974.

The United States simply cannot afford to go the route of the Weimar Republic in pre-Hitler Germany circa 1923 in which one million marks were worthless. Three single English language words ended the Administrations of the last three Presidents. Dallas ended John Kennedy's prematurely.

Vietnam ended Lyndon B. Johnson. Watergate ended Richard M. Nixon.

I sincerely hope depression or recession will not end Gerald R. Ford.

Thank you.

VIENNA, VA., *August 13, 1974.*

DEAR SENATOR MUSKIE: I believe that the effort to control inflation by limiting demand and continuing stagnation involves a faulty diagnosis that fails to recognize the source of a inflation in the exercise of market power which cannot be controlled by these means.

Enclosed is a one-page summary of a memorandum on: "How to Control Inflation Without Stagnation" and an outline of the proposal it contains.

Also attached is a copy of the memorandum.

Very sincerely,

GARDINER C. MEANS.

Summary

HOW TO CONTROL INFLATION WITHOUT STAGNATION

At no time in the past five years have we had traditional demand inflation with too much money chasing too few goods. Primarily we have had a new type of inflation unknown to traditional theory and not experienced in this country prior to World War II. It arises in the concentrated industries and is made possible by the substantial market power exercised by big business and big labor which allows profit margins and wage rates to be pushed up more than is justified by supply and demand conditions. It can be called "administrative inflation".

Administrative inflation first appeared in the Eisenhower era when there was substantial unemployment and unused plant capacity. In five years the wholesale price index rose 8 per cent, half of this attributable to the direct and indirect effects of the 36 per cent rise in steel prices. Efforts to control this inflation through a tight money policy were quite unsuccessful.

The crude Kennedy price-wage guideposts were successful in limiting administrative inflation but were unfair to labor and broke down in 1966. Johnson made the guideposts more equitable, limited administrative inflation and halted the demand inflation from the Vietnam war through the surtax and slower growth in the money stock. At the end of 1968 the economy was in good shape.

The Nixon advisers were tied to the traditional demand theory of inflation and never learned the lesson of administrative inflation. Faulty diagnosis led them to planned stagnation as their main instrument. The controls of Phases I and II were quite successful in limiting administrative inflation but this success was hidden by the effects of crop failures, foreign inflation, etc. These wage-price controls were soon dropped for more planned stagnation.

In the concentrated industries where administrative inflation arises prices are not determined by demand and supply in the traditional fashion but by management which has a considerable degree of discretion in the setting of prices and such prices do not behave in the traditional manner. In particular, prices tend to have an upward bias and produce a significant upward creep in adjusting to increases in productivity. This can be accentuated in various ways. Labor also can contribute to administrative inflation by pushing wage rates up faster than productivity and living costs justify, though in practice labor's contribution has usually been a legitimate catching up for cost-of-living increases as in 1966 and 1967 rather than an initiating contribution.

A program to control inflation without stagnation should aim to limit administrative inflation while expanding general demand to a point where it will support full employment of men and machines. In broadest outline it would include three main features:

(1) A price guidance program applied only to the more concentrated industries;

(2) The expansion of general demand through increasing the money stock while the budget is balanced or produces a small surplus;

(3) The maintenance of a floating exchange rate to minimize the effect of foreign inflation on the domestic economy.

Such a program should prevent both administrative and general demand inflation and produce full employment. It would not prevent some differential price increases from the effects of crop failures, inflation abroad and reflation but these could be kept to a minimum by pressures to expand supply. Emphasis on budget balance and money expansion would reduce the danger of a liquidity crisis. An outline of a price guidance program is attached.

OUTLINE OF A PRICE GUIDANCE PROGRAM

The big problem of controlling administrative inflation turns partly on developing price and wage guidelines which are both fair and more sophisticated than those previously used and partly on the minimum sanctions which would be needed to produce reasonable adherence to the guidelines.

Because traditional theory gives management little guidance on what represents legitimate use of market power and what constitutes abuse, the mere publication of fair guidelines would tend to produce more responsible exercise of such power. Private sanctions could also be expected to come into play.

Government sanctions could properly be limited to only a few hundred of the biggest corporations whose market power is so great as to vest them with a public interest. The sanctions could also be varied according to a new index of administrative inflation, being severe only if the index showed an excessive rate of increase.

A temporary "Price Guidance Board" with the necessary powers might well be set up parallel to the Federal Reserve Board and outside the Executive branch of the Government so as to avoid economic advisers committed to treating administrative inflation as if it were demand inflation.

At the outset the program would be faced with a serious imbalance between the compensation to capital and that to labor so that there needs to be some rollback in prices or a considerable increase in wage rates.

Price and wage guidance would represent some degree of intervention in the free enterprise system. But there are many well-accepted government interventions such as preventing theft and enforcing contracts.

Also the pricing power of big corporations is not a "natural right". The power to incorporate is a power granted by government. Therefore preventing the abuse of corporate market power is not an interference with the natural rights of individuals.

Twenty-eight years ago the Congress made a major change in national economic policy by passing the Employment Act of 1946. Today there is need for a second change in national economic policy, the limitation of the abuse of market power by the large corporation. Price guidance would seem to be the immediate solution. In the longer run other methods may be developed. And in any case some degree of price guidance would appear preferable to years of stagnation.

For five and a half years, the Nixon administration has sought to control inflation and failed. The index of wholesale prices has risen 50 percent and the consumer index has risen 40 percent.

This great failure in policy has come from a faulty diagnosis. The inflation has been treated as a traditional type of inflation—a general demand inflation coming from too much money chasing too few goods. Yet at no time in the five and a half years has there been a general excess in demand.

Most of the inflation of the last five and a half years has involved a new type of inflation. It is a type new to the theory of inflation and a type not experienced in this country prior to World War II. It grows out of the market power of big business and big labor. In the concentrated industries, the market forces of demand and cost do not determine prices. They only limit the range within which price can be set. Within this range, management has an area of discretion in pricing which can lead to inflation. And no excess in demand is necessary to bring about inflation. The new type of inflation will be referred to here as "administrative inflation" because it arises so largely from the private power to administer prices within a substantial range of discretion.

This article will briefly review the emergence of this new type of inflation, examine the bungling effort of the present government to control it, explore its anatomy and finally propose a positive program to bring it under control.

I—The Emergence of Administrative Inflation

The first appearance of administrative inflation came in the Eisenhower years. In the five years between 1954 and 1959, the wholesale price index went up 8 percent in spite of the fact that unemployment averaged more than 5 percent and in no year averaged as low as 4 percent. This is to be compared with the absence of inflation in 1953 when unemployment was 2.9 per cent and the Korean War price controls had just been removed.

The 8 per cent rise in wholesale prices was almost entirely in the concentrated industries, with at least half attributable to the direct and indirect effect of a 36 per cent steel price increase. If the rise in the wholesale price index had resulted from demand inflation it would have appeared primarily in the non-concentrated parts of the economy.

The Federal Reserve Board regarded this mild inflation as a case of traditional demand inflation and adopted a tight money policy which brought a contraction in the money stock and in general demand. This effort to control administrative inflation by a general contraction of demand produced the recession of 1957–58, yet it did not halt the administrative inflation.

Fortunately, the inability of tight money to halt administrative inflation come to be recognized at the Federal Reserve Board and its policy was reversed. As Dr. Woodlief Thomas, then a chief economist of the Board, wrote in a letter to the Washington Post (March 12, 1959) ". . . there are unstabilizing forces in the pricing actions of the private economy—on the part of both management and labor—that cannot be effectively controlled by governmental actions in the area of fiscal and monetary policies".

THE KENNEDY GUIDEPOSTS

In 1961 the Kennedy forces took over at a time when nearly 7 per cent of the labor force was unemployed and only 73 per cent of manufacturing capacity was being utilized. It set out to achieve high employment without inflation. Its economic advisers had learned the lesson of administrative inflation and adopted a program to resist such inflation through price and wage guideposts combined with persuasion, while fiscal and monetary measures were used to expand general demand.

From 1961 to 1965, general demand was increased by a third with a rise in the wholesale price index of only 3 per cent. The wage and price guideposts and persuasion were over-successful in holding down wage rates and moderately successful in holding down prices in the concentrated industries. As a result of the great increase in general demand and the resistance to administrative inflation, industry was operating at 89 per cent of capacity by the end of 1965 and unemployment was down to approximately 4 per cent.

Unfortunately, the Kennedy guidepost for wages had been badly designed. It appropriately called for wage increases to take account of increases in national productivity, but it left no room for the natural increase in the cost of living which is an essential part of recovery from 7 per cent unemployment to 4 per cent.

A normal recovery would call for increased sales, production and employment in the more concentrated part of the economy, and increases in prices in the least

concentrated, such as farming. Thus some "reflation" should have been expected and a cost-of-living factor should have been included in the wage guidepost.

Such a cost-of-living factor was intentionally excluded from the wage guidepost because it was believed that it would create a dangerous upward spiral as a living-cost increase in wages would be passed on in higher prices and these in turn would justify further wage increases. What was not realized was that the spiral would have been self-limiting, with each round of the spiral producing only a fraction of the price increase justified by the previous round. This would be true because labor is only part of the cost of goods and concentrated industry is only part of the total economy.

Because there was the normal price rise in the unconcentrated part of the economy, the resulting cost-of-living rise took away nearly half of the productivity gain which workers should have received over the 5 years.

The inadequate wage guidepost also allowed profit margins in the concentrated industries to be increased somewhat without adding to price increases. As a result the division of income between capital and labor shifted against labor. In the previous decade capital had received as interest, dividends and undistributed profits approximately 12½ per cent of the income generated by non-financial corporations and divided between capital and labor. Labor had received 87½ per cent in wages, salaries and fringe benefits. By the end of 1965 the compensation to capital had risen to 16 per cent of the joint income and compensation to labor was down to 84 per cent. The failure to include some cost-of-living adjustment was manifestly unfair to labor.

THE LABOR REVOLT

Up to mid-1965 labor had in very large degree adhered to the wage guidepost, an action which was made easier by management's resistance to wage increases in excess of those indicated by the guideposts. But then the unfairness of the wage guidepost became so clear that labor rebelled and insisted on wage increases greater than the guidepost allowed.

In the following two years, there was administrative inflation as labor sought to catch up on living costs and management sought to retain its widened profit margins. In the two years from mid-1965 to mid-1967 the wholesale price index went up at the rate of 1.7 per cent a year.

This two years of administrative inflation has often been regarded as a general demand inflation resulting from the requirements of the Vietnam war. However, there is little evidence of a general excess in demand. In farm prices where a general excess would be expected to show itself first, there was only a 1.0 per cent a year price rise, which must be attributed to the decline in crop yields in 1966. Most of the two-year rise was in the more concentrated industries. In manufacturing there was a reduction in the amount of over-time hours worked and a smaller proportion of industrial capacity was used in 1967 than in 1965. These figures do not suggest an excess in general demand.

INFLATION FROM EXCESS DEMAND

In the latter half of 1967 and early 1968 there was true demand inflation combined with some administrative inflation. While the money stock was increasing only at a normal rate (6.6 per cent in 1967 and 7.8 per cent in 1968), the economic budget was $12 billion in deficit ($25 billion deficit in the administrative budget). During the fiscal year unemployment averaged 3.5 percent and manufacturing operated at 85 percent of capacity. But there was a rise in the wholesale price index of 2.3 percent. How much of this was demand inflation and how much administrative is difficult to say.

The demand inflation was short-lived. At the beginning of 1967, Johnson, foreseeing the inflationary effect of Vietnam expenditures, requested a surtax. In the summer of 1967 and at the beginning of 1968 this request was repeated. Finally in August 1968, the 10 percent surtax was passed and by the end of 1968 was bringing in a budget surplus at the annual rate of $10 billion. This, plus a slower rate of growth in the money stock, eliminated the general excess in demand.

By early 1968, wage rates had also caught up with the cost-of-living increases and the long-run balance between compensation to labor and compensation to capital was re-established. With cost-of-living adjustments included, the guideposts and persuasion again became a reasonably effective way of controlling administrative inflation. Combined with a budget surplus and moderate monetary

growth, inflation at the wholesale level was limited to 1.1 percent in the eight months before the election in November 1968.

II—The Bumbling Nixon Policies

It is abundantly clear that Nixon and his economic advisers did not understand administrative inflation.

At the time Nixon came into office, our economy was in excellent condition. The surtax was producing a Federal surplus at the rate of $10 billion a year. The money stock was growing at the moderate rate of 4 percent a year. There was no excess in demand. The balance in external payments was favorable. Demand inflation from the Vietnam war had been brought under control and administrative inflation was being controlled by a moderate program of price-wage guidelines. Manufacturing industry was operating at 87 per cent of capacity. Employment was high, with the seasonally adjusted unemployment rate under 3.5 per cent. The wholesale price index had risen only 1.1 percent in the eight months before the election. and the balance between the compensation to capital and the compensation to labor was good. The stage was set for a period of high employment without serious inflation.

But Nixon's economic advisers were tied to the traditional conception of inflation as *demand* inflation with too much money chasing too few goods. They had not learned the lesson taught by the abortive tight-money effort to control administrative inflation in the 1950's; the partial success of the guideposts in the early 1960's; or the final success in 1968. Their thinking was dominated by the traditional idea of inflation as the result of a general excess of demand and a tight money policy as the accepted way to prevent further inflation. This conception still dominates the Nixon policies.

THE FIVE NIXON GAME PLANS

In the five and a half years of his incumbency, Nixon has adopted five different economic game plans to control inflation. Yet the index of wholesale prices has risen by more than 50 per cent, the rate of plant utilization has been low and unemployment has been high. Some of the price rise resulted from crop failures, the Arab cut-off of oil and from other foreign developments. But even leaving out farm products, food and fuel, the wholesale index went up 32 per cent in the five and a half years, an average rate of approximately 6 per cent a year. It is only necessary to look at the five game plans and the faulty interpretation of actual conditions to see how little the administration advisers have understood the actual workings of our economy.

PLANNED STAGNATION

On achieving office, Nixon *immediately* canceled the guidepost program, announcing that he would rely entirely on free market forces to determine prices and wage rates. Further, he adopted a program of planned stagnation to "bring inflation under control". This program was based on the belief that the 8 per cent rise in the wholesale price index during the preceding four years was entirely the traditional demand inflation. Thus in his first Economic Report, the President said "the growth of total spending, public and private, . . . was the driving force of the inflation" and "had gathered powerful momentum by the time the Administration took office . . . ". The game plan was to eliminate this assumed "momentum" by halting the growth in total demand for a year thereby intentionally increasing unemployment to more than 5 per cent and then allowing some growth but holding the stagnation level for two more years.

This ruthless program was carried out, but wholesale prices rose in 1969 and 1970 faster than in any of the preceding five years in spite of a large budget surplus, almost complete cessation in monetary growth and a substantial decline in real demand. Instead of reducing inflation, the program stimulated inflation and created a recession, bringing utilization of manufacturing capacity down to 74 per cent of capacity, a 15 per cent drop, and raising the unemployment rate to 6 per cent. In two years, the wholesale price index rose 7.2 per cent, an annual rate of 3.6 per cent in spite of recession.

Clearly the diagnosis was wrong. Why?

The answer is simple. At the beginning of 1969 there was no demand inflation.

The real problem was the new type of industrial inflation which arises from the market power of big business and big labor: It cannot be controlled by the traditional prescription of limiting demand.

What Nixon did on taking office was to adopt a program which could not control administrative inflation and publicly eliminated the guidepost program which had held such inflation in substantial check. He unleashed the "unstabilizing forces" of market power.

THE "CONVERSION" TO KEYNES

When it became clear after two years that the stagnation program was a failure, the President announced his conversion to what he called the Keynes' doctrine.

In the spring of 1970, both fiscal and monetary policy had been made somewhat expansive as was planned in the original stagnation program. But in the winter of 1970–71, unemployment seasonally adjusted averaged 6 per cent and manufacturing was operating at less than 75 per cent of capacity.

In these circumstances, the President in his 1971 Economic Report adopted what he called the principle of the "full employment budget". This called for a budget which would balance at full employment but would automatically provide a substantial deficit when employment is low, partly because revenues would tend to be lower and partly because government expenses, especially unemployment insurance payments, would tend to be higher.

Following this principle, the Administration developed budgets which produced the largest economic deficits since World War II. But this second game plan, like the first, relied on free markets to control prices and practically the whole of the increase in buying power that was generated by the expansionist fiscal and monetary measures was absorbed by price increases. In the eight months to August 1971, wholesale prices rose at the annual rate of 5.3 per cent, partly because of poor harvests in 1970 but primarily because of the large increase in the industrial price index. It rose at the annual rate of 4.5 percent in spite of the fact that less than 75 per cent of manufacturing capacity was being utilized and unemployment was still over 6 per cent. No effort was made to control administrative inflation yet the rise in prices in the presence of the large volume of unused manpower and equipment made it clear that something other than excess in demand was causing inflation.

Again the diagnosis was wrong.

THE NEW ECONOMIC POLICY

By the summer of 1971, the failure of the second game plan was also evident with inflation rampant in a depression, a condition theoretically impossible in the traditional theory of the free market on which the advisers to the President relied.

On the 15th of August, 1971, the President suddenly announced a third game plan which he called "The New Economic Policy". This plan finally faced the fact that traditional policy could not control inflation, though it is doubtful that the reasons for this fact were well understood. The plan included a price-wage freeze to be followed shortly by Phase II with more flexible controls.

The essence of this plan was to resist inflation while a huge deficit and a more rapid expansion in the money stock expanded demand, production and employmet. It was announced as a general inflation control program and made no clear distinction between the objective of controlling market prices and that of controlling administered prices.

This program was remarkably successful in limiting *administrative* inflation. In the 16 months of Phase I and II the index of industrial prices rose at the annual rate of only 2.8 percent compared to 4.5 per cent in the year before the freeze, and much of this rise was in non-concentrated industrial products such as lumber, textiles and leather. In the corporate sector of the economy where most of the market power of big business and big labor resides, the inflation rate dropped from 4.0 per cent in the year before the price freeze to 1.3 per cent in the year after the freeze. This limiting of inflation was accomplished without markedly changing the relation between the compensation to labor and the compensation to capital.

This very substantial success in controlling administrative inflation was hidden by three developments which raised prices in the non-concentrated sections of the economy. The first was crop failures, mostly abroad, which contracted the world food and feed supply and engendered the big grain exports to Russia. The second was in the international field where a combination of dollar devaluation and heavy demand inflation abroad raised import prices and stimulated

exports. The third was the normal rise in the prices of the non-concentrated products such as food, lumber and scrap steel which could be expected from the expansion in real demand which raised real GNP at the rate of 7 per cent a year, brought industrial utilization up to nearly 82 per cent of capacity and brought unemployment down from 6 to 5 per cent.

As a result of these three developments, farm prices rose in the 16 months of Phases I and II by 21 per cent, hides and leather products by 24 per cent, lumber by 11 percent, fuel by 6 per cent and textiles by 5 per cent. These and similar competitive items accounted for most of the 7 per cent rise in the wholesale price index and the 4.3 per cent rise in the consumer price index in that period. None of these represented an exercise of market power by big business or big labor. And the should not be allowed to disguise the very substantial success of the Phase II program in resisting *administrative* inflation.

The rise in farm prices due to the world-wide reduction in farm supply and the partial recovery would have happened whether or not administrative inflation had been controlled and does not indicate a failure of the control program. Rather it emphasizes the inability of price control to limit a rise in traditional market prices without also introducing rationing.

The true failure was again the failure of the Administration to understand the character of the inflation. It should have accepted the small reflation as a necessary and temporary part of the process of bringing prices into balance during recovery. It should have recognized the price rise from crop failures as a misfortune that hopefully would soon be reversed by normal crops. It acted wisely in adjusting the external value of the dollar and in expanding farm acreage. It should have recognized the success of the control program in limiting administrative inflation and kept it in operation.

DISMANTLING CONTROLS

Having concluded that Phase II was no longer needed, the President set up his fourth game plan in January 1973. It set out to dismantle the controls over a period of months. It was not only based on inapplicable theory but was so badly designed that it ended in chaos.

The new plan rested on the major assumption that there had been a "momentum" of inflation when he took office in 1969 which had been largely eliminated by Phases I and II. This is shown in the President's Economic Report of January 1973 which says that by the end of 1972, not only had there been a suppression of price increases but "a more durable change had taken place in the conditions underlying wage and price increases. Expectations of rapid inflation had diminished . . ." (p. 68). In other words, the "momentum" of inflation had been largely overcome.

This diagnosis in terms of traditional theory and the failure to understand the role of administrative inflation produced the confusion and chaos of Phase III. The Phase II control organization which had been working well in limiting the arbitrary use of market power by big business and big labor was suddenly dismantled and a new and less well designed organization was set up. Controls were abolished or made self-administered for most non-food commodities and services but kept on for foods where they could not be expected to work without rationing. The President's abhorrence of price controls was made clear without any clear recognition of their role in limiting administrative inflation.

Phase III was widely interpreted as a signal that price restraints had come to an end and industrial prices shot up. In five months they rose at the annual rate of 14 per cent compared to the 2.8 per cent rate of Phases I and II.

Part of this rapid increase was in adjustment for increased labor and material costs but to an important extent it was a widening of profit margins. For manufacturing corporations, profits per dollar of sales increased at an annual rate of more than 40 per cent while hourly wage rates in manufacturing went up at an annual rate of less than 6 per cent.

The developments in this period are highly confused because of the several sources of inflation, particularly the continuing effect of inflation abroad and meat prices at home. But it appears that a considerable part of this burst of inflation was administrative and not directly related to either a contraction in supply or an expansion in specific demand. And certainly it was not a product of a general excess of demand. Manufacturing in the second quarter of 1973 was operating at little more than 83 per cent of capacity and unemployment in that quarter was nearly 5 per cent.

Faced with this burst of inflation, the Administration gain instituted a freeze on prices for two months and in August 1973 introduced Phase IV which expired with the law at the end of May in this year, with industrial prices (other than fuel) up 17 percent since the end of Phase II. The in-and-out policy of the Administration, the lack of clear realization of the non-traditional character of much of the inflation, the sharp rise of prices in the last year and a half and the continued high unemployment have combined to destroy any credibility in the Administration's grasp of the inflation-employment problem.

MORE PLANNED STAGNATION

We are now operating under the fifth Nixon game plan. As it was explained by the President on July 25th it calls for more planned stagnation. The President said: "In the short run we must focus on measures to restrain demand" and he outlined this restraint as follows:

"As far as the Federal government is concerned we will cut the growth of Federal spending. We will hold down the growth of money and credit to check private spending. And I will call on state and local governments, on businesses and consumers to hold down their own spending and increase their own saving as their contribution to the fight against higher prices," adding "Most families could reduce or defer some expenditures—building their savings instead . . .".

This takes us back to square one, the planned stagnation of the first game plan, with three important differences:

(1) The Wholesale price index is 50 per cent higher and the industrial price index is rising at a double-digit rate whereas the rate of inflation before the 1968 election was almost negligible by comparison.

(2) National production is well below our full potential with unemployment at the rate of 5.2 per cent instead of 3.5 per cent and industrial plant operation at only 83.5 per cent of rated capacity instead of 87.7 per cent that prevailed in 1968.

(3) A dangerous degree of illiquidity has been created through the tight money policy. The money stock in constant dollars has been reduced in the last year by between 4 and 8 per cent, depending on the price index used to deflate. This illiquidity is reflected in the highest short-term interest rates in a century.

The President's plan to limit demand might be appropriate if the present inflation were caused by a general excess of demand. But at no time in the last five and a half years has there been a general excess of demand or a demand inflation. For this reason, a program to limit demand would mean continued stagnation or, worse still, further recession, an aggravation of the dangerous degree of illiquidity and a continuation or stimulation of administrative inflation.

Because the current inflation is largely administrative and because we can produce much more than we are now producing, the immediate problem is to expand demand and make sure that the extra demand is not absorbed by price increases in the more concentrated industries.

Clearly the President's economic advisers have not yet learned the lessen of administrative inflation which was learned with much trial and error in the Eisenhower-Kennedy-Johnson era.

III—The Anatomy of Administrative Inflation

In order to reach full employment and to control administrative inflation it is first necessary to understand more clearly how the latter comes about.

According to traditional theory, administrative inflation is not possible. Prices are determined by supply and demand. Specific price increases can arise from unplanned reductions in supply such as crop failures or an oil cut-off and these can add to the level of prices. But the only source of general inflation is an excess in demand. This can be controlled by appropriate monetary and fiscal measures.

There would be no reason to question this theory if each product in the economy were produced by a multitude of enterprises. No producer would have significant market power. This is the condition under which wheat and cotton and hogs and scrap steel are produced. With a general fall in demand their prices fall. With a general rise in demand their prices rise. Government can limit the supply in order to support price. But it cannot for long prevent price increases when demand rises without some form of rationing. And if price control is temporarily successful, prices rise when the controls are removed. If such products were

typical of the whole economy, the only form of general inflation would be that from a general excess of demand and this type of inflation could be controlled by limiting general demand.

Traditional theory would also apply if there were only a few suppliers in each market for goods but it was easy for newcomers to break into the market. Then the few sellers, even though they had enought market power to set their own prices, would be *closely* controlled in the prices they set by the market considerations of demand and costs. With easy entry any attempt to set prices significantly above a competitive level would tend to bring in new competitors, thus reducing the share of the market held by each. This would cut profits per enterprise even though profit margins were increased. Thus, once prices were adjusted to demand and costs, those in a position to administer prices would have little pricing discretion. The fear of bringing in new competition would tend to keep prices close to costs plus a competitive profit. In these circumstances, demand inflation would be the primary type of inflation and it could be controlled by limiting demand.

It is when we examine situations involving big business, big labor and difficult entry that traditional theory does not apply. It is in industries such as steel, automobiles, and many other highly concentrated industries that the traditional principles of pricing become unreal and actual pricing can lead to administrative inflation.

Let us first consider the very difficult problem faced by management in setting prices where there is a protective wall of difficult entry and only a few producers. Then let us consider the respective contributions of management and of labor in generating administrative inflation.

MANAGEMENT'S PRICING PROBLEM

Traditional theory gives management a relatively simply problem in setting the price for a particular product. This is simply stated in the economist's jargon: "Set the price which will equate marginal cost and marginal revenue". The economist can show you with simple diagrams why this will result in the maximum profit. Also it is easy to show that, if all enterprises adhered to this formula, administrative inflation would not be possible.

Here we do not need to understand this formula because a big business which priced on this basis would be most unbusinesslike. The traditional economist is only talking about the price which would maximize profit in the very short run,—the coming week or the coming month. But the successful corporate management is not trying to set a price which will maximize profits "this week" or "this month". It is trying to adopt a current price as a step in pricing policies which will bring in high profits over a period of years. The current price which would maximize short-run profit would almost invariably defeat this purpose.

The big problem of management with substantial pricing discretion is to set a current price which will bring in good profits now and not prevent good profits later. A current price which brought in too high corporate profits now could induce other enterprises to climb over the wall of difficult entry and take away part of the market even if they did not force lower prices. Thus the price which would be most profitable in the short run could reduce the opportunity for future profits. In this and other ways the management in its pricing has to balance greater profits now against the prospects of greater profits later. As a result, the prices actually set tend to be significantly below those which would bring in the maximum profit in the current week or month.

The necessity of balancing more short-run profits against more longer-run profits also means that there is a range of possible current prices which are just about equally good. A higher current price can mean greater current profit but a greater risk of lower profits later, whatever price is then charged. A lower current price can mean less current profits but better prospect of future profits. Thus, even if management knew what its demand and costs would be, there is a range of prices among which it is difficult to choose and between which the management is likely to be relatively indifferent.

The pricing process for big business is difficult not only because of the necessity of balancing short and longer-run considerations but also because of the great uncertainty of demand and costs over any considerable period.

PRICING BY FORMULA

Because of the great difficulty of setting prices, managements have simplified the pricing process in two major ways. First they have adopted one or another

of a variety of pricing formulas: pricing for a target rate of return; full cost pricing; standard mark-up pricing; break-even pricing; and a number of others. Second, they tend to hold the prices constant for months at a time, changing them only when changed conditions call for a very substantial price change, one that is beyond the zone of relative indifference. For example, basic steel prices are so seldom changed that when a change is made of, say, 5 or 8 or 10 per cent, it becomes front page news. Similarly, the factory price of an auto is usually set for a year at a time. Just what triggers a price change thus becomes of vital importance to the problem of inflation.

THE UPWARD BIAS IN ADMINISTRATIVE PRICING

Neither the use of pricing formulas nor the practice of infrequent large price changes is in itself a cause of administrative inflation, but under them their is a tendency for management to be more sensitive to increases in costs than in cost declines. This is so for a number of reasons. For example, cost increases usually come from outside the enterprise and can be blamed on outside forces so management tends to pass them through. On the other hand cost reductions are likely to be the result of management's own constructive activity in seeking efficiency and management naturally takes credit for them. Unless the cost reduction is large, management is not likely to reduce the price.

In this and other ways management's reaction to changes in costs is not a balanced reaction and the magnitude of the cost change needed to trigger a price rise tends to be smaller than that needed to trigger a price reduction. This characteristic of big business pricing, alone, could be expected to produce some upward creep in prices.

To this is added the tendency to make an upward price change a little larger than a cost increase calls for and to make a price reduction a little smaller than a cost reduction calls for. In each case, there tends to be a small departure from the dictates of demand and costs and in both cases the departure is up. This reinforces the upward creep.

THE PRICE CREEP FROM INCREASING PRODUCTIVITY

This small tendency toward an upward price creep is reinforced by increasing productivity. There is nothing inherent in higher output per worker-hour which is inflationary. When national production per worker-hour goes up because of improved technology, it is to be expected that both labor and capital would share in the gain. This would certainly be expected in a small-enterprise economy. But in a big business economy the process by which the sharing is brought about can lead to an inflationary creep.

Under traditional theory which is for a small-enterprise economy, if the total real income produced jointly by a given body of workers and a given real amount of capital were to increase, the real compensation to workers could be expected to go up because real wage rates would rise. At the same time the compensation to capital would be expected to rise, not because profit margins increased, but because as the quantity sold increased, the same profit margin per unit would bring in a greater total profit. This could be expected where there was no pricing power.

In the presence of substantial pricing discretion and the upward bias in administrative pricing, the adjustment for increased productivity would be expected to produce an upward creep in prices in two ways. Partly the creep would come from the reaction of an average producer to the rise in wage rates required by the improved technology. Partly it would come from differences in the rate of increase in productivity in different industries.

Take first a product for which productivity has increased by just the amount of the increase in national productivity. Say that national productivity has increased 3 per cent and wage rates have appropriately increased 3 percent. Also say that in the case of a particular product, output per worker has also gone up 3 percent. In this case the labor cost per unit of output would not change and there would be no economic justification for a price increase. But with the upward bias in administrative pricing, the 3 per cent rise in wage rates is more likely to trigger a price increase than the 3 percent reduction in labor costs is likely to prevent such a triggering. The wage increase is likely to come all at once and be very visible. The productivity increase is likely to be spread out over time, be the net result of many factors and tend to be minimized or overlooked in the pricing process. Thus the perfectly offsetting rise in cost from increased

wage rates and fall in costs because of increased productivity are not just offsetting in their practical effect on pricing.

This source of creep is sometimes even built into a price-adjusting formula. This is the case, for example, where a corporation, once having set its price, makes subsequent price adjustments by maintaining a weighted index of the prices of the raw materials and the cost of labor *per hour* going into its product and uses this index to raise the price whenever the index has risen by a certain amount. Since the index takes no account of the difference between labor cost per hour and labor cost per unit of output, it is automatically inflationary when there is an increase in labor cost per hour and no increase in labor cost per unit.

Probably more important is the upward creep coming from the different rates of increase in productivity for different products. If there is no increase in productivity for product A and wage rates generally go up by say 3 per cent as a result of a rise in national productivity, the labor cost per unit in producing this product goes up and this can trigger a legitimate price increase. On the other hand, if productivity in producing product B has gone up 6 per cent, and wage rates have gone up only 3 per cent, the labor cost per unit will go down and this calls for a price reduction. Since the likelihood of a reduction in the price of B is much less than the likelihood of a rise in the price of A, the net effect of a 3 per cent average increase in productivity combined with a 3 per cent increase in wage rates is likely to be a rise in the average of prices.

The combination of the upward bias in pricing and the different rates of increasing productivity thus make the rising productivity resulting from improved technology a significant source of creeping inflation where there is substantial pricing discretion. It is ironical that improving technology which is one of the prides of a free enterprise system should also be a source of creeping inflation.

LEAPING ADMINISTRATIVE INFLATION

So far the analysis has assumed that there is no general *expectation* that there will be further inflation. Yet after inflation has continued for a period, with no end in sight, economic decisions tend to be made not only in the light of the usual consideration of demand and cost but also in the expectation of continued inflation. The effect of this expectation in an economy of big business is quite different from that to be expected in an economy of small enterprises.

In a small-enterprise economy, the expectation of inflation leads to speculative buying of commodities which adds temporarily to the total demand. To some extent the extra demand comes from users who seek to protect their future supply. And to some extent it comes from pure speculators who foresee the price rise and hope to cash in on it. This temporary extra demand helps to push up the prices for a period. But the speculative holdings overhang the market and cause a price drop when the speculators think the price is unlikely to go higher. The users who bought ahead use up their extra stock and so, for a time, buy less. The pure speculators sell out. The successful speculators make money at the expense of those who did not expect inflation. But the temporary speculative demand has little net effect on prices after the speculative period is over.

On the other hand, where there is substantial market power and pricing discretion, the results of an expectation of inflation can be quite different. Users can still be expected to buy ahead with much the same temporary results as under traditional conditions. But the pure speculator is seldom in a position to deal in administered-priced products. Sales organizations and promotion are usually required for that. Instead we have a wholly new phenomenon in which the producers arbitrarily raise their prices without any change in demand or costs.

This price rise grows out of the fact that their prices usually represent the rough balance between short-run and longer-run considerations already discussed. An expectation of continued inflation tends to shift the balance toward the short-run and to higher prices. Producers know that extra profits made from "beating the gun" of inflation will not add to the danger of new entrants and future loss of markets. Likewise the few competitors, also expecting further inflation, will go along with big price increases.

Such arbitrary price increases tend to be a one-way street. They do not involve the build-up of extra stocks which overhang the market and later reverse the price rise. And once the price increases have been made, they tend to resist reduction. Futhermore, if general demand is maintained at the higher prices through money and fiscal measures, the expectation of further inflation leads to further arbitrary price increases with no offsetting effect such as the accumulation of speculative stocks to damp it down. There is nothing in market forces

or the free enterprise system as it is now operated to prevent the continuation of this process.

Here we have a basis for leaping administrative inflation. Price leaders make large price increases, 10 or 15 per cent at a time, which are accepted by their followers because they also expect more inflation.

Unlike demand inflation, such leaping inflation cannot be controlled by a tight money policy short of business collapse. Thus a simple reduction in general demand would not halt either creeping or the more dangerous leaping administrative inflation.

LABOR'S CONTRIBUTION TO ADMINISTRATIVE INFLATION

There is little evidence that labor contributes directly to leaping administrative inflation. Once that stage of administrative inflation is reached, labor is perpetually in the process of catching up. Living costs go up drastically and large wage increases become legitimate. The appropriate wage increases can then trigger another round of excessive price increases and thus prolong the period of leaping inflation.

On the other hand, the bargaining power of labor could be used to contribute to creeping administrative inflation. If there were no administrative inflation from the side of management, i.e. if price changes by management were only those justified by changes in demand and costs, it would still be possible for labor unions in their collective bargaining to force wage increases greater than increases in national productivity and increases in living costs would justify. This in turn would add to production costs per unit and lead to greater price increases than legitimate wage increases would require.

Such excessive wage increases could arise from three major sources, a misinterpretation of the indexes of productivity and living costs, a belief by labor that management has raised profit margins excessively thus leading to a labor drive to get its share, and the simple use of market power to get more income comparable to management's action to increase its income. Each of these can result in creeping inflation but could not be expected to produce leaping inflation.

Of course, creeping inflation from the side of labor tends to reinforce that from the side of management. Creeping inflation in a particular period may come from only one side or from a combination of both. However, apart from periods in which labor is catching up for increased prices or unbalanced profits, most of the administrative inflation of the last 20 years has come from the side of management with price increases periodically taking away some of labor's rightful gains from increases in national productivity, followed by a period such as the present in which labor seeks to recover lost ground.

CONCLUSION

This analysis of the anatomy of administrative inflation can only hope to give an outline of the forces at work in bringing it about. The process is much more complex and many other factors enter into it. Nothing has been said of the market power of labor in the few industries in which labor is well organized but entry to new enterprises is so easy that management has little market power. Nothing has been said of the way increases in the prices of imported raw materials can trigger price increases greater than the increased costs warrant. What has been important here has been to show how it comes about that economic concentration and market power can bring about this new type of inflation so different from demand inflation and so little controlled by the measures which can control inflation arising from an excess in demand.

IV—A Program for Full Employment Without Serious Inflation

The President's chief economic counsellor, Dr. Herbert Stein, recommends three or four years of stagnation as the way control inflation. This would cost at least $60 billion a year in lost production. It would place the main burden of controlling inflation on those seeking work and unable to find it. And there is no reason to expect that such a $200 billion program would succeed in bringing the present inflation under control.

An alternative program is to attack the arbitrary use of market power directly while expanding general demand to achieve full employment of men and machines. This would mean more real income to labor and to capital. It would put the main burden on those in a position to wield market power and this need

not be a heavy burden. And experience has already indicated that the abuse of market power can be successfully limited, at least for short periods of time.

In broadest outline this program should consist of three parts:

(1) A price-guidance program applied only to the more concentrated industries.

(2) The expansion of general demand through increasing the money stock while the budget is balanced or produces a small surplus.

(3) The maintenance of a floating exchange rate to minimize the effect of foreign inflation on the domestic economy.

Of these, the price-guidance program will be the most difficult and will be discussed after the role of the other two have been considered.

INFLATION OTHER THAN ADMINISTRATIVE

Even though most of the current inflation is administrative, some comes from abroad or from the specifics of supply.

A freely floating exchange rate tends to reduce the domestic effects of foreign inflation but is unlikely to eliminate them all. To the extent that it does not, an effort to control the internal effects by contracting the level of general demand in this country would be self defeating.

The appropriate government policy for the items involved is to stimulate production and accept the changed price relationships involved, leaving it to the free market to make the adjustments even though this means a small rise in the average of prices. When inflation abroad is overcome, there would tend to be a return to more normal price relationships.

The same stimulus to production and adjustment to temporarily higher prices would apply to crop failures and energy shortages rather than a limitation in general demand.

EXPANDING GENERAL DEMAND

The expansion of general demand could be brought about by either a budget deficit or expansion in the money stock but only the latter would deal with the danger of a liquidity crisis. The high rates of short-term interest and the low values of equity securities arise from a combination of not enough capital funds for financing new plant, equipment, inventories and consumer buying and a money stock too small to meet the public's desire to be more liquid by holding larger money balances.

To the extent that general demand is increased through a government deficit, the resultant borrowing takes capital funds out of the market and raises interest rates. To the extent that the government runs a surplus, this tends to increase the funds available for industrial and consumer borrowing thus reducing interest rates.

On the other hand, increasing general demand by expanding the money stock would not only increase the capital funds available to industry and consumers, thereby reducing interest rates, but would increase the stock of that most liquid asset, money, thereby reducing or eliminating the danger of a liquidity crisis.

Also the reduction of interest rates could be expected to bring a price rise in the stock markets, thereby making it easier for industry to obtain equity capital.

For the foregoing reasons the expansion of general demand through monetary measures would be very much superior in the present circumstances to the use of a government deficit. But an expansion of general demand could be absorbed by general inflation unless there is an effective program to control administrative inflation.

CONTROLLING ADMINISTRATIVE INFLATION

The short-run problem of controlling administrative inflation is to minimize inflationary abuse of market power. How far this can be done through persuasion and how far it requires government sanctions remains to be seen. Here a program will be presented which can use persuasion as far as that can be effective and government sanctions beyond that.

PRICE AND WAGE GUIDELINES

Whether or not government sanctions are used, the first step to inhibit the inflationary abuse of market power is to draw a line between pricing actions which constitute non-inflationary use of such power and those which constitute abuse. Traditional theory gives no solid basis for such guidelines. Its dictum

that price should be that which equates marginal cost and marginal revenue is irrelevant to longer-run pricing.

The problem is to distinguish between legitimate uses of market power and those which would contribute to administrative inflation. This is not a simple matter for either prices or wage rates. The crude guidelines of earlier attempts at intervention need to be refined.

For example, the simple guide for labor compensation which allows for increases in national productivity and for changes in living costs needs to be reconsidered. The increase in productivity which is available for general division between capital and labor is that which arises from improving technology. When output per worker goes up because a larger part of the work force is more skilled and occupies higher paying jobs, the higher pay absorbs a part of the gain in productivity and only the remainder is available for general division. The cost-of-living index may not be an accurate index for adjustment. To the extent that wage rates in different industries or activities are out of reasonable balance and are brought into better balance by raising the laggards, this absorbs some of the productivity gains and reduces those available for general division. There is some question whether higher living costs due to crop failure, in themselves justify wage increases. Thus, the guideline for the compensation of labor needs to take account of other factors than just an index of national output per hour and the cost-of-living index.

Similarly, the guideline for prices should focus on gross profit margins and should take account not only of the relation of prices to costs but should also include a cost-of-living adjustment for capital i.e. an adjustment for the changes in the buying power of the dollar.

This is not the place to spell out suitable guidelines but only to suggest that they need to be sweated out by experts who reflect the viewpoints of business, labor and consumers. Also it should be emphasized that the guidelines are concerned with changes in prices and wage rates not in whether the rates of return on capital are fair. Allowance would have to be made for hardship cases but the immediate inflation control program should not be made to deal with the longer-run problem of reducing market power or minimizing its harmful longer-run effects.

THE PERSUASIVE INFLUENCE OF FAIR GUIDELINES

For both business and labor, administrative inflation is a bad thing. For most big enterprises, if one could offer the management a contract which said "if you sign this contract to abide by the guidelines and adhere to them all other big enterprises and big labor will also sign and adhere" management would sign it as a "good piece of business" provided, of course, that the management thought the guidelines were fair and that others would adhere.

There is clear evidence that manageemnt and labor in the concentrated industries both recognize some degree of responsibility for administrative inflation although each tends also to blame the other perhaps even more than itself.

There is also clear evidence that both management and labor do want to exercise some responsibility for the market powers they wield. At the beginning of the Great Depression, President Hoover called on big business not to cut wage rates and for a year and a half most big business enterprises adhered to this guideline even though profits were disappearing. When President Kennedy called on big labor not to push for wage increases greater than increases in productivity this guideline was largely adhered to for nearly four years even though its unfairness was increasingly apparent. There is a substantial reservoir of responsibility on the part of management and labor which could be drawn on if a fairi set of guidelines could be developed and agreed on throught the joint activity of management, labor and consumers. There could also be important public pressure to adhere to such guidelines.

PRIVATE SANCTIONS

With a fair set of guidelines generally accepted, certain private sanctions could be expected to come into play.

The most important private sanction would be that exercised by management in the process of collective bargaining with labor. If labor sought to obtain wage increases greater than the wage guideline made legitimate, management would have an important tool to resist excessive wage increases. This is, of course, a tool which could be abused and there might be need for a labor appeals board,

not to set wage rates, but to interpret the application of the wage guidepost to the facts of the concrete situation as supplied by management and labor.

A comparable sanction would arise where transactions were between big buyers and big sellers, particularly where open-ended contracts were involved. If the seller sought to raise its price more than the price guideline would make legitimate, the big buyer could use the guideline as a tool to resist.

In the case of the ultimate consumers, traditional theory makes the consumer king, giving consumers the sanction of not buying. But in practice, the consumer is not king. Refraining from buying may not hold down price. Indeed, where the practice of full-cost pricing is used, a reduction of demand would mean that the producer must spread overhead costs over a smaller volume, thus increasing full unit costs and a *higher* price may result. In the absence of collective bargaining between management and consumers, only government can provide the sanctions on pricing where manageemnt fails to abide by the guidelines.

LIMITING THE SCOPE OF GOVERNMENT INTERVENTION

Government sanctions to enforce the adherence to guidelines should be limited to those enterprises which have substantial market power. The existence of such power can be deduced from past price behavior, from the degree of concentration in relation to markets and from the relative importance of the products being priced. Where there is no private market power as where there are a multitude of producers of essentially the same products for the same market, there is no problem. Where entry is easy, there would usually be no problem of substantial market power on the part of management. Even where there was market power but the product was unimportant, interference in pricing might not be necessary.

Since the core of the problem lies in the market power of big business, legislation might specify that the pricing of all unregulated corporations controlling assets of more than, say, $1 billion are deemed to be vested with a public interest and automatically subject to government sanctions with respect to prices. Then the decision of what smaller corporations should come within the scope of intervention could be left to a government agency responsible for such determination. A lower limit of, say, $100 million assets might be set so that any power to intervene would not apply to corporations under this size.

Such limitations would focus attention on the few hundred corporations that produce more than half of the country's manufactured goods. Of the corporations not covered, some, if not most, could be expected to abide by fair guidelines. The terms of labor contracts negotiated by such designated corporations would also come within the scope of intervention though it is doubtful if such intervention would be needed.

Such a limitation on the enterprises subject to intervention by government would make the scope of the program very much narrower than that of Phase II of the Nixon controls.

THE POWERS OF A PRICE GUIDANCE BOARD

In order to develop fair price and wage guidelines, and exercise such government sanctions as are essential, government would need to set up a price guidance board with adequate powers. While the price and wage guidelines should have general application, the sanctions to enforce adherence should not only be limited to a relatively small number of enterprises and unions but should also be as limited in character as events make possible. If there were widespread voluntary adherence to the guidelines, the problem of sanctions would apply only to the few cases in which market power was being abused. If departure from the guidelines was widespread, more extensive sanctions would have to come into play.

At least three different levels of sanction could be employed.

At the minimum, the Guidance Board would presumably have the power to publicize departures from the guidelines. This would require regular reporting and justification of price increases by the big enterprises subject to the Board's scrutiny. The likelihood of an announcement of any abuse of power found by the Board could act as a deterrent in some degree while persuasion to roll back an excessive price increase might sometimes succeed.

A stronger sanction would be available through requiring prior notification of price changes. This would give more opportunity to exercise persuasion and bring to bear the forces of public opinion and avoid the more difficult process of rollback.

A more extreme sanction would be a power in the Board to prevent what were deemed to be excessive price or wage increases.

The use of the more extreme sanction might be limited to major products while the prior notification could apply to a wider range of products and the requirement of regular reporting of price changes would apply generally to the few hundred enterprises designated by the law or the Board as within the scope of the Guidance Board's powers.

The powers of the Board to induce adherence to the Guidelines could also be limited by the rate of administrative inflation. It would be possible to develop a rough index of administrative inflation by compiling an index of prices at wholesale for the products of the more concentrated industries and a price index for the raw materials for these products. With a proper weighing for raw materials and due adjustment for appropriate cost of living adjustment in the compensation to labor and capital, it would then be possible to derive an index which tended to reflect changes in prices due to a widespread abuse of market power by management or labor. This would then reflect roughly the rate of administrative inflation. Indeed, it should be possible to develop a set of price indexes which divided up, at least crudely, the total inflation at the wholesale level into that attributable to crop failures, etc., that attributable to foreign inflation, that attributable to the abuse of market power and that, if any, due to a general excess in demand.

Once a suitable index of administrative inflation was available, the powers of the Guidance Board could be linked to it. Thus, if the index of administrative inflation rose at the rate of less than 1 percent a year, the power of the Board could be limited to price reporting. If it rose at the annual rate of 1 to 2 percent for two successive quarters, the Board would thereby automatically have the power to require prior reporting but not the power to limit or roll back prices. The direct power to control prices in the case of abuse would then accrue to the Board only if the administrative inflation index increased in two successive quarters at the annual rate of, say, 2 percent or more. Of course, it would be up to the Board to decide how extensively it should use its power as thus limited.

THE LOCATION OF A GUIDANCE BOARD

Where the Price Guidance Board should be located in the structure of Government is a serious problem.

If the President and his economic advisers really understood the anatomy of administrative inflation and were not so committed to treating the current inflation as a demand inflation, the appropriate location would be in the administrative arm of the Government. But the Executive arm of Government is not mentally or psychologically equipped to control administrative inflation. Its proposal of a Cost-of-Living Task Force is coming at the job from the wrong end with no real grasp of the problem and there is no repudiation of the three or four years of planned stagnation as the way to control inflation.

An alternative is to follow the pattern of the Federal Reserve Board but on a temporary basis. The Federal Reserve Board is responsible to the Congress, not the President. A temporary Price Guidance Board could be created which was responsible to the Congress, with its membership appointed partly by the President and partly by the Congress. It could be required that its membership reflected the three interests most concerned with pricing, business, labor and consumer.

INITIATING THE PROGRAM

At the present time there is a serious unbalance between the compensation to capital, the compensation to labor and living costs. In the concentrated industries, real wage rates have gone down in the last year while real profits have gone up. There is a question whether the unbalance should be corrected through a rise in wage rates or a roll back in prices. If the former it would be difficult to prevent some rise in prices without strong resistance to price increases. And a roll back would presumably require even stronger intervention.

Also a program to reflate to a reasonable level of production and employment will involve some degree of price rise of the less concentrated part of our economy.

It cannot be expected that all inflation can be halted immediately but a vigorous program to minimize administrative inflation while demand is expanded to a substantially higher level with a greatly reduced rate of inflation. And it would not cost any $200 billion of lost production.

Nor is there any reason to expect that a price-wage guidance program to limit administrative inflation would simply create an explosive situation as would a price control program to control inflation from a general excess of demand. In the case of demand inflation, a holding down of prices and wage rates by government only postpones the effect of the excess demand. But in the case of administrative inflation a price program which prevents the abuse of market power does not create an excess of demand. If the program of intervention is halted after a successful period, further administrative inflation will arise only if there is further abuse of market power. Whether there will be need for continued price guidance will then depend partly on how well the wielders of market power accept the responsibility which goes with wielding such power and partly on structural changes which might reduce such power.

INTERVENTION IN THE FREE ENTERPRISE SYSTEM

It will be said with justification that a direct effort to limit the abuse of market power is interference with the freedom of individual enterprises in the free enterprise system. But the free enterprise system has never given the individual enterprise complete freedom. The law interferes with freedom when it says one corporation shall not steal from another corporation and most don't. The law interferes with freedom when it says a corporation shall abide by contracts which it has entered into and most do. The government regulates the prices of public utilities which have the extreme of market power in the form of monopoly.

In each case the interference with the absolute freedom of enterprise arises from the substantial public interest in limiting the particular power of the individual enterprise in order to make the free enterprise system work better. The issue of interference with free enterprise thus turns not on some concept of absolute freedom but on whether the free exercise of substantial market power threatens the working of the free enterprise system.

In weighing the interference with the freedom to exercise substantial market power against complete freedom to set price, it should be recognized that the market power of corporations does not arise from "natural right". The right to combine the capital of many individuals and organize it in the form of a corporation is a right granted by government. And since enterprises would have little market power if there were no corporations, the main problem of the abuse of market power is the abuse of a power arising from a grant of power by government. In no sense would the interference wit hthe free use of the substantial market power of the big corporations be an interference with the natural rights of individuals.

MAJOR CHANGES IN ECONOMIC POLICY

Twenty-eight years ago the Congress made a major change in economic policy when it passed the Employment Act of 1946. This act gave the Federal Government the new function of maintaining high employment made necessary in part by the changes wrought in the national economy by the modern corporation.

Today we are faced with the need for a second basic change in national policy due to the modern corporation, that of limiting administrative inflation. In the immediate future the program outlined above would seem to be the most suitable. Over a longer period, other ways of limiting administrative inflation may be found and much effort should go into ways of limiting administrative inflation. It does not seem impossible for our society to achieve both full employment and price stability. In no sense does planned stagnation and continued rapid inflation provide a satisfactory alternative to some government intervention to limit the abuse of market power.

THE SECRETARY OF THE TREASURY,
Washington, D.C., September 16, 1974.

HON. EDMUND S. MUSKIE,
Chairman, Senate Budget Committee,
U.S. Senate, Washington, D.C.

DEAR MR. CHAIRMAN: The following is my response to your question during last month's Budget Committee hearing regarding the amount of funds that were lost by U.S. banks in the closing of ID Herstatt and Bass and Herz banks.

As far as we are aware, no U.S. banks experienced losses through the closing of Bass and Herz or through the closing since your Committee's hearings of another two small private banks in Germany.

The German Banking Supervisory Authority withdrew the banking license for Herstatt Bank in June and ordered liquidation. The full extent of the claims against Herstatt by U.S. and foreign banks will be revealed during the course of the liquidation proceedings.

As a clearing agent for Herstatt on international transactions, Chase Manhattan Bank had some $156 million on deposit in Herstatt's account and became involved in claims against these assets. On July 15, Chase informed the U.S. Court for the Southern District of New York that it was without means to determine the validity of conflicting claims and asked the Court to rule on the claims. Attached is a copy of that portion of the Chase request to the Court enumerating the claimants to the Herstatt funds Chase had on deposit. Moreover, in early August, First National City Bank and others petitioned the Court to have Herstatt declared bankrupt under U.S. law. Action pursuant to the filing of this petition may also reveal the extent of losses by U.S. banks as a result of the German bank's failure.

If I can be of further assistance, please let me know.

Sincerely yours,

WILLIAM E. SIMON.

39. At the present time Chase holds moneys in the account of Herstatt with Chase at its head office, 1 Chase Manhattan Plaza, New York, N.Y., in the amount of $156,097,023.32 ("the Fund"), subject to correction for errors and omissions and to the various claims described hereafter.

THE ATTACHING CLAIMANTS TO THE FUND

40. In the actions and on the dates set forth below, orders of attachment were served upon Chase, by the United States Marshal for the Southern District of New York with respect to the first such order of attachment (in an action pending in this Court) and by the Sheriff of the City of New York with respect to the remaining such orders (in actions pending in the Supreme Court of the State of New York, County of New York), each of which orders purported to attach such property of Herstatt in the possession of Chase as would satisfy demands for the amounts as listed below together with interest, costs, etc.:

Action	Date	Amount exclusive of interest, costs, etc.
Morgan Guaranty Trust Co. of New York versus Bankhaus, I. D. Herstatt, K.G.a.A	June 27, 1974	$13, 000, 000. 00
Bank of America National Trust & Savings Association versus Bankhaus, I. D. Herstatt, K.G.a.A	June 28, 1974	5, 000, 000. 00
Chase Manhattan Bank, N.A., versus Bankhaus, I. D. Herstatt, K.G.a.A	do	5, 000, 000. 00
Seattle-First National Bank (Switzerland) Zurich versus Bankhaus, I. D. Herstatt	July 1, 1974	22, 500, 000. 00
Investitions-und Handels-Bank A.G. versus Bankhaus, I.D. Herstatt, K.G.a.A	do	25, 000, 000. 00
Nederlandse Credietbank N.V. versus Bankhaus, I. D. Herstatt, K.G.a.A	July 2, 1974	5, 000, 000. 00
Svenska Handelsbanken versus Bankhaus, I. D. Herstatt, K.G.a.A	do	7, 090, 200. 00
Asian & Euro-American Merchant Bank, Ltd., versus Bankhaus, I. D. Herstatt, K.G.a.A	do	1, 000, 000. 00
Walter J. Oehler versus Bankhaus, I. D. Herstatt, K.G.a.A	do	3, 925, 000. 00
Bankhaus, Friedrich Simon versus Bankhaus, I. D. Herstatt, K.G.a.A	do	10, 000, 000. 00
First National Bank of Chicago versus Bankhaus, I. D. Herstatt, K.G.a.A	July 28, 1974	5, 875, 000. 00
Ruhrkohle, A. G., Essen versus Bankhaus, I. D. Herstatt, K.G.a.A	do	5, 905, 511. 82
Asian and Euro-American Merchant Bank Limited versus Bankhaus, I. D. Herstatt, K.G.a.A	do	1, 000, 000. 00
Bank of America National Trust & Savings Association versus Bankhaus, I. D. Herstatt, K.G.a.A	do	5, 000, 000. 00
Hesse Newman & Co. versus Bankhaus, I. D. Herstatt, K.G	do	39, 700, 000. 00
Deutsche Girozentrale-Deutsche Kommunalbank versus Bankhaus, I. D. Herstatt, K.G.a.A	July 9, 1974	11, 000, 000. 00
B. Metzler seel. Sohn & Co. versus Bankhaus, I. D. Herstatt, K.G.a.A	July 11, 1974	2, 000, 000. 00
Dresdner Bank A. G. Frankfurt Main versus Bankhaus, I. D. Herstatt, K.G.a.A	do	1, 000, 000. 00
Girard Trust Bank versus Bankhaus, I. D. Herstatt, K.G.a.A	July 12, 1974	5, 000, 000. 00
Total		173, 995, 711. 82

OTHER CLAIMANTS TO THE FUND

41. Girard International Bank has demanded the return of $17,500,000 paid to Chase for the account of Herstatt on June 26, 1974.

42. Manufacturers Hanover Trust Co. has demanded the return of $12,500,000 paid to Chase for the account of Herstatt on June 26, 1974.

43. Hessische Landesbank-Girozentrale has demanded the return of $27,000,000 paid to Chase for the account of Herstatt on June 26, 1974.

44. Donaubank has demanded the return of $8,000,000 paid to Chase for the account of Herstatt on June 26, 1974.

45. Chase has not returned the sums demanded as alleged in paragraphs 41 through 44 above since Chase is in doubt as to the rights of those claimants to said sums and cannot safely determine to whom it is required to make payments from the Fund.

POTENTIAL CLAIMANTS TO THE FUND

46. On June 26, 1974 First National City Bank paid a total of $19,000,000 to Chase for the account of Herstatt. Upon information and belief, First National City Bank may make a claim for the return of such sum.

47. On June 26, 1974 Continental Bank International paid $1,200,000 to Chase for the account of Herstatt. Upon information and belief, Continental Bank International may make a claim for the return of such sum.

48. On June 26, 1974 Bankers Trust Company paid $1,000,000 to Chase for the account of Herstatt. Upon information and belief, Bankers Trust Company may make a claim for the return of such sum.

49. On June 26, 1974 Northern Trust International Banking Corp. paid $200,000 to Chase for the account of Herstatt. Upon information and belief, Northern Trust International Banking Corp. may make a claim for the return of such sum.

50. On June 26, 1974 Girard International Bank paid $4,000,000 to Chase for the account of Herstatt. Although Girard International Bank has not made demand for reversal of this transaction, it has made such demand with respect to other sums similarly credited to the account of Herstatt as alleged in paragraph 41 above. Upon information and belief, Girard International Bank may make a claim for the return of said sum of $4,000,000.

51. On June 26, 1974 J. Henry Schroder Banking Corp. paid $100,000 to Chase for the account of Herstatt. Upon information and belief, J. Henry Schroder Banking Corp. may make a claim for the return of such sum.

52. On June 26, 1974 Bank of Montreal Trust Co. paid $1,500,000 to Chase for the account of Herstatt. Upon information and belief, Bank of Montreal Trust Co. may make a claim for the return of such sum.

53. On June 27, 1974 Chase received a check for deposit to the account of Herstatt in the amount of $200,000 from Bank of Boston International. Upon information and belief, Bank of Boston International may make a claim for return of such sum.

54. On June 27, 1974 Chase received $2,500,000 in federal funds from Irving Trust Company for the account of Herstatt. On information and belief, Irving Trust Company may make a claim for the return of such sum.

55. On June 27, 1974 Chase received $64,000,000 in federal funds from the New York branch of Commerzbank A.G. for the Account of Herstatt. Upon information and belief, Commerzbank A.G. may make a claim for return of such sum.

56. Chase has received numerous instructions from Herstatt directing payments out of Herstatt's account with Chase and a number of checks have been presented for payment out of said account. Since Chase learned of the actions taken by West German authorities referred to in paragraph 38 above, the total amount of such payment instructions and checks which have not been honored by Chase is $619,634,961.60, subject to correction for errors and omissions.

57. On July 12, 1974 Chase received a cable from Herstatt, by "the liquidator Dr. Woeste", which stated in part:

"Please remit immediately under cable advise to Deutsche Bank, Koeln the A [sic] balance of our account with you as follows:

Beneficiary: Deutshe Bank, Duesseldorf.

regarding: Deutsche Bank, Koeln Acc. No. 1147800.

Trust Account RA Dr. Reiss."

58. Chase has not paid over the balance in Herstatt's account in accordance with said cable request because the Fund is subject to the attachments described above in paragraph 40 and to the other claims and potential claims described in paragraphs 41 through 56, and Chase is therefore in doubt as to whom it is required to pay sums from the Fund.

CHASE'S STAKEHOLDER POSITION

59. Chase is without means to determine the validity of the conflicting claims and potential claims against the Fund as set forth above. Chase is in a dangerous and doubtful position and cannot safely determine to whom it is required to pay sums from the Fund. Chase may be exposed to multiple suits and multiple liability.

Chase's interest in the Fund is limited to its claim against Herstatt for $5,000,000 with interest, costs, etc. in connection with the action brought by Chase against Herstatt in the Supreme Court, New York County (referred to in paragraph 40, above), and to charges, legal fees, disbursements and other costs of this action.

60. Contemporaneously with the filing of this complaint of interpleader, Chase has given bond payable to the Clerk of the Court in the amount of $156,097,023.32 conditioned upon compliance by Chase with the future order or judgment of the Court with respect to the Fund.

Wherefore, plaintiff, The Chase Manhattan Bank, N.A., demands judgment:

(1) that defendants be required to interplead and set up their respective claims to the Fund;

(2) that defendants be restrained from instituting or prosecuting any proceeding against Chase affecting the Fund;

(3) that defendants be restrained from prosecuting any proceeding to compel payment or delivery of any sums from the Fund other than in this interpleader action;

(4) that Chase be directed to pay over to the Sheriff of New York City such amount as will satisfy the order of attachment levied on June 28, 1974 in connection with the action in the Supreme Court of the State of New York, County of New York entitled *The Chase Manhattan Bank, N.A.* v. *Bankhaus I.D. Herstatt K.G.a.A.* Index No. 74-09774, and that Chase be otherwise directed as to whom payments from the Fund should be made and in what amounts.

○