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# WAGE AND PRICE CONTROLS

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## HEARING

BEFORE THE

SUBCOMMITTEE ON

ECONOMIC GROWTH AND STABILIZATION

OF THE

JOINT ECONOMIC COMMITTEE

CONGRESS OF THE UNITED STATES

NINETY-FIFTH CONGRESS

SECOND SESSION

DECEMBER 6, 1978

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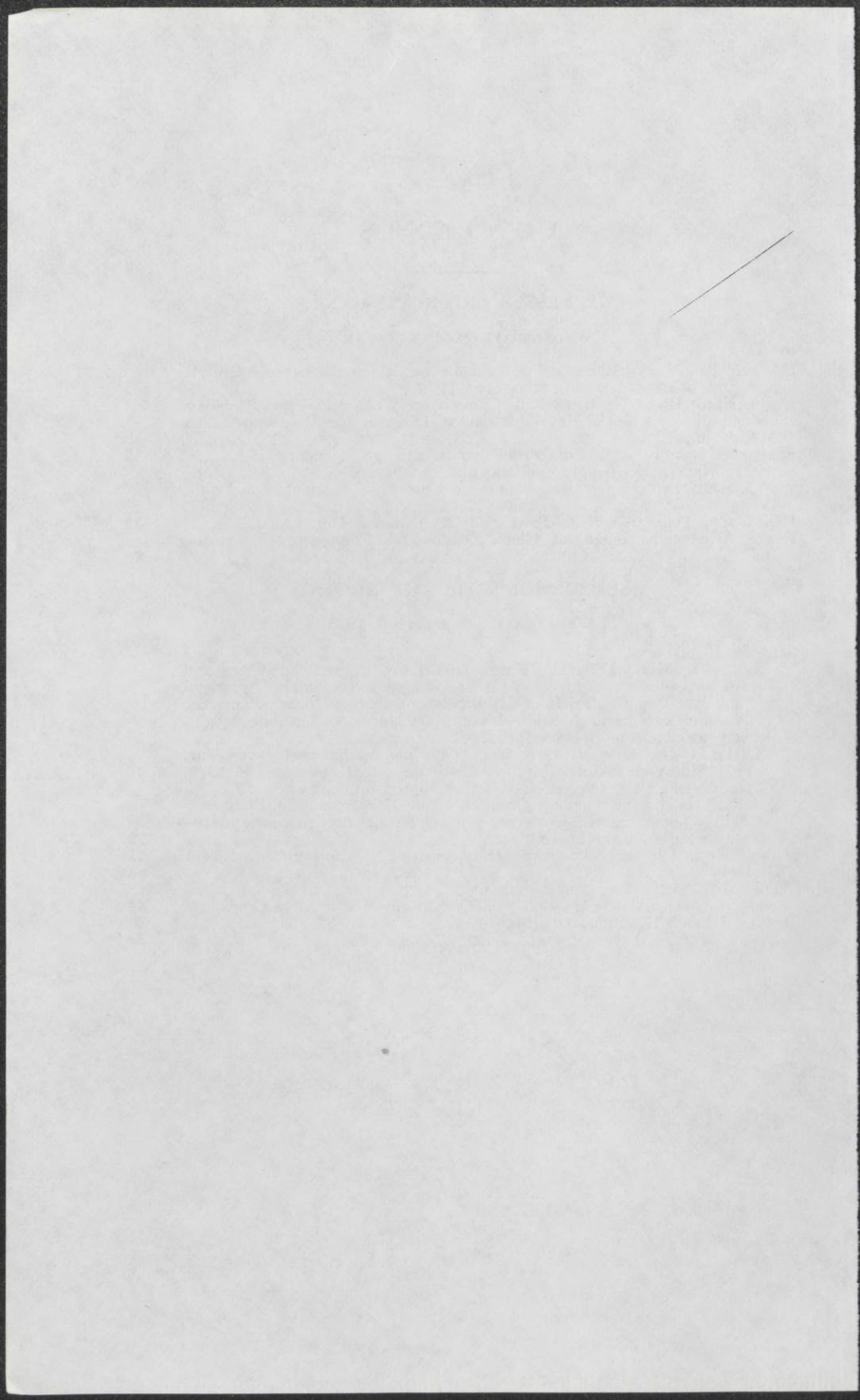
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## WAGE AND PRICE CONTROLS

WEDNESDAY, DECEMBER 6, 1978

CONGRESS OF THE UNITED STATES,  
SUBCOMMITTEE ON ECONOMIC GROWTH AND  
STABILIZATION OF THE JOINT ECONOMIC COMMITTEE,  
*Washington, D.C.*

The subcommittee met, pursuant to notice, at 9:30 a.m., in room 6226, Dirksen Senate Office Building, Hon. Lloyd Bentsen (chairman of the subcommittee) presiding.

Present: Senator Bentsen; and Representatives Brown of Ohio and Heckler.

Also present: Louis C. Krauthoff II, assistant director; Richard F. Kaufman, assistant director-general counsel; John M. Albertine, Lloyd C. Atkinson, Richard D. Bartel, Thomas F. Dernburg, L. Douglas Lee, Katie MacArthur, Paul B. Manchester, Deborah Norelli Matz, George R. Tyler, and Robert Ash Wallace, professional staff members; Mark Borchelt, administrative assistant; and Robert H. Aten, Charles H. Bradford, Stephen J. Entin, and Mark R. Policinski, minority professional staff members.

### OPENING STATEMENT OF SENATOR BENTSEN, CHAIRMAN

Senator BENTSEN. This hearing will come to order.

Mr. Kahn, we appreciate having you here this morning with the many challenges and problems that you are facing and hope that the Joint Economic Committee again can provide a forum for some of the most major economic problems facing this country and the difficulties of the task facing you and the President.

There are a lot of people in this country who are sincerely concerned about inflation but don't really enforce the President's program and who look on voluntary guidelines as just the first line of defense which are going to fail and who think that what really is going to come is mandatory wage and price controls.

But mandatory wage and price controls don't stop inflation any more than the maginot line stopped the defeat of the French Army. And they are not going to protect the American consumer from all of the hurt and the damage of inflation.

The Joint Economic Committee, in anticipation of this hearing and the task facing you, has just completed a staff study of the effect of mandatory wage and price controls through the 1971-74 period.<sup>1</sup> And they found that the mere prospect of controls, mandatory controls coming out, resulted in a substantial increase in cost to the consumers

<sup>1</sup> See the staff study beginning on p. 63.

of this country and additional inflation because of manufacturers increasing prices in anticipation of the wage demands that resulted.

Mandatory wage and price controls don't avert a recession and, Mr. Kahn, not even a banana.

I must say I don't look at bananas with quite the same enthusiasm that I used to. [Laughter.]

So mandatory wage and price controls aren't acceptable. The President's program will work; the voluntary program will work if the American people will have the kind of unity of purpose that has built this country of ours, if they will go back to President Kennedy's statement of not what this country can do for me but what I can do for my country.

If we can get rid of some of the "me first" philosophy that we are seeing and all the special interest groups that are going to say, "Sure, we are for wage and price controls except for me," then the program will work. And that is the objective that I think you have to be able to sell to this country and the President. And even that is not going to be enough, because we are going to have to cut back obviously on the cost of regulation, and you have been in the forefront of that fight.

I am doing all I can to help in the Senate with a package of legislation, some of which we passed, to cut back on the cost of regulation and redtape.

In addition to that, we need the support of the President in cutting back on the deficit in the budget. People are fed up with the increased size in government and intrusion in their personal lives and the increased cost of government. And they know that these factors, too, contribute to inflation and the costs of the consumer.

Mr. Kahn, in this hearing today I want to tell you that I, for one, and this committee are going to do all we can to assist in seeing that these voluntary wage and price controls work and that if we can be of help we intend to do so to try to turn this thing around and cut the cost to the American consumer.

Mr. Kahn, we are pleased to have you. If you would proceed with your testimony and give the name of your associate who is testifying with you.

**STATEMENT OF HON. ALFRED E. KAHN, CHAIRMAN, COUNCIL ON  
WAGE AND PRICE STABILITY, ACCOMPANIED BY JACK MEYER,  
ASSISTANT DIRECTOR FOR WAGE AND PRICE MONITORING**

Mr. KAHN. Thank you very much, Mr. Chairman. I really deeply appreciate not just the opportunity to be here, but your remarks. There is not a word you said with which I do not agree, except perhaps your implication that I intended to malign bananas. Some of my best fruits are bananas. [Laughter.]

Accompanying me is Mr. Jack Meyer, who is Assistant Director for Wage and Price Monitoring on the Council on Wage and Price Stability, and he will undoubtedly be helpful if you have detailed questions about the wage price standards program particularly.

I do have a prepared statement. It is comparatively brief, so perhaps it would be well for me to go through it. It is brief because there is almost certainly no group of people in the country as well informed

as this committee about the seriousness of the inflation we have been experiencing for the last 10 years, the disappointing course it has taken during the last few months, and with the general outlines of the President's program for combating it.

I will keep it short so that I may have as much time as possible to try to answer your questions.

I would just remind you of what the Joint Economic Committee staff study observed in this very brief section, with which again I agree, that the rate of inflation did dip from the double digit rate into the 5- or 6-percent rate during the 1974-75 recession. But it is important to remind ourselves that that was the worst recession in 35 years and certainly 5- to 6-percent inflation was still unacceptably high. It remained at 6 percent or so during the long recovery from mid-1975, then suddenly accelerated in 1978. It is now averaging close to 10 percent.

Initially, people in the Government reporting this acceleration of inflation blamed it very largely on food prices. However, in the last few months it has become perfectly clear that other prices and wages are soaring as well; we simply can't explain this deterioration away by a couple of months of bad California weather or too few cows. The fundamental problems we now perceive are much wider and deeper.

I really don't feel I have any wisdom to impart to you about how to distribute the blame for this disease. It has become something of a cliché now to observe that when you talk to businessmen, they will tell you inflation is caused by Government and labor unions; that when you talk to labor unions, they say the culprits are Government and business; and people in Government will blame business and labor.

It is also kind of a cliché to say the truth is that each group is two-thirds right.

I do think one thing that is fair to say is exactly what you observed, Mr. Chairman: If there is a villain, it is all of us and we are all going to have to be part of the solution.

I know that that assertion, coming from a Federal Government official, sounds a little self-serving and glib. I think if you look at the sources of the 10 years of inflationary momentum we are now trying to arrest, you would have to assign blame first to the ill-advised expansions of the money supply and of Federal spending, unmatched by tax increases, during the late 1960's and again in 1971 to 1973.

This is a nonpartisan statement, since I have embraced both the Democratic and Republican administrations in that account. Although there may be differences of opinion on this, I don't think one could make a similar criticism of our monetary and fiscal policies since 1975.

Expansion of total demand has surely been desirable as we emerged from this deep recession, but I don't think the Federal Government can be accused of having sought an excessively rapid reduction of unemployment, or of having overstimulated the economy from 1975 to 1977.

We have had large Federal budget deficits but their effect on total spending has been at least partially offset by large surpluses at the State and local government level and by the greatly expanded deficit in our current balance of international payments. I am not saying that was a healthy state of affairs. On the contrary, our economy would almost certainly have been stronger had the Federal deficit

been smaller, had the deficit in the balance of payments been smaller, and had private investment expenditures been larger.

We would have had a healthier and stronger economy. All I am saying is Federal spending during these last few years has not produced an overheated economy, the way it did in the late 1960's and early 1970's.

On the other hand, I think there is little doubt that Federal Government policy has contributed substantially to inflation in the last few years; for example, with tighter restrictions on agricultural production, sharp increases in minimum wage and social security taxes, and in the sharply increased costs imposed on the private economy by its regulatory activities about which I will say more later.

But all these actions serve in my judgment to underscore the point that I am anxious to drive home and, again, the point you have already made, Mr. Chairman; the responsibility for this inflation and for its remedy is one we all must bear.

When the Federal Government engages in these increased expenditures, it doesn't do so out of some malevolent will of its own, merely to aggrandize the power of some bureaucrats in Washington. It does so in response to pressures from the American people to meet some need that they express, to protect some exposed group from excessive hardship, or to serve some other social purpose.

And when now an attack on inflation requires that we curtail Federal expenditures, and it does, the burden will be borne not just by Federal employees but by all the beneficiaries of these programs. The sacrifices will have to be borne by all of us.

If inflation has been a chronic problem in Western society, as I think is the case, it is because we have experienced a decreasing willingness to rely on and expose ourselves to the functioning of an uncontrolled market system.

The expanded commitment of our governments to maintaining full employment, to widely increased income transfer programs, to a broad range of economic and social regulations—most of these clearly laudable and desirable to the extent we can afford them—are all manifestations of that change.

Similar changes have occurred in the way the private economy functions. Business and labor no longer passively accept whatever changes in fortune are visited on them by the market. Instead they play an active role in determining their wages and their prices.

I think it just does not describe the major part of our economy any longer, if it ever did, that prices go up when demand rises and prices go down when demand falls. Nor do wages. The fact is most people in this country don't like the way a truly competitive economy functions and have found ways of protecting themselves from it.

I don't see how you can explain the undeniably inflationary coal wage settlements earlier this year in terms of a shortage of coal miners. You certainly can't explain the 35-percent wage increase that railroad workers got on the basis of a demand to recruit additional railroad workers.

In much of our economy, obviously, wages are not determined by a process of competitive demand interacting with competitive supply. They are determined by a process of bargaining between powerful interest groups on each side of the table.

These bargains are very powerfully influenced by what has happened in preceding months and years with the cost of living, rather than what is happening now to the demand for labor. What is true of wages is true also of prices. Businesses respond to wage increase demands almost regardless of what is happening to the demand for their products by passing through their increased costs, sometimes with something to spare. So the problem continues to feed upon itself. Wages chase prices, and prices chase wages in an apparently unending spiral.

This inflationary wage-price-wage machine is not totally impervious to declines in total spending. We can stop inflation by putting a tight rein on total spending and by producing a sufficient level of unemployment. Nine million people out of work in 1975 did not suffice, although it certainly helped bring inflation down from the double digit level to the 5- or 6-percent range.

The reason we don't know how deep and long a decline it would have taken to go the rest of the way is that the American people were unwilling to tolerate so Draconian a solution.

When I say these things, I am not in any way minimizing the importance as the first plank in the President's anti-inflation program, which is to restrain Federal spending, reduce the deficit, and limit the growth in the money supply.

Without those fiscal and monetary restraints, wage and price guidelines are worthless.

Of course, there are people who will argue that with those you don't need the wage and price guidelines. I happen to disagree with that. I think the wage and price guidelines are an important part of the program.

But clearly the first and most important step is to restrain the growth in Federal spending and diminish the size of the deficit. All I am saying is that it is unacceptable to the President, and I believe it would also be unacceptable to you and to the American people, to rely only on reducing growth of the money supply and on reduced Federal spending to stem inflation. The way they work is by reducing demand for goods and services drastically enough so that perhaps then industries will not be able to raise their prices, and by throwing enough people out of work so they no longer will be able to demand higher wages. I do not believe this is a cost the American people are willing to pay.

The second part of the President's program, therefore, is aimed directly at the ways other than budgetary policy in which the Government becomes a major contributor to inflation.

It is quite true that Government regulations that protect and promote special interests, that restrict competition, that interfere with the functioning of markets, that set minimum wages and prices, that limit production, that limit competitive entry into markets, that limit the flow of international trade, and that impose additional costs on industries, that all together these impose a powerful upward thrust to the general price level. The control of inflation demands a thorough review of all of them.

The need for reviewing the regulations aimed at such undeniably desirable goals as health, safety, and environmental protection, is exactly the same in principle and in concept as the need for reviewing direct Federal budgetary expenditures, most of whose goals are equally

acceptable. But in our provisions for reviewing these regulatory costs, we are in much the same situation as we were in reviewing budgetary expenditures back in the 1920's. Then, individual agencies and departments of government used to send their own budgets up to Congress.

Gradually we evolved a system under which the President submitted a single annual budget. This process permitted an evaluation and ranking of individual programs in terms of their value relative to the others, and an appraisal of the inevitable trade-offs that are necessitated by the fact that tax revenues are not unlimited and, therefore, the more we give for one thing, the less we have available for others.

In the last few years, Congress has moved further to reform the budgetary process by doing much the same thing itself.

Whether or not you agree with all of the results, I think you must agree that such an integrated review of direct Federal spending projects is essential to intelligent fiscal policy. The problem that we now perceive is that the budget has become a decreasingly complete measure of all the ways in which the Federal Government dictates the use of our limited total resources.

This shift from budgeted to off-budget demands on the economy was understandable. When early in the 1960's Congress found that opposition to higher taxes was limiting its ability to carry out desirable social programs, it looked for ways of doing these things without spending tax revenues. It began with off-budget financing, which involved Federal Government loan guarantees and direct loan financing.

What these did was merely re-rank people and programs in the capital markets. They put some outlays at the top of the list and they put others further down in the list.

Since in doing this we were not encouraging more savings, or creating more funds for investment, the effect was simply to make capital more scarce for the ones shoved down on the list. Would be homeowners and small businesses, typically at the bottom of the list, complained at the squeeze. Eventually we listened to them, and loan guarantees and direct loan financing lost favor.

Then we discovered an even more efficient way of doing these things. We simply wrote regulations ordering the private sector to do them. The costs then did not appear in the Federal budget. But they still show up in the costs of doing business and hence, in prices.

I am not suggesting that there was anything surreptitious in our deciding to achieve these social purposes in this way. Nor do I suggest it was undesirable. On the contrary, as an economist, I believe that when the production or consumption of particular goods or services, or particular processes of production, deteriorate the environment, or threaten the safety of workers or consumers, as a matter of principle those costs or the costs of abating them should properly be borne by the purchasers or the users.

Only if prices include all the social costs of production will consumers be in a position to decide whether the benefits of having the goods outweigh all the costs to society of making them available.

My point is only that the costs of imposing those regulations are real and they must be subjected to the same kind of rigorous economic scrutiny as direct government expenditures. Because environmental protection and improved occupational health and safety use scarce resources or increase the amount of other scarce resources that have to

be used to abate them, more capital, more raw material, and more labor, are needed to abate these consequences.

These regulations must be subjected to economic tests. More environmental protection means less of everything else, from national defense and hospital services and medical services and schools and museum hours and assistance to the arts, to automobiles, toothpaste, and deodorants. If the decisions to require environmental protections are to be rational, therefore, they must be subjected to the weighing of the sacrifices against the benefits.

Moreover, the spread and intensification of these regulations contribute to the process of inflation. We can't have cleaner air and cleaner water and safer products and reduced industrial accidents—all of which are obviously desirable—while at the same time having just as much of everything else as we had before. Yet that is exactly what we are, in effect, demanding when, as businesses increase their prices to cover these additional costs, we then ask for cost-of-living escalators in our wages to cover those additional costs.

That is just another way of saying I want just as many automobiles, just as much housing, just as much toothpaste, just as much eating out in restaurants as I had before, and, in addition, I now want cleaner air, cleaner water, and better safety. I am not in any way denigrating the latter, obviously. But there is just not enough to go around to say we can have unlimited increases in these.

The workers who enjoy the benefit of additional safety, achieved by imposing additional costs on business cannot, except at the cost of promoting inflation, also ask to have their wages increased sufficiently to offset the resulting increases in prices.

Of course, when workers demand higher wages to cover those costs, then businesses raise their prices again in a never-ending process. We simply must ask questions.

First, is it the lowest possible cost means to achieve the desired result? I submit that we have not asked that question. To some extent, Congress in some of its laws has prohibited us from asking that question.

Does it inefficiently prescribe particular ways of accomplishing the results rather than giving incentives to businesses and consumers? And second, do the benefits justify the sacrifices?

We have not consistently applied these tests in the past, partly because we had for so long neglected environmental and occupational protection that the initial incremental benefits in most cases were almost certainly worth more than the costs they imposed.

But that is certainly no longer universally the case. I am sensitive, as I hope I have made clear, to the great social value of providing protection to the environment and to worker health and safety. I am sensitive also, however, to the effect that inflation is having on the ability of people living on fixed incomes to make ends meet; the effect of inflation on the quality of our lives, and on the ability of the Government itself to expand its humane programs to insure adequate food, shelter, and medical care to all of us.

As I come to the end of my statement, I have said comparatively little about the third portion of the President's anti-inflation program, the standards of responsible wage and price behavior, because I am sure you are generally familiar with them.

Wage increases are to be limited to a 7-percent average for each employee group. Businesses are expected to follow a policy of decelerating their rate of price increases in a manner which, if they follow the standards, can reduce the overall rate of inflation in this country next year between 6 and 7 percent. That may not look good, but it is certainly a lot better than the 10 percent we are facing now. The President's program tries to be honest. It does not promise miracles. We must recognize that this is a deep and intractable problem and we must be ready for a long-term fight which will require sacrifices by all of us.

It is not going to be easy for individual groups to adhere to these standards, or for us to induce them to do so. The reason is obvious. It takes an act of faith and social responsibility for a group of workers who have gone for a year without a pay increase at a time when the cost of living is rising 10 percent per year to settle for 7 percent in the hope and expectation that their self-restraint will pay off in a lower national rate of inflation.

How, the union leader will say, can you expect us to take the first step with no assurance that others will follow and we will not, therefore, end up losers if others do not follow?

Yet, the inescapable fact is—it is simple arithmetic—if all workers together do not conform to the guidelines in the wage increases they obtain, inflation will continue at present rates, and all of them together will find themselves at the end of the year just as frustrated as they were at the beginning of the year.

And the only way that all workers together can finally get out of this rat race is if they do so individually, contract signing by contract signing.

It seems clear to me that mere persuasion, mere requests for cooperation will not suffice, even though I am convinced that most workers of this country realize that a continuation of the process of wages chasing prices and prices chasing wages will produce nothing but frustration and anger.

In order to insure that those who do cooperate will not suffer if others fail to do so, the President has proposed a real wage insurance program. This will provide a Federal income tax rebate equal to the difference between the actual rate of inflation and 7 percent for those workers who do comply. So if the inflation rate should go above 7 percent next year, workers who have cooperated will be protected from a loss of real income.

Real wage insurance seems to be an excellent idea. It offers a real hope of breaking the wage-price spiral. It obviously involves fiscal risks. But we are persuaded it will be possible to keep those risks to modest levels and the risk to me seems well worth taking.

I am genuinely persuaded the President's program is quite simply the only one available to us. I agree with you thoroughly that people who have the notion that down the line lies the salvation of mandatory wage and price controls have got to be discouraged of that view. Controls do not work, and they are not acceptable to the American people.

I can conceive of such a program being adopted in a time of military emergency when the need for sudden and total institution of controls may be manifest to everybody, but I have not seen them succeeding in times of peace.

I am impressed with the studies that show while there may have been some temporary benefit, it was offset by permanent losses when we did it in the 1971 to 1974 period. I think it is very important that Congress make it clear that it is not prepared, it is not now preparing and it will not be prepared to give the President that authority.

We don't even want it suggested that the authority be given to us. I am persuaded that the President's program is the only one that is available. It has had mixed reviews. Some observers have succumbed to the cheap ego-inflation of demonstrating that their predictions are smarter than everybody else's predictions that it will not work.

What has been particularly satisfying to me, however, has been the discovery in the last 5 weeks of how widespread is the recognition in the country that this program has to work for the sake of all of us, that cooperation with the President's program offers us the only genuine hope of curing this disease without plunging ourselves into a recession or straitjacketing ourselves with comprehensive mandatory wage and price controls.

That recognition, I submit, is our strongest and clearest reason for believing that the program will in fact work.

I earnestly solicit your support as well as your advice, Mr. Chairman. Now I will be happy to try to answer your questions.

Senator BENTSEN. Mr. Kahn, I am very pleased with your testimony. I have been making that fight for some time on the regulations, and so have you. But as I listen to your testimony, it looked to me that what you were trying to do is to put a limitation on the off-budget cost that we find through regulation.

I have introduced, I think, the only bill in the Senate for a regulatory budget. I understand Commerce is giving some consideration to that. What do you think about the idea that we have a regulatory budget with the costs, a limitation on those costs, how much we can pass on to the consumer in increased costs as the result of regulations where we make an evaluation of the cost-benefits that are in such a regulation, and how they might affect the American consumer?

Mr. KAHN. I expect to spend the next several months giving very serious attention to that particular proposal, Senator Bentsen. It is clearly directed at a genuine problem.

Senator BENTSEN. If you have not already received a copy of my bill, we will send it to you.

Mr. KAHN. I will be very happy to have it. I think it is a serious proposal—and I am not being merely polite in saying that it clearly deserves serious consideration. It is clearly preferable to the present situation because, as I said in my statement, in the present situation there is no agency which is responsible for looking at the aggregate. Instead, what you have is a series of separate agencies, each pressing in the interest of its own constituency without regard to the consequence on the entire economy. Nobody seems to be responsible for the aggregate.

What is giving me pause at the moment is that in principle, if legislation like the Clean Air Act, the Clean Water Act, and so on, promulgated a genuine economic evaluation in each case, if in each case it said:

You shall institute regulations which impose additional costs only, one, in the most cost-effective way, and second, only where you are satisfied that the additional costs are justified by the additional benefits, then it would not be necessary to have a regulatory budget.

You would already have that scrutiny built in in every case, just as in the whole economy at large you don't have a budget for how much individual businessmen spend to produce automobiles, or cosmetics, or restaurant meals. Each one is subjected to a market test. Each one says, "I will incur these costs if the consumer will pay the higher price." But for regulations, you often don't have those economic evaluations made. Therefore, if we can't build those economic evaluations in each individual decision, then there is no alternative, I think, than to try to set up some overall regulatory budget, as you propose.

Senator BENTSEN. What are you going to do to try to break this self-fulfilling prophecy where you ask for an increase in wages—you get an increase in prices, or vice versa? I know if you go to a supermarket, and you see a clerk going down the aisle stamping prices on the ends of cans, I know you sure don't get behind that clerk, you try to get in front of that clerk. [Laughter.]

People understand what is happening. How do you break that psychology? What can you do? I think your real wage insurance objective is a good one. I am on the Finance Committee. I suppose that will go to the Finance Committee because of the tax incentives in it. I support the objective. But I hear a lot of criticism, as you do, on any new idea about the technicalities of it, the practicality of enforcing it, and making it work. Would you comment on that?

Mr. KAHN. Yes, I would be glad to, at least generally.

When you ask how to induce a breaking of this cycle, clearly this offer of a real wage insurance is one imaginative attempt to break it by saying to people, "You will not be hurt if you do restrain yourself." I will come back to a few specific questions on that in a moment. But I do want to emphasize the other parts of it. Certainly, one important part of the program of reducing that restraint is to restrain total spending in the economy. After all, I am an economist and in the end, I don't really believe in appeals to altruism for long periods of time. I believe we have to work on the external constraints on individual actions and to the extent you restrict the growth of aggregate demand, you do diminish the ease of passing on wage and price increases.

Third, there are the standards, themselves.

You and I both know that this is not a program of thorough, comprehensive controls. We are not enforcing it with 6,500 people as we did under phase II in this country, or 65,000, as we did in World War II.

We are going to do it with something like 100. And we can administer this program with this many people. But by the same token, what this means is the tremendous amount of the responsibility for enforcement must shift down to individual business firms. We are getting excellent responses, because businesses know they are exposed. They know the nature of the problem. We are getting better responses at the union level than you may have read about in the papers as well, because when you get down to the local level, the workers themselves are just as angry and just as frustrated as everybody else. But finally, I think you have to expect enforcement efforts at the local level.

On television, I saw a story about a manager of a supermarket chain who decided to demand explanations from his suppliers of what he saw as anticipatory price increases. And where he was not satisfied, he was actually putting tags under their products and recommending his customers buy something else.

We are appealing to people at the local level. We are appealing to the League of Women Voters. We are appealing to consumer outfits all over the place to vocalize consumer reaction.

Coming back to real wage insurance, I will answer first very generally. If you want to press me, you may succeed very quickly in pressing me to the limit of my knowledge.

We have been working very intensely in the last month with the people in the IRS to try to expose the major issues in real wage insurance programs. We have reached tentative decisions on a number of these.

In other cases, we have reached choices which we are now in the process of deciding. I am scheduled, when I go back to the office, to meet with five Congressmen, and Charlie Schultze, I know, has been doing the same thing. We will be discussing the details of this during the next 2 weeks very intensively.

Senator BENTSEN. I think the objective is good because you take the wage earner, the salaried person, the union member, the nonunion member, who says, "All right, I am going to be a part of this, and I want to be patriotic. I am concerned about what is happening to my country"; and afterward he will feel like a real chump if it goes beyond the guidelines, and he in fact is holding an empty sack. If we can work this out where we can have a practical application of it, I think the objective itself is a very good one. I am concerned about the question of productivity and what happens with the cost.

We had testimony before this committee that said half of the loss in increase in productivity in this last year resulted from the increased cost of regulation. Then I understand that Jackson Grayson, who is the chairman of the American Productivity Center, has charged that the wage-price standards as outlined would seriously curtail some of the most effective productivity improvement programs in America.

What I want to know is why would it impair productivity? I thought productivity was one of the ways we helped to stop inflation and that these things would help really bring on some productivity. Why, to the contrary, would he say that?

Mr. KAHN. Let me try. There are several pieces to this. I will try to be brief, Senator.

No. 1, I can't really assess that arithmetic assertion that these costs of regulations account for  $x$  percentage of the diminution in growth of productivity. One reason I am not terribly interested in playing that game is what it really tells me is that productivity isn't measured correctly. You can always get high productivity measuring if you put up in the numerator, output, and in the denominator, you just put part of your costs such as labor, or raw materials costs and leave out the cost of deteriorating environment, the cost of industrial accidents, or the cost of hospitalization of workers who get emphysema.

When you put the costs in, you make the businessman bear them, and it looks as though you have diminished productivity. In part, it is

illusory. It doesn't carry us very far. But I still argue that you are getting additional benefits in the form of cleaner air, in the form of reduced industrial accidents, and in the form of safer products.

It still contributes to inflation in that case, if the prices now go up, and you simply say, "Yes, but I still want as many goods and services as before." So I am not in any way quarreling, No. 1, with the assertion that we surely must examine each of those regulations to make sure the costs are justified by the benefits.

No. 2, I believe that most economists would agree that the major reasons for the declining rate of growth of productivity in our economy are not to be sought in the nature of individual wage price bargains, or union contracts. But they are to be sought in the inadequate level of new investment in our economy, for example, in the decline of R. & D. as a percentage of our gross national product; in the shift of our demand from industrial products, manufacturing which tends to have high rates of productivity increase to services, including Government services, which do not seem to be susceptible to the same kind of productivity increase.

If you shift to attending concerts, it still takes something like 2 man-hours to play a Mozart quartet, just as it did 200 years ago. In services, you don't get the same kind of productivity increase.

Senator BENTSEN. There are some who would argue that in some services you do, that you are getting a substantial improvement in productivity in some services. I would agree with you wholeheartedly that on the manufacturing capacity of this country, we have had less put back into it as a percentage of our GNP than any other major industrial nation in the world, and approximately half of what Japan is putting back into theirs in the modernization of their manufacturing capacity.

Mr. KAHN. That is all I meant. I don't deny in some service sectors you are getting productivity increases. For example, the phonograph industry has increased productivity. But on the average, productivity has not gone up as rapidly in services as in industry. It seems to us the real solution is to aim at greater encouragement of research and development and encourage investment. I wish, for example, I had in my pocket \$5 billion worth of budgets to devote to accelerated depreciation.

Senator BENTSEN. You are reading my mail. I had an amendment for accelerated depreciation. I won it in the Finance Committee; lost it on the floor of the Senate. Business wasn't very happy about it. They didn't support it. Do you know why? Because they wanted a corporate tax cut so they could use that money to buy another company, or to increase their dividends, or whatever they wanted to do with it. But I was trying to channel it into modernizing the manufacturing capacity of this country, but not let them have it unless they utilized it for that purpose.

Mr. KAHN. I agree with that.

Senator BENTSEN. I have gone over my time. I really have a lot of questions, but I yield to Congresswoman Heckler.

Representative HECKLER. Thank you very much.

I apologize for not having been here to hear your statement, but your presence is encouraging. I shall review it in great detail. As a New Englander, I have to say that while we are as concerned as the

rest of the country with the problems of inflation, we are almost overwhelmed by the most recent increases in the prices of heating oil. It is inflation in the energy field that threatens to bankrupt at least my region of the country.

I found it interesting that in one of your answers to Senator Bentsen, you commented on the willingness of business and their forthrightness in responding to you.

I am deeply distressed at the lack of similar forthrightness, in my judgment, by the Department of Energy. It seems to me while we in the Congress were asked to vote on the energy bill during the waning hours of the Congress, around the 15th of October, that somehow, someone in the Department of Energy should have known, at that point, that we were going to have a serious shortage of unleaded gasoline, and somehow it seems to me that that issue should have been communicated to a relevant committee, this committee, or another committee of the Congress, that there was to be a projected increase in heating oil.

We are living with a partial rationing of gasoline. And the proposal that such a scheme could develop is frightening New Englanders, and I think other Americans. But we are also living with a staggering increase in the price of heating oil, 3 or 4 cents a gallon with each new delivery.

I am told if OPEC raises the price of heating oil, that this increase will be transmitted to American consumers immediately. How can you, in your new capacity—as wage and price stability czar, how can you deal with this? What hope can you give to the New England consumer that somehow energy prices are not going to bankrupt them, that you are really going to fight inflation in that field?

Mr. KAHN. You have understandably singled out the area of the inflation problem that is the most perplexing and the most extraordinarily difficult.

I have no difficulty in trying to hold down most prices in the economy because I do not see shortages. For example, had we succeeded in holding down the increases in the wages of railway workers so they did not go up 35 percent in 3 years, but had gone up instead 21 percent in 3 years—I will leave out the compounding problem—we would not have had a shortage of railway workers.

But energy is much more difficult. There is no concealing from the American people the fact that the marginal cost, the cost of additional supplies to this country, is the OPEC prices. Holding down the price in that case is like holding down the price of beef. When cattle herds are declining, it promotes shortages. As you observed yourself, we seem to be facing at least the spot shortages of unleaded gasoline. Now, why? This is a subject that I have a group of economists looking at right now because this tension between the inflation problem on the one hand and the energy problem on the other is just tearing us apart. But it appears that the reason is that we have had price controls. You see, this isn't a situation where there is a range at which you can try to hold down prices and not worry about supply. This is a situation where in the long run I believe we've got to let the price go up. How fast? And can we afford to do it just at this time? Here, we are trying to strike a balance because I know people are suffering.

But in the long run, if you just continuously postpone letting that price go up to the level of the cost of the additional supplies, you continue to expose us to imports.

Look at what is happening in Iran right now. Think what will happen if we continue to be that dependent upon the Middle East. Think how important it is, therefore, to encourage domestic production.

I wish we had had some sort of excess profits tax so the American people could be satisfied that we weren't simply creating enormous profits for oil companies in this case. To some extent, however, if you want that encouragement, you have got to be willing to do it.

I know I am giving you a typical economist answer, two hands, one on the one hand and the other on the other hand; if I had a third hand, I would give you that, too. But there is no way I can resolve that dilemma. It exists in the facts of the situation. I can't change those basic facts.

We can think about trying to moderate it. We can think about trying to relieve bad suffering. I know New England is a perfect example of this suffering.

Senator BENTSEN. What this country needs is a good arm to Congress. Isn't that what Harry Truman said?

Mr. KAHN. With the correct arm.

Representative HECKLER. Mr. Kahn, I can understand your explanation with regard to the unpredictability of OPEC pricing oil, and the impact of oil prices. But what we are seeing in New England—this is the area that I happen to represent—is staggering increases immediately. There has been no increase in OPEC and yet we have the price increases. This not only creates a frustration, but it creates a growing rage.

Just last week, in Wellesley, Mass., the Shell Oil Co. experienced considerable violence. But there has been violence to the pocketbooks of the middle-income family and violence to the budgets of the poor who can't cope with 3 or 4 cents more per gallon. This is a social situation that makes all of the other aspects of the fight on inflation pale.

I wonder what explanation you can give for the immediate increase in heating oils in New England?

Mr. KAHN. I have to answer that only tentatively. I have a group of people working intensively right now to try to see what has happened to the price of gasoline and why it has happened. I am a little reluctant to speak for Secretary Schlesinger, but I know that his general view is, at least as far as unleaded gasoline is concerned—there is a genuine shortage, not only immediate, but also in terms of refinery capacity. And I hope he will contradict me if I am misstating it, but I believe it is his view that the reason for that shortage is the existence of price controls; that it simply does not pay to install the refinery capacity that is needed to incur the additional costs of making unleaded gasoline compared with leaded.

And if that is true, we are in one terrible box.

We have the choice in the short run, if that is true, only of going to rationing as a kind of a short-range avoidance of injury or of just letting the price go up.

The other explanation that I have seen—forgive me for giving you something that I have seen—

Representative HECKLER. I am particularly interested in heating oil.

Mr. KAHN. Believe it or not, it seems to be related, as well, to the fact that we have had a mild fall, which has apparently resulted in a

great increase in the demand for gasoline. And it seems that this has slowed the ability to build up heating oil stocks. I am not trying to get out of an uncomfortable situation, but I would be very happy the moment we get this report—which is due next week—to supply it to you, if that would help answer your question.

Representative HECKLER. That would help. I would also ask you to give some attention to special monitoring of the impact of new price increases. The shortage of unleaded gas could again produce a shortage in heating oil in the middle distillates. But we must know if this warrants a 4-cents-a-gallon increase immediately.

I just hope, that while you are obviously sincere in your war on inflation, that you are not going to adopt, what I sense as a passive acceptance of unlimited inflation in the energy field; particularly in the heating oil area. I hope that certain product lines that suffer drastic increases will come under your scrutiny for special concerns because this will bankrupt many, many families; and second, bring about the defeat of your policies because of the kinds of social ramifications which will inevitably follow.

I look forward to receiving your report, Mr. Kahn, and hope passive acceptance is not your view of your role in terms of energy.

Mr. KAHN. I assure you, Congresswoman, that we are looking at this precisely in order to seek the best balance between these conflicting considerations. I should observe, by the way, that heating oils and other refined petroleum products are in no sense exempt from the guidelines, and that the refinery margins are not exempt from the guidelines.

So it is not only sensible for this to occur to me, but it is in fact part of the President's program. I will do my very best.

Senator BENTSEN. Congressman Brown.

Representative BROWN of Ohio. Thank you, Mr. Chairman.

Mr. Kahn, I am delighted to have this opportunity to meet you and to hear your views on what ought to be done at this point.

I just would like to make one observation. You seem to take a pretty strong stand in your statement. Most of it seems to deal with the question of regulation; I guess crystallized in the rather long sentence which says, "I believe it is simply undeniable that the Government regulations that protect and promote special interests, that restrict competition, that interfere with the functioning of markets," and so forth and so on, "altogether impart a powerful upward thrust to the general price level."

I am fascinated by that after having been a member of one of the longest running legislative conferences that the Congress has ever had; the Conference on the Energy bill. As a result of that bill, I think it is generally concluded now that all of the burner tip decisions of major industries in the United States will be made in the Department of Energy.

The bill increases natural gas regulation from two categories to 23 or 29: 23 is the minority judgment; 29 was the judgment of the Federal Energy Regulatory Commission, and every well is going to be regulated under that particular piece of legislation. That is, every well will be studied to determine the price of the gas coming out of that well. Where were you when that was all being put together? [Laughter.]

Did you have no input at that time in Mr. Schlesinger's judgment as to what was desirable from the standpoint of regulation and its impact on inflation in the country?

Mr. KAHN. I was deregulating the airline industry. [Laughter.] Representative BROWN of Ohio. But obviously not commenting on the additional regulation. I think you will find that the regulation in the energy field multiplies several fold the regulations that you deregulated in the airlines.

Mr. KAHN. Congressman, I merely mentioned that, and therefore don't want to waste your time with uninformed answers. But as I understand it, this complex of regulations was part of the process of moving toward deregulation and the nature of the compromises that were necessary. Perhaps I might introduce you to Congresswoman Heckler and ask you two to discuss that question.

Representative BROWN of Ohio. We have met. [Laughter.]

We have met and have discussed it. Congresswoman Heckler was not on the conference and, for all intents and purposes, when they set those regulations, neither was I.

I am not one who believes, quite frankly, that the workingman and the businessman are really the major culprits in this. I am a little concerned about the fact that over the last two budget messages, the President has recommended, I think, respectively, \$58 billion worth of deficit and \$60 billion worth of deficit.

I happen to feel very strongly that sort of the future of the economy is going to be determined somewhere between January 18—when that budget message comes in—and May 15, when Congress reacts to it by setting the temporary budget ceiling. There is in fact, a fiscal impact that will occur this year, that will add to whatever the Federal Reserve Board is doing with reference to monetary management of trying to reduce the money supply growth.

In other words, what I am trying to suggest, Mr. Kahn, is there may be a great deal more impact on our future by what happens to monetary growth over the next few months and what happens to the fiscal plans of the President and the Congress for the next couple of years, than there is in whether or not every wage negotiation winds up at 7 percent or less, or every pricing decision winds up at 5¾ percent or less, because it seems to me the problem is worldwide.

The people who hold the \$600 billion that we have floating around the world tend to think that it may wind up being Confederate money and that they better get rid of it pretty quickly before it dwindles to nothing. That has something to do with monetary and fiscal practices. Can you comment on that?

Mr. KAHN. I will do that briefly because you have Mr. Greenspan following me and he will speak much more authoritatively than I.

Representative BROWN of Ohio. But he doesn't have the authority that you have. He is not in this administration. I won't comment on that. You have the reins.

Mr. KAHN. I understand. I have listened to him and will continue to listen to him on that subject. He speaks most impressively, and he observes that the most serious—again, he follows me, so he can correct me if I am misstating his views—but he observes—

Representative BROWN of Ohio. I am not interested in his views.

Mr. KAHN. I will try to be more direct. Mr. Greenspan observes that the main impact of the Federal deficit is less on aggregate spending than on the effects on financial markets, and I think that is a very persuasive argument. That is an important reason I put first emphasis on the President's resolution to reduce the Federal deficit. As I said in my statement, you must, if you have to take the plain explanation, it has got to be monetary and fiscal policy in the last years, and it is for that reason that I put it first in terms of its importance in the President's program.

Representative BROWN of Ohio. Apparently the world was not terribly impressed with this resolution in his October 24 speech because it was right after that that the bottom really dropped out of things.

What have you recommended to him in terms of a maximum budget deficit so as to avoid that problem when that budget is announced?

Mr. KAHN. I was not in on the decisions on the proper size of the budget deficit. That is largely the function of people like the Chairman on the Council of Economic Advisers and the Secretary of the Treasury.

They were involved in the decision to get it below \$30 billion. They, as well as I, in this latter case, were involved in the decision on November 1, to further tighten monetary restrictions.

Representative BROWN of Ohio. That decision was taken because of the reaction of that October 24 speech, was it not?

Mr. KAHN. That is correct. I think it was very sound.

Representative BROWN of Ohio. So it was not the 7-percent wage limit or the 5 $\frac{3}{4}$ -percent price limit, or the sort of general statement about the efforts to balance the budget some day that impressed the world but rather the monetary steps that were taken on November 1; isn't that right?

Mr. KAHN. Yes, the monetary steps played an important role. It is possible that the rest of the world might like nothing better than an American depression.

Representative BROWN of Ohio. You really believe that?

Mr. KAHN. I think it is possible.

Representative BROWN of Ohio. You think the major industrial nations of the world would feel they would be benefited by an American depression?

Mr. KAHN. I am talking about the people who actually sold dollars and bought francs. In any event, I do agree that your account of the sequence of events is correct. It was the lack of confidence in the effect of the President's program he announced on October 24 that was clearly manifested, at least in the short run in the plight of the dollar. The steps taken on November 1 were, therefore, necessary. I participated in those.

Representative BROWN of Ohio. These are programs you would be managing. It follows from your statement that it is very important that you have some input in the prospective plan for fiscal policy and monetary policy if there is to be any success at all in the programs that you are managing. Wouldn't you conclude that?

Mr. KAHN. I am not sure that my input is very important. In any case, I certainly agree that monetary and fiscal policy are an essential part of this game.

Representative BROWN of Ohio. And can undo what you are trying to do if they are not handled properly.

Mr. KAHN. That is what I said in the beginning.

Representative BROWN of Ohio. Would you agree \$30 billion or a little below is a sufficient cutback in the fiscal deficit for this year, or do you think it ought to be lower than that?

Mr. KAHN. I am not competent to answer that question.

Representative BROWN of Ohio. How about monetary policy?

Mr. KAHN. I just am not competent in that area. I can't substitute my judgment for that of Secretary Blumenthal and Charles Schultze. I am a microeconomist. [Laughter.]

Representative BROWN of Ohio. It may be that your micro responsibility will be overwhelmed by a macro failure, and that is the point I am trying to address.

Mr. KAHN. You are quite right, sir.

Representative BROWN of Ohio. You have to be very careful about that, don't you?

Mr. KAHN. I quite agree. I just can't do everything. [Laughter.]

Representative BROWN of Ohio. I wish you would call them on the phone and tell them what you told us this morning, because I happen to think you are right. Unfortunately, my time is up.

Senator BENTSEN. One further comment from me, or question really, Mr. Kahn. As I stated earlier, I share your deep concern about the cost of regulation with the full understanding we have to have regulations.

The question is the cost-benefit ratio and the effectiveness and is this the best way to do it, or is there a better alternative? But I am concerned about the President's commitment on that point when I see the regulatory council that was put together is generally headed up by people who, in effect, are being asked to regulate themselves.

I saw one comment that said that would be comparable to asking on the price side, to ask the 50 largest companies in the United States to get together and counsel, determine prices, try to keep them in mind. Would you care to comment on that?

Mr. KAHN. Yes, of course. I think one useful and important part of the program of bringing these regulatory costs under control is to give the regulators an opportunity first to review and to develop some overall look at regulations. In fact, there is some genuine indication that there are cases in which needlessly restrictive and costly regulations are being imposed by one agency following scientific standards that are different from the scientific standards used by the other agencies.

That might be a very useful way in which they can work, but as for asking the regulators to do it all themselves, I agree with you totally—

Senator BENTSEN. I think it is ridiculous. I have introduced legislation to address the problem of conflicts in regulation. But asking for the OMB to assume that kind of responsibility I think would be substantially more objective in that regard than would the regulators themselves. You are a rare one who did what you did in your agency. I have no further questions.

Representative BROWN of Ohio. Mr. Chairman, would you suffer one microeconomic question because it is a simple yes or no answer from Mr. Kahn. That is, that Mr. Miller, William Miller of the

Federal Reserve Board, has suggested one step that might be taken to ease the current pressure on wage increases would be to defer the minimum wage package that takes effect the first of this year. Do you join him in that?

Mr. KAHN. I can't answer yes or no. We are looking at it very actively.

Representative BROWN of Ohio. Will you have a recommendation in that regard to the administration?

Mr. KAHN. Yes.

Representative BROWN of Ohio. Since it does seem to have significant impact on wage requests and that is the area in which you work.

Mr. KAHN. There's no question that it has a significant impact.

Representative BROWN of Ohio. You will let us know?

Mr. KAHN. I will.

Representative BROWN of Ohio. Do you have a time frame?

Mr. KAHN. Next month.

Representative BROWN of Ohio. Thank you. It goes into effect, I might say, next month, January 1. [Laughter.]

Mr. KAHN. I understand.

Senator BENTSEN. Thank you very much, Mr. Kahn. We are very pleased to have you here.

The great interest in this subject and the concern by all the American people, I think, is evidenced by the kind of attention we have seen given to the statements of the man who is charged with that responsibility and, in turn, to these gentlemen here, all experts in their field.

We are very pleased to have Mr. Sharpe, Mr. Kesters, Mr. Greenspan, and Mr. Evans testifying before us.

I understand that there are at least one or two of you who have an early plane to catch and we will keep our limitation of questions, those of us here as members, to 10 minutes each.

Mr. Sharpe, we will start with you. Please proceed with your statement.

#### **STATEMENT OF MYRON E. SHARPE, EDITOR AND PUBLISHER, CHALLENGE MAGAZINE**

Mr. SHARPE. I hate to be a naysayer, but I don't think that the current wage price programs are going to work.

Senator BENTSEN. Maybe we better start with Mr. Evans. [Laughter.]

No, please go ahead.

Representative BROWN of Ohio. I don't want to presume my agreement or disagreement, but I wish somebody would turn on your microphone.

Mr. SHARPE. Maybe if you did start with Mr. Evans, I might hear some reasons to be persuaded.

I have great respect for Alfred Kahn. I agree with his analysis of the problems of our economy. But I don't think that wishful thinking—which makes up a very large part of this program—is going to solve the serious problem of inflation that we face.

We have a task of reorienting ourselves to a post-Keynesian economy in which the market does not, by and large, automatically grind out solutions to the problems. I would like to focus on what I think

is the issue here. It is not wages and prices, as such, but relative income shares of different sectors of the economy. If we could find a way to determine those relative income shares in a noninflationary way, then the wages and prices obviously would take care of themselves. But we try to hold down wages and prices by fooling around with the level of mercury in the thermometer and not with the real cause behind what we are reading.

My skepticism is based on at least two factors. One is that inflation fever is so high that the people who make the decisions in businesses and unions are more likely to believe that the inflation is going to continue than they are to believe that the President's program is going to work. And they will act accordingly.

There is good reason to believe that because of what is happening to the cost of living and particularly to the cost of four extremely important elements, food, housing, energy, and medical care, which as of September were going up at the rate of 11.6 percent.

I don't see how these costs are going to be abated soon enough for this program to work. Therefore, I think that if you talk to people, they are going to praise the program, but they are going to disregard it because these increasing costs will upset relative income shares. That is what people go to the bargaining table about. And even though the results are that the advantages they get at the bargaining table are undone by later price increases, and we have further wage hikes and then we have a spiral, that is what happens anyway.

Well, how can that be stopped? I know that everybody hates the thought of it and that it is not a permanent solution, but I am in favor of an across-the-board wage and price freeze.

The reason is that I think it can give us 6 months to a year in which we can do something that can meet the problem better than we are meeting it now. If we had nothing that we could do during the period of a wage and price freeze, then it wouldn't do any good. We would stop the increase of prices, we would stop inflation in its tracks—I believe that a wage and price freeze is the only thing that can do that—but at the end it would resume even more furiously.

What I propose is a new and different approach for the United States, and that is an incomes policy by the consent of those who are involved in setting the wages and prices. What does this mean? It means calling together leaders of business and labor, of Congress and the administration. And they sit down together and talk together about what to do, what they can do about wages, about prices and about the inflationary sectors of the economy, such as food, fuel, housing and medical costs, and work out a supply-management program for those areas. Incidentally, the sectors I mentioned—government, business and labor—they are the ones who contribute to inflation. So they are the ones who have it in their power to do something about it.

How can it be done? I would propose that the Congress, in conjunction with the President, establish a top level permanent, independent "Anti-Inflation Council" composed of representatives of Congress, the administration, business, unions—and this proposal is not completely worked out—the council may very well have representatives of farmers, consumers, and other interested sectors of the economy.

It should have in its membership chief executives of corporations that act as price leaders and presidents of unions who make the key wage bargains that set the pattern for the whole economy.

It should be supported by a technical staff that can do the econometric work. It should have an overall, comprehensive analytical framework of all the elements of inflation and not just a few of them.

I was impressed by Representative Brown's question to Mr. Kahn about monetary and fiscal policy and what it has to do with the wage-price program. The answer given is disastrous. If you have one set of people doing monetary and fiscal policy and you have another set of people doing wage and price policy, the work is going to be undone. All these things relate to each other. You have to have an anti-inflation council that will consider everything, all the factors together in one program, not several programs.

My next question is, Can an anti-inflation council do the job? My answer is that it ought to add two elements that are missing from previous and existing efforts. One is participation in a dialog, instead of imposition of something that has been either thought out or half thought out and imposed from the outside.

If you tell labor, if you don't comply, we would rather take strikes than anything else—and I have regard for Charles Schultze—but if you tell that to labor as he did, you are alienating them from the start.

The thing to do is to get them in on the making of the system, of the noninflationary incomes policy from the beginning. What can they contribute and what concessions will they get in turn?

So, participation is one of the new elements that I am proposing. The other is comprehensiveness of view. This anti-inflation council should have a staff which is able to bring together, within one econometric framework, one model, all the elements of inflation, including those of the sector that Representative Heckler is talking about, fuel. You can't have a program to control inflation if you don't have some program to deal with that particular sector.

I am not saying it can be done quickly. I am not saying it can be done overnight. I am not saying you can have no inflation. But at least you know what you are getting into at the beginning.

Business, labor, and the Government—Congress and the administration—all participate in this. What is the cost? Is it worth the effort? Is it worth the new thinking to establish this kind of participatory anti-inflation council in which business, Government, labor and others take part in a dialog and help make the decisions? I think it is because the cost of failure is going to be an engineered recession, a return to high unemployment, loss of hundreds of billions of dollars of potential output and decimation of social programs which we cannot blithely pretend are superfluous.

That is too high a price to pay and that is the price that we have paid for the political business cycle in the whole postwar period. First you step on the accelerator and then you step on the brake. It is the type of program which is suitable to an economy where the market works as it does in the textbooks. But we don't have that kind of economy. In the post-Keynesian economy, we have large blocs of power in which people make decisions. Instead of having those decisions made separately without reference to each other, bring them together.

What I am proposing is called a social contract type of incomes policy, which is new to us. But I maintain it is not alien to us because we prefer bargaining, compromise, concessions made for concessions

given, and it is our practice to engage in cooperation among corporations, unions, and government; in other words, between the private economy and government. And I think that in order for the majority to rule—and the majority don't want inflation—we have to have this kind of cooperation.

[The prepared statement of Mr. Sharpe follows:]

PREPARED STATEMENT OF MYRON E. SHARPE

*Is Inflation Inevitable in Post-Keynesian Capitalism?*

I think not. But I think that we must deal with inflation in a way suitable to an economy where wages, prices and business cycles are largely the results of direct decisions, rather than the resultants of impersonal market forces.

I doubt that the President's anti-inflation program is going to succeed. Inflation fever is so high that the people who make the decisions in businesses and unions are more likely to expect the current rate to continue than to expect the President's plan to work. They will act accordingly. Tremendous pressures from food, housing, energy and medical care are certain (these increasing at the rate of 11.6 percent as of September). A tax rebate on wages and salaries is uncertain. Nobody is sure of anything, which means that the guidelines will be praised, and then disregarded. After that—possibly with that—ineluctably comes the decision to bring on the recession.

Almost everybody hates the thought of it; almost everybody knows it is no permanent solution; but if we want to stop inflation now where there is only one way to do it, and that is by an across-the-board wage-price freeze. That is easy to say, if not to swallow. The real question is, what to do next? Can anything be done that hasn't been done before, during the six months or year of a freeze, that has the slightest chance of success?

The one arrangement that hasn't been tried is incomes policy by agreement, incomes policy by consent rather than by imposition. What does it mean? It means that leaders of government, business and labor—they all contribute to inflation—sit down together and thrash out an agreement on a noninflationary policy for wages, prices and taxes, as well as supply management in the inflationary sectors of the economy. It makes eminent good sense to ask the people who are supposed to carry out the program to help make the program, to help make the analysis, to help consider the alternatives, and finally, to make the commitment to what they had a hand in shaping.

How can it be done? In various ways, but the gist is this. Congress, in conjunction with the President, might set up a top-level, permanent, independent Anti-Inflation Council composed of representatives of Congress itself, the Administration, business and unions. The Council should include chief executives of corporations which act as price leaders and presidents of unions which make the key wage bargains. It should have the support of a technical staff able to do the necessary econometric work, including the study of what to do in particular sectors that contribute heavily to inflation. Above all, the Council should be instructed to deal with all major sources of inflation together in one analytical and policy framework, rather than piecemeal as we do now.

Can an Anti-Inflation Council do the job? We can specify on paper various ways to have price stability. The problem is not inherently or logically insoluble. What so far has proved intractable is finding a way to consider together the strategic, interacting decisions of business, unions and government that produce—but do not have to produce—inflation. At best this is not easy. But two elements have been missing from previous and existing efforts, and some day we are going to have to include them. One is participation in a dialogue of those who now vie with each other to maintain or improve their income shares, and who in the process produce inflation which nullifies all the individual efforts. The other is comprehensiveness of view, which means that those who participate in the dialogue sit down and systematically consider the whole economy and discuss what each (including Congress and the President) can contribute to an over-all anti-inflation program.

Is the great effort needed to set up an Anti-Inflation Council worthwhile? Yes, because the cost of failure is an engineered recession, a return to high unemployment, loss of hundreds of billions of dollars in potential output, and the decimation of social programs which we cannot blithely pretend are superfluous.

Though a social contract type of incomes policy is new to us, it is not alien to our preference for bargaining and compromise, with concessions made for concessions in return, or our practice of cooperation between government and the private economy. The fact is that in post-Keynesian capitalism, large corporations and unions have a lot of muscle, some of which they use to make inflation. It can only be unmade with a mechanism that takes into account this power, but that also reasserts the right of the majority—who don't want inflation—to rule.

Senator BENTSEN. Thank you very much, Mr. Sharpe. We will withhold our questions until all the witnesses have an opportunity to make their statements.

Mr. Kosters.

**STATEMENT OF MARVIN H. KOSTERS, RESIDENT SCHOLAR AND DIRECTOR, CENTER FOR THE STUDY OF GOVERNMENT REGULATION, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH**

Mr. KOSTERS. Thank you, Mr. Chairman.

I appreciate the opportunity to testify on wage-price policy. I should say at the outset that as an employee of the American Enterprise Institute I present my own view with which the institute doesn't necessarily agree or disagree.

AEI is a nonprofit research and educational institution that doesn't take views on public policy. I have a prepared statement which I have submitted. I would like to discuss some of the main points in that statement here.

First of all, I would like to discuss the role of wage and price standards that are often regarded as the centerpiece of the anti-inflation program. Why are these standards put forward for an economy that for the most part has operated on the basis of prices and wages that are set in the marketplace? The main idea, apparently, is that inflation is deeply entrenched in the economy and the standards are intended to break the momentum of self-perpetuating price and wage increases.

But turning to these standards as a remedy for inflation I think rests on two related propositions. The first is that wage and price increases are indeed self-perpetuating; that they show little response for reductions and restraint of aggregate demand. The second is that wage and price standards can, in fact, be expected to contribute to lower wage and price trends.

What is the evidence about the responsiveness of wage increases to market conditions? In discussing that it might be useful to first point out two phenomena that have been seen as evidence that they are quite unresponsive.

The first is that the rate of wage increase during the past 10 years has been remarkably stable. Wage increases have averaged almost 7 percent almost every year except for 1974, and to some extent 1975. The second is that union wage increases, particularly, have sometimes not slowed down very quickly in the wake of a recession.

Take 1970, for example; the apparent perverse behavior was quite pronounced. First year wage increases averaged over 11 percent in 1970 and 1971 compared to just over 9 percent in 1969. I think that regarding this as evidence that wages are unresponsive to aggregate demand is much too superficial a reading, however.

First, institutional characteristics in the labor market need to be taken into account. Many workers are covered by long-term contracts. In the case of 1970, for example, we had a situation in which those workers whose contracts expired in 1970 and 1971 had fallen behind prices and other wages during the preceding years of accelerating inflation.

Second, first year wage increases reflect not only current market conditions but also what has happened in the past in the rest of the economy. That is to say, strong demand at the time contracts are negotiated, can lead to large wage increases, but strong demand before they expire can also lead to large wage increases for contracts that expire during a period of slack.

The net result of this has been there was very little deceleration in wage increases during the 1970 recession, and in the recession that began in 1974, there was only a deceleration to approximately the level that prevailed prior to the burst of inflation in 1973 and 1974.

But for those parts of the economy, those sectors in which long-term contracts were not a major factor, wage increases did slow down in both recessions.

To summarize, it seems to me the evidence doesn't support the view that inflation is unresponsive to demand restraint and that such unresponsiveness stems primarily from wage increases that are rigid downward and thus are essentially self-perpetuating. The evidence does show that there are lags in average wage increase response and differential responses among sectors owing largely to different institutional circumstances.

Let me turn now to what difference wage and price standards might make. Even if general numerical standards are established that correspond closely to wage and price increases that can on average be achieved, diversity in the economy and changing circumstances mean that there will be a great deal of variation in individual wage and price situations.

The importance of this variation is often not sufficiently recognized, but it is what leads to a growing complexity and detail in any set of standards that is established.

Consider for example the dispersion in the size of wage increases during 1977 when average hourly earnings rose by 7 percent and the Consumer Price Index by nearly 7 percent. Although wage increases for workers covered by major collective bargaining agreements averaged 8 percent in 1977, about 25 percent of these workers got increases of less than 7 percent and about 30 percent received increases of more than 9 percent.

The data show that there is a great deal of variation here and a great deal of potential for inconsistencies of individual situations with the standards, even if the standards are set close to the average outcome. That is, conflict with standards is likely unless the dispersion in wage increases is sharply lower than our usual experience has been.

These data also suggest that under a real wage insurance program, a large fraction of the work force would receive tax benefits as windfalls, because market conditions permitted only relatively small wage increases; and that a similarly large fraction of the work force would find potential tax benefits not very interesting to them because they

were able to increase their real wages under their normal bargaining arrangement.

The potential contribution of wage and price standards seems to me to be not very promising in view of the lessons from history. There is little evidence, I think, that they can have any measurable or enduring effect. What evidence there is indicates that small, short-term effects are usually not present when effects are evaluated over a longer period.

There is no great mystery about why standards have generally proven to be ineffective. The establishment of standards and of procedures for administering them influences how other economic policies are set.

The influence of wage and price policies on other policies can sometimes be favorable, but they can also be very unfavorable.

To the extent that standards are binding, many unfavorable effects often appear directly. But even more importantly, wage-price policies have often been viewed as a tool for permitting additional demand stimulus to attain higher output in employment levels than what otherwise would be regarded as prudent, or for helping to avoid the need to pursue policies that might increase the risk of recession.

The temptation to pursue more expansionary demand policies than would otherwise be considered prudent, is strengthened not only by the tendency to rely on wage-price standards to offset their inflationary effect, but also by the possibility that such standards may temporarily mask, by moving into the future, some of the symptoms of excess demand that would otherwise be evident in the market.

Yielding to this temptation of stimulating aggregate demand is a prescription for higher inflation rather than lower inflation.

When a program of wage and price standards is established, the discussion usually shifts from whether we should have one, to how it should be administered. Having taken the step of establishing standards, the discussion often shifts to whether mandatory controls might be more effective.

If a voluntary program as perceived is ineffective, there may be calls for mandatory controls. It is important to be clear about the limitations of a program of mandatory controls.

If mandatory controls are used to significantly suppress prices and wages below what they would otherwise be, we would have dislocations, shortages, and so on, and the relevant example here, I think, is a World War II-type situation.

If on the other hand, they are administered in a way that attempts to avoid market disruption and reductions in supply, we will get price and wage increases very similar to what would have occurred in their absence, and the burst of inflation in 1973 and 1974 when we had mandatory controls is an example.

This seems to me to be the central dilemma of mandatory controls. To the extent that they are stringent enough to actually keep wages and prices down, they replace the market as the mechanism for organizing economic activity.

After a period in which we have had  $3\frac{1}{2}$  years of economic expansion, the rise in inflation during the past year is evidence that further movement toward a higher resource utilization would result in still higher inflation.

The rise in real output during the cyclical expansion since 1975, and the inflation that has occurred were sustained by increases in the aggregate demand. As the cyclical component of rising real output has been exhausted, increases in demand have increasingly been translated into more inflation.

To unwind the inflation, growth in nominal demand will necessarily need to be tapered off. Gradually restraining the growth of aggregate demand, of course, poses a risk of recession. This is a risk that always arises under these circumstances, particularly when the economy is operating close to capacity.

Under these circumstances, options are also quite limited. Delaying demand restraint raises the risk of accelerating inflation, which only delays and eventually exacerbates the risk of recession.

Monetary restraint, for example, is likely to be accompanied by higher short-term interest rates, but interest rates would probably eventually need to rise even more in the absence of monetary restraint. The burden of monetary restraint can be reduced by stringent budgetary policies, and the policies announced by the administration can be very helpful in that regard.

The announced intensions of the administration to pursue other regulatory review policies can also play a role. But a gradual reduction in aggregate demand will be necessary in order to curb the increased rate of prices that we have seen.

It seems likely that wage and price standards, whether they are mandatory or voluntary, can play little role in helping us to avoid the need for demand restraints and the risks that this poses.

Thank you.

[The prepared statement of Mr. Kosters follows:]

#### PREPARED STATEMENT OF MARVIN H. KOSTERS

Mr. Chairman and Members of the Committee: Thank you for this opportunity to testify on wage-price policy and the inflation outlook. The views I express are my own and do not necessarily represent those of the American Enterprise Institute (AEI) with which I am associated. As you know, AEI is a non-profit, publicly supported research and educational institution and does not take positions on public policy issues.

Now that inflation is said to be our most serious economic problem, we have what is said to be an anti-inflation program. The set of wage and price standards that President Carter announced on October 24 is apparently viewed as an essential element—if not the center piece—of the program. Other elements of the program as it was originally announced include restraint of federal spending to reduce budget deficits in the future and establishment of procedures to minimize the inflationary impact of government regulations. The actions announced about a week later (on November 1) to strengthen the dollar can be viewed as another—and a potentially more important—element, to the extent that they indicate a willingness to accept higher short-term interest rates that may be associated with controlling the rate of expansion of the monetary aggregates.

While I will return to these other elements of the anti-inflation program, I would first like to discuss the role of wage and price standards. Why are standards prescribing appropriate wage and price behavior put forward for an economy that, for the most part, has operated on the basis of prices and wages set in the marketplace? The main idea apparently is that inflation is "deeply entrenched" in the economy and the standards are intended to "break the momentum of self-perpetuating price and wage increases." After more than a decade of inflation, there are, of course, many ways in which it has become entrenched.

But turning to wage and price standards as a remedy for inflation would seem to be premised on two related propositions. The first is that wage and price increases are "self-perpetuating"—that they show little or no response

to restraint of aggregate demand. The second is that wage and price standards can, in fact, be expected to contribute to lower wage and price trends. A question that arises in this connection is whether the costs of any contribution to lower inflation that might be made by a set of standards are lower than for a comparable reduction in inflation achieved by aggregate demand restraint. Such a comparison of costs is not easily made. But to the extent that standards have shown little effectiveness in reducing inflation, except for possible temporary postponement of the need eventually to turn to restraint of aggregate demand, the question of relative costs of the two approaches loses much of its relevance.

#### IS INFLATION INSENSITIVE TO DEMAND?

The view that inflation is unresponsive to aggregate demand is usually based primarily on analyses suggesting that the trend of average wages shows little response to current market conditions. In such analyses, wages are treated as costs that are rising at rates that are viewed as excessive and self-perpetuating, and demand conditions are viewed as influencing mainly output and employment levels instead of price and cost trends. Wage-price policy proposals are developed in this context with the primary aim of directly influencing average rates of wage increase. The aim for prices is in general to keep them consistent with wage trends. These are the themes that are common to most incomes policy proposals: the numerical guideposts of the 1960's, proposals for wage-price review boards, the mandatory controls of 1971-74, proposals for tax incentives to influence average wage increases, calls for developing a "social contract," and the current wage and price standards.

What is the evidence on responsiveness of wage increases to market conditions? It may be useful to begin by noting some observations on wage behavior that have been seen as evidence of a lack of responsiveness. First, average wages, as measured by the average hourly earnings index, have increased at rates that have been remarkably stable over the past 10 years. If 1974 is excluded (when wages rose by 9.4 percent and prices by 12.2 percent), annual wage increases averaged 6.9 percent and the average deviation from this average was less than 3 tenths of one percent. During this same period both the unemployment rate and consumer price inflation ranged from about three and a half percent to eight and a half percent.

Second, average union wage increases showed little tendency to slow down during the two recessions of the 1970's. First-year wage increases under major collective bargaining agreements, for example, averaged 10.2 percent in 1975 and 8.4 percent in 1976 compared to 9.8 percent in 1974, before the recession. For the recession of 1970, the apparent perverse behavior was even more pronounced: first-year wage increases averaged 11.9 and 11.6 percent in 1970 and 1971 compared to 9.2 percent in 1969.

While the data show that these various measures of average wage increases have not been reduced promptly as unemployment rose, interpreting these developments as strong evidence of a lack of responsiveness of wages to aggregate demand would be much too superficial. First, institutional characteristics of wage-setting arrangements need to be taken into account. Wages under long-term union agreements cannot be expected to respond significantly to market slack until the agreements expire and new agreements are negotiated. Although a significant response to prices can be expected for wage agreements with cost-of-living escalator provisions, prices typically respond with some lag to market slack. Wages in less unionized sectors, on the other hand, have increased less rapidly when aggregate demand growth was reduced and unemployment rose.

Second, union wage increases—particularly first-year increases—have reflected not only current labor market slack, but also what happened to prices and other wages since expiring long-term contracts were negotiated. The delayed effects of rising inflation were particularly important for new wage contracts negotiated in 1970 and 1971. Strong demand before 1970 pushed up prices and other wages at accelerating rates. Only limited cost-of-living escalation had been provided for in expiring contracts, and the large first-year wage increases in 1970 and 1971 can be viewed for the most part as "catching up" for erosion of real and relative wages because of inflation. Large union wage increases in 1975 and 1976 were apparently attributable to a combination of lack of cost-of-living escalation for some contracts expiring then (in the wake of the high inflation in 1973 and 1974), and pressures to "keep up" with wages under agreements that provided substantial cost-of-living escalation or large negotiated wage increases in response to the price surge. Thus, lags in union wage adjustments contribute

to lagged, and even apparently perverse, short-term wage behavior in sectors that are affected.

The net result of these cross-currents—with construction wage behavior largely reflecting changing patterns of demand in that sector—was that only limited deceleration in average wage trends occurred in the wake of the 1970 recession, and deceleration in the wake of the 1975 recession brought wage increases down only approximately to rates that prevailed before the price surge of 1973–1974, before the larger price increases and tightening labor markets of 1978 produced renewed wage acceleration. However, wages increased less rapidly in the wake of both recessions in the less unionized sectors of the economy, facilitating the slowdown in price increases that occurred and pointing to the prospect of deceleration through lagged adjustments in sectors with wages set under long-term unions contracts.<sup>1</sup> These differences in the timing of wage adjustments among sectors of the economy are summarized in table 1.

TABLE 1.—CHANGES IN THE INDEX OF AVERAGE HOURLY EARNINGS AND MAJOR COMPONENTS, 1969–76  
[Annual percentage change<sup>1</sup>]

	1969–70	1970–72	1973–74	1974–76
Index of average hourly earnings.....	6.6	6.8	8.2	8.0
Components:				
Construction.....	9.4	7.3	6.0	6.7
High union.....	5.8	8.9	8.7	9.5
Medium union.....	6.5	6.3	8.3	8.9
Low union.....	6.5	6.1	8.2	7.2

<sup>1</sup> Annual percentage rates of increase are computed from average annual levels for the index and for the major components. The index of average hourly earnings is adjusted for overtime (in manufacturing) and interindustry shifts, and the components are also based on straight time average hourly earnings for manufacturing industries.

CHANGES IN RATES OF INCREASE OF THE INDEX OF AVERAGE HOURLY EARNINGS AND MAJOR COMPONENTS AND CONTRIBUTIONS OF MAJOR COMPONENTS  
[Changes in annual rates of increase<sup>1</sup>]

	From 1960–70 to 1970–72	From 1973–74 to 1974–76
Index of average hourly earnings.....	0.18	-0.15
Major components:		
Construction.....	-2.1	+7
High union.....	+3.1	+8
Medium union.....	-2	+6
Low union.....	-5	-1.0

<sup>1</sup> Changes in annual rates of increase are computed from the data in the upper part of the table.

CONTRIBUTIONS OF MAJOR COMPONENTS TO CHANGES IN RATES OF INCREASE IN THE INDEX<sup>1</sup>

	From 1969–70 to 1970–72	From 1973–74 to 1974–76
Index of average hourly earnings.....	0.18	-0.15
Major component contributions:		
Construction.....	-13	+04
High union.....	+62	+13
Medium union.....	-05	+12
Low union.....	-26	-44

<sup>1</sup> The weights for the major components of the index are sums of the weights for the industries included in each of the major components. The weights are: construction, 0.06; high union, 0.19; medium union, 0.22; and low union, 0.53.

Source: Marvin H. Kusters, "Wage Behavior and Inflation in the 1970's", *Contemporary Economic Problems*, 1978, William Fellner, project director (American Enterprise Institute, 1978), tables 8 and 9, pp. 157 and 158.

<sup>1</sup> Marvin H. Kusters, "Wage Behavior and Inflation in the 1970s", *Contemporary Economic Problems*, 1978, William Fellner, project director (American Enterprise Institute, 1978), pp. 137–166.

More detailed econometric analyses of wage increases negotiated in collective bargaining agreements show a response to unemployment when new agreements are negotiated roughly comparable to the response for non-union workers.<sup>2</sup> In addition, both newly negotiated wage increases and wages under contracts with cost-of-living escalator provisions show pronounced responses to price changes. Finally, there is virtually no evidence from careful studies that wages have been less responsive to market slack in the 1970's than earlier.

To summarize, the evidence does not support the view that inflation is unresponsive to aggregate demand as a result of rigidities stemming mainly from rates of wage increase that are essentially self-perpetuating. The evidence does show significant lags in the overall response of wage increases, and differential behavior among sectors owing to differences in wage-setting arrangements.

#### WILL WAGE AND PRICE STANDARDS WORK?

There are at least two ways of addressing the question of whether a program of wage and price standards will work: First, will it be subject to breaking down so that it needs to be abandoned? Second, if it does not break down, will it make any difference on the inflation rate?

Vulnerability to breakdown has been a common characteristic of incomes policies. Establishing standards gives rise to the potential for confrontation and apparent or obvious failure when a particular wage or price decision is difficult to reconcile with the standards. Sometimes this problem appears on the wage side, as in the case of the airline machinists' settlement in 1966 during the guidepost period and the longshoremen's settlement in 1972 when four of the labor representatives resigned from the Pay Board.

In other instances, the standards are discredited by price behavior, as occurred when rising price inflation in the late 1960's made the wage guideposts obsolete and in 1973 when the surge in prices, initially mainly food prices, made a partially voluntary program appear ineffective. It is sometimes possible to obscure to some extent the degree to which any particular wage or price decision is inconsistent with general standards by applying exceptions criteria to deal with the inevitable differences in circumstances that become evident. But diversity and the need to take obvious differences in circumstances into account tend to undermine the credibility of any general standards.

Even if general numerical standards are established that correspond closely to average wage and price trends that can be expected to be achieved, diversity and change mean that any particular wage increase or price increase for a product, service, or firm, may vary widely from the average, and it is these individual situations that need to be dealt with in the context of administering anti-inflation standards. The importance of this variation in circumstances is often not sufficiently recognized, and it accounts for the growth in complexity and detail that always accompanies standard-setting. Even casual inspection of price data shows marked differences in price changes among products for any year and over time for the same product or product groups. There is also a great deal of variation in wage increases because of changing conditions and sometimes long periods between raises.

Consider, for example, the dispersion in the size of wage increases during 1977 when the average hourly earnings index rose by 7 percent and the consumer price index by 6.8 percent. Although wage increases for workers covered by major collective bargaining agreements averaged 8 percent in 1977, about 25 percent of these workers received wage increases of less than 7 percent and about 30 percent received wage increases of 9 percent or more. For workers receiving wage increases under contracts negotiated during 1977 these percentages were approximately reversed. On the other hand, nearly three-fourths of the workers receiving wage increases under previously negotiated contracts received wage increases of less than 7 percent. Many of these workers, however, also received wage increases under cost-of-living escalator provisions in addition (table 2).

<sup>2</sup> Daniel J. B. Mitchell, "Union Wage Determination: Policy Implications and Outlook", *Brookings Papers on Economic Activity*, 1978:3 (Brookings Institution, forthcoming).

TABLE 2.—PERCENTAGE OF WORKERS RECEIVING WAGE INCREASES IN 1977 BY SIZE OF INCREASE AND TYPE OF WAGE CHANGE FOR WORKERS UNDER MAJOR COLLECTIVE BARGAINING AGREEMENTS

	Total effective wage changes <sup>1</sup>			Current settlements <sup>2</sup>			Prior settlements <sup>3</sup>		
	Private nonfarm	Manu-fac-turing	Non-manu-fac-turing	Private nonfarm	Manu-fac-turing	Non-manu-fac-turing	Private nonfarm	Manu-fac-turing	Non-manu-fac-turing
Average increase.....	8.1	8.6	7.8	7.7	7.7	7.7	5.7	5.1	6.1
Under 6 percent.....	15.0	9.0	20.0	18.0	16.0	20.0	51.0	65.0	39.0
Under 7 percent.....	26.0	16.0	32.0	30.0	34.0	31.0	73.0	72.0	72.0
7 to 9 percent.....	43.0	52.0	39.0	47.0	40.0	51.0	20.0	21.0	17.0
9 percent and over.....	31.0	32.0	29.0	23.0	26.0	18.0	7.0	7.0	11.0
10 percent and over.....	18.0	25.0	13.0	18.0	16.0	15.0	4.0	3.0	7.0

<sup>1</sup> Adjustments during the year for all workers under major collective bargaining agreements, including cost-of-living escalator payments.

<sup>2</sup> Adjustments under settlements negotiated during 1977, including only guaranteed minimum payments under escalators.

<sup>3</sup> Adjustments under agreements negotiated in earlier years, including only guaranteed minimum payments under escalators.

Source: Current Wage Developments, April 1978, table 4, p. 53.

The data clearly show the potential for particular wage settlements inconsistent with a simple general standard, even if the numerical standard is consistent with the average outcome, unless the dispersion in the size of wage settlements is sharply lower than the usual experience. These data also incidentally suggest that if prices rose unexpectedly rapidly under a "real-wage insurance" program, a large fraction of the work force would receive tax benefits as windfalls because market conditions permitted only relatively small wage increases, and a similarly large fraction of the work force would find potential tax benefits of little interest because they were able to obtain increases in their real wages under normal wage-setting arrangements.

What potential contribution to lower inflation could reasonably be expected from a set of standards? The lessons from history provide little ground for any hope that they produce any measurable, enduring effect on inflation.<sup>3</sup> While evidence of small, short-term effects is shown by some studies, even these effects are no longer evident when incomes policy experiences are evaluated over a time period that extends well beyond the duration of the policy.

There is no great mystery about why wage and price standards have historically proved to be ineffective. The establishment of a program of standards and of procedures for administering them influences how other policies affecting inflation are shaped. Sometimes this influence can be favorable. For example, during the period of controls from 1971 to 1974, the Cost of Living Council and related committees provided forums for focussing attention on policies affecting inflation ranging from farm and food price policy to limitations on imports. Careful review of the steady stream of policy decisions for their impact on costs and inflation by the Council on Wage and Price Stability, stringent limitation of the growth of federal spending by the administration, and review of the cost-raising implications of regulatory decisions by the Regulatory Council can also have a favorable influence under the current program. It must be recognized, however, that the favorable effects of careful review of regulatory actions and other decisions influencing costs and prices can be swept away by a wave of excess demand, as they were in 1973 and 1974.

The influence of wage-price policies on other policies of central importance for inflation can also, however, be unfavorable. To the extent that standards are binding, unfavorable effects are produced directly by the costs of administering the standards, by inefficiency or shortages induced by the standards, and by discouraging investment and increases in supply and thereby creating an economic environment for more inflation in the future. Even more importantly, wage-price policies have often been viewed as a tool for permitting additional demand

<sup>3</sup> See, for example, Lloyd Ulman and Robert J. Flanagan, *Wage Restraint: A Study of Incomes Policies in Western Europe*, (University of California Press, 1971). Crauford D. Goodwin, ed., *Exhortation and Controls: The Search for a Wage-Price Policy 1945-1971*, (Brookings Institution, 1975) and Marvin H. Kesters, *Controls and Inflation: The Economic Stabilization Program in Retrospect* (American Enterprise Institute, 1975).

stimulus to attain higher output and employment levels than would otherwise be regarded as prudent, or for helping to avoid the need to pursue policies that could increase the risk of recession.

The temptation to pursue more expansionary demand policies than would otherwise be considered prudent is strengthened not only by the tendency to rely on wage-price standards to offset their inflationary effect, but also by the possibility that such standards may temporarily mask, by shifting into the future, some of the symptoms of excess demand that would be evident in the market. Yielding to this temptation is a prescription for higher inflation instead of reduced inflation.

#### OTHER WAGE-PRICE POLICY APPROACHES

When a program of wage and price standards is established, the public dialogue usually shifts from whether such a program is desirable to how it should be administered and what sanctions should be imposed to induce compliance. When standards have been developed, government has already taken a step that is premised on the idea that it is in a position to prescribe the appropriate size of wage and price increases, not just as an overall target for average wage and price increases, but for workers affected by every wage decision and for prices, and relationships between them, for every firm and its customers. Having taken this step, if actual price behavior does not conform to hoped-for targets under voluntary standards, attention frequently turns to what seems logically to be the next step—making the standards mandatory.

The distinction between voluntary and mandatory is frequently, and often deliberately, blurred when wage and price standards are established. The administrator has indicated that compliance with the current so-called voluntary standards will be encouraged, to the extent this is feasible, by policies that involve strong elements of coercion. Moreover, even standards that are explicitly mandatory have historically relied strongly on appeals for voluntary restraint, and voluntary acquiescence is always an essential requirement in the sense that any program must command sufficiently widespread public support to permit its continuation.

If a voluntary program is perceived as ineffective, or if the tools available for encouraging compliance appear arbitrary, clumsy to work with, or lacking in legislative basis for their application to enforce anti-inflation standards, there may be calls for enacting explicit authority for controls on wages, prices, rents, dividends, and other economic transactions. What can be accomplished by mandatory controls, however, is subject to serious limitations. If mandatory controls are used to suppress prices and wages significantly below levels that would otherwise prevail, dislocations, shortages, quality deterioration, rationing and so on are included in the list of symptoms that can be expected, along with the massive force of bureaucrats to police the program and the loss of freedom of economic choices that this entails. The controls of World War II provide an example. On the other hand, if mandatory controls are administered with the goal of avoiding market disruption and supply reduction, prices can be expected to rise at essentially the same rates as they would in the absence of controls. The burst of inflation in 1973 and 1974 provides an example. This is the central dilemma of mandatory controls: to the extent that they are sufficiently stringent to be effective in reducing inflation, controls replace the market as the mechanism for organizing economic activity. Potential for harm by disturbing the system for coordinating production and consumption in the economy inevitably accompanies efforts to do any good by keeping prices or wages down by using controls.

#### THE LIMITED POLICY OPTIONS

After more than three-and-a-half years of expansion, the rise in inflation during the past year is evidence that further movement toward higher resource utilization would result in still higher inflation. The rise in real output during the cyclical expansion since 1975 and the inflation that has occurred were sustained by commensurate increases in nominal aggregate demand. As the cyclical component of rising real output has been exhausted, increases in nominal demand have increasingly been translated into more inflation. To unwind the inflation, growth in nominal demand will necessarily need to be tapered off.

Gradually restraining the growth of aggregate demand, of course, poses the risk of recession. This is a risk that arises whenever it becomes necessary to rein in aggregate demand increases, usually to restrain the rate of inflation. It is

also a risk that tends to occur when the economy is operating at a rate close to its production capacity, because when cyclical increases in real output growth can no longer be achieved, the only alternative to smaller increases in aggregate demand is higher inflation. Under these circumstances the options are quite limited. Delaying demand restraint raises the risk of accelerating inflation, which only delays and eventually exacerbates the risk of recession.

Restraint of aggregate demand can be achieved by reducing the rate of monetary expansion. Although monetary restraint may be accompanied by temporarily higher short-term interest rates, interest rates would eventually need to rise even more if inflation was instead allowed to rise. The burden of monetary restraint can be eased by curbing the rate of growth in federal budget expenditures to reduce the deficit. The budget policies announced by the administration as a part of the anti-inflation program can make a valuable contribution. The announced intentions to carefully review government regulatory policies to minimize their inflationary impact and to avoid actions that benefit narrow special interest groups can also make a constructive contribution, and they would be worthwhile for helping to assure that these decisions serve the interests of the general public even if inflation were not the immediate concern.

A gradual reduction in aggregate demand will produce a gradual reduction in inflation, according to all of the available evidence. The evidence also indicates that progress in reducing inflation comes only at the cost of a period of higher unemployment. There are differences in views about how long a period of higher unemployment would be necessary and how quickly inflation would subside, but there is a general agreement that higher unemployment would be a temporary condition. Wage and price standards, whether mandatory or voluntary, cannot remove the necessity for aggregate demand restraint, and the need to restrain demand is what poses the risk of recession. While the standards are intended to help to convert the effects of demand restraint into a slowdown in prices and wages instead of output and employment, they have repeatedly been subject to failure when they were used as a tool to facilitate a transition to lower inflation. The belief that wage and price standards could make a worthwhile contribution as an element in policies to reduce inflation is contradicted by most of the evidence from experience, and there is little basis for believing that this evidence is not applicable to current anti-inflation policies.

This completes my prepared statement. I would be happy to address any questions you might have.

Senator BENTSEN. Thank you very much, Mr. Koters. It is obvious we have a strong difference of opinion here in the application of the particular mechanics in achieving our objective. We will try to hold our questions until we conclude the entire panel.

Mr. Greenspan.

#### STATEMENT OF ALAN GREENSPAN, PRESIDENT, TOWNSEND-GREENSPAN & CO., INC.

Mr. GREENSPAN. Let me say first, Mr. Chairman, that I agree with most, if not all, of what Mr. Kahn has said.

Senator BENTSEN. Could I request that you speak a little closer to the microphone?

Mr. GREENSPAN. I was saying that I also agree with very much of what Mr. Kahn had to say about the causes of inflation, the various problems in the regulatory area, and the difficulties that occur with respect to the basic forces engendering inflation.

My disagreement with him, and with the administration, rests only in the area of standards or guidelines which I think are counter-productive.

And I will come in a moment to the reasons why I believe that is

the case. There really is no shortcut at this particular point to restoring a noninflationary balance. We have to get at the fundamentals.

I know there has been this vague discussion about the guidelines programs breaking down and ultimately leading to mandatory controls as though it were part of some Greek tragedy. I think it would be very helpful, myself, if the President would stipulate here and now that even if the Congress were to submit to him some standby authority for mandatory wage and price controls, that he would veto that bill. That has not been stated.

And the failure of the President to go all the way on that question has left open the issue as to whether this Greek tragedy, which none of us wants—or I should say very few of us want—will ultimately occur.

The basic underlying problem with respect to inflation is that we do not have the ability at this point to bring money supply growth down to noninflationary rates without driving interest rates through the roof.

This can only be done by reducing aggregate credit demands flooding capital markets. Federal Reserve policy typically tends at least partially, to accommodate these very strong credit demands by supplying reserves to the banking system, which in turn are the base for the excessive expansion in money supply.

It strikes me that the key role of the Federal Government at this stage is to focus on the extent that it is a prime creator of credit, and that not only is it engendering very substantial borrowing requirements through its direct budget financing requirements, and its off-budget financing, but it also is indirectly preempting very significant quantities of credit, first by mandating many types of actions on the part of the private sector, the Environmental Protection Agency, and some of the OSHA regulations being just a few, it is forcing private industry to borrow to implement those requirements. That is adding to the aggregate of credit demands.

It is also indirectly increasing borrowing by State and local governments through tied grants-in-aid programs which induce a good deal of expansion in numbers of programs which I suspect would not otherwise occur and would not be financed in the capital markets.

However, the largest number we are facing is in the mortgage realm. It was very rare prior to the last 5 or 7 years that mortgage credit would expand by more than \$15 billion annually. We are now expanding close to a \$100 billion annual rate. This is largely a consequence of monetizing capital gains on sales of existing homes and is not immediately or directly related to the level of home building. It has nonetheless been created by a series of governmental actions, direct and indirect, which has caused a huge flood of mortgage moneys into the system.

I would appreciate being able to submit for the record an article I recently wrote for the Wall Street Journal on this subject, which expounds on this question in some detail.

Senator BENTSEN. We would be delighted to have it.

[The article referred to follows:]

[From the Wall Street Journal, Nov. 21, 1978]

## THE EXPLOSION OF MORTGAGE CREDIT

(By Alan Greenspan)

During the latter part of October, the financial markets were clearly signaling the onset of a major financial crisis. From levels that were already demonstrably undervalued, the dollar came under severe and accelerating downward pressure, reflecting the expectation of a mounting inflation rate in the U.S.

The same message was being conveyed by the stock market. Stock price levels, which by any reasonable standard could not be judged excessive, followed the exchange rate downward, recording one of the sharpest declines in recent memory. Only dramatic action could have moved the financial markets back from the brink.

It is to the credit of the President and the Federal Reserve that they recognized half-way measures would not work. The Fed's full percentage point hike in the discount rate produced a dramatic turnaround that day in both the dollar and the stock market.

The shift from rhetoric-laden economic policy to clear and forceful action at the beginning of November could signal a critical shift in United States economic policy. After the stunning one-day success, however, it is important that the Federal Reserve should not be perceived as slipping back to monetary policy "as usual." It could easily get ahead of the market (even now) and hold the initiative by pressing federal funds rates to a range of 10¼ percent-10½ percent. With the fundamentals of the dollar exchange rate currently highly favorable, such signals could drive the dollar up sufficiently to induce *selling* of dollars by foreign central banks to slow its rate of rise.

## THE FED NEEDS HELP

Even with the best of monetary policies at this stage, however, it would be a mistake to presume that the Federal Reserve alone can contain inflation, or confront the more difficult fundamentals of the inflation bias in the American economy. Interest rates are high because credit demand exceeds savings flows; and money supply growth is excessive (and inflationary) because the Fed feels politically compelled to suppress interest rates by at least partially accommodating the excess credit requirements.

The only viable solution is to slow the monetary aggregates without engendering excessively high interest rates, and that can be done only by reducing the demand for funds pressing on our financial system. It has been the exceptional pressures from the credit markets that have placed the Federal Reserve in its current unenviable situation.

The marked increase in aggregate capital market borrowing has not only driven interest rates higher, but, in the process, diverted an ever increasing amount of borrowing from the capital markets (by those who were "crowded out") to the commercial banks. In an endeavor to accommodate the loan requirements of their customers, commercial banks attempted to obtain the reserves required to back up loans by borrowing in the federal funds market.

The accompanying rise in the federal funds rate placed the Fed in its typical "no win" position. It had to determine whether to stand aside, allowing the fed funds rate to rise, thwarting some of the prospective commercial bank borrowing; or, by supplying reserves to the market, temporarily hold the federal funds rate below what it would otherwise be, thereby accommodating the expanding loan demand.

That latter path, however, enlarges the monetary base, inducing an acceleration in money supply growth with inflationary consequences. The Fed as usual straddled the issue, only partially accommodating the demand for funds. As a result, over the past half year both money supply growth and interest rates rose, but the increases in each were less than might otherwise have prevailed, at least in the short run.

Curbing the growth in federal spending and deficits is a necessary, but not sufficient, condition to restore balance to the financial markets. If we focus wholly on the budget deficit, however, we are missing what may well be a far more inflationary set of credit-preempting policies fostered by the federal government.

Off-budget borrowing has risen sharply in recent years. So have mandated capital investment by business (pollution, safety equipment, etc.) which must be

financed; and matching grants, which have induced increased spending and borrowing by state and local governments. These demands have added heavily to capital market pressures, but in total have been small compared with the extraordinary expansion in mortgage credit.

Prior to the 1970s an increase in mortgage credit on one- to four-family homes rarely exceeded \$15 billion. During the past year, the increase has approached \$100 billion. This veritable explosion of mortgage credit growth is a consequence of the increasing political concern that emerged in the 1950s and 1960s. Whenever short-term interest rates rose, thrift institutions withdrew from the mortgage markets, sharply contracting housing starts.

Changes in institutional structures and subsidy programs sponsored by the federal government, from mortgage-backed bonds to the newest six-month certificates tied to the Treasury bill rate, have apparently successfully insulated mortgage credit availability from periodic credit crunches.

The political exercise has worked all too well, with the not atypical effect of overkill. The consequence of "solving the mortgage problem" has, not unexpectedly, created a different problem whose consequence may be far more profound to the structure of the American economy. It has clearly been a significant contributing factor to the excessive money supply growth and, hence, the high base rate of inflation which the United States has experienced.

By significantly increasing the financial system's capacity to supply mortgage credit in the face of rising short-term interest rates, the adjustment process of the financial markets has been markedly altered in recent years.

Most recently, households have been diverted from other forms of savings into the savings and loans' six-month certificates, the proceeds of which they then invested in mortgages. Inducing indirect mortgage purchases by financial institutions through mortgage-backed bonds has come at the expense of their ability to purchase corporate issues, state and local securities, and federal obligations. If the Federal Reserve had not created additional reserves to support the broadened credit demand, the total volume of investable resources would have been fixed, and the increase in the demand for mortgages by financial institutions at any particular interest rate would have correspondingly reduced the demand for other securities.

In the past the drying up of mortgage funds, because of Federal Home Loan Bank Board limits on interest rates the S&Ls could pay to attract funds, rapidly squeezed prospective home purchasers (and mortgage borrowers) out of the market. As a result, the excess of demand for funds for the financial system as a whole was largely eliminated by squeezing out the demand for mortgage debt. When interest rates rose in the process of bringing balance to the debt markets, a relatively small increase in interest rates was adequate to "crowd out" the amount of mortgage borrowing required to bring the overall demand for funds back into balance with the supply.

In the new mortgage-dominated financial markets, interest rates must now rise much further than they would have under comparable conditions a decade ago in order to crowd out the excess demand for funds. Because mortgage credit is becoming increasingly insulated against such pressure, the pressure must now move to other instruments as well; business borrowing, real estate financing, municipal borrowing, foreign loans, etc.

And because larger interest rate increases are required to curb the demand for such credit, the supply and demand for funds can come into balance only at much higher interest rates than previously. Mortgage credit may still have to bear much, if not most, of the reduction in credit demand—only this must now occur at significantly higher interest rates than earlier.

Hence, the net effect of improving the availability of mortgages in the face of rising interest rates is to decrease, at the margin, the responsiveness of credit demand to a rise in interest rates. It means that at any given underlying demand for funds, higher rates are required than, say, 10 years ago, to equate the supply and demand for funds. This would be true even in a noninflationary environment in which there was no perceptible inflation premium embodied in interest rate levels.

#### HELP FOR THE HOUSING BOOM, BUT . . .

The institutional changes that have expanded the mortgage market explain the extreme difficulty the Fed has had in attempting to simultaneously dampen monetary growth while keeping interest rates at moderate levels. Shoring up the mortgage market clearly contributed to the underlying inflation bias in the econ-

omy. While it may have sustained the home-building boom, this has probably been accomplished at a significant cost to the economy's overall stability.

It is probably too late in this business cycle to undo the new mortgage-based inflation bias that has been added to our financial system. The Fed has little choice but to hold a tight rein on credit availability until mortgage (and other credit) demand subsides. In fact, economic policy is unlikely to be able to significantly alter the path of an inflation-caused recession over the next couple of years.

It is not, however, too late to reset our economic priorities and policies for the 1980s. If we wish to defuse the current underlying inflationary bias which pervades our economy, we will have to reverse the federal government's increasing direct and indirect preemption of the nation's available credit. Only then can we expect the Federal Reserve to be able (during the next economic expansion) to hold inflationary money supply growth in check, without driving interest rates to extreme heights.

In the interim, we can do little more than hold the fiscal and monetary reins tight as the credit (and presumably the economic) expansion comes to a halt. Spectacular "incomes policies" can only divert our attention from what must be done.

Mr. GREENSPAN. Unless we come to grips with this overall credit problem, we will not be able to reduce the rate of growth in the money supply, and all the other actions which we take will be futile. We will just be spinning our wheels and nothing I could envisage will successfully confront the inflation problem.

Certainly, the so-called wage and price standards or guidelines, at least in my view, are ill-advised. It now appears that for the next 6 months we will see a continuing series of changes in the current set of wage and price guidelines. In each case the administration is likely to restipulate that the current set of guidelines is final and immutable, only to revise them as market and political pressures emerge. In fact, this is the very process by which controls, whether voluntary or mandatory, gradually break down. The only thing that distinguishes the current program from older ones is that it appears to be running into trouble sooner than expected.

The guidelines program has already begun to deteriorate. It will continue to do so over the next several months until it ultimately breaks down in an intractable degree of complexity. The reason is that any set of guidelines, by its nature, must be relatively simple and easy to comprehend if it is to gain overall political acceptance. Obviously, the guidelines must also be set at levels below those which normal market forces would create. Otherwise, the whole exercise would be quickly perceived as a sham.

A well crafted, but simple, guideline may well capture an impressive 95 percent of the relevant wage and price decisions. But if the total decisions over a period of time are, say, 100 million, that still leaves 5 million decisions which are outside easily definable categories or standards and which would require special interpretation by the Council on Wage and Price Stability. If this were truly a voluntary program, the obvious answer to anybody who requested a special interpretation would be: "This is a voluntary program. The President has specified his overall criteria and we leave it to you to determine how you should appropriately behave in the context of those broad principles."

But this is scarcely the type or response which is being given. More often than not, a specific answer is being formulated which, by its very nature, is indistinguishable from a mandatory regulation. We are in

the process of creating wage and price controls based on dubious legal authority. Since one regulation, of necessity, breeds another and one distortion, even if partially adjusted, creates a distortion for somebody else, an uncontrollable proliferation of regulations is in process whose growth can get rapidly out of hand.

Market forces must inevitably begin to press against these regulations. As this happens, the regulations will have to be changed to prevent totally unacceptable distortions from emerging. In such cases, it would become evident that compliance would not be forthcoming or political pressure would be brought to bear to ease the burden of compliance.

In either case, the regulation is likely to be altered. As the alterations proliferate, the system will become increasingly complex. Since such systems tend to back away from confrontations with the market, we are likely to end up with a huge, largely unmanageable, controls program whose beneficial effects on overall wages and prices will become increasingly dubious over time.

This was largely the experience of the Nixon administration's episode. Its legacy is still with us in the energy area. The latest embarrassment is the shortage of unleaded gasoline, which a Washington Post editorial appropriately characterized yesterday as "turning into a classic illustration of the way that price controls don't work."

The newest justification for a guidelines, or even a controls program is that it will supplement the reduction in inflationary forces which will be set in motion by more restrictive fiscal and monetary policies. Since there is now general agreement that any form of controls or even guidelines will not function in an economic environment of excessive fiscal and monetary stimulus, justification for a guidelines program is now more modest and is viewed as supplementary. It is argued that at worst, the cost of failure of a guidelines program is negligible; therefore, what can we lose? The answer is, quite a great deal.

The distortions which any form of guidelines or control program generates undercut the expansion of productivity and create a bottling up of inflationary forces which ultimately, when unleashed, could create a level of prices 18 months to 2 years from now which would be far in excess of what would otherwise have been the case. Moreover, the costs of compliance of a controls program are not small. They divert a significant amount of managerial efforts from endeavoring to be responsive to subtle changes in consumer wants and needs to focusing on understanding—no mean task—and figuring out how to comply with the newest set of so-called voluntary regulations.

These are unacceptably large costs, especially since most evidence suggests that the economy will slow down in the latter half of 1979 and could very well tilt into a financially induced recession. It is important that our economic system have maximum flexibility to deal with that sort of circumstance. A hodgepodge of wage and price controls, mandatory or quasi-mandatory, will not improve the American economy's ability to pull out of the slowdown or recession easily.

Thank you very much, Mr. Chairman.

Senator BENTSEN. Thank you very much, Mr. Greenspan.

Mr. Evans, please proceed.

STATEMENT OF MICHAEL K. EVANS, PRESIDENT, CHASE ECONOMETRIC FORECASTING ASSOCIATES, INC.

Mr. EVANS. Thank you very much, Mr. Chairman.

I am very pleased to be here this morning to discuss the important problem of wage and price guidelines and controls. My statement is fairly lengthy. I will summarize it briefly in the 10 minutes allotted to me. The testimony consists of three parts. The first is a brief discussion of the factors which have led to the current inflation; the second is an examination of our previous experience with controls; and the third is a discussion of what can be done about the current round of inflation.

It is our contention that inflationary spirals take 3 to 5 years to wind up and wind down, so we really should not expect instant solutions from any program which is tried.

Most of the causes of the current inflation have been developing over the past 10 years or more. I have previously testified in front of this committee about the slowdown in productivity growth, the high rate of increase in Government spending, the cost of regulation, and other factors. I won't repeat all that material, but very briefly, the rate of productivity has slowed down from 3 to 1.3 percent per year.

The ratio of total public sector spending to GNP, which was 27 percent in 1965 reached a peak of 35 percent in 1975. The cost of Government regulation has been estimated by the Government itself at \$70 billion a year, and by private sources at over \$100 billion a year. So the factors causing inflation are not just something that has been sprung on the economy this year. They clearly have been with us for quite a while.

Table 5 of my prepared statement is the table that shows wage and price changes over the business cycle. This table is taken from the 1978 Economic Report of the President. So I guess it could be considered a nonpartisan document and not necessarily one representing my own views although I certainly agree with the results. What it shows, very simply, is that inflation is becoming institutionalized. Early in the postwar period, wages and prices actually went down during recessions; later wages and prices moderated during downturns. But in the last recession, which was in fact the most severe one, wages and prices continued to rise until well into the downswing.

The factors leading to this institutionalization of inflation are the cost-of-living adjustments and the increase in the relative size of the public sector, indicating that we cannot get quick turnaround on inflationary spirals; they wind down very slowly.

Another factor which has returned is the so-called Phillips curve, the tradeoff between unemployment and inflation.

Again, we have some graphs here, figures 1 and 2, which show what has happened to this relationship.

The economy used to operate under what some economists call the rule of eight, which is that the rate of unemployment plus the rate of inflation in any year added up to eight. If the economy had 6 percent unemployment, the rate of inflation would be only 2 percent, and vice versa. During the period of controls of the Nixon administration, this relationship disappeared. But it didn't improve; in fact, it worsened. As shown on these graphs, it reemerged in the period of 1974 to 1978,

and instead of the rule of eight, we now have the rule of 14. In other words, the rate of inflation plus the rate of unemployment now adds up to 14, as it has over the past 5 years.

It is, of course, this vicious spiral that we seek to break. But controls were in large part responsible for moving the economy from the rule of 8 to the rule of 14 by slowing the rate of growth and productivity and contributing to deficiencies and distortions in the economy.

In March 1976, Chase Econometrics undertook a study to examine the effect of wage and price controls for the previous 4 years. What we found was that the rate of inflation at the end of 1975 was higher, while the level of prices was about the same. Yet we had a severe recession in between, which could have been avoided without controls. So it certainly would seem to be a disaster to go back to mandatory controls. We had our experience with that.

In 1971 many well-meaning economists, politicians, lawyers, bureaucrats, and so forth, were misled, because they didn't know what would happen with controls. We had seen them in wartime, when they accomplished what they were supposed to accomplish. We didn't know what they would accomplish in peacetime, but now we have the answer—higher inflation and severe recession. Regardless of one's political stripe, it is not clear why anyone would return to mandatory controls. But often when I say this, I am asked the question, "All right, what do you suggest?" Certainly, the rate of inflation has averaged 9 percent this year and in recent months it has been closer to 10 percent; but it seems to me that if the Carter administration adheres to a line of fairly restrictive monetary and fiscal policy, the rate of inflation will drop from approximately 9 percent to about the 6½-percent range by the end of next year. There are three major factors which account for this decline.

First would be the stabilization of the dollar. According to our estimates, the devaluation of the dollar added about 1½ percent to the rate of inflation this year.

There are lags involved where the dollar started to decline in mid-1977. It wasn't until the beginning of 1978 that inflation shot up. The dollar, I believe, has stabilized due to the November 1 announcements and the monetary policy swap arrangements. This will be reflected in the stabilization of import prices in the latter half of next year, which should reduce the rate of inflation by 1½ percent.

Another factor causing a reduction in the rate of inflation is that real GNP will decline in the middle of next year. We will have a decline in housing starts from about 2 million to 1.5 million. While this has negative side effects, it also has the positive side effect of reducing price increases in the building materials industry which rose 14 percent this year, but, according to our forecasts, will rise only 6 percent next year.

So the rate of inflation will come down because of less demand pressure.

A third factor is that the higher rate of unemployment next year, which is expected to average 7 percent, and the lower rate of inflation, will cause wage gains to moderate. The average increase, which has been running about 8½ percent a year, will diminish to 7½ percent in the latter half of 1979.

Many people have claimed that a recession, throwing people out of work, causing misery to the economy, is not the correct way to proceed, and I agree with that.

But faced with the existing situation in December 1978, our options are severely limited. We have suffered a whole decade of mismanagement of monetary and fiscal policy. We cannot expect to make the entire economy whole in 6 months. We need to increase aggregate supply at a faster rate, which is only growing at 3 percent a year. Economists agree that in order to keep unemployment stable, we need to grow about 4 percent a year. You can't have demand growing at 4 percent and capacity growing 3 percent without reaching bottlenecks sooner or later; and the later is rapidly turning into sooner. The rate of inflation will intensify once the economy reaches maximum capacity.

We need to fall back and take our medicine. A moderate recession in 1979 may be necessary so that a severe recession does not develop in 1980. While this may seem like harsh medicine, we need to set our priorities in order. We need to increase the growth in aggregate capacity through tax reduction and other factors. It takes time to accomplish this.

We will have balanced growth in 1980 and beyond if we follow these ideas. But we cannot expect 1979 to have a lower rate of inflation unless we are willing temporarily to decrease aggregate demand and keep a stringent monetary and fiscal policy.

I believe this is the way to reduce inflation to the 6-percent level. I do not think that the guidelines, no matter how strict they are, will accomplish a rate of reduction in inflation unless it is preceded, as Mr. Kahn has already said, by monetary and fiscal policy which for a time is contractionary.

Thank you.

[The prepared statement of Mr. Evans follows:]

#### PREPARED STATEMENT OF MICHAEL K. EVANS

##### I. INTRODUCTION

Policy makers for the U.S. economy currently find themselves facing a series of unpalatable alternatives. The rate of growth is rapidly diminishing, and yet inflation continues to accelerate. Higher interest rates and tighter monetary policy are likely to lead to at least a mild recession in 1979. The spectre of mandatory controls continues to haunt the business community in spite of repeated denials by Administration officials, while the initial reception of the voluntary controls program can best be described as frosty.

It is our contention that inflationary spirals take from three to five years to wind down, and that instant results should not be expected regardless of which particular programs are initiated. While the current round of inflation has been exacerbated to a certain extent by Mr. Carter's policies, in large part the problems have been inherited from previous administrations. These include the slowdown in productivity growth, the steady increase in the ratio of public sector spending to GNP, the increasing cost of government regulation, and the slow growth in total capacity. We briefly examine some of these factors in the first part of this testimony.

The experience with controls and guidelines during the Nixon administration was totally negative. The level of inflation by the end of 1975 was no lower with controls than it otherwise would have been, while the severe recession which ensued can be directly linked to the controls and the distortions which it spawned. Early in 1976 Chase Econometrics completed a study entitled "The Effect of Wage and Price Controls on the United States Economy 1971-1975" which contained these and other conclusions. In view of the widespread discussion of a possible return to mandatory controls in the near future, we have included part of that study with this testimony.

While the rate of inflation is expected to remain near the 9% level for the next two quarters, market forces will then cause it to decline to the 6% to 6½% range by the end of 1979. The major factors leading to this deceleration are the stabilization of the dollar, smaller increases in commodity prices because of negative real growth, and more moderate wage increases because of the rise in unemployment. We would expect this moderation of inflation to occur even if no controls program were in existence, and believe that the voluntary program by itself will not reduce inflation at all. In other words, it is the policies of November 1st, not of October 24th, which will lead to more moderate rates of inflation by the end of next year.

## II. FACTORS LEADING TO HIGHER INFLATION

As I have previously testified before the Joint Economic Committee, output/manhour in the private sector increased at an annual average rate of 2.8% for the period from 1948 to 1968, but has declined to 1.2% per year since that time. Table 1 contains the tabulation of the postwar record for increases in output/manhour in the private nonfarm sector. We have taken three-year averages rather than yearly figures in order to smooth out the fluctuations in productivity caused by sharp changes in output. While some traces of recessions still remain in these numbers, the overall swings in productivity emerge much more clearly than is the case in the series for annual changes.

As shown in Table 1, productivity rose very rapidly in the years immediately following World War II (no figures are available before 1948) because of the large proportion of GNP devoted to investment to replace obsolete plant and equipment. Productivity increases then declined to the 2.0% range for the period 1956-1961, considerably below the long-term average. This was due in large part to the severity of the 1958 recession. Productivity then rose rapidly from the period 1962 to 1968, due to the increase in capital spending spurred by the investment tax credit, liberalized depreciation allowances, and the reduction in the corporate income tax rate; productivity gains were also increased by the substantial increases in Federal spending for research and development. Beginning in 1969, both of these driving forces toward higher growth were removed. The investment tax credit was cancelled, and recurring financial crises reduced the amount of money available for new investment spending. The reinstatement of the investment tax credit in 1971 did raise investment above the levels which would otherwise have been reached, but this was offset by the substantial expenditures required for environmental and safety standards. As a result, productivity actually declined for the first time in the postwar period in 1974 and for the three-year period 1973-1975 showed virtually no improvement. While the 1977 figure does indicate a rebound, that is due mainly to cyclical factors, and the 1978-1980 period clearly indicates yet another slowdown.

TABLE 1.—Long-term trends in productivity growth

3-Year period ending in	Average annual growth rate in productivity (private nonfarm sector)	3-Year period ending in	Average annual growth rate in productivity (private nonfarm sector)
1950	4.2	1966	3.1
1951	4.0	1967	2.4
1952	3.5	1968	2.4
1953	2.2	1969	1.3
1954	2.0	1970	1.5
1955	2.4	1971	2.1
1956	1.6	1972	2.3
1957	1.6	1973	2.9
1958	1.7	1974	1.0
1959	2.8	1975	0.2
1960	2.3	1976	0.9
1961	2.4	1977	2.7
1962	2.7	1978E	2.2
1963	3.5	1979E	1.1
1964	3.5	1980E	1.0
1965	3.0		

In addition, productivity growth has been reduced by increased investment required to meet Federally mandated standards, as summarized in Table 2. This table should also include investment undertaken by the automobile industry to meet pollution, fuel economy, and safety standards, but we were unable to find even approximate estimates for these figures. Even without them, however, we note that adjusted capital stock has grown at an annual rate of only 2.4% since 1970, compared to 3.0% as calculated from the investment figures before adjustment.

The reduced rate of growth in capital stock since 1970 has a number of negative implications for the equilibrium growth path of the U.S. economy. First, it increases inflation by lowering the real wage of the average employee, thereby forcing him to bargain for higher money wage increases. This creates an inflationary spiral which reduces real income for both individuals and corporations and enlarges the government sector of the economy, hence reducing productivity growth still further. Second, the expansion of the overall economy is stunted because capital stock increases at a much slower rate. As a result the maximum potential capacity of the economy grows sluggishly and shortages and bottlenecks occur well before the economy reaches what is generally considered to be full-employment level. This phenomenon, which clearly adds to inflationary pressures, has previously been characterized under the nomenclature of demand-pull—too many resources chasing too few goods. However, the "too few goods" in reality represents the same phenomenon as does so-called cost-push inflation, i.e. the lack of growth in productivity. Upon closer examination, it turns out that the recent bursts of inflation have been caused by a lack of supply rather than an excess of demand. This suggests that we need an accurate measurement of the maximum capacity of the economy, and the growth rate of this capacity.

TABLE 2.—FIXED INVESTMENT AND CAPITAL STOCK ADJUSTMENT FOR INFLATION AND POLLUTION CONTROL EQUIPMENT

Year	Fixed business investment, current dollar	Pollution control	Health and safety	Energy	Productive fixed business investment, current dollar	Productive fixed business investment, constant dollar	Net capital stock <sup>1</sup>	Net productive capital stock
1970	100.5	2.2	1.2		97.1	106.4	833.7	830.0
1971	104.1	2.9	1.3		99.9	103.7	859.5	851.4
1972	116.8	4.1	1.8		110.9	110.9	889.8	875.8
1973	136.0	5.3	2.0		128.7	124.0	929.5	908.5
1974	150.6	5.8	2.8		142.0	122.9	965.1	936.7
1975	150.2	6.5	2.6	1.3	139.8	105.7	980.9	944.6
1976	164.6	6.8	2.4	2.8	152.6	110.3	1,001.4	956.7
1977	190.4	7.5	2.9	4.6	175.4	119.6	1,031.2	975.9
1978E	219.0	8.0	3.2	5.8	202.0	128.1	1,066.5	1,000.2

<sup>1</sup> April 1976 Survey of Current Business; last 3 years extrapolated by CEAI. All figures are in billions of dollars.

Hence a second major factor contributing to the recent round of inflation has been the very small gap between actual and maximum potential GNP. Previous figures for maximum potential GNP published by the Council of Economic Advisors (CEA) showed that the growth rate of the U.S. economy accelerated from 3.5% during the 1955-1965 period to 4.0% from 1965 to 1973 and 3.9% more recently. These estimates suggested that the gap between actual and potential GNP was some \$30 billion even in 1973 and ballooned to \$166 billion in 1975, representing some 13% of maximum GNP for that year. In its 1977 and 1978 reports, however, the CEA decided that the rate of potential output diminished to 3.6% from 1965 to 1973 and 3.5% thereafter, which produces a negative gap in 1973 and only a 9% gap in 1975. They state that this revision is due to slower growth in labor productivity since 1966. As shown in Table 3, the gap between actual.

As show in Table 3, the gap between actual and maximum GNP this year is only about 1%. Thus if the economy were to grow at the equilibrium rate of 4% next year, and total capacity were to increase only 3%, the gap would be zero—

which would have even more severe inflationary implications. Thus faced with the present position of the U.S. economy it is indeed necessary to reduce the rate of growth temporarily next year while we put our house in order.

TABLE 3.—POTENTIAL AND ACTUAL GROSS NATIONAL PRODUCT, 1952-79  
(All figures in billions of 1972 dollars)

Year	Potential GNP			GNP gap	
	CEA	CEA standard	Actual GNP	Potential less actual CEA	CEA <sup>1</sup>
1952	584.9	(0)	598.5	-13.6	(0)
1953	608.2	(0)	621.8	-13.6	(0)
1954	629.7	(0)	613.7	16.0	(0)
1955	651.4	(0)	654.8	-3.4	(0)
1956	673.9	(0)	668.8	5.1	(0)
1957	697.2	(0)	680.9	16.3	(0)
1958	721.3	(0)	679.5	41.8	(0)
1959	746.2	(0)	720.4	25.8	(0)
1960	771.9	(0)	736.8	35.1	(0)
1961	798.6	(0)	755.3	43.3	(0)
1962	826.4	(0)	799.1	27.3	(0)
1963	857.1	(0)	830.7	26.4	(0)
1964	890.3	(0)	874.4	15.9	(0)
1965	925.0	(0)	925.9	- .9	(0)
1966	958.3	956.5	981.0	-22.7	-24.5
1967	992.8	989.0	1,007.7	-14.9	-18.7
1968	1,028.5	1,022.6	1,051.8	-23.3	-29.2
1969	1,065.6	1,057.4	1,078.8	-13.2	-21.4
1970	1,103.9	1,093.3	1,075.3	28.6	18.0
1971	1,143.7	1,130.5	1,107.5	36.2	23.0
1972	1,184.8	1,168.9	1,171.1	13.7	-2.2
1973	1,227.5	1,208.7	1,235.0	-7.5	-31.3
1974	1,270.5	1,245.0	1,217.8	52.7	27.2
1975	1,314.9	1,282.3	1,202.3	112.6	80.0
1976	1,360.9	1,320.8	1,271.0	89.9	49.8
1977	1,408.6	1,360.4	1,332.6	76.0	27.8
1978	1,458.0	1,401.0	1,383.0	75.0	18.0
1979	1,500.0	1,443.0	1,398.0	111.0	45.0

<sup>1</sup> Same as CEA.

Source: 1978 Economic Report of the President, p. 84, and Chase Econometrics estimates.

The assumptions underlying the measurement of maximum capacity, as calculated by Chase Econometrics and by CEA are given in Table 4. As can be seen from this table, no differences appear through 1965, and our estimates differ only slightly from the new CEA estimates for the 1965-1973 period, although they are 0.5% per year lower than the old estimates. For 1973-1978 we estimate that the growth in capital stock has declined from 4.4% to 1.9% and the growth in technological progress is only 1.2%, up from 0.9% during the 1967-1973 period but well below the 1.8% for the 1947-1965 period. This has resulted in a decline in output per manhour from 1.9% to 1.3%.

The new CEA methodology assumes that the capital stock growth has declined only from 4.7% to 2.8% and that growth in technology has rebounded from 1.0% to 1.5%. This results in the growth in output per manhour declining only from 2.0% to 1.7%.

It seems that the old CEA estimates of growth in capital stock are unrealistically high. Even if one does not adjust capital stock as we have done for pollution control and for alleged understatement of inflation, we still find that capital stock grows at only a 2.5% annual rate for the period 1973-1978. This would itself reduce that estimate of real growth by an additional 0.3%. We continue to mention the old CEA estimates because some policies are being formulated on that basis.

In addition, we find it very unlikely that growth in technology in the most recent four-year period has recovered to 1.5%. In fact, it is likely that even our meager estimates of technological growth for the 1973-1978 period are overstated for the following reasons.

TABLE 4.—CALCULATION OF MAXIMUM POTENTIAL GNP

Time span	Growth in maximum potential GNP (1)	Growth in labor force (2)	Growth in capital stock (3)	Growth in gamma <sup>1</sup> (4)	Add: Growth in labor productivity <sup>2</sup> (5)
(A) Using Chase Econometrics estimates:					
1947-55.....	4.3	1.2	4.9	1.9	3.1
1955-65.....	3.5	.9	3.7	1.7	2.6
1965-73.....	3.4	1.5	4.4	.9	1.9
1973-78.....	3.0	1.7	1.9	1.2	1.3
(B) Using old CEA estimates:					
1947-55.....	4.3	1.2	4.9	1.9	3.1
1955-65.....	3.5	.9	3.7	1.7	2.6
1965-73.....	4.0	1.5	4.7	1.4	2.5
1973-78.....	3.9	1.7	3.6	1.5	2.2
(C) Using new CEA estimates:					
1965-73.....	3.6	1.5	4.7	1.0	2.0
1973-78.....	3.5	1.7	2.8	1.5	1.7

<sup>1</sup> Calculated as  $(1) - \frac{2}{3} + (2) - \frac{1}{3} + (3)$ .

<sup>2</sup> Calculated as  $(1) - (2)$ .

(1) We have adjusted the capital stock for nonproductive investment which occurs because of environmental and safety standards, but we have made no explicit adjustment for increased costs of complying with government regulations which do not require additional capital expenditures but nevertheless lower efficiency and productivity. Regulations allegedly based on consumer safety are particularly onerous in this regard. Other regulations lead to more restrictive work practices, which require more labor input per unit of output; but the additional labor input does not lead to greater total production.

(2) The quintupling of imported oil prices in 1974 and the subsequent steep increase in the price of most basic raw materials have resulted in a permanent shift in the relative price structure of labor, capital, and raw materials. This has diverted cost-cutting measures from labor-saving devices to material-saving devices. It used to be commonplace to argue that of all the basic factor inputs, labor was the one whose price rose the most rapidly. For the past four years, however, wages have risen far less than industrial commodity prices and most capital goods prices. This has not particularly helped labor, as the unemployment rate soared from 4.5% to a peak of 9% and still remains at 6%, with an increase to 7% expected in 1979. Yet the switch in emphasis of cost-cutting methods from saving labor to saving materials has also played a significant role in reducing the growth in labor productivity. We have made some adjustments for this factor, but that estimate is undoubtedly understated.

(3) The structural imbalances in the economy have become more severe, particularly during the past five years. Thus the Federal Reserve Board (FRB) index of capacity utilization for primary processing industries averaged 90% in 1973, within striking distance of the previous peak of 92% reached in 1966 and 94% reached in 1953. Yet the index for total manufacturing averaged only 83% in 1973, compared to 92% in 1977 and 96% in 1953. If capacity shortages loom in finished goods industries, prices may rise, but they are not passed on through the economy with a multiplier effect. Yet just the opposite is true for primary industries. Thus in our analysis of the effects of capacity on inflation, it makes relatively little difference whether the consumer goods industries are at full capacity or not, but it matters a great deal whether shortages are likely to occur in the areas of metals, paper, chemicals, petroleum, and other basic industries. Thus we are currently near full capacity in aluminum, cement, and some paper products; and capacity utilization in the metals industry, while not yet approaching levels of maximum output, has increased markedly in the past year.

A third factor working against the Administration is that inflation has become institutionalized. Whereas a reduction in the level of economic activity used to bring quick relief for inflation, the factors built into the current economic infrastructure—cost-of-living adjustments, a larger public sector, and more government regulation—now keep prices rising long after the rate of economic activity has slackened or even declined. This pattern can be summarized by perusing the figures given in Table 5, which in fact appeared in the 1978 *Economic Report of the President*.

TABLE 5.—WAGE AND PRICE CHANGES AND UNEMPLOYMENT RATES OVER THE BUSINESS CYCLE

[In percent]

Cycle	Average hourly earnings index, manufacturing*			Consumer Price Index			Unemployment rate, wage and salary workers in manufacturing		
	At cyclical peak	2 quar- ters after trough	Change	At cyclical peak	2 quar- ters after trough	Change	At cyclical peak	2 quar- ters after trough	Change
	1948-49.....	9.1	1.9	-7.2	4.5	-0.6	-5.1	4.2	8.2
1953-54.....	5.8	2.4	-3.4	.9	-.6	-1.5	2.8	7.1	4.2
1957-58.....	5.0	3.6	-1.4	3.5	1.9	-1.6	4.6	9.3	4.7
1960-61.....	3.1	2.6	-5	1.8	1.2	-.6	5.8	8.0	2.2
1969-70.....	6.0	6.8	.8	5.8	4.4	-1.4	3.3	6.7	3.4
1973-75.....	6.6	9.5	2.9	8.4	8.7	.3	4.3	10.4	6.1

\*Adjusted for overtime and interindustry shifts.

Source: 1978 Economic Report of the President, p. 145.

As shown in this table, the first two postwar recessions resulted in an actual decline in the CPI two quarters after the trough had occurred. In the 1958 and 1961 recessions, manufacturing wages and consumers prices increased at a slower rate during the recession, although the prices did not actually decline. In the 1970 recession, the rate of inflation diminished but wage rates rose faster. Finally, in 1975 both wages and prices rose faster during and shortly after the recession than at the previous cyclical peak.

A fourth factor contributing to higher inflation has been the return of the Phillips curve. During the 1955-1970 period, a very stable relationship existed in the U.S. economy between the rate of inflation and the level of the unemployment rate in the previous year. The sum of these two figures invariably added up to eight. Thus at 6% unemployment, prices would rise 2% the following year; whereas if unemployment were reduced to 4%, a 4% rate of inflation could be expected to follow. The original theoretical work was done by A. W. Phillips of the London School of Economics, but the modification to empirical conditions in the U.S. was first undertaken by Professors Samuelson and Solow at M.I.T.

The demise of the Phillips curve during the 1971-1973 period was pinned on several factors. One was the distorting effect of controls, although most of that has now worn off. A second was the permanently higher price of energy and energy-intensive commodities. A third was the shift in the demographic mix of the labor force, which meant that the full employment rate of inflation was now closer to 6% than to 4%. Other factors mentioned from time to time included the increase in the relative price of food, floating exchange rates, higher relative costs of extracting raw materials, and so forth.

This combination of reasons actually sounded fairly convincing, and like most other economists, we assumed that the relationship between inflation and unemployment was no longer stable. However, as can clearly be seen from Figures 1 and 2, the fit for the period 1974-1978 is closer than it was during the 1955-1970. Furthermore, the correlation is even stronger when we use the unemployment rate for married men, thereby correcting for shifts in the demographic composition of the labor force, than when we use the overall unemployment rate. The transformation is complete—but at a much worse trade-off level. Instead of the Rule of 8, we now find the economy operating under the Rule of 14. In other words, if unemployment declines to 6%, as it has this year, we can reasonably expect an inflation rate of 8% in 1979. Using the married men unemployment rate yields an even higher prediction, namely 8½% inflation next year. The "79?" points on these two graphs are not necessarily our predictions for inflation in 1979—although they are fairly close to our forecasts—but rather the rates which would develop if 1979 were to remain on the same curve which has characterized the 1974-1978 experience of the U.S. economy.

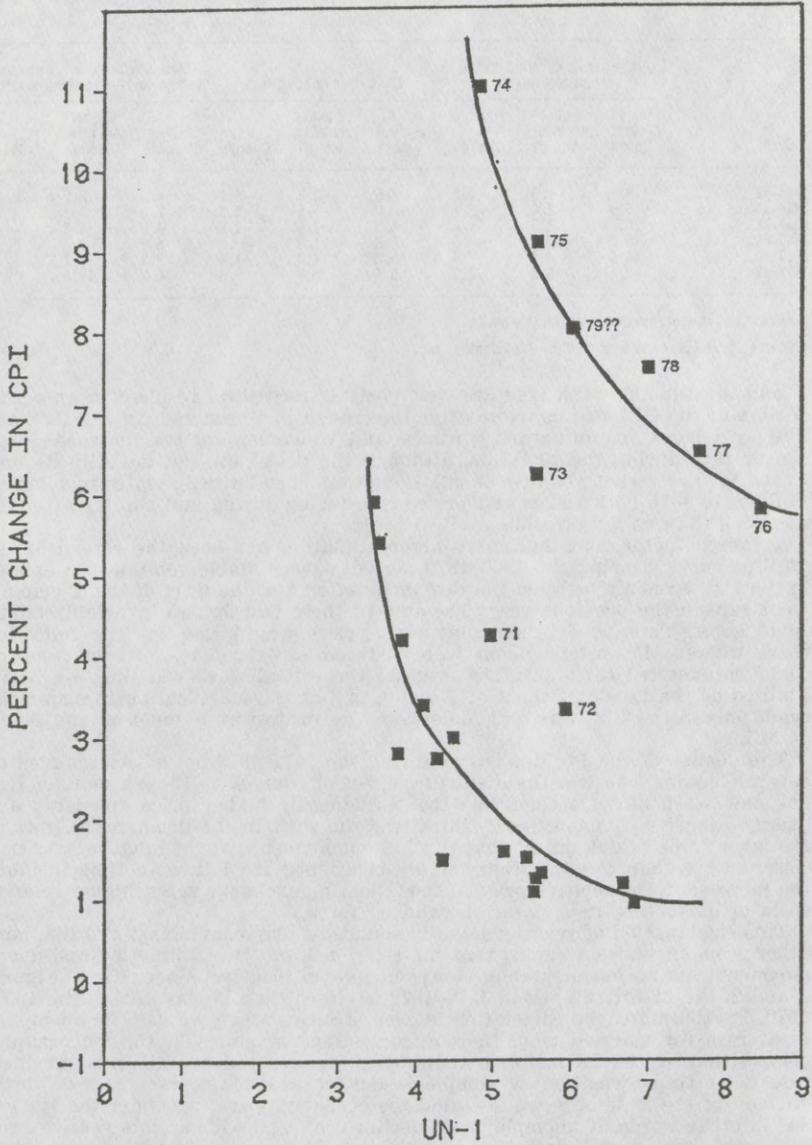


Figure 1

To summarize this section, it is clearly no simple task to reduce the rate of inflation next year. The institutionalized nature of inflation, the sluggish growth in productivity, the apparent minimal gap between actual and maximum GNP, and the return of the Phillips curve all will tend to strengthen rather than diminish inflationary pressures for the first half of the year. Yet controls offer nothing more than a short-term palliative, while worsening the disease of inflation in the long term. Furthermore, taking our medicine now in the form of a mild recession next year should reduce inflation, an option which is much preferred to continued strong growth followed by a severe downturn in 1980.

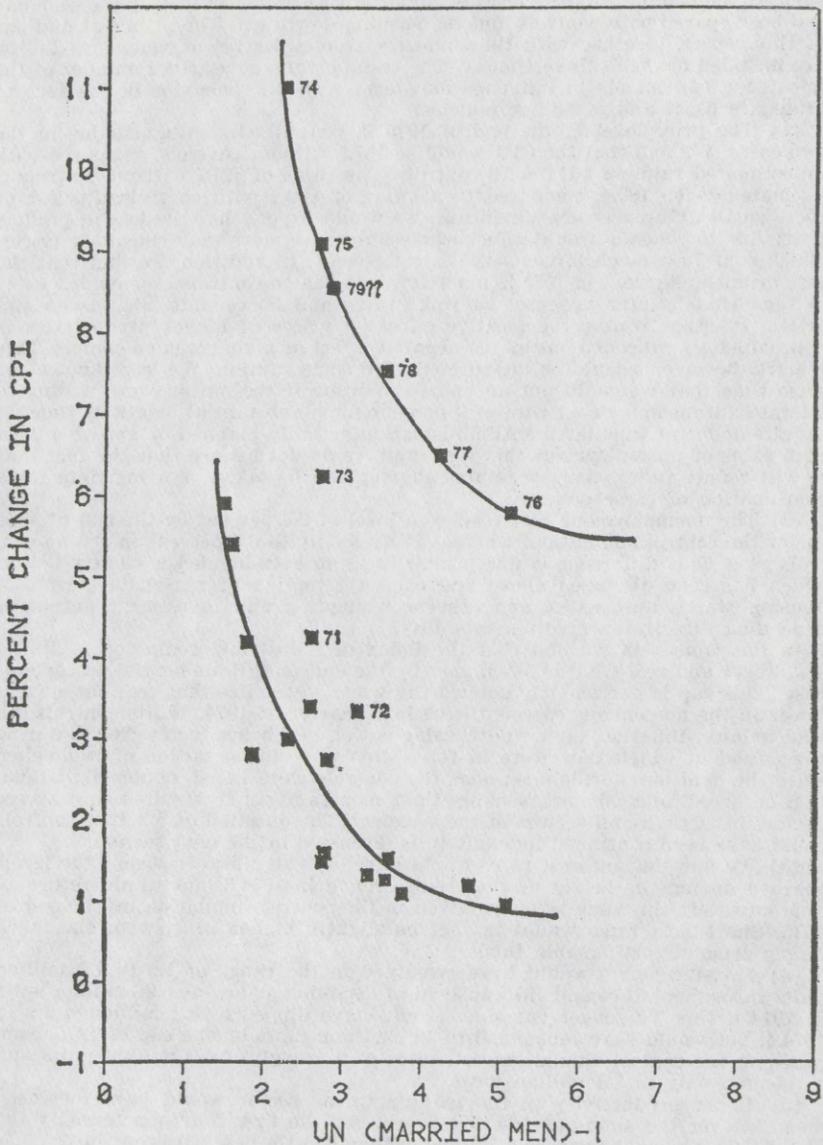


Figure 2

### III. THE EFFECT OF THE NIXON ADMINISTRATION CONTROLS ON THE U.S. ECONOMY

In March 1976, Chase Econometrics undertook a study to examine the effect of wage and price controls on the United States economy for the period from 1971 through 1975. While it is true that controls initially reduced inflation by about 2% in 1972 and 3 percent in 1973, the distortions stemming from the controls resulted in a loss of productivity, imbalances in the international arena, and tighter monetary policies, all of which contributed to the 1974-1975 reces-

sion. At the end of 1975, the level of inflation was no lower than if the economy had been spared both controls and the ensuing downturn. The principal findings of this report, together with the summary results for key economic variables, are included next in this testimony. The results stand as a grim reminder of the impotency of controls to influence long-term economic behavior in the face of profligate fiscal and monetary policies.

(1) The price level at the end of 1975 is virtually indistinguishable in the two cases. We find that the CPI would be 167.5 without controls, compared with an estimated value of 167.3 with controls. The value of WPI without controls is estimated to be 180.4, compared to a value of 180.1 with controls. Insofar as these small differences are significant, we would expect that the loss in productivity due to controls would affect wholesale prices more than consumer prices, which contain a much larger services component. In addition, we find that the rate of unemployment in 1975 is much lower in the no controls case, which leads to somewhat greater pressure on wage rates and hence unit labor costs and prices. In other words, the positive effect on prices of higher productivity is approximately cancelled out by the negative effect of higher wage demands. This remark, however, should be interpreted with some caution. We have known for some time that we could put an end to inflation if the nation were willing to tolerate an unemployment rate of 9 percent for a substantial length of time. It is quite doubtful whether the Administration actually planned or expected such high rates of unemployment this year, and we do not believe that the fact that it will reduce inflationary pressures sharply can be taken as a mandate for a continuation of these policies.

(2) The unemployment rate reaches a level of 9.3 percent by the end of 1975 under the control simulation, whereas it rises only to 6.5 percent in the no controls case. This difference is due primarily to an even-handed monetary policy, which has been discussed above and thus a retention of reasonable levels of housing starts, auto sales, and other consumption and investment purchases depending directly on credit availability.

In the same vein we find that the index of industrial production is almost 9% higher and real GNP is 5% higher by the end of 1975 under the no controls case. This gap is particularly noteworthy when we realize that real output was lower in the no controls case until the last quarter of 1974. While controls did lead to lower inflation, higher purchasing power, and hence faster growth during the period in which they were in force, this was only a facade of well-being, since the dam burst wide open once the controls were lifted, double-digit inflation occurred, and an unreasonably tight monetary policy resulted in a severe decline in virtually all sectors of the economy. The question of whether controls could have been continued indefinitely is discussed in the next section.

(3) We find that interest rates would have been significantly below the levels reached during the height of the credit crunch in 1974.3, but would return to approximately the same levels as given in the control simulation by the end of 1975. Short-term rates would in fact be slightly higher in view of the much larger demand for loanable funds.

(4) Housing starts would have remained in the range of 1.6 to 1.9 million units throughout 1974 and 1975, instead of declining as low as 0.98 million units in 1974.4. New passenger car sales would have dipped to 8.2 million units in 1974.4, but would have rebounded to 10.1 million units by the end of 1975, compared to the control simulation estimates of a trough of 6.9 million units and a rebound only to 8.3 million units.

(5) Labor productivity in the manufacturing sector would have increased steadily over the simulation period except for the first four quarters. By the end of 1975 it would have been 4.5% higher than was the case with controls.

1971.3 1971.4 1972.1 1972.2 1972.3 1972.4 1973.1 1973.2 1973.3 1973.4

<b>Consumer Price Index:</b>										
Controls	122.1	132.6	123.6	125.0	125.8	127.1	128.6	131.8	134.5	137.7
No controls	122.4	123.7	125.1	127.2	128.7	130.7	132.5	136.0	138.9	142.3
Difference	.3	1.1	1.5	2.2	2.9	3.6	3.9	4.2	4.4	4.6
<b>Wholesale Price Index (Industry):</b>										
Controls	114.9	114.8	116.2	117.9	118.2	119.0	121.1	125.4	126.6	130.3
No controls	115.4	116.5	118.3	120.6	121.4	122.7	124.7	128.8	129.8	133.8
Difference	.5	1.7	2.1	2.7	3.2	3.7	3.6	3.4	3.2	3.1
<b>GNP deflator:</b>										
Controls	142.2	142.7	144.6	145.7	146.5	148.2	149.7	152.6	155.3	158.7
No controls	142.4	143.5	146.0	147.7	149.3	151.6	153.6	156.8	159.5	163.0
Difference	.2	.8	1.4	2.0	2.8	3.4	3.9	4.2	4.2	4.3
<b>Unemployment:</b>										
Controls	5.9	5.9	5.9	5.7	5.6	5.3	5.0	4.9	4.6	4.6
No controls	6.0	6.1	6.0	5.8	5.6	5.3	5.2	5.1	5.2	5.2
Difference	.1	.2	.1	.1	.0	.0	.2	.2	.6	.6
<b>Index of industrial product, total:</b>										
Controls	106.5	107.6	110.3	113.7	116.2	120.1	123.1	125.1	127.1	127.7
No controls	106.4	107.2	109.4	113.0	115.7	119.1	120.5	122.0	123.5	123.8
Difference	-.1	-.4	-.9	-.7	-.5	-1.0	-2.6	-3.1	-3.6	-3.9
<b>Gross National Product, 1958 dollar:</b>										
Controls	747.3	759.5	771.3	785.9	797.7	814.4	834.7	839.7	844.4	851.3
No controls	746.8	757.0	766.9	781.4	793.2	807.2	822.4	825.4	829.8	837.6
Difference	-.5	-2.5	-4.4	4.5	-4.5	-7.2	-12.3	-14.3	-14.6	-13.7
<b>Prime commercial paper rate:</b>										
Controls	5.74	5.07	4.06	4.60	4.92	5.34	6.27	7.50	9.88	9.01
Noncontrols	5.77	5.12	4.10	4.71	5.09	5.56	6.49	7.72	9.70	8.75
Difference	.03	.05	.04	.11	.17	.22	.22	.22	-.18	-.26
<b>Aa corporate bond rate:</b>										
Controls	8.10	7.64	7.49	7.71	7.66	7.56	7.66	7.75	8.19	8.04
Noncontrols	8.13	7.74	7.58	7.90	7.97	7.98	8.13	8.28	8.54	8.34
Difference	.03	.10	.09	.19	.31	.42	.47	.53	.35	.30
<b>Total housing starts:</b>										
Controls	2.09	2.20	2.41	2.27	2.36	2.41	2.40	2.22	1.99	1.61
No controls	2.08	2.15	2.39	2.24	2.29	2.32	2.31	2.03	1.90	1.77
Difference	-.01	-.05	-.02	-.30	-.07	-.09	-.09	-.19	-.09	+.16
<b>New passenger car sales:</b>										
Controls	10.71	10.52	10.30	10.57	11.31	11.24	12.46	12.18	11.71	9.87
No controls	10.65	10.28	10.07	10.37	11.09	10.95	12.11	11.77	11.21	9.41
Difference	-.06	-.24	-.23	-.20	-.22	-.29	-.35	-.41	-.50	-.46
<b>Labor productivity, manufacturing sector:</b>										
Controls	5.64	5.64	5.68	5.75	5.86	5.94	6.00	6.06	6.10	6.08
No controls	5.63	5.62	5.62	5.75	5.89	6.01	6.12	6.21	6.25	6.21
Difference	-.01	-.02	-.01	.00	.03	.07	.12	.15	.15	.13
<b>Pretax Corporate profits:</b>										
Controls	85.9	86.2	91.5	96.9	99.3	107.5	120.2	126.6	123.5	123.7
No controls	87.4	90.4	95.7	101.6	105.4	113.0	121.4	125.7	122.2	122.8
Difference	1.5	4.2	4.2	4.7	6.1	5.5	1.2	-.9	-1.3	-.9

	1974. 1	1974. 2	1974. 3	1974. 4	1975. 1	1975. 2	1975. 3	1975. 4
<b>Consumer Price Index:</b>								
Controls	141.7	145.7	150.1	154.5	158.4	161.7	164.2	167.3
No controls	146.3	149.7	153.1	156.6	159.9	162.5	164.5	167.5
Difference	4.6	4.0	3.0	2.1	1.5	.8	.3	.2
<b>Wholesale Price Index (industrial):</b>								
Controls	138.8	150.4	160.8	165.7	169.2	173.4	177.7	181.0
No controls	142.0	152.6	162.2	166.4	169.5	173.4	177.4	180.4
Difference	3.2	2.2	1.4	.7	.3	.0	-.3	-.6
<b>GNP deflator:</b>								
Controls	163.6	167.5	172.2	177.9	181.8	186.0	189.2	192.8
No controls	167.9	171.3	175.5	180.1	183.1	186.5	189.1	192.3
Difference	4.3	3.8	3.3	2.2	1.3	.5	-.1	-.5
<b>Unemployment:</b>								
Controls	5.1	5.0	5.4	6.5	8.4	8.9	9.2	9.3
No controls	5.5	5.7	5.9	6.0	6.3	6.6	6.6	6.5
Difference	.4	.7	.5	-.5	-2.1	-2.3	-2.6	-2.8
<b>Index of industrial production, total:</b>								
Controls	125.7	126.2	126.0	122.0	118.0	115.8	115.3	116.8
No controls	122.1	123.3	124.0	124.9	122.4	122.7	124.4	127.2
Difference	-3.6	-2.9	-2.0	2.9	4.4	6.9	9.1	10.4
<b>Gross National Product, 1958 dollar:</b>								
Controls	834.5	829.7	825.0	805.7	790.6	783.0	786.4	798.5
No controls	825.6	822.6	822.8	817.3	811.9	813.8	823.3	837.4
Difference	-8.9	-7.1	-2.2	11.6	21.3	30.3	36.9	38.9
<b>Prime commercial paper rate:</b>								
Controls	8.35	10.50	11.57	9.09	7.39	6.36	7.56	7.41
No controls	7.87	9.11	9.41	9.96	7.78	6.94	7.86	7.90
Difference	-.48	-1.39	-2.16	.87	.39	.58	.30	.49
<b>Aa corporate bond rate:</b>								
Controls	8.44	9.41	10.36	9.69	9.32	8.78	9.28	9.42
No controls	8.49	8.85	9.32	10.02	9.07	8.85	9.20	9.32
Difference	.05	-.56	-1.04	.33	-.25	.07	-.08	-.10
<b>Total housing starts:</b>								
Controls	1.63	1.54	1.19	.98	1.08	1.26	1.51	1.64
No controls	1.90	1.91	1.70	1.61	1.70	1.73	1.72	1.61
Difference	.27	.37	.51	.63	.62	.47	.21	-.03
<b>New passenger car sales:</b>								
Controls	9.31	9.30	10.35	7.27	6.96	6.90	7.70	8.27
No controls	9.14	9.17	10.52	8.17	8.90	8.97	9.72	10.14
Difference	-.17	-.13	.17	.9	1.94	2.07	2.02	1.87
<b>Labor productivity, manufacturing sector:</b>								
Controls	6.06	6.16	6.13	6.15	6.15	6.13	6.18	6.23
No controls	6.21	6.30	6.22	6.34	6.43	6.41	6.46	6.51
Difference	.15	.14	.09	.19	.28	.28	.28	.28
<b>Pretax Corporate profits:</b>								
Controls	137.5	140.7	157.7	132.4	121.0	117.3	119.6	126.9
No controls	138.2	139.6	155.6	142.1	132.2	133.8	140.2	149.0
Difference	.7	-.1	-2.1	9.7	11.2	16.5	20.6	22.1

	1972	1973	1974	1975
<b>Consumer Price Index:</b>				
Controls .....	125.4	133.2	148.0	162.9
No controls .....	127.9	137.4	151.4	163.6
Difference .....	2.5	4.2	3.4	.7
<b>Wholesale Price Index:</b>				
Controls .....	117.8	125.9	153.9	175.3
No controls .....	120.8	129.2	155.8	175.2
Difference .....	3.0	3.3	1.9	-.1
<b>GNP deflator:</b>				
Controls .....	146.3	154.1	170.3	187.4
No controls .....	148.7	158.2	173.7	187.8
Difference .....	2.4	4.1	3.4	.4
<b>Unemployment:</b>				
Controls .....	5.5	4.8	5.5	8.9
No controls .....	5.7	5.2	5.8	6.5
Difference .....	.1	.4	.3	-2.4
<b>Index of industrial product, total:</b>				
Controls .....	115.1	125.8	125.0	116.5
No controls .....	114.3	122.5	123.6	124.2
Difference .....	-.8	-3.3	-1.4	7.7
<b>Gross National Product:</b>				
Controls .....	792.4	842.5	823.7	789.6
No controls .....	787.2	828.8	822.1	821.6
Difference .....	-5.2	-13.7	-1.6	32.0
<b>Prime commercial paper rate:</b>				
Controls .....	4.73	8.17	9.89	7.18
No controls .....	4.87	8.17	9.09	7.62
Difference .....	.14	.00	-.80	.44
<b>Aa corporate bond rate:</b>				
Controls .....	7.61	7.91	9.48	9.20
No controls .....	7.86	8.32	9.17	9.11
Difference .....	.25	.41	-.31	-.09
<b>Total housing starts:</b>				
Controls .....	2.36	2.05	1.33	1.37
No controls .....	2.31	2.00	1.78	1.69
Difference .....	-.05	-.05	.45	.32
<b>New Passenger car sales:</b>				
Controls .....	10.86	11.56	9.06	7.46
No controls .....	10.62	11.12	9.25	9.43
Difference .....	-.24	-.44	.19	1.97
<b>Labor productivity, manufacturing sector:</b>				
Controls .....	5.81	6.06	6.13	6.17
No controls .....	5.83	6.20	6.27	6.45
Difference .....	.02	.14	.14	.28
<b>Pretax corporate profits:</b>				
Controls .....	98.8	123.5	142.2	121.2
No controls .....	103.9	123.0	143.9	138.8
Difference .....	5.1	-.5	1.7	17.6

## IV. FORECASTS OF INFLATION FOR 1979

According to the latest Chase Econometrics forecast, the rate of inflation will continue to increase at approximately 9 percent for the remainder of this year and the first two quarters of 1979, but will then decline significantly to the 6 percent to 6½ percent range by the end of next year. The three principal factors accounting for this decline—none of which involves guidelines or controls—are as follows:

(1) The dollar will stabilize relative to the yen, the Deutschmark, and other strong European currencies and will appreciate relative to other foreign currencies, particularly the pound sterling and the Italian lira.

(2) The decline in the index of capacity utilization from 86 percent to 81 percent in late 1979, coupled with the sharp reduction in housing starts from 2.0 million this year to 1.5 million next year, will moderate the upward pressure on industrial commodity prices, particularly in the building materials industry.

(3) The increase in the unemployment rate to an average of 7 percent next year, with a peak of 7½ percent or possibly even 8 percent by the end of 1979, will reduce the gain in wage rates from 8½ percent in the first half of the year to about 7½ percent in the second half.

The dollar depreciated 38 percent relative to the yen from mid-1977 until the November 1st tightening of monetary policy and defense of the dollar led to a dramatic rally. Since our imports from Japan this year will be about \$23 billion, or 1.1 percent of GNP, that decline alone would have a primary impact of 0.4 percent on the rate of inflation. The dollar has depreciated 16 percent relative to a weighted market basket of Western European currencies—including the chronically weak pound sterling and Italian lira.

Since our imports from Europe this year will be about \$35 billion, or 1.7 percent of GNP, that has a primary impact of 0.3 percent on the rate of inflation. Since a conservative estimate of the multiplier of imported prices on domestic inflation is two, taking into account sympathetic upward movements in domestically produced goods and the impact on wages through COLA adjustments, this indicates that inflation is 1.4 percent higher this year than would have been the case with a stable dollar. Inflation will average 9 percent this year on a quarterly average basis, and that suggests that the underlying rate of inflation would otherwise have been 7.5 percent.

We believe that for all practical purposes the slide of the dollar came to an end on November 1st. Next year the rate of exchange between the yen and the dollar is expected to be 190, which is very close to its present level, and the DM will probably be valued at 52 cents, again almost its present level. The dollar will strengthen against the pound sterling and lira, and should show little change relative to other European currencies. This is one major reason why we expect the rate of inflation to decelerate next year.

Another major factor leading to a higher rate of inflation in 1978 has been the increase in capacity utilization for basic materials industries. In the construction industry, a surprisingly strong demand for housing all during the year plus a sharp increase in nonresidential construction will push the price of lumber and wood products up some 15 percent over the course of 1978, while the price index for nonmetallic mineral products will rise almost as rapidly at 13 percent. With the substantial hike in interest rates and the expected decline in housing starts to 1.5 million in 1979, these prices are expected to increase at much slower rates of 7 percent and 5 percent respectively. The rate of price increase is also expected to slacken noticeably in the second half of next year in the metals and machinery industries, where price increases have also been well above average in 1978.

While not all economists yet agree on the inevitability of a recession in 1979, virtually all of them do expect a significant decline from the 3.8% increase in real GNP which will be posted for 1978. We look for a real growth rate of only slightly better than 1% next year, with actual declines in real GNP during the second and third quarters of the year. While housing will bear the brunt of this decline, sales of consumer durables and capital spending will also be quite sluggish in 1979.

The third factor which is likely to lead to a lower rate of inflation is a reduction in the average wage increase from 8½% in 1978 and the first half of 1979 in the second half. In the coming months wage gains will be kept at present high levels by the current rate of inflation, generally tight conditions in labor markets, and the 9.4% increase in the minimum wage which will go into effect

at the beginning of next month. However, as these effects wear off, wage hikes will begin to moderate. The combination of slower growth in the CPI coupled with a rise in the unemployment rate to 7% by mid-1979 will have a significant impact on wage bargains. While settlements with major unions are certainly expected to shatter the guidelines with annual gains of 10% or more, these will not affect the majority of wage increases granted next year. Only 20% of the labor force is unionized, and while to a certain extent increases in the non-unionized sector follow those gains reached in pace-setting negotiations, this carryover effect is much weaker when unemployment is rising than when it is falling.

In summary, if the Administration is willing to show some flexibility and patience, inflation is likely to decline substantially during the latter half of 1979 as weaker demand, a more stable dollar, and some abatement of cost pressures combine to lessen the rate of price increase. If, however, the guidelines are applied as if they were mandatory, with sanctions and stepped-up harassment for those that do not comply, the short-term improvements garnered by such strongarm methods will eventually boomerang and result in moving the economy to an even higher plateau of inflation. For the distortions of the 1971-1974 period of controls, far from breaking the back of the inflationary spiral, have left the U.S. economy with a legacy which is still not under control.

Senator BENTSEN. Thank you very much, Mr. Evans.

Mr. Sharpe, one of the problems we have seen in wage and price controls and mandatory ones in particular, there are so many ways they can be evaded by business; by lowering the quality of the product, not carrying out some of the servicing that they have done in the past. You get a brother-in-law to become a broker, and he in turn sells it to your son-in-law. Finally, when you stay within the percentages, you run up the cost. We sure saw that the last time we had mandatory wage and price controls.

How can you talk about the effectiveness of them with that kind of experience?

Mr. SHARPE. It all depends on what you want to accomplish by those controls. I recognize and agree with you, and admit that you have all kinds of distortions with controls. If you want to stop inflation for 6 months to a year under the present circumstances—and I really think it is too late to do it in other ways—there is only one way you can do it that I can see, and that is through controls.

The important thing is what you are going to do next, and whether you can convince the public that you are going to do something useful. In World War II, I think the good will of the public was absolutely essential for the working of controls to the extent that they worked. If people don't believe in them, to that extent they are going to evade the controls. But if you do something that people believe will be useful during that period, then the 6 months or a year, I think, will not be wasted.

I am not suggesting permanent controls. I am not suggesting long-term controls. I am suggesting controls in order to break the inflation fever, the inflationary expectations, so you can do something else.

I have to express some skepticism that inducing a recession, that going back to the political business cycle, is going to do that. We will have a recession, but we will continue to have an increase in administered wages and prices during that recession.

If we have a really major depression, yes, we can break inflation that way. But I think the price is too high. So if administered wages and prices are part of the problem, then part of the answer is to get together the people who administer the wages and prices and get them

into a dialog to bring those decisions which are now made separately together; and at the same time deal with the inflationary sectors of the economy in a supply-management kind of a program so that the cost of living doesn't go up and blow up any wage and price agreement that may be reached.

Senator BENTSEN. Thank you very much.

Mr. Greenspan, you talked about and emphasized the monetary and fiscal policies. You also have talked about the relationship between Federal requirements and expenditures and programs that the States have to go ahead and carry out. I have requested the staff of this committee to try to quantify that correlation of Federal expenditures and the growth of State and local expenditures, and the cause and effect of that coming about, because I share that concern, certainly, with you.

But we have heard some policy statements that the President is thinking of holding the budget deficit to something below \$30 billion. I would like to hear your comment as to whether you think that is a sufficient reduction in the deficit, and that of Mr. Evans on that point.

Mr. GREENSPAN. No, it is not. If we describe the problem as an excessive demand on the credit markets, then a \$30 billion limit on budget borrowing of the Treasury is still too high.

I would like to see it reduced significantly more than that. I regret, however, that my forecast of what is likely to happen is going in the other direction. At this stage, it is far more probable that the budget deficit will be closer to \$50 billion than to \$30 billion. The assumptions which are implicit in the revenue estimate, which creates the \$30 billion deficit, have a relatively low probability of occurring.

Representative BROWN of Ohio. Would you yield, to ask if that is off- or on-budget?

Mr. GREENSPAN. That is on-budget. We have, obviously, substantial additional borrowing through the Federal Financing Banks.

Senator BENTSEN. What kind of figure do you think would be adequate?

Mr. GREENSPAN. At this stage, I would describe what we have to do in terms of an aggregate; in other words, bring down all the forms of direct and indirect credit coming from Federal Government activities by something in the area of perhaps \$20 to \$40 billion at an annual rate. That would include not only Federal direct financing requirements, but also the indirect effects on the private sector, State and local governments, and the mortgage market.

Senator BENTSEN. Could you comment on the size of the deficit as forecast, and its adequacy?

Mr. EVANS. First of all, I would agree with the estimate which Alan has just given. Our own is also about \$50 billion next year. That is because I perceive a much slower economy than does the Carter administration.

I think that besides looking at the deficit number, we have to look at the total—

Senator BENTSEN. You are looking on—

Mr. EVANS. This is on budgets.

Senator BENTSEN. You are looking at problems of unemployment compensation being up?

Mr. EVANS. Right.

Senator BENTSEN. And tax reductions lowered because you think the economy is going to be substantially slower than they are forecasting on the income side?

Mr. EVANS. Yes, that is correct. And I think we also need to look at restraining expenditures. What I would like to see is a commitment to have total Federal spending grow at the rate of inflation plus 1 percent a year, and furthermore, to at least have the President make this commitment for more than 1 year at a time.

I don't think the political process allows us to go back and actually cut programs. I am not even recommending that. I think if we can put the lid on new programs and hold spending even with the rate of inflation plus 1 percent over the next 3 or 4 years, that would solve the problem of excess spending. Yet the President's budget message, as far as I can interpret it, implies a continuation of rate of growth of spending of 4 percent a year, plus the rate of inflation. I would cut it back to the 1-percent figure.

Senator BENTSEN. Mr. KOSTERS, I have been proposing a regulatory budget and legislation to try to bring that about. I understand the Commerce Department is giving some consideration to it.

Mr. Kahn was favorable to that approach, to try to do something about the required off-budget expenditures that are passed on to the consumer. What do you think about trying to accomplish something like that?

Mr. KOSTERS. These expenditures, of course, are just as real as what we count as budget items or as off-budget items, even though they are off, off-budget as has been mentioned earlier. I think it is an idea whose time has come, at least from the point of view of exploring how it might be introduced.

I am not confident that we could construct a very adequate overall regulatory budget immediately, starting at this point, for, say, next year. But I do think we ought to be working in that direction.

It is a very important part of the overall claims on our resources. It is very important to get a handle on in terms of surfacing it so we can see what it is we are spending in these regulatory areas.

I think we ought to begin sooner rather than later to introduce the concept, perhaps initially on a somewhat experimental basis for some agencies.

I think that a very important contribution could be made to better policy formation in the regulatory area by developing a tool of this kind.

Senator BENTSEN. I recognize the complexities of it. We will have all kinds of codes working it trying to determine what those costs would be. That is pretty difficult.

We will have Mr. Evans at Chase Econometrics, and others, I assume, trying to work on that. We will have a great deal of disagreement. But I don't think this is something we can ignore and walk away from.

We have to have some discipline on it. The President has to change the make-up of the regulatory council. To say that you are going to have it made up with the predominance of the regulators themselves, they will hardly exercise the discipline that is necessary if they are going to have everybody trying to protect their own turf and lobbying for their own particular regulations.

Congressman Brown.

Representative BROWN of Ohio. I would like to pick up on that question, because Senator Bentsen and I are cosponsors of this legislation and we are both very much interested in it.

For instance, a scrubber on a new utility generating plant adds a certain percentage of consumer costs to get another percentage of, say, slightly cleaner air in the area.

That has an obvious inflationary impact. But is there any place in any of the econometric models or the Federal Government where off-budget—and I am glad you used that term—impact is really assessed in terms of what it has done to our inflation rates, our productivity or anything else?

Mr. EVANS. Chase Econometrics did a number of studies in this area for EPA and CEQ. We estimated some years ago the cost of regulations for environmental pollution abatement added about 1 percent a year to the rate of inflation and reduced the growth rate in productivity by about a half percent a year.

These findings have been around for a while. They were not especially well received, I believe, by the agency or the commission. But they are available.

Representative BROWN of Ohio. I would like to get the source of them because I would like to look at them. When we had the clean water legislation—I won't stand behind these figures, but something like this—to get 95 percent purity in the water would have cost a certain figure; to get the next 2½ or 3 percent would have doubled the cost; and to get the next half percent would have quadrupled that cost. So you get to the question of how much total cost do you add in regulation.

Ultimately when you get a perfectly safe, perfectly healthy work place, the cost is immense in both our productivity and competitiveness in the world to generate products that can sell in South America in competition with the Japanese and the Germans. There is also a terrific impact on inflation for all of us.

Mr. EVANS. I am interested in what you would tell us about where the economy is headed because as I understand, the Federal Reserve Bank in Dallas says of the major econometric models, yours is the most accurate. I give you that free plug. I hope to get something back from you some day. [Laughter.]

But with that in mind, I would like for you to answer this question: Is the recession of 1979, that you estimate will occur in the second and third quarters of 1979, inevitable in your judgment? Have we mismanaged the economy so badly and are the lags involved in monetary and fiscal policy so long that the recession is coming no matter what we do in the next 6 months?

Mr. EVANS. First of all, I appreciate the plug. Thank you.

But to answer the question, I think we have very little choice. A modest recession is not all bad. I think that the eleventh hour—

Representative BROWN of Ohio. That is the good news, a mild recession.

Mr. EVANS. That is the good news. The alternatives that I see are two: A more serious recession or a more serious recession. [Laughter.]

I don't really see a way out. The word "inevitable" is a very strong one. Forecasters are told on page 1, chapter 1, never to use words like

"inevitable." So I beg off on that word. But I would say it is extremely likely.

If we do use monetary and fiscal policy to pump the economy, we would run into capacity problems; then I think the roof would cave in. We would have a very severe setback.

If we try to slow the economy down any further, we run the risk of a more serious deficiency in aggregate demand. That is the other side of the bad news.

I would say that given we don't have adequate capacity, given that we have had a fiscal and monetary policy mismanagement which covered several administrations, not this one particularly, I would say we had very little way in which to escape a recession and the best we could hope for is only a mild setback.

Representative BROWN of Ohio. You said the last round of controls gave us several years of low capital formation and rotten productivity growth. You just, in effect, repeated that.

It left us with a permanently lower than otherwise capital stock and less capacity and higher inflation.

If controls are used will that get even worse?

Mr. EVANS. I would certainly expect that it would get worse; that is right. In fact, in a certain sense, controls the second time around would be even worse than the first time.

There were some well meaning people out there who didn't know how bad controls would be. But now it is pretty well established that they don't work and I think the business community would say we are going to wait this one out.

Representative BROWN of Ohio. One of the great speeches ever given before the Ohio Bankers Association was given by the Congressman in the district where they met. Unfortunately, I predicted that we never would have wage and price controls because they wouldn't work. The speech was given the night before President Nixon imposed them. [Laughter.]

This is memorable for two reasons: One is, it was a terrible prediction as to what would happen the next day and an excellent prediction as to what would happen over the next couple of years. I would like to cite those figures, but let me go on and pick up another question based on what you have just said.

I want to ask this to Mr. Greenspan, also.

Why do we always assume that monetary and fiscal policy steps have to be taken in an easy vein or a tight vein? Can't we kind of mix up the action a little? For instance, try to cut Federal spending as you have suggested, and make it a cut in total aggregate Federal demand; both off-budget and on-budget.

In other words, if we substantially cut the off-budget stuff we could afford a little higher deficit on budget. Unfortunately, however, that is now all very difficult because on-budget/off-budget costs and off-off-budget costs, which are a result of regulation, cannot be easily measured at this time.

In other words, you put on that scrubber, you require that utility to go out and borrow money to do it, that is just the same as the Government borrowing the money or making a guarantee to somebody for public housing expansion and having to cover that guarantee. It

doesn't really make any difference whether it is on-budget, off-budget or off-off-budget, does it?

Mr. GREENSPAN. It does not.

Representative BROWN of Ohio. Why can't we mix up those things and, for instance, cut spending in order to get Government out of the credit market, cut taxes to stimulate private sector growth and further productivity and tighten the money supply to fight inflation and to reduce further credit financing?

Would that provide, in other words, two tightens and one loose somewhere? Is that going to mess things up or do we have to tighten up everything?

Mr. GREENSPAN. No; in principle there is no reason why you can't have a mixed set of policies. In fact, we often do. The trouble with trying to be too subtle with mixed policies is we end up with mixed up policies.

I too often have seen those sorts of packages implemented by an administration coming up to Capitol Hill and what we end up with is the wrong part of the mix.

Representative BROWN of Ohio. You mean the Congress responds to the nice part, the good part, the political part, and does not respond to the necessary economic part?

Mr. GREENSPAN. That, unfortunately, has been my experience. But there is no question, in principle, what you are saying is absolutely correct. If we could implement it, it would certainly be a superior policy to one which is more simplistic.

Mr. EVANS. We once tried this 10 years ago now. We had a tax surcharge in 1968 and many economists predicted this would be "overkill," it would ruin the boom we were in. The Fed increased the money supply so much that the economy went up faster than it had done before. We want to avoid that.

I think if we cut taxes and spending we will have an effect on the economy and some modest tightening of monetary policy would then be in order.

If the Fed and the Congress and administration could all agree on a common goal, that would be a very spurring idea. But as Alan says, the odds for that are not particularly good.

Representative BROWN of Ohio. The administration announced its wage and price guidelines as if they were a substitute for slowing down the money supply. I raised this point with Mr. Kahn, Mr. Greenspan. He advertised you in his response. So, let me address it directly to you.

It is my impression that interest rates really have never been lower, if you take into account the inflation that we have. In other words, if you take inflation out of the interest rate, the margin really isn't that much different or it isn't that much higher.

I assume that many economists and businessmen think money is cheap and easy as a result of that. If I am right, that people are assuming real interest rates to be low, borrowing money is relatively easy, that that could blow the lid off of any wage and price guidelines, could it not?

In other words, didn't the dollar fall after the guidelines were announced and then recovered more sharply because the Federal Reserve Board took tough action? Doesn't that confirm my suspicion

that businessmen and others think that the real interest rate is not very high right now?

Mr. GREENSPAN. I think that is correct, Congressman. One way we have of testing that hypothesis is to observe the extent to which the current high level of interest rates, especially in the short end of the market, are not clearly deterring credit requirements or the borrowing needs of business.

Representative BROWN of Ohio. It might be said of individuals buying homes to some extent, although that seems to have eased up?

Mr. GREENSPAN. I think that is beginning now to change. We are getting the first signs that the high mortgage rates are beginning to deter but it is only just now beginning at these levels. But there is no question that the real rate of interest is low.

I might say that is one of the reasons why I think the expectations that interest rates are peaking out at this particular period are misleading.

Representative BROWN of Ohio. You think they will go higher?

Mr. GREENSPAN. I certainly do.

Representative BROWN of Ohio. Could I get a prediction from each of you about how high you think they might go regardless of wage and price controls?

Mr. EVANS. I think the prime rate which is now  $11\frac{1}{2}$  percent will go up  $12\frac{1}{2}$  percent. There is a 1-in-4 chance it would go up to  $13\frac{1}{2}$  percent at the peak.

Representative BROWN of Ohio. You mean before it goes over the top and drops sharply as was the case in the last recession?

Mr. EVANS. That is right.

Mr. GREENSPAN. My peak is  $13\frac{1}{2}$ .

Representative BROWN of Ohio. Do you have a peak, Mr. Kusters?

Mr. KUSTERS. I don't really have a peak. I have not made any projections, but I don't disagree with the foregoing predictions. I do think that the peak is likely to be higher the longer it is delayed and the worse the inflation trouble we experience in the meantime.

Representative BROWN of Ohio. 15?

Mr. KUSTERS. Perhaps.

Representative BROWN of Ohio. Mr. Sharpe.

Mr. SHARPE. I wouldn't dare to second-guess somebody who has a big model. [Laughter.]

Representative BROWN of Ohio. There are a lot of lines that follow that but I am not going to use any of them. [Laughter.]

What can we say specifically, Mr. Kusters and perhaps Mr. Sharpe, about how wage demands get formed?

Is it real wages people bargain for, or is it nominal wage increases? In other words, do workers take their tax rates into account when they bargain? Do they take the interest rates and fringes into account when they bargain, in addition to the cost of living and the specific percentage on how much they make per hour?

If taxes go up, for instance, how much does a firm have to pay additionally to give a worker an extra dollar after taxes? I am talking about social security taxes and the recent supposed tax reduction we had.

It seems to me that nontaxable fringe benefits are an important safety valve sometimes when we have tax changes and higher interest

rates and lower interest rates, and so forth, and that they have an impact at the bargaining table.

But as I understand from Mr. Kahn's wage-price guidelines that those fringes now are not the safety valve. In other words, when you talk about increased medical costs, you mentioned that they were one of the new high costs and yet some unions bargain for medical benefits covered by the company so that that has been taken out of the impact on the wage increase.

All this leads to the question, is it real wages or is it perceived wage increases that workers are after—in other words, nominal wage increases?

Mr. KOSTERS. Let me begin by expressing some modesty about what we know. We don't know all that much about what is it precisely that workers bargain for.

We do know that when inflation has become a more important phenomenon, there has been much more of a tendency to move toward cost of living escalators.

Clearly, prices are important, as we would expect them to be. Workers do have an interest in real levels of living rather than just nominal dollars that are depreciating in value.

Representative BROWN of Ohio. I might say when I asked the question about interest rates a minute ago, I noticed the television cameras got a lot more alert.

Apparently the interest rate is one of the common man's concern today?

Mr. KOSTERS. I think that may be one factor. For example, before the Teamsters and other unions go to the bargaining table, one of the things that they do, as I understand it, is to canvass their membership and ask them what kind of wage increases they think they ought to try for, and what kinds of other concerns they have.

I think that discussions with union leaders, with labor representatives generally, can be very useful for an administration to keep closely in touch with their concerns because it has implications, for example, for how they plan to deal with international trade policy and other policies that affect not only particular labor groups, but also other groups indirectly.

With regard to fringe benefits, at the present time, as you know, the standards set by the administration call for inclusion of all fringe benefits and wages. The treatment of fringe benefits can be important because they can be large, but also difficult to measure because it is not clear, for example, whether having a window in your office counts as a fringe benefit or not.

But what is being contemplated, as I understand it, is some change in the standards that would permit maintenance of the existing real fringe benefits, and not counting the increased costs of those benefits against the overall standard.

This might perhaps be necessary to fit a number of prospective wage increases within the standards. But it is similar to double indexing, in a sense, permitting a certain wage increase and not counting as a wage increase that part of increased costs that reflects a price increase that is included in addition.

Representative BROWN of Ohio. Mr. Sharpe, do you have any comment you want to make? My time is up.

Mr. SHARPE. You asked, What do workers bargain for? You have to take into account that we don't have one labor market; we have several. They are referred to as dual or segmented labor markets. Principally, we have a labor market in the concentrated sector and we have a different type of market in the more competitive sector.

I would say that in the competitive sector, workers bargain for what they can get, based largely on supply and demand, the phase of the business cycle we are in.

In the union or concentrated sector, they try to bargain for real wages because people do have inflationary expectations. That is part of the motivation that goes into the wage bargains.

What I have been trying to say here, if I can concentrate on one point, is precisely that the wage decision is a decision made at one time and place and the price decision is another decision made at another time and place. The Government's decision on monetary and fiscal policies is a third. An "Anti-Inflation Council," as I have proposed, is a place to come together and discuss all these decisions that contribute to inflation so that in some way the decisions can be made noninflationary.

What I think is a great tragedy is that we are embarking on a course of antigrowth policies, which is a continuation of what we have been doing for many years.

This will not solve the problem of administered prices or of bottlenecks in health and fuel or housing or food. And if we don't bring all these pieces of analysis together—such as in a budget for regulation, which I think is good, but that budget has to be brought together and looked at with all the other pieces within one comprehensive framework of analysis—we will repeat the antigrowth syndrome. We will pay the price, which I think is tragic, and we will not get any benefits.

In connection with this, to attribute to controls what belongs to administered prices, wages, and bottlenecks, the deep institutional problems that we have in our economy, I think, is to mislead ourselves. For all that I have said that controls cannot do, I think they can give us a breather and a respite.

Finally, you asked, Are people concerned with interest rates? From the people I talk to, I don't know anybody who isn't, because they are part of the cost of living.

Senator BENTSEN. If I could ask you to summarize, please, because I promised some of the witnesses they would be out of here before 12. I would like to live up to that.

Mr. EVANS. I want to throw a couple of figures on the table.

I think the wage earner is concerned about the eroding standard of living. With the increase of inflation of 7 percent and social security taxes, this means the average worker making between \$15,000 and \$25,000 a year has to get an 8.4 percent wage increase just to keep up with 7 percent inflation.

If you impose guidelines on him, he will become even more frustrated than he is presently. Fringe benefits have been growing 15 percent a year, instead of the 7- or 8-percent for wage rates. The principal reason is because these benefits are tax free.

Representative BROWN of Ohio. I ask unanimous consent and request that pages 4 and 5 and the first paragraph of page 6 of the staff study

prepared by the Subcommittee on Economic Growth and Stabilization of the Joint Economic Committee be inserted in the hearing record.

It is a reference to a study done by Otto Eckstein, who comes from a different economic philosophy quarter, in his recent book, "The Great Recession," in which he tends to confirm some of the positions taken today about the ineffectiveness of the mandatory controls used during the Nixon administration.

Senator BENTSEN. Without objection, Congressman Brown, we will place the entire staff study in the record at this point.

Representative BROWN of Ohio. Thank you, Mr. Chairman.

[The staff study follows:]

INFLATION AND DIRECT CONTROLS

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A STAFF STUDY

prepared for the use of the

SUBCOMMITTEE ON  
ECONOMIC GROWTH AND STABILIZATION

of the

JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES

December, 1978

December 4, 1978

The Hon. Richard Bolling  
Chairman, Joint Economic Committee  
U.S. Congress, Washington, D.C.

Dear Mr. Chairman:

In view of the deteriorating inflation situation, the staff of the Joint Economic Committee has undertaken an analysis of the policy options which may be considered in the coming year. One of those options -- mandatory wage and price controls -- is of particular concern to me. This section of the analysis was complete, and I am releasing it now so that it can provide background material for a hearing which the Subcommittee on Economic Growth and Stabilization plans to hold on December 6, 1978.

The study, prepared by L. Douglas Lee and Thomas F. Dernburg, concludes that wage and price controls are no solution to the policy dilemma for 1979. This study shows that controls may affect the timing of inflation by speeding it up or slowing it down, but they do nothing to permanently solve the problem. Permanent solutions may very well require permanent additions to our economic policy tools.

It is understood, of course, that the views expressed in this paper are those of the authors and do not necessarily represent the views of the Committee, its individual members, or other members of the Committee staff.

Sincerely,

LLOYD BENTSEN, Chairman  
Subcommittee on Economic  
Growth and Stabilization

After winding down in 1976 and 1977, inflation in the United States is once again accelerating. This can be seen in the accompanying table which shows the inflation rates for the economy during the decade of the 1970s. The first four columns show the growth of overall consumer prices and their three major subcategories, and the last two columns trace the growth of compensation per manhour and unit labor cost.

Following the explosive price behavior of 1974, the inflation rate decelerated in 1975 for all categories except services, with further deceleration continuing for all major components into 1976. In 1977 the rate of increase of the Consumer Price Index (CPI) once again increased, and it has continued to rise since that time. Consumer prices increased 8.3 percent between September 1977 and September of this year. Food prices are once again rising at doubledigit rates, and the cost of services is not far behind. Commodities less food remain below the 10 percent inflation rate, but they are showing a disconcerting tendency to accelerate. Underlying this acceleration is a renewed updrift in the rate of increase of employee compensation per manhour which, in conjunction with subpar productivity performance, has been pushing up unit labor costs at steadily increasing rates.

The reacceleration of inflation at a time when considerable slack remains in the economy has prompted the staff of the Joint Economic Committee to undertake a number of studies of various aspects of the inflation problem; analyzing its various causes and

TABLE 1  
 MEASURES OF INFLATION IN THE UNITED STATES: 1970-1978  
 (Annual Rates of Change)

	Consumer Price Index	Food Component	Commodities Less Food	Services	Compensation Per Manhour	Unit Labor Cost
1970	5.9	5.5	4.1	8.1	7.1	6.4
1971	4.3	3.0	3.8	5.6	6.7	3.2
1972	3.3	4.3	2.2	3.8	5.6	2.7
1973	6.2	14.5	3.4	4.4	8.0	6.2
1974	11.0	14.4	10.6	9.3	9.4	12.5
1975	9.1	8.5	9.2	9.5	9.9	7.8
1976	5.8	3.1	5.0	8.3	8.9	5.0
1977	6.5	6.3	5.4	7.7	8.5	6.5
Sept. 78 to						
Sept. 79	8.3	10.8	6.7	9.1	9.2*	8.8*

Source: U.S. Department of Labor, Bureau of Labor Statistics

\*Compensation per manhour and unit labor cost data are for the private business sector. The last figure in each column is the change from the third quarter of 1977 to the third quarter of 1978.

searching for policy options that could permit inflation to be slowed without forcing the economy to undergo the pain of recession. Among the various policy options is a return to comprehensive wage and price controls.

Senator Bentsen has found this part of the staff's inflation analysis exceedingly useful as a background paper for the December 6 hearing of the Subcommittee on Economic Growth and Stabilization, and he is making it available prior to the hearing. The following is taken directly from the staff's study.

Comprehensive wage and price controls have considerable appeal because it is widely thought that such controls can stop inflation without at the same time necessitating the demand restriction that brings recession. In theory that is correct; but in practice it has not worked that way. A review of the controls episode of 1971-74 is instructive in showing why this is the case.

In 1970 Congress provided President Nixon with the authority to impose comprehensive wage and price controls. No one believed at the time that the President would use his authority, but in August of 1971, and as part of his "New Economic Policy," he imposed a 90-day freeze on wages, prices, and rents. After the 90 days, the freeze was followed by a Phase II which continued until January 1973. Under Phase II the Cost of Living Council, the Price Commission, and the Pay Board were created to administer regulations for prices, wages, rents, dividends, and profit margins. A notable feature of Phase II was that prenotification of price increases was required of all companies with annual sales in excess of \$100 million.

Under Phase II the Pay Board set standards for wages and employee compensation. Wages and salaries were allowed to rise as much as 5.5 percent a year. Productivity was expected to grow at a rate of 3 percent, and this implied that unit labor costs, and therefore overall prices, could be limited to a target rate of 2 to 3 percent.

Phase III began in January 1973. It was designed to be a strategic retreat back to free markets even though the Government continued to set standards for price changes that, however, required only voluntary compliance. Phase IV then brought a return to mandatory controls in August of 1973. However, by this time popular support for controls had been badly eroded, and there was no way to prevent inflation from reaching double-digit levels under the pressure of the world food and energy price explosions. Phase IV ended on April 30, 1974, amid a roaring inflation. But that, of course, could not be blamed on the controls.

How effective were the controls? An answer to this question has been supplied by Dr. Otto Eckstein, President of Data Resources, Inc., in his excellent new book The Great Recession. <sup>1/</sup> Dr. Eckstein's procedure was to compare the actual history of the economy under price controls with a simulation of the economy as it would have behaved had controls not been imposed. His major findings were as follows:

. . .price controls achieved limited success in reducing inflation in 1972 and 1973; Phase I and Phase II proved to be the only effective segments of the stabilization program. In the solution without controls, the price level, measured by the implicit GNP deflator, is 1.2 percent higher by the end of 1972. Wages are only 0.4 percent higher.

By the second half of 1974 the benefits of controls are lost. In 1975 the price level is actually 0.8 percent worse in the solution because of price controls. Wages, which are strongly influenced by past inflation, are 0.9 percent higher in 1975 in the 'No Price Controls' simulation. The striking conclusion from this exercise is that the inflation experience would not have been substantially different in the absence of price controls. <sup>2/</sup>

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<sup>1/</sup> Otto Eckstein, The Great Recession (New York: North Holland Publishing Company, 1978), Chapter 5.

<sup>2/</sup> Ibid., p. 55.

To make matters worse, it appears that price controls were a major cause of the industrial bottlenecks of 1973 and 1974. To cite Eckstein's study again:

Capacity utilization is lower in the alternative (no control solution) during this period, particularly in the raw materials industries. With market forces allowed to work, excess demands are less acute. . . . Vendor performance is the proportion of companies reporting slower deliveries in any given month. Under price controls, vendor performance reached .92 in May 1973, the highest mark recorded since September 1950 during the Korean War. 3/

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3/ Ibid., p. 56.

The lesson to be learned from Eckstein's study is that price controls reduced inflation during the control period, but the subsequent catch up after the elimination of controls put the price level right back to where it would have been in the absence of the controls. Furthermore, the elimination of the controls probably contributed to the recession of 1974-75. The reason is that prices shoot up rapidly with the phasing out of controls. Without accommodating monetary expansion, this causes the real quantity of money to decline (in fact it fell 1.4 percent in 1973 and 5.7 percent in 1974), and this forces up interest rates and slows the growth of the economy. Therefore, although direct controls are often viewed as a means of combating inflation that averts recession -- because the imposition of controls means that inflation can be squelched without restrictive monetary-fiscal policies -- the shock effect of the removal of controls suggests that the controls only delay the recession, and that their removal helps to bring the recession about.

The recession could be averted if the Fed "accommodated" the price level increases that accompany decontrol by raising the nominal quantity of money by enough to prevent the real value of the money stock from declining. But this is asking the Fed to raise the rate of nominal monetary growth at a time of accelerating inflation, and the Fed has, thus far, not been willing to undertake such a radical departure from traditional monetary management. Certainly it is clear that the Fed was not willing to provide such accommodation in 1973 when controls were being phased out and inflation was accelerating. Robert J. Gordon summarizes the problem as follows:

The termination of price controls is like a crop failure, an increase in the price of imported oil, or any other supply shock in that inflation is made temporarily worse than it would have been. More of existing nominal income growth is "used up" to pay for the inflation, and as a result real output may fall. 4/

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4/ Robert J. Gordon, Macroeconomics (New York: Little, Brown and Company, Inc., 1978), p. 318.

The next controls episode, of course, will differ radically from the 1971-1974 experience. One crucial difference that can readily be anticipated is that there is a widespread belief that President Carter would use the authority to impose controls if he were provided it, whereas President Nixon was not expected to use his authority. President Carter at present does not have the authority to impose controls, and its provision would entail a lengthy congressional debate. Such a debate will very likely produce an acceleration in the rate of wage-price inflation as those with market power exercise their power to attain the highest wages and prices possible prior to the control period. This acceleration in the inflation rate will then put additional pressure on the Congress to grant price-fixing authority to the President. He, in turn, will be forced to use the authority whether he wants to or not because of the deteriorating inflation situation. Finally, and perhaps worst of all, the accelerating inflation will force the Fed to pursue an even more restrictive monetary policy, and this means that the recession will arrive that much sooner and be that much deeper.

These considerations suggest that direct controls will not help to avert recession. The anticipation of the controls will bring about an acceleration of inflation and of monetary tightness, and this will cause the recession to arrive that much sooner. Even if this can be avoided, the recession will arrive when the removal of controls brings about the price explosion that typically accompanies such removal.

The unpleasant conclusion to which we are led is that an effective anti-inflation program cannot be limited to a set of temporary "freezes" and "phases" but must be a permanent and central element of day-to-day economic policy. To cite Dr. Eckstein again:

Price controls were. . . successful in reducing inflationary expectations, a major objective of stabilization policy. A survey by the University of Michigan Survey Research Center shows that between February 1971 and May 1972, the percentage of consumers expecting prices to rise by 5 percent or more in the coming year dropped from 41 percent to 30 percent. The favorable change in price expectations had a moderating influence on wage demands. . . . 5/

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5/ Eckstein, p. 55.

The key to slowing price inflation is to slow wage inflation, and the key to that is to slow inflationary expectations. As Dr. Eckstein has suggested, the controls program did reduce inflationary expectations. The trouble is that the termination of the controls destroyed this favorable expectations effect, and the result was that no net gain was achieved by the controls program.

The evidence strongly suggests that the adoption of direct and comprehensive wage-price controls would be unwise. Controls will not produce a permanent reduction in the inflation rate unless they are permanently maintained; they will not prevent recession although they may affect its timing and magnitude; and they will produce undesirable bottlenecks and administrative costs.

Senator BENTSEN. The complexities of the problems are shown by the fact that some of the witnesses are talking about some tough monetary policies, yet at the same time talking about reducing substantially the deficit in the budget, both very meritorious.

But when you get into tough monetary policies, we have concern about unemployment and increasing unemployment compensation and the lessening of income tax, and they work against each other. It is very difficult to achieve the balance that we need in that kind of approach.

The comments this morning, I think, have been very helpful to us, and we appreciate them. We certainly have had a diversity of opinion. I think you have expressed your own particular philosophy well. I appreciate very much your attendance. Thank you.

[Whereupon, at 12 noon, the subcommittee adjourned, subject to the call of the Chair.]

[The following information was subsequently supplied for the record by Senator Bentsen:]

AMERICAN PRODUCTIVITY CENTER, INC.,  
Houston, Tex., November 28, 1978.

Re proposed voluntary standards for noninflationary wage and price behavior, 43 Fed. Reg. 51938 (Nov. 7, 1978).

Hon. ALFRED E. KAHN,  
Chairman, Council on Wage and Price Stability,  
Washington, D.C.

DEAR CHAIRMAN KAHN: The American Productivity Center ("APC") herein submits its comments in response to the Council on Wage and Price Stability ("COWPS") proposal to establish voluntary standards for noninflationary wage and price behavior. The proposal was published in 43 Fed. Reg. 51938 (Nov. 7, 1978) and invited comments to be submitted by December 2, 1978.

The APC is a privately funded non-profit organization dedicated to improving productivity and the quality of working life in America. It is the largest private, non-profit, non-partisan organization in America working with labor and management in the productivity area. With its independence and expertise, the APC is in a unique position to provide an impartial assessment of the effect the proposed wage-price standards will have on productivity. Therefore, the APC has carefully studied these standards with regard to their probable implications for productivity, and respectfully offers the following findings and modifications.\*

#### FINDINGS

As proposed, the COWPS wage-price standards could seriously curtail some of the most effective productivity improvement programs in America. This would be contrary to the goals of the President's Anti-Inflation Program and to the statutory authority pursuant to which the standards are promulgated.

As authority for promulgating wage-price standards, the COWPS relies primarily on Sections 2(c), 3(a) (4), and 3(a) (5) of the Council on Wage and Price Stability Act, 12 U.S.C. § 1904 note. See 43 Fed. Reg. at 51952 (§ 705.1 Authority). Section 3(a) (5) of the Act states in part that COWPS shall "focus attention on the need to increase productivity in both the public and private sectors of the economy."

The central importance of productivity to a lasting solution to inflation, to an increasing standard of living, and to decreasing unemployment has been recognized many times by government, business, and labor leaders. The President, the Federal Reserve Chairman, the Comptroller General of the United States and the Chairman of COWPS have all stressed the high priority of increasing productivity.

In order to further the statutory policy cited as enabling authority, and to be consistent with established national policy and with the public interest, COWPS wage-price standards should encourage rather than hamper efforts to

\* Staff with expertise in anti-inflation programs were asked to review all suggested modifications for their consistency with a controls program.

improve productivity. The following proposed modifications will remove impediments to productivity now contained in the wage-price standards without increasing the regulatory burden, or reducing the effectiveness of the program. The modifications also are designed to be consistent with the objectives of the program, and to fit into the proposed standards with minimum redrafting.

#### MODIFICATIONS

##### Proposed Modification of Section 705A-4 Profit Margin Standard:

Add:

To the extent that an improvement in profit margin can be demonstrated to be directly attributable to an improvement in productivity it will be in compliance with this standard.

##### *Rationale*

This standard acts as a disincentive to productivity improvement efforts and as an incentive to increased inefficiency. In some cases it would even prohibit productivity improvement. For example, a bank compelled by the government's monetary policy to increase interest rates would automatically be in violation if it substantially increased its productivity.

As modified, this standard would act as an incentive for increasing productivity and decreasing costs. It would not open any loopholes and would encourage voluntary compliance. It would decrease regulatory burden, regulatory lag and compliance costs by decreasing the number of exception requests.

##### *Section 705A-4 as modified*

705A-4 *Profit margin standard.* A company which does not achieve the price deceleration standards in 705A-1, 2, and 3 will be considered to be in compliance if its program-year profit margin does not exceed its profit margin base. If product lines excluded under parts 705A-6(i) (1) and 705(A)-6(i) (3) account for more than 75 percent of program-year dollar sales volume and there is no reasonable accounting method capable of establishing a separate profit margin for the nonexcluded product lines, the company is excepted from the preceding profit margin criterion for compliance. To the extent that an improvement in profit margin can be demonstrated to be directly attributable to an improvement in productivity it will be in compliance with this standard.

Proposed Modification of § 705A-9 Undue Hardship or Gross Inequities:

Add: "or negative productivity impact."

##### *Rationale*

In its current form, this section does not allow for exceptions where the standards inadvertently and unintentionally act in a manner inconsistent with maintaining or increasing productivity. Without modification, it could destroy productivity in specific instances and embodies a generally negative attitude toward productivity improvement.

The additional language, while not weakening the standards, will provide a necessary safeguard against hampering productivity and will help to create a positive atmosphere for productivity improvement programs. It will also act as a stimulant to these efforts by highlighting the Council's concern that its standards not be detrimental to productivity.

##### *Section 705A-9 as modified*

705A-9.—*Undue hardship or gross inequities.*—The Council on Wage and Price Stability may except a company from the application of the price standard, make adjustments to the base rate of price change, or alter application of the profit-margin standard to avoid extreme situations of hardship or gross inequity or negative productivity impact.

Proposed Modifications of Section 705B-6 Pay-rate Increases Traded for Productivity-Improving Work-Rule Changes:

Delete: "contractual."

Change: "alter to improve."

Add: "practice."

##### *Rationale*

In its present form, this section would bring many progressive and necessary productivity efforts to a complete standstill and undo recent progress in this area. Recent programs have tried to dispel the erroneous and detrimental beliefs

that productivity only involves the "blue collar" worker, and that productivity only means working harder and faster. In fact, productivity includes all workers, and improvements come from working more effectively. Furthermore, productivity improvement comes not only from improvements in labor productivity, but also from capital, energy, and materials inputs. This "total factor" approach requires that all employees share the responsibility for productivity improvements and should be provided appropriate incentives.

The present standard, by allowing pay above the seven percent limit only for contract labor and only for changes in work rules, inhibits efforts to stress total factor productivity. Rather, it fuels the erroneous assumption that productivity comes only from squeezing more from workers, and would have many undesirable effects; it would prohibit many productivity gainsharing plans, such as Scanlon Plans; it would be detrimental to labor-management cooperation; and it would largely prohibit incentives, direct or indirect, to non-contract labor. In short, this section is discriminatory, unfair and unjust to all non-contract labor.

This sort of unfairness erodes public support for a program that is entirely dependent upon such support for success.

As modified, Section 705B-6 will exert a positive influence by providing recognition of and incentive for productivity improvement by all employees. It will not weaken the standard but strengthen it. It is non-inflationary in every sense and will improve support of and compliance with the pay standard and with the entire anti-inflation program.

*Section 705B-6 as modified*

*705B-6.—Pay-Rate Increases Traded for Productivity-Improving Work-Rule Changes.* In determining compliance, that part of a pay-rate change that is in return for changes in contractual work-rules and practices that improve productivity will be deducted from the pay-rate change. In order to comply in this manner, it must be demonstrated that the cost reductions generated by the work-rule-practice change are equal to or greater than the excess of the pay-rate change over the pay standard.

Proposed Modification of § 705B-7 Undue Hardship or Gross Inequities:  
Add: "or negative productivity impact."

*Rationale*

Same as given above for § 705A-9.

*Section 705B-7 as modified*

*705B-7.—Undue hardship or gross inequities.*—The Council on Wage and Price Stability may grant an exception from the application of the pay standard or may make appropriate adjustments in the standard to avoid extreme situations of hardship or gross inequity or negative productivity impact.

*Proposed additions to § 705C Definitions.*

*Productivity.*—The Bureau of Labor Statistics productivity definitions, where applicable, should be used.

*Work practices.*—"Work practices" are the activities and processes associated with the performance of a specific job or group of jobs. Such practices can be identified in contractual agreements, employee manuals, policy manuals, etc., or developed informally over a period of time and accepted by employees and management as "standard" or past practice.

*Rationale*

In the proposed standards, the terms "productivity" and "work practices" are omitted from the definitions in section 705-C. Since the meaning of these terms will be crucial to determining compliance for many companies, they should be defined.

CONCLUSION

The APC strongly urges COWPS to adopt the above suggestions and is prepared to aid and assist the Council in any appropriate manner.

For further information, or specific requests, please contact Michael S. Lang at 713/961-7740.

Sincerely,

C. JACKSON GRAYSON,  
*Chairman.*  
MICHAEL S. LANG,  
*General Counsel.*

cc: APC founder companies and Members of Congress.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,  
 Washington, D.C., December 8, 1978.

Hon. LLOYD BENTSEN,  
 Vice Chairman, Joint Economic Committee,  
 Dirksen Senate Office Building, Washington, D.C.

DEAR SENATOR BENTSEN: In connection with the official record of the hearing of the Joint Economic Committee which you chaired, we would appreciate having included in the record the text of our letter of December 4, 1978 to Peter H. Lowry, General Counsel of the Council on Wage and Price Stability. This relates to the proposed wage and price standards. Several copies of the letter are enclosed.

Incidentally, you have been providing leadership in the Congress for appropriate capital recovery allowances for federally mandated expenditures for environmental and safety equipment. In my opinion, this is a bipartisan issue. The country wants to get on with the job of improving our environment and workplace safety. However, when funds for capital expenditures which will increase productivity are eroded by about 12 percent annually due to government mandated expenditures, the consequences are severe and not in the national interest. The percentage of erosion just stated does not include the large amount of funds required for maintenance and operation of environmental and safety equipment.

The Congress has addressed the problem of such capital recovery allowances but has never taken the kind of action which is required. I hope you will continue to give this subject your attention.

Sincerely,

CHARLES W. STEWART,  
 President.

Enclosure.

MACHINERY AND ALLIED PRODUCTS INSTITUTE,  
 Washington, D.C., December 4, 1978.

Re proposed wage and price standards.

MR. PETER H. LOWRY,  
 General Counsel,  
 Council on Wage and Price Stability,  
 Washington, D.C.

Dear Mr. Lowry:

We appreciate the opportunity extended in the *Federal Register* of November 7, 1978 to comment on the proposed wage and price standards which will govern the operation of the new "voluntary" control program. As you may know, the Machinery and Allied Products Institute is the national spokesman for the capital goods and allied products manufacturers. Our member companies are strong supporters of the anti-inflation goals of the President's new program.

Our statement is in two parts: First, our views in general; and second, our recommendations on some specifics.

ECONOMIC STABILIZATION AND CONTROLS

We wish to make it clear at the outset that we do not believe that controls—even of a quasi-voluntary nature—can or should be a "long-run" solution to the problem of economic stabilization. We start with the premise that, in general, controls, mandatory, voluntary, or something in between, have had a dismal track record in this country. We also start with the conviction that the capital goods and allied product sector has not been a major contributor to the inflationary spiral which is plaguing the country. Basically, capital goods firms compete in highly competitive markets and are not in a position to force general price levels upward. In short, our members are the victims of inflation, not the causes of it. Moreover, they are manufacturers of producers' goods designed to increase productivity in their customers' plants.

SOME SPECIFICS

*Base periods*

Without exception, when base periods are employed under a control period, significant inequities immediately arise. This is a built-in shortcoming of a base period approach. On the price side the Council has put in a maximum limit—9.5 percent average increase. Equity demands relief on the low side. We would

think it appropriate, for example, to introduce a minimum rule as well. For the price deceleration standard, it might be a 2-3 percent rule. For the profit margin test, it should be structured to allow firms to meet an industry average.

Accompanying these minimum safeguards, there must be a viable exception process. Our economy is too complex to be compressed into a "general guideline" on economic conduct even with "min's and max's." We urge the Council to provide a "safety valve" in the form of an exception process that can reasonably and promptly respond to inequities. For example, the Council would be notified of a company's "inequity" and the relief proposed to be taken, and then have a 30-60 day period to say "no". Following the expiration of the period, the firm, absent a specific veto or any response, could put its planned exception into effect.

On the wage side, the base period approach results in a general inequity for nonunion employees because it is retroactive. For such employees it extends back to July 1, 1978—the start of the base period quarter. This base quarter inequity has two facets. Any increases taking place after the start of the base quarter—automatic progression, salary and pay increases, promotions, etc.—count against the limitation proposed for the program year. Second, increases granted in early October before the program was announced appear to be totally chargeable to the program year and thus could force pay roll-backs to ensure compliance. We urge that these inequities be eliminated by allowing firms for purposes of wages and salary average rates to use the average pay rate of the employee unit in effect on October 24, 1978. For ease in calculating, the company could use end-of-month payroll data minus any increases granted after October 24, 1978. In many cases this would also be simpler from an accounting and administrative standpoint.

#### *Some price standard inequities*

Two serious inequities which appear in the proposed price standard are as follows:

1. *Full pass-through of any deceleration (Section 705A-2).*—This full pass-through provision makes little sense. To explain, we are told that there are no sanctions for unions who refuse to comply with the wage program so companies must go it alone with the threat of significant sanctions if they fail. Further, despite the fact that companies alone cannot guarantee collective bargaining agreements within the guidelines, wage costs above the guidelines will not be considered "uncontrollable costs." Thus, the company is expected to absorb higher labor costs imposed through the bargaining process. If this creates an erosion in profits because of the deceleration standard, it apparently is just too bad in the view of the government.

On the other hand, if a company is successful in holding down wage settlements below some totally arbitrary base level through assuming the burden of strikes and consequent loss in profit or however, it must further decelerate prices. This is the old "heads I win, tails you lose" game. The results of any success in holding down pay settlements should be the quid pro quo for price deceleration. Any other approach would fail to meet the logic of the program.

2. *Six-month standard for price increases (Section 705A-5).*—In an apparent zeal to spread out price increases and prevent an immediate "blip" in price levels, companies are asked to limit price increases during the first six months of the program year to one-half of the total price increases allowed by the basic guideline. This is highly inequitable because it does not consider when the company had its last increase, there is no restraint against full wage guideline increases occurring immediately, and, in some cases, firms contract at the beginning of the year for full-year procurements. The result will be unfair for many. We suggest the elimination of the rule.

#### *Executive compensation*

The rules as currently proposed make little sense with regard to executive compensation. Specifically, the proposed guidelines do not permit the exclusion of amounts earned prior to the base quarter under long-term incentive or deferred compensation programs. Examples of problem areas include restricted stock, stock options, stock appreciation rights, performance share/units, and other deferred compensation plans. Many of these long-term incentive bonus or deferred compensation plans are in substance contractual commitments between the company and the employee because the employee has already earned the amount yet to be paid.

We urge the Council to exclude all long-term incentive or deferred compensation arrangements, especially those entered into prior to the base period. This exclusion could be accompanied with a simple caveat to the effect that future bonus, incentive, or deferred compensation plans should keep in mind the 7 percent restraint in any change in formulas determining payout. In addition, it should be made clear that the exception is not intended to be a freeze on the status quo, but rather an expediency in terms of the inability to properly measure the pay involved. Thus, firms would be allowed to adjust plans to reflect changes in business conditions, e.g., mergers and acquisitions, and to shift the mix of pay if done within the spirit of the 7 percent guideline.

#### *Commission pay*

Commission and bonus pay present serious concerns not addressed by the proposed guidelines. In practice, these kinds of plans generate fluctuating levels of income depending in significant measure on the productivity of the individuals involved. We would urge that such plans be exempted under a general caveat that the formulas are not to be adjusted in a manner contrary to the 7 percent rule.

#### *Gross inequities*

Two areas in the pay standard cry out for immediate relief. The first is the requirement that the cost of maintaining benefits is chargeable against the 7 percent guideline. The second is the failure to exclude all government-mandated wage and fringe benefit costs from the program.

The argument for corrective action regarding the cost of maintaining benefits is well known to the Council. Given the congressional concern over the adequacy of private pension and medical benefit protection, it appears totally counterproductive to penalize employees whose employers have provided plans in these areas. We would recommend the simple approach of excluding all costs of maintaining benefits from the wage and salary calculations. This avoids any and all problems, including the timing of such payments, the requirements of ERISA and so on.

As to the second gross inequity, it appears that the exclusion for government-mandated fringe benefit costs stops short of including requirements of the new pregnancy law, the new age law, new rules under ERISA, and requirements stemming from equal employment opportunity demands. The definition should make it clear that the cost of such programs are included in the group of legally mandated ones which may be excluded from the calculation.

#### *Merit pay*

As others have noted, the rules as proposed greatly favor union employees over nonunion employees. A major reason is due to the fact that the rules do not exempt merit programs now operating in mid-stream. We would urge that companies be allowed to complete merit pay years before the 7 percent standard is considered to apply.

#### *Cost-of-living*

Another inequity between union and nonunion employees is the rule for bargaining purposes which assumes for calculation purposes that cost-of-living increases are 6 percent. We think one way of providing equivalent equity for the nonunion side would be to (1) allow a similar rule for firms paying such cost-of-living adjustments or (2) allow merit-pay pools to remain at existing levels after adjustment and recognition for changes in covered groups of employees.

#### *Calculation concerns*

On the pay side, a number of concerns arise with regard to calculating the 7 percent increase. These include:

1. The requirement to include promotions when expansion demands that new high level jobs be created.
2. Counting automatic progression for new hires.
3. The inability to adjust for changes in the mix of employees in a given unit, e.g., layoffs result in the unit having a higher proportion of higher paid employees.

We urge that the "ice cube" approach adopted for union settlements be an option for calculating nonunion increases. In other words, employers be given the alternative of tracking a specific group of jobs in a given unit in contrast to all employees in the unit.

#### *Additional observations*

1. Eximbank should not be used as an "enforcer." Eximbank is dealing with sales to foreign entities and the United States has a serious trade deficit which

is acknowledged by the President's "export program." Also, failure on the part of the firm to receive Eximbank assistance where it is necessary not only could hurt U.S. exports, but may force companies to seek financial assistance in the private sector at higher interest rates. This could create an inflationary result in the domestic economy where the higher cost cannot be passed on to the foreign purchaser.

Also, it would be inappropriate to use or try to use independent regulatory agencies to enforce the anti-inflation program. Indeed, there is a legal question involved here.

2. In public statements on the goals of the program, officials should continue to stress the modest goals of the immediate program so that expectations for early deceleration are not raised too high. Failure to do so is likely to endanger the credibility of the program.

#### CONCLUDING COMMENT

We offer the above comments not only to point out specific problem areas but also to underscore the need for the Council to be very flexible in terms of its final guidelines. Given COWPs' limited staffing, the recognized complexity of our economy, and the goal of "voluntary" compliance for the most part, it appears obvious that guidelines which cause dislocations, perverse business decisions, and unfair treatment of competitive firms will not work for long. We submit that the urge of firms for self preservation will soon destroy any program designed to force them to impose arbitrary restraints which run contra to their own long-run best interests. Given this reality, we believe the Council must find a middle ground. It must look for guidelines that will help decelerate prices while at the same time tend to restrain wage and salary actions within the 7 percent framework. A guideline which lacks flexibility in trying to achieve this delicate balance will surely fail.

We appreciate the opportunity to express our views. If we can be of additional service in the drafting of final guidelines, please call upon us.

Sincerely,

CHARLES W. STEWART, *President.*



