522

THE PRESIDENT'S NEW ECONOMIC PROGRAM

HEARINGS

BEFORE THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

NINETY-SECOND CONGRESS

FIRST SESSION

PART 1

AUGUST 19, 20, AND 23, 1971

Printed for the use of the Joint Economic Committee

U.S. GOVERNMENT PRINTING OFFICE

67-193 WASHINGTON : 1971

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402 - Price 70 cents

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THE PRESIDENT'S NEW ECONOMIC PROGRAM

THURSDAY, AUGUST 19, 1971

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

The committee met, pursuant to notice, at 10:05 a.m. in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire and Mansfield.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone, research economist; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today the committee opens one of the more important sets of hearings in its history. The President has just brought about a drastic change of course in public economic policy, one that switched the Nation from a passive economic policy to an activist one. The President has released what I have referred to as an "economic bombshell."

This committee has the primary responsibility of advising the Congress on economic policy. In view of the momentous effects that the President's program is having and will have, it is essential that we start these hearings as soon as possible.

Of course, I would have preferred that we could have had hearings at a time when members of the committee were in town and could be here, but there is no way we could do that save defer them until after September 8, and I think we shouldn't defer a matter of this great importance that long because this committee's function is to develop a record and make the recommendations in a timely way to the Congress, and, I think, to wait until September 8 when the committees that have jurisdiction over the legislation involved in this program meet, would be too long and too late.

Because the administration is still working on program plans, they have said they were not able to testify at this time. But the Congress and the public cannot afford to wait. We are embarked on a startlingly new course. This committee has a major role in bringing as much intelligence and wisdom as possible to bear on the economic problems ahead. Breaking the back of inflation and stimulating our economy in this golden 3-month period is going to require public and congressional understanding and discriminating support. Engendering this understanding is the mission of this committee.

We are interested in all aspects of the President's program and intend to explore them. But I think it is fair to say that the most crucial element, so far as the great majority of the people are concerned, is his effort to stop the upward spiral of costs and prices which has been plaguing the Nation. I might add that this is in accordance with the recommendations of a majority of economists and with the repeated urgings of the Joint Economic Committee. We recommended a program somewhat different in form and longer in term, and I expect, among other things, to explore the relation between what the President is doing or may do and the recommendations of this committee.

In any case, it is imperative that the new cost-of-living council immediately take vigorous and effective steps to carry out the purpose of the President's actions in the interest of achieving a greater stability of wages and prices. Greater stability is a crucially necessary element in restoring full employment. As I have said before, the Congress and the public are awaiting anxiously to learn what programs the administration is developing to carry out its purposes. We intend to hear from some leading economists and from several former officials who have directed wage or price programs in past emergencies.

They have a tremendous amount of knowledge and help to give us and we mean to avail ourselves of it. Later, we will also hear from leaders of labor and business and representatives of consumers and other affected groups.

The fundamental, underlying purpose of these hearings is to achieve a deeper and better public and congressional understanding of the sacrifices and burdens that many groups in our economy are going to have to bear if we are to break the back of inflation.

If we are going to achieve this extremely difficult victory over inflation while stimulating the economy, it is going to depend, above all, on the broad and deep public and congressional understanding of what is at stake and what sacrifices have to be made. These hearings are designed to develop that understanding.

I am convinced that once this is fully understood, there will be a good chance to achieve an understanding and an agreement which will make it possible to hold down price increases.

I am also convinced that without this understanding, the prospects of keeping inflation under control are extremely unlikely.

That is why, in my view, it was so important to have these hearings, to have them now, and to ask the ablest economic experts, the most experienced administrators of price control, and those with the authority and responsibility for the actions of organized labor and of business to appear before the committee.

Today we are particularly fortunate in having as our leadoff witness, Mr. Walter Heller, one of the most eminent of American economists and a man who achieved great distinction as the Chairman of the Council of Economic Advisers during the Kennedy and Johnson administrations, and as an economic statesman since that time.

Mr. Heller was the father and certainly the outstanding expert on the wage-price guidelines that helped hold inflation under control in the early 1960's.

Mr. Heller needs no introduction to the Joint Economic Committee. He has been one of the most outstanding contributors to our work over the years and, as always, we are delighted to welcome him again.

May I say that I am delighted and very proud that the majority leader has interrupted his recess to come join the committee this morning at my request, at my urgent request. This is of such great import and significance to the Congress that I felt having the majority leader here would be most helpful to us and indicative of the very great interest we have in this program.

Mr. Heller, you may proceed in your own fashion.

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

Mr. HELLER. Thank you, Mr. Chairman, Senator Mansfield, I welcome this opportunity to examine with you the historic initiatives the President took Sunday night, initiatives, by the way, for which your committee laid much of the groundwork not only by stimulating the Congress to its farsighted action in forcing the necessary standby authority for a wage-price freeze on a rather reluctant President, but also by the prophetic work of the Reuss subcommittee on cutting the dollar free from gold. Your recent program for fiscal stimulus is also right on the mark. Indeed, it points the way for Congress to bring some balance and put some real thrust into the President's lopsided and rather weak-kneed program of fiscal stimulus.

In my informal opening remarks this morning I would like to do three things: First make a few observations on the President's bold new economic package as a whole. Second, comment briefly on the wage-price-rent freeze and the floating of the dollar. Third, zero in on the President's fiscal package on which I believe the Congress has a great deal of work to do, not merely in responding to the President's initiative but in adjusting the package so that it will have more thrust and better balance.

I referred a moment ago to the historic nature of the President's about-face on economic policy, his economic trip to Peking, if you will. And it is historic. The economic world will never be quite the same again. Floating the dollar really pulls out the linchpin of the world's monetary system, and inevitably puts the world on a new, and I hope, more flexible monetary course.

And the first peacetime wage-price freeze in our history means that business and labor and the consumer are on notice that the Government is going to be a price-wage watchdog from here on out. We have added to our traditional fiscal and monetary weapons against inflation the big stick—not always the fact but always at least the threat—of direct intervention in private wage-price decisions. That is a major change, not just in this administration, but in the basic setting of economic policy from now on. No economic calculus of the future can ignore that.

Sunday night, the country heaved a huge collective sigh of relief that the President was at long last biting the economic bullet. Indeed, he deserves high marks for his courage and his logic in floating the dollar, clamping on a temporary wage-price-rent freeze, and reversing himself on the tax stimulus to put more starch into our wobbly recovery.

But now that the initial euphoria is wearing off a bit, the country is also saying "you know, that was great for openers but where do we go from here?" And that is why your Joint Economic Committee hearings are so timely and so vital.

The President's blockbusting initiatives are just that, intiatives. They open doors that the administration had kept securely locked for over two and a half years. But now that they are open, what next?

In addressing myself to that question, I don't intend to be a carping critic today—no carping criticism, just constructive criticism, and I hope that you will discern the difference.

Never mind that two and a half years of hands-off economics and an economic game plan that was more talk than action had a lot to do with the economic fix we are in, with the conversion of the "economic mess" the administration inherited into an economic crisis that was catching up with us this summer.

Never mind either that the President's rhetoric isn't really consistent with his logic. In effect he has told us the patient is doing fine, so we are going to operate. But actions do speak louder than words. The President has moved from a do-nothing to a do-something policy, from a no-no to a go-go policy, and that alone is enormously important in terms of its potential for consumer and taxpayer confidence.

But the critical point now, I repeat, is to recognize that these bold initiatives are only first steps to cope with the three-ply crisis of a faltering recovery, of a vicious price-wage spiral, and a teetering dollar. The White House, the Congress, and the country are going to be judged not so much by what the President did last Sunday as by the followthrough, by what is done to capitalize on the new options and opportunities that he so unexpectedly opened up. Let me illustrate that with some specifics in the international and wage-price field.

In the international field he set the dollar free unilaterally and without consultation. Now that lanced the boil. It took the unbearable immediate pressure off the dollar. Economists and financial observers—throughout this country, at least—almost universally applaud the floating of the dollar. But now we have to go into multinational full consultation to convert that action into a more lasting and more flexible adjustment of the dollar to other currencies. We must make full use of the golden opportunity that he has created (perhaps that wasn't quite the right adjective) not simply to rejigger the fixed parities but to set the world monetary system on a new course of automatic and elastic adjustment—of wider bands and a broader currency base—that will end the periodic crises that have bedeviled us over the past 10 years in particular.

Or take the wage-price-rent freeze, that surprising shock treatment. We needed that, but what comes next? After the shock therapy, do we slide into a straight jacket of direct mandatory controls because of inadequate planning or impatience with some of the reactions to the freeze or the messiness of a voluntary freeze? Or do we, as I would prefer, use the time and the leverage that the President's hasty but courageous freeze order has given us to develop, not a binding straight jacket of controls that fastens a huge bureaucracy on us and erodes our economic freedom, but a set of carefully thought out wage-price tranquilizers that will replace the wage-price freeze with wage-price moderation?

And here again the President has laid the groundwork. But there is not a moment to lose, it seems to me, in getting labor, business, and public representatives in this country to hammer out some kind of a social compact, some kind of ground rules, some kind of a plan for a wage-price review board, not mandatory controls, that can replace the freeze once the 90 days are over. Ninety days is a terribly short time. The President and his advisers should be spending virtually full time on phase two.

We are already seeing what a Pandora's Box direct controls open up. Just consider, for example, teachers who are unlucky enough to have their salary increases go into effect on a 9-month or 10-month basis—they are frozen out—while those who are paid on a 12-month basis are frozen in. Or when is an egg or a soybean or honey a raw agricultural product and when does it become a processed food, and who gets squeezed when one is controlled and the other isn't? Or consider the hassle over pro football salaries. Imagine the Government permanently in the business of deciding all of these slippery and often almost ludicrous questions.

It is going to be an extremely informative lesson to the public to see the potential for massive bureaucracy and eventual corruption implicit in trying to fasten a full-fledged system of controls on this enormous economy.

Now, let me turn to the program for fiscal stimulus because that is where the program the President announced last Sunday leaves most to be desired. His tax program and budget program are heavily biased against the modest and low income families. In putting its big chips on business and investment when it is the consumer who needs the stimulus, his program as it stands is strictly cart-before-the-horse economics. If the Congress does not bring more balance and stimulus into the President's tax and budget program, more relief for the little fellow, I am afraid that what the President gains in the swings he will lose in the round-about. What he gains in the intangibles of consumer confidence and at least temporary relief from the inflation bugaboo he may lose in the specifics of his wrong-side-to fiscal program.

Let me get to the specifics. Look at, first of all, the tax relief for business. Earlier this year, by Executive action, the President put into place new accelerated depreciation rules that are worth about $4 billion a year of tax savings to business. Now he is proposing to superimpose on that $5 billion more of relief for business, at least in the first year (cutting it after that to $2½ billion a year).

That is $9 billion of immediate relief for business. That is raw meat for business, and the consumer gets little more than a soupbone.

He gets an acceleration of higher exemptions and standard deductions, which is worth some $2½ billion for 1 year. He gets relief from the automobile excise tax in the save-Detroit part of the program. Granted, that is another $2½ billion, but only those who can afford to buy a new car will get any direct benefit.

Also, let me note that I agree with Allen Otten's column this morning in the Wall Street Journal which says that in a day and age when we are trying to fight pollution, when we are trying to get some of the emphasis away from that great American symbol, the automobile, it is somewhat curious to focus the most effective job-creating part of the President's program on that part of the economy. And with your permission, Mr. Chairman, I would like to enter Mr. Otten's column in the record.

Chairman PROXMIRE. Yes; that was an excellent column, I read it, and without objection it will be put into the record following your oral statement.

Mr. HELLER. Both from the standpoint of fairness in taxation, and from the standpoint of consumer sluggishness as the key to our slow recovery, the President's fiscal program is wrong-side-to. Let's review the numbers. He has $9 billion of tax relief this year for business (coupling those two measures, the accelerated depreciation and the investment credit). He has about $2½ billion for the general taxpayer (plus the auto excise repeal). Then, in a rather contradictory move, he offsets a very considerable part of the new stimulus with budget cuts in the areas that hurt the little man most, especially the postponement of welfare reform.

It seems to me he should have done exactly the opposite with the welfare program. As part of a recovery program focussed on the consumer, the fellow we need to stimulate, he should have tried to accelerate that program rather than delay it for a year. The disadvantaged and lower income population of this country, as they look more closely at the President's fiscal package, could be forgiven for saying, "It looks to us as though there is a big boon to business and a big boost to the automobile industry at our expense." This is where the Congress surely has a great deal of work to do.

Look at the economics of it. Less than 75 percent of our operating capacity in manufacturing is being used today. Somewhere between 25 and 30 percent of that capacity is idle. Under those circumstances, good economics would say, get the consumer back into the marketplace, get him to increase his spending and thereby turn the wheels of industry faster. As unused capacity falls, higher investment in machinery and equipment and new plants will surely follow.

Now some might say, but won't that touch off inflation? Mr. Chairman, we have today a $70 billion deficiency of aggregate demand. We have not only broken the back of demand inflation, we have killed it. Demand is running $70 billion below the capacity of the economy to produce. At the same time, cost-push inflation is abating. That is to say, last year average hourly compensation rose some 7½ percent, offset by less than 1 percent increase in productivity per man-hour. This year the increase in average hourly compensation may again be about 7½ percent, but it is offset by 3 or 4 percent in productivity per man-hour.

So the major inflation thrust that's left is exceptional. And Mr. Nixon's program should help break the psychology or psychosis of inflation. So it doesn't make good economic sense to be so niggardly with the consumer. His stepped-up spending will, under these circumstances, express itself mainly in more output, more jobs, more income, and not in higher prices. So both in equity and in economic terms, the President's fiscal package is lopsided.

How can the Congress redress the balance? Using last weekend's Joint Economic Committee proposals as a point of departure, the Congress might readjust the President's program—in pursuit of his own laudable objectives—as follows:

No. 1, substitute the investment credit for liberalized depreciation. That depreciation revision is already tied up in the courts so it is not having much stimulative effect on investment. Even at best, it is very slow acting while the tax credit operates quickly. And to undercut and compromise the long-run productive power of the revenue system by $7 to $9 billion, as the combined depreciation and credit provisions would do, is indefensible in the light of the Nation's aching social needs.

Two, having saved $4 billion a year of permanent tax revenue by dropping the depreciation giveaway, give the individual taxpayer an added $2½ billion of one-shot tax relief by backdating the full 1972 and 1973 exemption and standard deduction increases to July 1, 1971. No reason that can't be done by cutting withholding rates quickly and issuing refunds early in 1972. The added stimulus would be fast, widespread, and right on target.

Three, by all means do what the committee has recommended, postpone that onerous increase in payroll taxes for social security purposes that would otherwise go into effect on January 1. That is a whopping tax increase of $5 billion or more. It has no business going into effect in an economy that is struggling hard to recover lost ground.

Four, enact welfare reform without delay.

I might underscore what I regard as a key characteristic of these proposals: They sharply step up the economic stimulus of the fiscal package without undercutting Federal tax revenues in the longer pull. Indeed, $4 bililon annually of those revenues would be preserved by dropping the depreciation bonanza.

I would summarize by saying once more that we can welcome the President's bold economic initiatives; they are a great relief. They put us back in the driver's seat, internationally, and start us back toward the right course, domestically. The fact that the President has grasped the nettle can help restore consumer confidence and change expectations, especially if the followthrough is prompt and balanced. But the followthrough is vital. And in particular, the fiscal provisions for stimulus of the economy are seriously deficient and urgently need correction in the course of congressional consideration.

(The article referred to in Mr. Heller's oral statement for the record follows:)

[From the Wall Street Journal, Aug. 19, 1971]

POLITICE AND PEOPLE—AUTO-INTOXICATION

(By Alan L. Otten)

WASHINGTON.—This column is dedicated to the proposition that at least one part of President Nixon's dramatic program—repeal of the 7% auto excise tax—may be great economics but is nonetheless very poor public policy.

The President's purpose is clear enough: By lowering car prices, to stimulate auto buying and thus expand employment in the auto industry, and all the auto industry's supplying system—steel, glass, tires, plastics, textiles and the rest. Early reaction suggests this probably is precisely what will happen.

Auto executives in Detroit hail the move: they see a strong surge in sales; interviews with the man-on-the-street indicate that a good many Americans indeed now plan to buy new cars they otherwise would have done without or at least delayed purchasing. The stock market stamps the final seal of approval on this analysis, with healthy gains posted for General Motors, Ford, Chrysler, even American Motors.

Yet couldn't President Nixon have found some better way to stimulate the economy? Aren't more cars just about the last thing the country needs right now—more congestion, more pollution, more accidents?

More cars inevitably mean greater pressure for more highways, already cutting too wide a swath through the central city and the countryside. Senate

Finance Committee Chairman Long broaches the thought that only part of the excise tax be lifted, and the rest be earmarked for new road-building. More cars need more parking space in the cities, wider-sprawling shopping centers in the suburbs. The drive to pave the nation highballs along.

Some continued movement in this entire direction is probably inevitable anyhow, as the nation's population continues to expand and as rising standards of living make car owners out of poor families that couldn't afford a car before, make two-car families out of one-car families, and even three-car families out of two-car ones. But why artificially stimulate the process? There's always the chance that somewhere along the way the nation may come up with more reasonable answers to the problems of getting from here to there.

Eugene McCarthy, the cynical poet-philosopher of the Democratic Party, views the country's auto-mania as merely the latest evidence of the classical theme of "whom the gods would destroy, they first make mad." In a recent New Republic article outlining his own suggestions for handling current economic problems, Mr. McCarthy complained that "much of what is being produced by the American economy does not satisfy real human needs." He cited military and space spending, and then zeroed in on Detroit.

"A comparable waste in expenditures by the federal government, at least in the short run, is the highway building program," he wrote. "As a matter of fact, the whole automobile industry is extremely wasteful. Most of the automobiles are one-third to two times larger than they should be; they use more fuel than they should; they contaminate more than they should; they take up more space than they should, both in parking and on the highway; and, of course, in their construction, more material than should be are used.

"This industry, more than any other, competes with military expenditures and with war for materials, manpower and finances. If Marx had known about Detroit, he probably would have written another chapter in which he would have suggested that in order to stimulate the capitalistic system, one could use either war or the automobile industry."

Mr. Nixon's program may not only result in many more cars but also in many more big ones. His new surcharge on imported goods applies to foreign cars, and, by boosting their cost, will dramatically reduce, if not eliminate, the competitive advantage these imports have enjoyed over American cars. With this element of foreign competition removed, may not Detroit's current enthusiasm for producing its own mini-cars vanish?

There's no question that it was increasingly successful sales by Volkswagen, Toyota, Fiat, Datsun and other small foreign models that finally persuaded American car makers to give up their complete preoccupation with what George Romney used to call gas-guzzling dinosaurs and to begin making a few smaller models of their own. They say they are now firmly committed to continuing with the Pinto, the Vega, the Gremlin—but are they really? Once before, U.S. car makers moved toward the smaller car, with the Falcon and Corvair and the rest; then, gradually, the cars started growing again.

The Administration has been at considerable pain to convince reporters that it did not act precipitously—that debate over new economic policies had been under way for several weeks, that a wide range of contingency plans had been in the works, that alternatives were weighed most carefully by the President and his advisers meeting at Camp David this past weekend.

If this is true, must there not have been some slight discussion of other, and possibly better, ways to stimulate the economy—steps to spur spending on bus and rail mass transit systems, for example, or to build more low-income housing or clinics and other new-type medical care facilities? Or, now that there seems to be a surplus of teachers, a plan to hire more of them for a crash teach-the-nation-to-read program?

Administration economists are sure to argue that the need was for action that would take effect in a hurry, and that little else would have as much impact as quickly as a real spurt in auto sales. Even putting aside the question of whether this should be the only basis for decision, is it necessarily true? Applications by cities for government help to buy buses and other mass transit equipment, for instance, are many times the money the Administration is alloting for this purpose. Might not more dollars for mass transit have resulted equally promptly in very specific buying orders? General Motors does make buses, as well as cars.

Obviously a verdict to let U.S. car makers slog along with lackluster sales might have involved some hardships for auto workers, auto dealers, auto suppliers. Yet the White House in the past stood firm on a wide range of decisions to trim military and space spending, and these decisions certainly pummeled those industries badly.

"I just wish there were some way we could stimulate this economy without ramming more autos down the nation's throat," a high-ranking economist in the Johnson administration said a few years back. It's a nice wish, and some day some administration is going to have to turn its attention to doing something about it.

Chairman PROXMIRE. Well, thank you very much, Mr. Heller.

As I understand it, you have enthusiastic approval for the action of the President to freeze prices and wages; you think that was a constructive beginning toward an anti-inflation policy.

You favor very much cutting the dollar free from gold and devaluation; you think that is also constructive. But you think the stimulus to the economy is too lopsided, one sided, in favor of business and not for the consumer and especially the low-income people in our economy.

Let me ask you first with respect to this freeze, you indicated that the Federal Government during this 90-day period is going to, is likely to, have to get into some ridiculous situations with all kinds of people who have inequities, and there are inequities involved. Would you agree that it is very important for the administration to follow a policy as much as they possibly can of virtually no exemptions, of holding firm on exemptions? I have in mind the statement by Secretary Connally this morning in answer to Secretary Laird's position saying that in his view the increases for the Defense Department, people in the Defense Department, should follow exactly the same rules as everybody else, no increases for them just as there should be no increases for other Government workers or other workers during this 90-day period. Would you agree with that?

Mr. HELLER. I would agree with that. If you are going to make a freeze work with only a handful of people to ride herd on it, it has to be primarily voluntary, so in these 90 days, the less exemptions the better. The feeling that everybody is taking the rap, so to speak, on the wage and price and rent freeze is very important to the success of holding the line these 90 days.

Chairman PROXMIRE. Now, how long can this kind of a freeze be maintained? One of the arguments against wage-price controls that has always been persuasive with me is that it immobilizes, paralyzes resources, they can't flow into areas that they should, it interferes with the efficiency of the free enterprise system. It prevents people from rewarding those who are working hard and doing a good job except by promotion, they cannot be rewarded in other ways. You can't have the useful adjustment in our system which other systems suffer because they don't have them. So how long can we in your view—after all, we are moving in, we hope, to relatively a peacetime situation—how long could we maintain this freeze productively on the assumption that it may have to go more than 90 days?

Mr. HELLER. We have to strike a compromise between the considerations that you just listed—that you do begin to get not only the inefficiencies in the freezing of resources but the longer it is in effect the more chafing, chiseling, and cheating you are going to get—and being sure we have enough time to develop a substitute for the freeze, and I mean a believable substitute.

Let me underscore that, Mr. Chairman. Unless we develop a very different attitude than the President has taken to date about laying

White House prestige on the line in this field—and that means a not very popular position for the President to take vis-a-vis the directly affected industries and labor unions—together with an effective wage-price review board that has subpena powers, powers to suspend price and wage increases (but not powers to penalize and put people in jail) that is, unless we develop a policy that carries conviction with the public, we will not have accomplished the second half of the objective of the wage-price freeze. The first half is the shock treatment, and I think that is very much needed to break our inflation psychology.

But the second half is to keep those prices and wages from bubbling up, jumping up, bouncing back the moment the price freeze is over, and that is going to take some very difficult political and social engineering.

Chairman PROXMIRE. It is very interesting emphasis you put on the administration's attitude here. I would agree with you that the administration deserves a great deal of credit, is was a courageous action. At the same time, to be realistic, we have to recognize this administration until 9 o'clock Sunday night very much opposed this whole program and has repeated for years now that this kind of approach, control approach, incomes policy approach, would not work; that it never worked in the past, that it won't work this time. The Cost of Living Council consists of people who, by and large, have publicly stated that view. So under these circumstances it seems to me that some kind of vigorous constructive criticism and proposals from other sources, from economists such as you are, from the Congress, are most timely and appropriate.

Let me just run over a quick list that I have here of the various——

Mr. HELLER. May I interrupt to say——

Chairman PROXMIRE. Yes.

Mr. HELLER (continuing). That while the President has up until now opposed this kind of action, one must hope that this was a true conversion. Recently, I had a letter from one of my former professors who said, "You know, when you preach the gospel you must welcome all sinners who come forward." Since the President has come forward, we should accept his conversion and not have too many caviling doubts and carping criticisms. Let's give him a chance.

Chairman PROXMIRE. Henry Reuss, I think, said this was the most dramatic conversion since Paul was on the road to Damascus. [Laughter.]

Mr. HELLER. He topped me on that one.

Chairman PROXMIRE. Well now, in developing this mechanism, should it have the following attributes? Let me take each one of them and you might comment on it. No. 1, should it focus particularly on those industries and unions where the inflationary increases have been most out of line with productivity or must it be broader? I know you took this into account when you developed the way that the wage-price guidelines worked from 1962 on.

Mr. HELLER. Perhaps I should say a few words about the philosophy of thet wage-price guideposts as we visualized them at that time, because that will provide an answer to your question.

We have a market system on which the vast majority of economists feel we should basically rely. It is in effect a huge, impersonal computer, a cybernetic system that processes enormous amounts of information, passes it on through from the consumer to the retailer, the wholesaler, and the processor or manufacturer, and does so without any overall human direction. Except for prevention of abuses, we ought to rely fundamentally on that process instead of getting into this morass that we have already illustrated with the ridiculous questions and problems that are being raised by the wage-price freeze.

However, there are areas in which the competitive system clearly doesn't work very well. There are areas in which big business and big labor units have excessive market power. Such units, in effect, distort the working of the competitive economic system. The wage-price guideposts focused particularly on these noncompetitive or imperfectly competitive parts of our economic system, pressing them, in effect, to behave competitively—pressing them to set wages and prices at the lower end of their range of discretion.

The standard used to gage their actions was the national average increase in productivity, just over 3 percent a year. Wage increases that substantially exceeded that standard were prime objects of the policy. And where price increases were not justified by rising unit labor costs, they were challenged. Or if an industry's productivity was rising faster than average, price cuts were expected. This is essentially the way competitive markets work. So any new wage-price standards or ground rules that might emerge from the 90-day freeze would be an attempt, not to overthrow and substitute for competition, but to stimulate and maintain it. It is in that light that it ought to be acceptable to people who believe in the market system.

Chairman PROXMIRE. I just want to see if I am correct. During this period, during this period from 1962 to 1965 at least we had virtually stable wage costs in manufacture, and I think any kind of analysis of the situation then when we had diminishing unemployment, growing demand would have to give some credit to the wage-price guideline system that you championed and that was in effect.

There have been already, we have in the newspapers this morning, reports that this freeze may be beginning to break apart at this point because of labor protests.

Do you feel that from the very beginning that this kind of a program not only in the period after the freeze when we work out some kind of an agreement or understanding, that during the freeze we should have the full participation of the labor and business group subject to guidelines? I think without that full participation, and here one is going to need some very positive Presidential leadership because this is extremely tough and delicate—every country that has tried this has found that getting that cooperation is very tough indeed.

But you do have to have both labor and business participation, or the program is doomed. If you fail to get that cooperation, then direct controls, mandatory controls are not far off, and then we give up an enormous amount of economic freedom of action the moment those controls are put on.

Senator Mansfield.

Senator MANSFIELD. Mr. Heller, I am glad to have the opportunity to appear with the distingushed chairman of this committee at his request because the question under discussion is one which without a shadow of a doubt affects every American today and certainly the monetary future of this country.

For some reason or other the word devaluation seems to be seldom used but isn't it a fact that as inflation goes up the dollar is devalued as a result?

Mr. HELLER. As long as our inflation, especially as it hits the cost of our exports, exceeds that of other countries you are absolutely right. As U.S. inflation outstrips inflation in other countries, as it goes up, the value of the dollar goes down. I am assuming, Senator, that you are asking me in the context of the international position of the dollar.

Senator MANSFIELD. And the domestic position.

Mr. HELLER. Domestically, of course, as inflation goes up the value of a dollar automatically goes down.

Senator MANSFIELD. The reason I bring up the question is that the word seems to be taboo, but as long as you have got inflation you have got dollar devaluation, as I understand it. I am not an economist but at least I can understand prices going up, my wife does, too, I can understand unemployment increasing as well.

Is it true that at the present time we have approximately 6-percent unemployment, quantatively about 5.3 million of our people unemployed?

Mr. HELLER. Something like 5 million of visible unemployed who are looking for jobs, and somewhat over a million invisible unemployed who got discouraged and have gone out of the labor market, so I think you could safely and sadly put that figure above 6 million.

Senator MANSFIELD. And would you include in that figure the underemployed?

Mr. HELLER. Indeed.

Senator MANSFIELD. And is it correct to state that the rate of inflation at the present time is somewhere on a yearly average in the vicinity of 5 percent and based on the averages of the last 2 or 3 months around 7.2 percent?

Mr. HELLER. Yes; I hope the last 2 or 3 months are not representative, and 5 percent, or a little less, is closer to the mark as to the rate of inflation.

Senator MANSFIELD. Can you think of a more important, significant question facing the American people today than the question of inflation?

Mr. HELLER. Not in terms of our economic malaise, especially in the face of such high unemployment. The problem of inflation is not only severe in terms of its being a pickpocket. It is severe also in terms of cutting back the pace of our recovery because the consumer has stayed in his shell partly because of that inflation.

Senator MANSFIELD. In other words, generally speaking, no one can escape its effects?

Mr. HELLER. That is right.

Senator MANSFIELD. I listened with interest to the President the other night, Sunday night, and before he started to speak I made a few notes on my own as to what I would wish that he would discuss. They are very rough, a price-wage board now; wage, price, rent, profit controls now: a cutback in overseas bases which number almost 2,000, and troops which number, counting dependents, in Western Europe well in excess of 500,000, both of which take a great deal in the way of appropriations and expenditures on the part of this Government. Also profit sharing, dividends, interest rates, and bonuses.

Some of those questions I raised at the meeting which the President had at the White House on Tuesday last. I raised the question, along with at least one other Senator, perhaps two, what about the question of interest rates? Why aren't they being frozen?

The answer was that consideration was given to such a proposal but that in doing so you might freeze them and there would be no chance for a decrease in the interest rates.

We were informed that on Monday interest rates declined from somewhere around $6\frac{1}{8}$ percent to about $5\frac{7}{8}$ percent, those are approximate figures. That on Tuesday they were still decreasing, still going down, and what happened yesterday I don't know or what is happening today I do not know.

Mr. HELLER. They continued to go down.

Senator MANSFIELD. They still are going down. Do you think there should be be a freeze on interest rates in view of the fact that this voluntary reduction has taken place?

Mr. HELLER. The interest rate problem, Senator Mansfield, is a very tough one. The desired result, of course, is that while you put a freeze on wages and prices and rents, you hope that interest rates will melt, will come down. This would result, first, from a breaking of the inflation psychology. Second, it could be helped by the fact that you free up the Federal Reserve for a more independent policy. It has had to carry much too big a burden so far. The Federal Reserve had to take on the main burden of stimulating the economy and it has also had the main burden of avoiding inflation, always with an eye cocked on the international situation at the same time.

Given this kind of situation, there is a lot of merit, it seems to me, in the administration's position. They did not want to run the risk of freezing interest rates at these high levels—unfortunately, that does tend to be the result in a freeze, prices tend to move toward the ceiling.

They are seeking two results really. First, the breaking of the high interest rates, and so far the portents are good—though it's too early to tell whether the dip in short-term rates will hold. A lot of people seem to be parking their money temporarily in these short-term instruments. So there has been an ample supply of such money, and we can't yet make a determination of what is going to come of that.

Second, if you are to have a flexible monetary policy, if you are to have a Federal Reserve policy that can now adjust better to the ebbs and flows of the economy, you ought to be in a position both to raise and lower interest rates as needed to keep the economy on an even keel. So I would concur with the administration in not clamping a ceiling on interest rates at this time.

Senator MANSFIELD. Mr. Heller, if my recollection serves me correctly, the distinguished chairman of this committee did introduce legislation 2 years ago, I believe, which allowed the Federal Reserve Board to exercise discretionary authority on the question of interest rates; is that correct?

Chairman PROXMIRE. That is correct.

Senator MANSFIELD. That is correct. And, of course, that authority still stands.

Mr. HELLER. May I just add to that, Senator?

Senator MANSFIELD. Yes, indeed.

Mr. HELLER. I think those selective credit control powers are very useful standby powers, and I am delighted they are on the books.

Senator MANSFIELD. Well, you have used the word "standby." I think it should be brought out that the Senate a year ago and a few months ago, on both occasions unanimously, passed a wage-price-rent control bill giving to the President standby powers. It is my understanding that at the time he indicated he didn't want this legislation, and didn't intend to use it, but factors evidently have forced a change in the situation and he has exercised, in my opinion, a degree of leadership which psychologically, and hopefully in other fields as well, will tend to break the recession, and I use the word advisedly, which has confronted this country for some months now. Statements will not cure a recession which could, without action being taken, develop into a depression, and having gone through one depression in the 1930's, I never want to go through another one because a depression this time, I think, would be calamitous, to say the least.

I raised the question also at the White House meeting of bonuses for executives. I was informed that they are out under the 90-day freeze.

I also raised the question of dividends. It was stated there that all corporations had been contacted and asked to freeze their dividends at the level of Saturday midnight for the next 90 days.

And then I raised the question of why weren't profits included? It was stated, as you have indicated, that we are operating at about 70 percent, a little bit more, capacity at the moment, that some corporations were making a lot of money, others were making little, in the way of profits, that is, and others were going out of business because they were operating at a loss, and the question was raised: How do you establish a criterion for putting a freeze on profits? I don't know what the answer is. Do you have an answer to that, Mr. Heller?

Mr. HELLER. No, I don't.

Senator MANSFIELD. I believe in an across-the-board freeze if you are going to have them because it should be applicable to all segments of our population and should not be at the expense of one segment.

Mr. HELLER. I have two things to say on a profits freeze. One is that the price freeze tends to be at least a per-unit profit freeze in its net effect. But if businesses sell more units they are going to earn more profits, that is quite right. So, while prices are frozen, overall profits are not, just as wages are frozen, but earnings are not (where more hours are worked).

Secondly, to define and administer a profits freeze, Senator, is something that we found exceedingly difficult in the excess profits tax laws of World War II and the Korean conflict. To freeze profits in any meaningful way by putting a cap on them, as we put a cap on wages and prices and rents, is impossible for a 90-day or even 180-day period. We'll have to rely temporarily on the price freeze to hold profits at fairly reasonable levels. But if we go to a wage-price restraint policy something like the old guideposts, I would agree that profits also have to come within the ground rules.

Senator MANSFIELD. Mr. Heller, what you are saying is that it is a virtual impossibility to develop an across-the-board set of proposals which would be as equitable as possible to all concerned?

Mr. HELLER. Well, it is impossible to put them into place over night or within the time frame of a 90-day or 6-month freeze. I am trying to suggest, however, that the price freeze itself will have in many industries a substantial profit moderating effect, and I think that that ought to be at least some comfort to the critics on this score.

Senator MANSFIELD. Do you think that would be the case with the imposition of a 10-percent surcharge tax on various types of foreign imports and a reinstitution of the 7-percent investment credit?

Mr. HELLER. I am very glad that you provide an opportunity for me to comment on the import surcharge. That strikes me as a questionable measure other than as a short-term temporary bargaining instrument. All too often we have seen in the course of history that measures that are imposed for balance-of-payments reasons tend to stick for protectionist reasons. The moment we freed the dollar and, in effect, forced the up-valuation of other currencies to bring the currencies into a more reasonable parity, we already did the biggest part of the job that needs doing to correct our export-import situation. So I hope we will get rid of that import tax as quickly as possible.

For another thing, of course, it runs counter to the price stabilization objective. When you are trying to stabilize prices, a 10 percent price increase on all imports is not in itself very consistent. I can see why it was done—again, a kind of temporary shock treatment and source of leverage—but it certainly should be done away with at the earliest opportunity.

So far as the investment credit is concerned, we know how to administer it, we have had it before, and I don't think it poses at all the same kind of problems as, say, a profit freeze would.

Senator MANSFIELD. You favor the investments credit?

Mr. HELLER. Senator, I favor the investment credit if it is substituted for the liberalization of depreciation that the President put into effect on January 9 by Executive action. I think the Congress ought to look at those two things in concert, most carefully. The so-called ADR's, accelerated depreciation reserves, are under court attack as an alleged unwarranted use of executive power. Mr. Nader is a tenacious bulldog on this and has created a great deal of uncertainty. At the very least, if the Congress really believes in it, it ought to sanction it by congressional action to remove the uncertainty.

But once the Congress takes a close look at it, I don't see how it could in good conscience put the investment credit tax cut of $5 billion on top of a tax cut of $4 billion in the form of accelerated depreciation. It just doesn't make sense to hand out $8 or $9 billion to business in 1 year when we are treating the consumer so shabbily, giving him so little by way of tax relief in the President's package.

Senator MANSFIELD. The emphasis has been placed on the benefits which the auto industry will receive. The question was raised why the auto industry. It was pointed out that the auto industry in one way or another, directly or indirectly, employs or is responsible for the employment of, one out of every six workers in this country. Is that a fair statement?

Mr. HELLER. It strikes me as a little high. Their GNP share in the auto industry directly, at least, is the $35 to $40 billion range; that is, around 3 or 4 percent. I find it difficult to get up to a one out of six number.

But there is no question about the fact that it is a bellwether industry and one can understand the concern of the President and his advisers with that industry.

But that does not mean going overboard, as I think we may have. We are trying to eliminate the auto excise tax. At the same time, we put on a 10-percent import tax and de facto devalue the dollar—which will tend to hit the man who buys the little imported cars—while taking off the excise tax tends to help the fellow who is better off, who can afford a new domestic car. So quite apart from environmental questions and employment questions, one has to think of fairness and equity. I have grave doubts about the combined move, the import tax plus the removal of the automobile excise, on those grounds even though there is no doubt it will create about 25,000 additional jobs.

Senator MANSFIELD. Getting back, Mr. Heller, to the foreign implications of this, the President has made it very plain and has stated so publicly, either in New York the night before last or in Springfield yesterday, that he did not intend to—Springfield it was, I believe—build a wall around this country, the implication being that the 10-percent surcharge would be of a temporary nature and would perhaps not invite retaliation although it is my understanding that under GATT if such a proposal as this is put into effect against all countries that the possibilities of retaliation by any country are considerably lessened. I don't know the intricacies of it but that was my understanding. But we have had large numbers of troops and dependents since the end of the Second World War, for a quarter century.

It is my understanding at the present time it takes $14 billion out of the defense budget to maintain those forces and their dependents in Europe and their backup support in the United States. Over 25 years that is a lot of money.

Furthermore, the President indicated in his speech to the Nation on Saturday when he announced he was reducing foreign aid by 10 percent, which I dont' think is anywhere near enough, that we have spent over the past 25 years $143 billion in that area. Furthermore, we have spent, I would assume, well in excess of $120 billion, perhaps in excess of $130 billion in a tragic, unfortunate, mistaken and utterly unnecessary war in Vietnam.

Isn't it possible because of our generosity, and because of our adventures and because of our taking on the responsibilities which other nations should assume, primarily in Western Europe, in foreign aid, in Southeast Asia, in the accumulation of practically 2,000 bases throughout the world, that we have helped to pull the noose around our own necks in so doing?

Mr. HELLER. There is no question that carrying out what we have interpreted as our military and economic responsibilities around the world has been very costly on the balance-of-payments front.

The questions you raise obviously go way beyond economics. They go to the basic foreign policy of this country, to, as you say, the misadventure in Vietnam, and so forth. In the present context, Senator, floating the dollar has put us in a new and better bargaining position vis-a-vis those, particularly those in Western Europe, for whom we are providing the defenses. We have been in a rather weak bargaining position for some time in terms of getting the Germans in particular to provide a quid pro quo and take some of the pressure off of our balance-of-payments position for the defense forces we have over there. Floating the dollar provides (*a*) an occasion for the review of the military and foreign policy involved, and (*b*) a chance for renegotiations of the sharing of burdens between the European countries and ours on a hard basis.

Senator MANSFIELD. Mr. Heller, my time is up but I have some more questions I would like to ask because I know so little about economics, and it is a pleasure to, speaking figuratively, sit at the feet of one of the great economic professors in this country.

But you mentioned the teachers and their contracts. I have been receiving a number of telegrams from Montana from teachers who signed their contracts last spring. They were to go into effect in September, next month. I don't know what the situation is but it appears to me that this would have been a fait accompli, that a contract should be honored.

It is going to create a difficult problem. I don't know what the answer is. I am not at all sure the administration knows what the answer is, but I raise this question because I want to emphasize the fact that there are many questions, as you indicated, which will come up, and for which answers will have to be found.

I can think also of other unions which have signed contracts but a small segment of the combined, cooperating group has refused to sign up and that will place people in that position in a very weak posture, but I won't pursue it. But I want, if I may, to ask one final question, Mr. Chairman: Generally do you approve, Mr. Heller, of the shock action taken by the President as announced in his speech of last Sunday evening and amplified since then?

Mr. HELLER. As a vital first step in meeting the three economic crises the country was meeting, the foreign economic crisis. the inflationary crisis, and the unemployment crisis I welcome the President's shift from a do nothing to a do something policy, and I give him high marks on certain parts of that program.

But I would underscore once again it is only a first step and what he now does, what the Congress does, with this opportunity that he has created in both the international and domestic field is going to determine whether this country will, in the last analysis, reap the benefits from the program that are potentially there.

So that my answer is, yes, I welcome what he has done. I think it should be interpreted not as a solution but a challenge. But especially on the fiscal program, I have to underscore again that it is so badly out of whack. so badly out of balance, that I think the U.S. Congress has a big job to do.

Senator MANSFIELD. Thank you, Mr. Heller. Thank you, Mr. Chairman.

Chairman PROXMIRE. I would like to pursue very quickly, because Mr. Eckstein is waiting and we will have him up and I know you have to leave, Mr. Heller. the attributes which some kind of a program has to have if we are going to be able to continue after November 12 with an effective program. As you say, this is a golden opportunity, this is a first step, it is a challenge. it is not an answer. We must take advantage of it. I discussed with you a couple of the elements that must be involved here. Should an agreement on wage and price increases be tied to productivity as under previous guidelines? You did that in what you did in 1962 to 1965. Can we do that again?

Mr. HELLER. It seems to me that productivity again has to be the departure point, has to be the base for any new guidelines. That is something that has been accepted by both Republican and Democratic administrations in the past and would also be the consensus of most economists.

Chairman PROXMIRE. So you would put into effect a system which would permit wages to go up but they would go up in relationship to overall productivity increases of the economy as a whole, say at a 3- or 4-percent rate as far as productivity is concerned?

Then would you make some further allowance for prospective inflation, how can we aim at something that would be fair and workable and proper?

Mr. HELLER. Yes; one has to allow for the inflation factor. We have not exorcised inflation, we have not stamped it out overnight, and therefore there has to be some sort of cost-of-living provision, it seems to me, in any kind of a wage guideline. And that is a very difficult thing. Having waited two and a half years, the President's timing in coming in with a wage and price freeze now was good in one sense; namely, that it was at the end of a contract negotiation cycle. The steel settlement marked a kind of watershed, an end to a major negotiation catch-up cycle. We are now in a better position to develop those guideposts than we would have been, say, 3 months ago.

Chairman PROXMIRE. How about requiring major price and wage determinations to be announced 30 days in advance?

Mr. HELLER. That is definitely one of the changes that should be made from the previous type of guideposts. We need a little more starch in them this time. To make a wage-price restraint policy work, one has to hold the key wage bargains and the price decisions up to the light of public opinion early in the game. A 30-day advance announcement requirement would be excellent.

Chairman PROXMIRE. And then after that, I take it, this would be a voluntary system, as it was in 1962–65, if the wage-price review board disagreed with it then the President would bring the force of his office to bear to try to reach an equitable settlement, is that it?

Mr. HELLER. Yes, that is true, and there is one other difference, and I really don't know just how to factor this in.

It is a very difficult area, but there is that mandatory power still on the books. I presume it will be renewed and somehow or other in the background——

Chairman PROXMIRE. Will you hold just for a moment? All right, go ahead.

Mr. HELLER. It will come in mighty handy for purposes of dealing with really flagrant cases, though I believe that the mandatory power should be invoked in only very limited cases.

Chairman PROXMIRE. How about providing something that was not provided before, that under present circumstances may be necessary, sections to enforce, to act against, noncompliance. Should there be penalties and, if so, what kind of penalties? What would you think of that?

Mr. HELLER. If you start to put in a set of penalties, fines, and jail sentences and so forth, you run an enormous risk of sliding into a full set of mandatory controls. One thing leads to another. That may sound a little bit inconsistent with saying you ought to keep this big stick of the mandatory powers in the background but it is not meant to. In other words, I would use these only in very extreme cases.

Chairman PROXMIRE. Would you envision this as freeing most of the economy so that he would not have to act against the millions of firms that we have, we would only concentrate it on, say, the largest firms and the largest unions? Would it be workable on that basis or would you have to extend it?

Mr. HELLER. Most of the excess market power in our economy is concentrated in relatively few industries and that's where the restraint efforts will be mainly concentrated. Nobody should pretend that it is going to be a perfect system. Democracies are not very perfect either in their politics or economics. We should not expect perfection here. What we are buying in exchange for some unevenness and some imperfections is the maintenance of our basic freedom of economic choice.

Chairman PROXMIRE. Would you argue that competition would take care of most of the economy—that part of it which is subject, at least more subject, to the forces of the marketplace? You would concentrate therefore the wage-price guidelines and the President's attention, to the extent that he has at least a moral compulsion, you would concentrate that on the big industries which do have market power and the big unions that also have market power, is that right?

Mr. HELLER. Essentially what you do is set standards for the country as a whole but then focus most of your efforts and attention on big industries and big unions.

Chairman PROXMIRE. As you know a number of labor leaders have criticized the President's program with great emphasis because they fear wages will be frozen more than prices. They fear organized labor will be hit harder than other sections of the economy. Do you think their fears are justified and what can we do to meet their fears to the extent they are legitimate?

Mr. HELLER. Well, I don't really see why, especially in a short 90-day freeze, labor should be hit any harder than business as far as the wage-price freeze itself is concerned.

Chairman PROXMIRE. What you are saying is the freeze does not hit labor any harder than business, is that right?

Mr. HELLER. I don't see that it does. I can see that labor would be unhappy with the fact that there isn't enough job-creating punch in the program, that they are not getting a fair shake in the tax part of the program. But I cannot be very sympathetic to their breaking the traces on grounds that a 90-day freeze is going to hit them much harder than it hits prices. After all, George Meany has said in the past that he would accept a wage freeze if he got a price freeze along with it, though he added "and a profits freeze." But as we indicated earlier, the profits freeze in the short run is totally impractical.

Chairman PROXMIRE. Just one more question, you covered this so well, while I have a lot of questions I won't have to press most of them and Senator Mansfield covered a large portion of the questions I had, but in the area of fiscal stimulus we get different views on this. The Brookings Institution said there was a substantial amount of fiscal stimulus involved here, more than $4 billion as I understand it. The analysis by the staff of this committee, and we have a good staff, I think an expert staff, comparable certainly with Brookings, says that the net budget impact will be negative. That the expenditure reductions, including the freeze of the Federal pay raises, reduction of Federal revenue sharing, deferral of H.R. 1, and so forth, the net budget impact will be minus $800 million, so it is hard to reconcile those two figures. Would you reconcile it on the basis that there is a very strong likelihood, and, perhaps a certainty, that the freeze will tend to give the consumer more confidence and persuade him to spend more of his income than he has in the past? There are enormous pent up savings. As you know people have been saving at a record rate and that this would provide the stimulus that perhaps would make up the difference, is that your conclusion or not?

Mr. HELLER. Well, I am not sure that would reconcile the exact numbers because when you are talking about fiscal stimulus you are talking about budget expenditures and tax receipts and so forth. How these will net out in reality—not in the administration's unrealistic fiscal arithmetic—I haven't yet ventured to predict. At the moment, it's true, the way the program stands the most hopeful part of the stimulus is in unleashing the consumer, in arousing him from his lethargy, based on his constant fear of inflation. One also hopes that his employment situation will improve. But on the basis of what you have just told me, not having worked through the numbers in detail, I can't reconcile the numbers for you.

Chairman PROXMIRE. Let me fault my own staff by saying, as a matter of fact, I think some of these expenditure reductions by the administration are reductions they would have gotten any way and then some. The majority leader has spoken of foreign aid, we cut that every year, we will cut it this year far more than the 10 percent the President proposes. I think we are going to cut some other things, we are very likely to cut military spending, we did it last year and the year before, we cut it $6 billion 2 years ago, and I think we will do it again, so I think it is very hard at the present time to determine what form the budget will finally take, and I would agree we have to place most of our reliance on the psychological reaction of the consumer for stimulus.

Mr. HELLER. In response to that, may I say, Mr. Chairman, all the more reason, it seems to me, to make sure that such stimulus as is provided is funneled and channeled to the consumer so that we begin to make up this tremendous 28-percent gap of idle capacity and the $70 billion GNP gap, the deficiency of the demand in the economy as a whole.

Chairman PROXMIRE. So I think that one of the things that we have not brought out in this dialog expressly, although it is implicit in everything you say, is we may be putting much too much emphasis on the investment part of the economy, on the buildup and equipment which is not needed, and far too little emphasis on the consumption part of the economy where we have a terrific deficiency of demand and where we most need it.

Mr. HELLER. And where rising consumption will lead to rising investment.

Chairman PROXMIRE. Yes.

Mr. HELLER. In the long run, we are going to need a lot of investment both in plant and equipment and in human brainpower. This is essential for the increases in productivity that will be our best long-run defense against inflation. But for the moment, the consumer needs the stimulus. Once the consumer is again spending at his normal pace and the unused productive capacity is put back to work, that will automatically lead to increased investment. That is really the central point, both from an equity and economic point of view, that the Congress should consider in looking at that tax package.

Chairman PROXMIRE. Senator Mansfield has a question.

Senator MANSFIELD. Mr. Chairman, the impression seems to be that this was a sudden change on the part of the President in announcing this policy and going against what he had been saying since he assumed office and even before. But it is my understanding that this matter covers months of work, and certainly it would be impossible for anyone to come up with a 10-point program as a result of a Friday and Saturday meeting at Camp David.

So they have been thinking about this for some time, and evidently the handwriting on the wall has been deciphered.

Chairman PROXMIRE. If my majority leader will yield to me, he may very well have been right and I hope he is, but if that is the case we certainly have a tremendous problem of credibility here because again and again we pleaded with the administration for an activist policy because as recently as August 4 the President in a press conference said he would not do any of these things, and Mr. Connally expressly dismissed them only a week before the deadline, so maybe they were working the other way and, if so, it is a marvelous job of concealing their intentions at best.

Senator MANSFIELD. It may have been necessary to achieve the shock effect it certainly had on me as well as the country as a whole.

I think there were 10 points suggested by the President, which were interlocking and part of the whole mosaic. It is my impression also we were pretty close to the brink at the time the President made his speech last Sunday night because, as all of us are aware, the dollar has been under extreme attack since last April, and it was my understanding that the time was growing short and we were approaching the edge of the precipice, and I hope that we stopped just in time.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Thank you, and thank you so much, Mr. Heller. Once again you have been tremendously impressive and responsive and helpful. You made a great beginning to these hearings, and I am tremendously grateful. Thank you so much.

Mr. HELLER. Thank you very much.

Chairman PROXMIRE. Our second witness is one of the truly gifted American economists, Mr. Otto Eckstein. Mr. Eckstein is well known to us, having headed one of our most productive studies back some years ago, and since that time he has distinguished himself in many ways, not the very least of which was as a member of the Council of Economic Advisers during the Johnson administration.

Mr. Eckstein, you have a prepared statement, and may I say, the full prepared statement, including the table, will be printed in the record.

STATEMENT OF OTTO ECKSTEIN, DATA RESOURCES AND HARVARD UNIVERSITY

Mr. ECKSTEIN. Thank you, Mr. Chairman, Senator Mansfield. My former boss, Mr. Heller, has covered the ground in his usual thorough and clear fashion, and so I will not read my entire prepared statement, much of which covers the same ground. Let me focus only on a few points which will complement his own remarks.

First, let me say that we believe that this program can work. We believe that if the followup actions are taken, and if the spirit of good will, indeed of almost euphoria by the public, can be maintained sufficiently long, the economy really will do significantly better than it would have done otherwise.

We have done some studies with our econometric models which suggest that the outlook has been revised upward. For example, prior to these actions, the prospect, according to most business forecasters, was that unemployment would hover between 5½ and 6 percent most of next year. Now, the prospect, if the program succeeds, is for a drop in unemployment to perhaps 5 percent, perhaps even better by the end of 1972.

In a table in my prepared statement, in table 1, we summarize these studies, and they show that while the dollar magnitude of the economy changed rather little, indeed the GNP is almost unchanged, the reduction in the rate of inflation from over 4 percent to perhaps less than 3, led to an extra growth of real production, real consumption, real business investment, real housing, which produces more employment, higher profits, and, of course, a greater sense of well-being. For example, the real income of the average American family now has a reasonable prospect of rising by a full 5 percent next year, which would at least close a portion of the gap to which Mr. Heller alluded, $70 billion between actual and potential production.

Well, having said all that, there then come a lot of questions about the specifics of the program, there are at least two areas, the international area and wage-price, where we have only taken the first step, and there are questions about later measures.

Let me deal first with the wage-price question. We now have a freeze, it is complete, it is legal; that is, it has a mandatory basis in the standby powers you gave the President so wisely. Can it last and what will come after it? In our judgment, even a 90-day freeze cannot survive successfully unless it becomes clear very early in that freeze that there will be a meaningful and fair followup. If all we were to have would be 90 days of complete paralysis and then nothing at all, business and labor would quickly compensate for those lost 90 days with wage and price increases the moment the freeze was over. I therefore consider it an unrealistic prospect to suppose that no followup actions at all will be taken, and indeed if you will permit me a political judgment, I don't believe this administration can afford to let this program fail, and will in fact be forced to take whatever other measures are necessary to get a reasonable success out of it, and by success I mean both a significant reduction of inflation and a substantial improvement in the unemployment situation.

What could be done in the wage-price area? Of course, there are some similarities and some differences to the experience of the mid-

1960's and the early 1960's when guideposts prolonged the period of price stability and had at least a limited effect in just holding, in preserving, a reasonable balance between costs and prices.

The similarity is that the basic principles are really still there. If you want price stability, there must be some relation of wages to productivity, and there must be some stability of profit margins. So that new principles, when they are hammered out, will surely have to come back to the old because that is economics, that is not a question of arbitrary choice, there is no other place to go except productivity in trying to develop a principle for costs, nor is there any other place to go except costs and profits in developing principles for prices.

Chairman PROXMIRE. Let me just interrupt to say, you say there is no other place to go except for productivity? Do you fault Mr. Heller's response, as I understood it, or the implications in my question that you can't tie in a cost of living?

Mr. ECKSTEIN. Not at all. The similarity is there. The difference is, at that time we came out of a period of price stability. Even when the guideposts were introduced, we already had several years of slack.

Chairman PROXMIRE. Yes; I understand during that specific period they did gear it to productivity only and exclusively; is that right?

Mr. ECKSTEIN. That is right.

Chairman PROXMIRE. During this time I think he indicated that perhaps you would have to make some allowance in addition to sheer productivity, some expectation of some cost-of-living increase.

Mr. ECKSTEIN. There has to be a clearly defined set of principles that do provide some correction, some catchup on prices. The timing is very good because we are really at the end of a cycle but that is not true of every person, every business, every price. You are going to need some catchup allowances. You are going to, if you do not achieve perfection on prices, and I don't think that is a good prospect, then the wage guideposts must include some element of continuing price change so you cannot repeat the principles exactly. They do need the catchup element, they do need some further price correction factor.

Now, one other difference—but nonetheless, these are really the modifications of the basic economic logic and those early guideposts were not the invention of the 1960 economists but were the simple arithmetic of costs and prices. The other major difference which leads to a procedural implication is that this time we are going into the incomes policy if we are to do that from a complete freeze, not from no policy, and so rather than trying to start from scratch in constructing incomes policy, I think it has to be considered a transition from the present status which is the freeze.

We already see in the kind of situations such as school teachers and importers and all kinds of petty situations where people are caught in a very awkward way by the freeze that the transition has to come rather quickly; that is, even before the 90 days are up, the principles have to become clear on how you convert the complete freeze into the more selective incomes policy.

There are different ways to do it and, of course, it is the task of the Connally committee to quickly develop that, put together the staff and have the consultations with interested groups, and give at least some clues as to the coming policy. For example, in the wage area once they are ready for it they might well decide to exclude all wages of firms with less than a hundred employees. The major inflation is not going to originate with the doctor's receptionist or the small retail business.

Chairman PROXMIRE. Let me interrupt to say if you do that, how about following the recommendations that Mr. Galbraith made before this committee that you exempt all but the 1,000 biggest firms?

Mr. Eckstein. Well, I don't think you need a thousand. If you look at the Fortune list of a thousand——

Chairman PROXMIRE. Five hundred or 400 or at any rate the firms that have the real market power. If you make the assumption that you and Mr. Heller seem to have made that excess demand is out of the economy and we have a deficit of demand, the smaller and medium-size firms by and large don't have market power, so can't you cut it down much more sharply by confirming price controls to very large firms?

Mr. ECKSTEIN. Well, on the wage side it would be a very easy first step. And I am really thinking now within the 30 days how do you begin to unlock the freeze without giving away the store? On the price side my own belief is if you controlled 100 prices starting with major items such as autos and steel, you would really have covered the concentrated sector of the economy. Firms with less than a hundred employees are rather minor. The forces of competition would probably keep them in line with the big visible ones.

Now, on the wage side, it is not that easy. On the wage side the major collective bargains require some kind of guideline.

That brings me to the broader question, the tax question. We are about now, in the words of Gardner Ackley, to enter into a new social contract. The program cannot proceed without consent from business and labor. The President has to take the lead and I think it is unrealistic to have business and labor lead the way; but consent is needed.

Where such experiments have been conducted before, the social contract also included the tax package. This is a tax package which happens to be very favorable for business and very unfavorable to the worker so it may well be that in order to make the wage policy fly, the tax package has to be more favorable to the consumer or worker.

Let me come back to the profit question to which both you and Senator Mansfield addressed yourselves. I don't believe it is possible to put a ceiling on the profits for any short period or maybe in the long run simply because the American acounting system would not bear the burden of such a ceiling. The arbitrariness of accounting is so great that it really would be something of a sham to do that, so you have to rely on indirect measures and that is the tax area. An excess profits tax is administratively impossible and could easily be avoided. To make the wage-price policy acceptable to labor one could have a simple increase in the corporate income tax from the present 48 percent to 49 or 50, or more. That would be a way to symbolically and realistically make businesses pay some part of the cost of the stabilization program just because it is more difficult on the price side to define the outcome than it is on the wage side.

Well, let me turn to the tax program in other regards. My main concern with the tax program is that it is yet another reduction in the total Federal tax base and we had already discovered from earlier studies that the fiscal dividend is gone for the next several years, that the budget will be hard to hold to full employment balance, even with tough spending policies. After all the reductions we have had we now have two more that are permanent; namely, the repeal of the auto excise and the investment credit.

On the other hand one might consider them as temporary, one might take the entire 10 percent investment credit and consider it temporary and phase it out a bit more smoothly than the proposal. Alternatively, one could substitute the investment credit for the depreciation change, thereby saving about $4 billion which could then be put into the consumer area.

Chairman PROXMIRE. Do you favor that proposal which, I take it, Mr. Heller made?

Mr. ECKSTEIN. Yes; I think that would be an improvement in the tax program.

Let me turn then to the international side and that will leave some time for questioning.

I strongly endorse the import surcharge. I think it is the critical element in the package because it was only through the import surcharge that we broke the possibility that the other minor currencies would continue to stabilize on the dollar rather than on gold as we changed the price of gold. If we had not included the import surcharge in the international package there would have been very little assurance that we would have had any accomplishment in our basic goal which must be the revaluation of the basic exchange rates.

Chairman PROXMIRE. That is a very interesting view. I have not heard anybody express it quite that way with that emphasis, even the administration. As I understand it, by cutting loose from gold and letting the dollar find its place in the international market there is every expectation that the dollar would drop in value and it would in effect have a great benefit in our exporting and also in reducing imports and therefore the 10 percent surcharge which you support seems to be overkill, seems to be unnecessary, seems to be excessive and to invite retaliation, and this seems to be the focus on which other countries are directing their criticism and why they are troubled with us. Give us a little more on that.

Mr. ECKSTEIN. The fear that had existed for years, the argument always raised against any change of price of gold was that the other countries on the morning after would stabilize their own exchange rates, which after all some officer of their central bank has to do the very next morning when the exchange window opens, in terms of dollars not in terms of gold. Indeed they had been doing that mechanically all the time.

Chairman PROXMIRE. Do they have the capability once we cut the dollar loose?

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. How can they do it?

Mr. ECKSTEIN. After all, the international currency is the dollar, so the man at the Bundesbank is buying dollars until the price of the mark is where he wants it. If he was doing that he would automatically follow the dollar down in terms of gold in his own currency and the exchange rates among the countries would be the same and all you would have done would be to enrich the gold speculators. That, indeed, was for a long time the standard argument against revaluing gold. Well, we simply made that impossible by the imposition of the import surcharge. The import surcharge is essentially a first step in the revaluation of the exchange rates. We will surrender the import surcharge as we come to an agreement with Japan, Germany, France, Italy, and with the other major trading countries

Chairman PROXMIRE. Let me say I got a quick consultation with the staff, they agree with you, you are right. [Laughter.]

Mr. ECKSTEIN. Well, in the international area——

Chairman PROXMIRE. It doesn't take much to convert me. Go ahead.

Mr. ECKSTEIN. In the international area I am sure our basic goal must be to get a new set of exchange rates, and that set, from the American point of view, should be, in our judgment, a revaluation of the yen on the order of 15 percent, of the mark on the order of 10 percent, of the franc and lira of smaller magnitude and, of course, in the case of the pound probably none at all. Now that must be the real goal of the United States in the coming negotiations in the international currency area.

Now, why? And let me make one other point. If we can accomplish that, then we will have substantially improved the long run outlook for the American economy and indeed that may be the most important measure in the entire package, because if you go back over the last 15 or 20 years, American manufacturing industries have steadily lost some significant fraction of the growth of their markets to Japan and Germany and other countries as their share in world manufacturing trade has risen very substantially, in part at our expense. Well, that loss of growth of markets in turn hurts the growth of American productivity in manufacturing. While the others have extraordinarily high productivity gain, we have extraordinarily low, because of this change in shares of world trade. While this situation has worked against us for 15 years, a sufficient change in exchange rates, seeking equitable rates, we would get an equitable share of the world growth in manufacturing, and in growth in productivity. In that sense a historical turn has come and the long-run prospects of the American economy, particularly manufacturing, are substantially better.

Now there are other issues, the future of gold which I hope they will do as much as possible to move out of the picture, and also on the question of adding flexibility to exchange rates in the longer term, such as wider bands and the creeping peg. In my view, the important thing is to get to the right exchange rates and if they can get additional flexibility as well, that is good, but that is perhaps secondary.

Let me emphasize one other point. The dislocation that we impose on the export industries of our trading allies are considerable but inevitable. On the whole, the reaction abroad has been amazingly sympathetic and good, and if there is, as reported in the paper, an occasional carping I don't think that should be misinterpreted. My own belief is that basically our allies are sympathetic to the situation, have understood it for a long time, have found it politically difficult, except in Germany, to take the steps that they could take on their own, and perhaps when all is said and done will be grateful for the unilateral way in which we converted the crisis from one of just steady, drifting erosion and deterioration of the world system into one where we have swept the table clean and created the possibility of putting together a better set of exchange rates, hopefully even some improvements in the financial system.

Let me stop on that.

(The prepared statement of Mr. Eckstein follows:)

PREPARED STATEMENT OF OTTO ECKSTEIN

ECONOMIC IMPLICATIONS OF THE PRESIDENT'S PROGRAM

The President's program contains the promise of a substantially improved economy. In many respects, the program is an opening move. If it is followed up effectively, the benefits should be great. If the succeeding moves are weaker or less successful, disappointment will be great and the economy is in worsened straits.

Data Resources has developed a solution to its econometric model which provides a first approximation of the economic effects of the President's program. The solution assumes that the follow through of the program is successful. Specifically it assumes ..

(1) That the Congress enacts the necessary legislation;

(2) That the wage-price freeze is followed by a more permanent but limited machinery to assure that wages and prices do not return to their previous inflationary track;

(3) That the import surcharge is only the first step towards a negotiated revaluation of the major currencies; and

(4) That monetary policy remains accommodating to economic growth, albeit at a somewhat lower rate of expansion of the monetary aggregates.

Table 1 summarizes the prospects for the economy under the old policies, as illustrated by the Data Resources forecast of July 26, 1971, and compares them with the new solution which assumes that the policies are made effective. The highlights of the comparison are these:

(1) The unemployment rate, which would have hovered not far from 6% both this year and next, now may fall below 5% by the end of 1972.

(2) The rate of inflation, as measured by the GNP deflator, drops from 4% to 2.6% for next year.

TABLE 1.—A COMPARISON OF DATA RESOURCES MODEL SIMULATIONS FOR THE 1972 ECONOMY WITH AND WITHOUT THE NIXON PROGRAM

	Without program (control July 26)	With Nixon program
Billions of current dollars:		
Consumption	725	723
Business fixed investment	111	112
Residential construction	45	45
Inventory investment	8	9
Net exports	3	5
Federal military	76	75
Federal civilian	29	27
State and local	150	145
Gross national product	1,148	1,147
Billions of 1958 dollars:		
Consumption	519	525
Business fixed investment	78	81
Residential construction	28	30
Inventory investment	7	9
Net exports	2.6	4
Federal Government	63	63
State and local	81	81
Gross national product	779	793
Other measures:		
Real rate of growth	5	7
Inflation rate	4.1	2.6
Unemployment rate year	5.9	5.4
Unemployment rate end of year	5.7	5.0
Housing starts	1.91	2.07
Profits after tax	46	53

(3) Lower long-term interest rates, resulting from less inflation, enables 100,000 more housing starts.

(4) The nominal value of the Gross National Product is little changed, and will continue to be projected at about $1,147 billion.

(5) But real GNP will grow at a significantly higher rate, at 7% for 1972 as compared to the earlier inadequate projection of 5.4%.

(6) The real income of the average American family should rise by 5% in 1972.

SHORT-TERM ECONOMIC GAINS

In the short run, the biggest economic improvement is produced by the wage-price freeze. The inflation has created economic uncertainty and contributed to the extreme caution of consumers. The wage-price freeze will contribute to consumer confidence, and the real purchasing power of their incomes will be enhanced. The temporary nature of the freeze will produce some extra consumer spending while there is the assurance of price stability. For example, consumers may feel that the 1972 automobiles are a particular bargain during the period of freeze. While the dollar volume of business and consumer spending may not change significantly, the real volume of purchases is raised substantially, leading to greater production, employment and profits.

The domestic fiscal measures are limited in scope and by themselves would not have a decisive effect. The personal tax speedup is desirable but small. The repeal of the auto excise forcuses additional spending on a private sector with little social priority; it does serve as another minor stimulus. The temporary 10% investment credit is a powerful device designed to make early investment in equipment more profitable, thus accelerating the upturn in the capital goods cycle. The effectiveness of the investment credit will be limited by the general excess of physical capital developed in the recent boom, but its impact on the profit arithmetic of investment is so great that a major effect should result. According to our model projections, real outlays for business fixed investment should rise by 2.4 billion dollars for 1972 as a result.

The proposed expenditure reductions are in part symbolic. Postponement of revenue sharing and of welfare reform were about to be produced by the political process in any event. Reduction in the number of federal and civilian employees reflects the general emphasis of this economic package which seeks to move the economy ahead through private spending and which sets aside questions of social priority. The postponement of the federal pay increase by a full year is an inequitable measure that will be hard to justify if the freeze on other wages is brief.

In the long run, the major benefit for the American economy will spring from new exchange rates among the advanced countries. American industry has lost a significant portion of its growth of markets to Western Europe and Japan because of the long overvaluation of the dollar. This lost growth of markets induced losses of productivity, employment and profits. The achievement of a more viable and equitable set of exchange rates will give American industry a greater share in the growth of world trade and will produce important benefits.

THE CRITICAL QUESTION OF FOLLOW-THROUGH

Our analyses conclude that the benefits of a successful execution of the President's program are very considerable. So far the programs have only just begun. The newspapers report that the Congress will agree to the various fiscal measures, although there is nothing sacrosanct about the exact proposed form. But in the other two components of the program, the wage-price freeze and the international monetary changes, only the first steps are known.

What Follow-Up To The Wage-Price Freeze?

The public has greeted the wage-price freeze with a sense of relief. Public support is running high because of the discomfort of the inflation and the knowledge that the freeze is truly short-lived. Nonetheless, inequities created by the freeze will become troublesome rather quickly. Since the freeze is almost totally dependent on good will and voluntary compliance, the public must be assured that on the one hand the freeze is truly temporary, and on the other that the government will take additional steps to assure that the freeze will not have been in vain.

If all government intervention on wages and prices were to cease after the ninety day freeze, the subsequent catch up of wages and prices would wipe out the immediate gains very quickly. The wage-price freeze creates a great opportunity. Just a few months of price and cost stability can set the stage for breaking the very tight price-wage spiral which has been the critical element of the recent inflation. If consumer prices can be kept virtually stable for a period, the next collective bargaining round could achieve results consistent with reasonable cost-price stability and still be fair to the workers. On the price side, we have passed through a round of increases in the concentrated industries some of which did represent a catch up with competitive prices. With a brief but good cost record, it should be possible to keep the concentrated sector of the economy on a more even price keel.

But this cheerful sequence of events will not occur of its own volition. Three months of freeze, without clear indication of subsequent policies, will not totally eliminate inflationary price and wage expectations. The wage-price freeze must be followed by a strong and meaningful incomes policy which will guarantee that the economy will remain off the disastrous inflationary track. Further, to make the three month freeze effective, the public, business and labor must receive the signal that a longer term wage-price policy is being developed.

A wage-price policy focusing on a limited set of major prices and wage bargains should be sufficient to assure this result. In the more competitive industries, prices will not rise substantially if the overall wage pattern of the economy is brought to a noninflationary state. No such assurance exists in the concentrated industries, yet these are the industries in which government has the greatest possibility of influencing private actions. In the case of wages, unemployment will remain above normal for another year or two even with the current set of limited measures. It will not be supply and demand by labor markets that will raise wages, but rather inflationary expectations in collective bargaining. Here again it is in the large bargaining situation that government has the greatest opportunity to assert the national interest.

The United States does not want elaborate control machinery and it does not need it. A small, central staff in Washington, led by high policy officials and operating with the advice of business and labor, could keep track of developments in the top 50 or 100 price situations and in the major collective bargains. The ninety day freeze is ample time to put together such a staff, to develop the rather transparent necessary principles and to obtain the collaboration of various representatives of business and labor. Presumably the authority for the new incomes policy would be found in the standby powers that are now being used. The transition from freeze to wage-price policy would come gradually in the form of increasing exemptions of competitive prices. The key prices and wages could only be changed after government evaluation with the new wage-price principles.

Follow Through on International Finance

The floating of the dollar and the imposition of the surcharge on imports have converted a situation of acute disequilibrium into one of fluidity. For practical reasons it was probably impossible for the United States to act other than unilaterally. Our trading partners recognize the basic disequilibrium that we faced, and on the whole, their reaction has been reasonably sympathetic considering the hardships that these measures bring upon their export industries. It remains to be seen, however, whether they will now cooperate in developing a more viable set of international financial arrangements. The United States could begin the current process of change by herself, but its successful conclusion requires the good will and collaboration of the major industrial countries. After some temporary dislocations in their export industries, all countries will benefit from an international economy brought into equilibrium. Furthermore, continued recession in the United States has had a major impact on other advanced economies, most of which are either in recession or on the edge of it. Yet there was no way for the United States to achieve recovery while clinging to its obsolete exchange rate.

Some Issues of Policy

The President's program has many elements of strength. The wage-price freeze and the international measures correspond closely to the recommendations of economists and other experts, and if they prove ineffective we will all be wrong together.

The particular character of the fiscal package of stimulus is more open to challenge. The major questions are these:

(1) Does the fiscal package rely too heavily on stimulating business investment? The investment credit follows close on the heel of the more liberal depreciation, giving business a corporate tax reduction of close to $8 billion. These measures will stimulate investment substantially but, given the current state of general excess capacity, the stimulus per dollar of lost tax revenue may be quite modest. Given its greater power, the investment credit could be treated as a substitute from more liberal depreciation allowances. There are other opportunities to stimulate the economy through tax reduction if that should be the chosen route: for example, the proposal by Chairman Mills to raise the minimum standard deduction has much merit. Alternatively, expenditures could be increased. While public works may be too slow, the welfare reform could be accelerated rather than postponed.

(2) Although some of the fiscal measures are temporary, others have a more permanent influence on the allocation of resources and social priorities in this country. The 5% investment credit and the permanent repeal of the automobile excises continue the repeated shrinkage of the federal revenue base. The resources that could be devoted to meeting our essential goals, to investment in education, research, health, revenue sharing or welfare reform, are continuing to be frittered away in piecemeal tax reductions. There were few fiscal dividends for the next several years even before the current round of measures: new tax reductions postpone the day when the budget can afford new initiatives. Perhaps we should treat the auto excise and investment credit measures as temporary rather than permanent.

Let me emphasize that disagreements over detail should not detract from the basic thrust of the President's program. The social cost of inadequately performing economy is very great. The benefits from reducing the rate of inflation and of moving employment toward our targets are so great that they can override disagreements about the exact nature of the desirable measures. Expansionary action is so critical at this time that it should not be lost in a political impasse. I therefore recommend the President's program to you (albeit with the Congressional prerogative to improve its structure). I also hope that the administration will take the follow-through actions that will make the program live up to its promise.

Chairman PROXMIRE. Mr. Eckstein, I want to thank you very much. This is a very, very helpful presentation and it is especially useful and desirable when economists come before this committee or any congressional committee and give us their best estimate or their judgment on what is going to happen, what it is going to do, how it is going to affect the economy, what stimulus this is going to have, you have done that and, of course, you stick your neck a mile out when you do it and I suppose you can be wrong when you do it, but I think it is very useful to have this kind of analysis because it gives us something precise and definite to stick to and it gives us also a basis for appraising the quality of your analysis in the future.

Mr. ECKSTEIN. Let me emphasize one point in that, if I may.

Chairman PROXMIRE. Yes.

Mr. ECKSTEIN. These projections that we have prepared here, without the Nixon program that was our basic forecast before and with the program in some respects are kind of an ideal script. This is what happens to the economy if it works.

Chairman PROXMIRE. I understand that and you have a lot of big assumptions in here including the assumption that this administration which has been very hostile to incomes policy is going to do all the right logical things in working out a policy; also making the assumptions you are going to get cooperation not only from business but from labor.

Mr. ECKSTEIN. That is right.

Chairman PROXMIRE. And as of this morning that appears to be one very, very big assumption.

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. I must say you gave us a very good insight into the reason for the surcharge, and the justification for it, and its effect. We all hope that this can be temporary, and Mr. Heller expressed the strong position that it should be temporary. He didn't differ with you from what you said when he said if it was justified it ought to be kept in only a few months. Do you think it can be only a few weeks and then dropped?

Mr. ECKSTEIN. The import surcharge?

Chairman PROXMIRE. Yes.

Mr. ECKSTEIN. I think the import surcharge will have to be abolished at the time the exchange rates are realined.

Chairman PROXMIRE. You think it is practical to work those out over the next few months?

Mr. ECKSTEIN. Yes; in fact it is an absolute necessity to do it rather quickly. Now they may conceivably let us keep the surcharge on some very short period, for a few months, just to make sure the new rates would stick but it would be a considerable act of generosity on their part.

Chairman PROXMIRE. Then you talked about altering the tax package to make the wage guidelines more acceptable to labor where they are having the greatest difficulty. This seems to be a program with which business, by and large, is quite happy. If there is an inequity involved here, you suggest not only should we look at the equity involved on the fiscal policy itself but also what this does to securing an agreement out of the group we have to get an agreement from. Labor is going to be, I would think, more cooperative, if they feel they are being treated fairly on the fiscal front. Can you give us a more specific indication of just what tax changes you would suggest? Will you, for example, agree that the social security tax increase scheduled for January 1 should be postponed?

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. That the investment tax credit should be a substitute, you favor that?

One part of the investment tax credit recommendation that troubles me a lot, maybe I just haven't had a justification for it, is the announcement this morning that it may go back retroactively to April 1. That would be a windfall; there would be no stimulus for business, people who have bought equipment are going to get a windfall. Those not so lucky would not. Is that justified?

Mr. ECKSTEIN. Yes, the investment credit experience has never really been totally analyzed so we have to rely——

Chairman PROXMIRE. That kind of activity, however, is certainly not going to stimulate jobs.

Mr. ECKSTEIN. In the retroactive.

Chairman PROXMIRE. What it is going to do is give a windfall to corporations and stockholders.

Mr. ECKSTEIN. The retroactive feature is clearly a windfall; the investment credit is something of a gimmick in any event. It led to a host of leasing devices, which makes it a somewhat less attractive policy than purely economic analysis on its impact on investments decisions would indicate.

But in this, I think, to some extent I am quarreling over detail, it is a powerful device even though it does lead to a certain amount of abuse, and I do not recommend against it. I do believe, as Mr. Heller does, that depreciation reform plus investment credit just spends too much of the Government's money on investment. We say there will be investment but for every dollar spent on this in the next year or two we do not see a full dollar of extra investment whereas if some of that money went into consumption, which you can do in a variety of ways, you could get a dollar of consumption for every dollar of tax loss.

Chairman PROXMIRE. Give us very briefly what you regard as unfair in the fiscal package so far as working people, labor are concerned and what you think might be more helpful in getting a more cooperative attitude.

Mr. ECKSTEIN. I will answer your question but let me preface it by saying that it is really a question that an outside expert in isolation is not really best equipped to judge. There are a variety of ways all of which would achieve about the same goal. One of them which we discussed in our recent hearing in the same place about 3 months ago, was the delay in social security tax. I gather that happens to be unpopular with labor. Well, if you are trying to put together a tax package to make labor cooperate——

Chairman PROXMIRE. It wouldn't be very unpopular, it would be very popular, a delay in the tax.

Mr. ECKSTEIN. Nonetheless the traditional position of the AFL–CIO has been in terms of actuarial soundness of the trust fund which has been interpreted that they are opposed to it. It is the single measure that is most clearly to the benefit of the working man because it is a tax only on wages and partly on the self-employed, and so that is where the benefit would go. But if that really is impossible then you could take the proposal of Chairman Mills in his Utah speech which would raise the minimum allowance in the income tax or you could modify rates of the income tax at the middle or bottom end. It may be that one of the things that is wrong with the package, that it is in the middle income brackets, where the wage freeze would be most actually felt, where no direct benefit is felt except from the auto excise tax.

Chairman PROXMIRE. What do you do about the great problem that seems to me is going to confront the administration if they try to go beyond the 90-day period of the freeze with the very large increases in wages that have already been contracted for?

This is true of the Teamsters, it is true of the Auto Workers, it is true of the Steel Workers, it is true of the Communications Workers, it is true of millions of workers in this country. Some of those are 8 percent, some are 10 percent, some are higher, and most of them are considerably above what seems to me to be any possible stable basis for prices in the future.

One was called to our attention vividly by Leonard Woodcock who is going to appear before this committee next week. On November 22, only 10 days after the end of the freeze, UAW is scheduled to get a 3 percent wage increase, based on the contract they have signed and agreed to. What can we do about this kind of a situation if we are going to have an effective system?

Mr. ECKSTEIN. Well, it would be both unfair and not particularly sound economics to attempt to freeze wages completely; that is, wipe out all contractual increases for a long period. Now 90 days is a sufficiently short period, and they picked 90 days which doesn't have much contractual change anyway, 90 days is a sufficiently small sacrifice on anybody that people can put up with it for the national good.

Now as you get beyond 90 days you do have to consider equity. Under the old wage-price guideposts which were a kind of a perfection, assuming stable prices, wages were not stable but were allowed to rise with productivity. So really what the second stages of these contracts pose as a problem is this. The Government must have some kind of principles put in place before these situations, before these deadlines, are actually upon us.

Chairman PROXMIRE. Don't we have something that will abridge or at least change the actual contractual agreement? They can't possibly go along, can they, with an 8-percent or 10-percent increase, if such is scheduled for later this year or next year.

Mr. ECKSTEIN. That is it. The specifics of the contract cannot be allowed to override the standby powers that have been invoked to stabilize wages and prices. I don't believe that the freeze could be said to have been a success if there is no reconsideration of these later increments. But zero is not the answer.

Now in the automobile case if the increase really only is 3 percent it might well turn out that is consistent with a later guidepost but if it is 8 percent it would not be.

Chairman PROXMIRE. That is the increase they have November 22, they already have had an increase this year and I take it they have a subsequent increase next year, the auto workers.

Mr. ECKSTEIN. That is why we need a set of principles because you have to have some way of taking a thousand cases and treating them all by some common means.

Chairman PROXMIRE. At any rate you would accept the notion that contracts are not inviolate, that you would have to be able to modify them, reduce the amount that had been agreed to.

Mr. ECKSTEIN. I think that is a necessity.

Chairman PROXMIRE. Otherwise it can't work.

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. Now since your model projects rather large increases in real GNP, real gross national product, as a result of the President's program, and I think this is an exciting part of your model because you indicate how we are going to grow and develop in real terms that will mean real jobs and schedule how we can decrease unemployment, as I understand it in the following way, you go about— most sectors of the economy, including the important consumption sector are first estimated in current dollars. Then these current dollars are inflated by your estimate of what inflation will be. Is this generally how your model works?

Mr. ECKSTEIN. Yes, that is right.

Chairman PROXMIRE. This means with actual current dollar GNP unchanged a reduction in your estimate of inflation will automatically produce a larger real gross national product; is that right?

Mr. ECKSTEIN. It is something of an accident that the same, that the dollar figures show so little change. That is the result of a number of pluses and minuses. The dollar volume of spending is affected by, of course, the inflation which drove up the incomes before, but there is in a more direct and concrete way the benefit which comes out of the fact that real consumer spending becomes greater. Why has the saving rate been so extraordinarily high? It has been at its peak record for over a year. Well, according to our quantitative approaches to it there are two elements, the high inflation which makes this a bad time to buy according to all the psychological studies of it, and high unemployment. The inflation factor is lowered if the freeze works and the unemployment begins to look better after a little bit of delay. The consumers are projected to spend as much money but it now buys more real things and that is one big impact.

The other source of impact is on the investment side where all these measures do begin to pay off after a while.

Chairman PROXMIRE. This means with actual current GNP unchanged, the real GNP we have gone through, translating this into what it really means, you are saying control of inflation by itself with other policies unchanged would produce a substantially larger growth of real output.

Mr. ECKSTEIN. That is right. The shortrun stimulus of this program comes out of the wage price freeze, not out of the fiscal package which is really very small.

Chairman PROXMIRE. Don't we have to have fiscal or monetary stimulus to produce a major growth in real output?

Mr. ECKSTEIN. No. That may be a shock after all these years when we have told the public that it is fiscal policy and monetary policy which makes the economy go; that just isn't true. We have found out the hard way in the last few years that the real sectors of the economy, production, and real purchases are very substantially affected by the inflation. Indeed this is one of the biggest minuses that has put us into the recession in which we now find ourselves.

Chairman PROXMIRE. Now since that is such a spectacular, almost unique view now because you said the only way we can get the economy moving ahead is fiscal and monetary policy, by less spending, less taxes, adjusting credit, making it more easily available, you are saying now there is another element that might be far more potent and that is holding down prices and providing more assurance for the consumers so they begin to save less and spend more.

Mr. ECKSTEIN. You have to have been through a bad inflation to see this effect. I think most economists would not really quarrel with that position. I think it is now generally accepted that consumer spending is hurt by inflation.

Chairman PROXMIRE. This is very interesting because we have the Friedmanites, the monetarists, who say the only thing that really counts here is monetary policy, making money, and credit available; then you have the fiscalists who say the thing that really counts is what the Federal Government does in reducing taxes and spending more money. You say you can keep monetary and fiscal policy fairly stable and get a real stimulus by what the President has done in effect and what we hope he will do in the future—which is much more important, what he will do in the future—to provide stable prices and overcome a previous inflationary psychology that has limited or paralyzed a substantial degree of consumption; is that right?

Mr. ECKSTEIN. Yes; the fiscalists achieved humility in 1969, and the monetarists in 1971.

Chairman PROXMIRE. It has been suggested to me that economists should be getting their degree in psychology now.

Mr. ECKSTEIN. It is a social science; the economy consists of people and their decisions and, of course, it is the most difficult element to predict. But there is a question why the economy did so badly lately and I think it is pretty evident that inflation itself was the major factor.

Chairman PROXMIRE. Let me ask this. In the current attempt to achieve equitable exchange rates should we scrap the existing capital export controls?

Mr. ECKSTEIN. Only if we can achieve a change in these exchange rates that is adequate to take care of that matter as well.

Now, for example, according to the papers this morning, there are stories in Japan that they are resigned to an 8-percent revaluation of the yen.

Chairman PROXMIRE. Which is not enough.

Mr. ECKSTEIN. Which is not enough. If that is the outcome then you certainly cannot afford to get rid of those controls. If you really reached goals——

Chairman PROXMIRE. As a matter of fact if the yen once rises 8 percent we have to keep the surcharge.

Mr. ECKSTEIN. I don't think we will be able to keep the surcharge under any circumstance because the surcharge is so thoroughly in violation of GATT rules. Now they have closed their eyes in the case of Britain and the case of Germany for a few months.

Chairman PROXMIRE. Secretary Connally said this morning that the President is operating in accordance with the GATT agreement. The President has authority under the GATT agreement, and therefore, he can take the action.

Mr. ECKSTEIN. We are entering into the negotiations, but certainly all the participants in the bargaining will assume what they yield us on exchange rates will surely buy them the end of the surcharge.

It is really the element that should make them cooperative in a set of measures which will hurt their export industry.

Chairman PROXMIRE. I understand Data Resources Inc., has prepared a revised economic forecast that takes into account the changes announced by the President in his new package. Could you please tell us how the proposed changes effect your forecast for GNP and its major components? How does it change your estimate for consumer expenditures on autos, for producers' durable equipment, and so forth?

Mr. ECKSTEIN. So far we have only prepared a forecast which assumes the program works. I suppose as we move ahead and see in the succeeding weeks how, to what extent there is cooperation, I fear we may have to revise. Table 1 in my prepared statement is a summary. Let me give you a few highlights. Let's take the automobile case because so much of the program is focused on that.

Chairman PROXMIRE. Right.

Mr. ECKSTEIN. We believe this program will raise the sale of domestically produced cars by half a million units. Why is that? Well, the stimulus, the price of American cars will now be cheaper because the 7-percent excise tax is off, a 7-percent price cut will lead to a substantial increase in number of units sold. In addition you have this great period where you can buy 1972 cars with 1971 prices without assurance it will stay that way after the freeze. There is a little extra push on the consumer to go out and buy that car.

In addition to that, we will regain some of the lost markets to Japan.

Chairman PROXMIRE. You say you estimate on that basis they will sell another half million cars?

Mr. ECKSTEIN. More than they have otherwise which will push the sales next year beyond 10 million to something on the order of 10½ million.

Chairman PROXMIRE. How can you make assumptions on that because you say they can buy 1972 cars at 1971 prices?

Mr. ECKSTEIN. That will help at the very beginning, but the half million is based just on the permanent price reduction associated with the end of the tax.

Chairman PROXMIRE. I see.

Mr. ECKSTEIN. In the last year, the American auto industry, last year we imported about 1.1 million cars. In the first 6 months of this year we imported about 1.7 million. We won't recapture all those losses, some of those losses had nothing to do with price but in response——

Chairman PROXMIRE. So your estimate it seems might be fairly conservative.

Mr. ECKSTEIN. So all we are really assuming they will recapture less than half of 1 year's loss.

Chairman PROXMIRE. How about producers durables in response to the increase of investment credit change?

Mr. ECKSTEIN. Well, the investment credit ordinarily would have rather little effect in the first 9 months to a year and then finally——

Chairman PROXMIRE. But they have a hooker on this one. It goes for 1 year and then goes down to 5 percent.

Mr. ECKSTEIN. Yes; and I gather, that is only on order for the equipment being placed but I gather they will only get the credit if they also get delivery within a few months after the period is over. That leads to distortion here and that is one of the odd aspects of this program, you get a little bit of extra consumer purchases because of the freeze; you will push a certain amount of investment purchases into 1972, from 1973.

Chairman PROXMIRE. Have you any specific estimate as to how much durable equipment will increase as a result of the President's program?

Mr. ECKSTEIN. Yes, it goes up about $2.4 billion. Total fixed business investment including construction is some benefit to that, too; $2.4 billion in addition to what it would otherwise have been.

Chairman PROXMIRE. You have an inflation rate without a program of 4.1 percent, with a Nixon program of 2.6 percent. You assume on that basis a wage-price freeze will continue after the 90-day period expires or what changes would you assume?

Mr. ECKSTEIN. Well, this assumes one quarter of virtual stability, and that the special factor that made inflation so bad; namely, the tightness of the wage price spiral.

Chairman PROXMIRE. You assume that is broken?

Once again if it were it would be a conservative assumption because there may be other elements that would tend to slow prices down once you overcome that.

Mr. ECKSTEIN. Well, it does require, it really does require, a very substantial followup to the freeze and it also does require that the freeze itself holds for 90 days.

Chairman PROXMIRE. You say the freeze itself. Of course we have so many different indices that mark that, we have a GNP deflator, we have the consumer price index, wholesale price index.

Mr. ECKSTEIN. This is the GNP deflator but the consumer price shows it.

Chairman PROXMIRE. What are your estimates for housing starts?

Mr. ECKSTEIN. They are now in excess of 2 million units. In fact, that is the rates it has been running recently. Of course, the drop in interest rates that should come from the better inflation outlook helps housing. Now housing has been stimulated very heavily by the Government and it is now substantially above its long-run trend figure so the question in housing was whether it can hang together, whether housing could stay at the high level that it reached earlier this year, and now with these measures the whole thing is just a little bit more secure.

Chairman PROXMIRE. You think it is likely to hold together; is it likely to have 2.2 million for the year, that is, the annual rate in July?

Mr. ECKSTEIN. Well, we project 2.1 million, not 2.2. The recent 2.2 does look a little extraordinary.

Chairman PROXMIRE. You are pretty firm, both you and Mr. Heller, that this will tend to hold interest rates down. I am not sure. This may be true on the basis of a careful analysis but at the same time does it take into account the additional demand for money because of investments credit and because of a greater real GNP and because it is likely there will be more business activity; doesn't that tend to push up interest rates?

Mr. ECKSTEIN. The magnitude is rather small. We had projected good industrial bonds to be closer to 8 percent. Now, assuming that the inflation control works and the Federal Reserve is reasonably accommodating in its policies, it would be closer to 7 percent. But the swing is only about half a point, so you are quite right that, on the one hand, you have a plus in the inflation factor and you have a minus in the more real demand for capital and more real activity, more real demand for credit, although here again, the investment credit does give industry money to invest, so the flow of funds is actually aided.

Chairman PROXMIRE. I just have a couple of more questions. Let me ask you how your estimates show the unemployment rate quarterly. You give us the total for the year as 5.7 percent without the program and 5 percent with the program. In view of the fact it is as high as it is now I take it that means quite a sharp drop during the year. How would it come down in each quarter? Do you have those figures beginning with the fourth quarter of this year and following through next year?

Mr. ECKSTEIN. Yes. Let me first give you a figure and then a little background. Our projections keep the unemployment rate at about 6 percent this year and then dropping steadily through next year.

Chairman PROXMIRE. At about 6 percent this year, all right 6 percent last quarter, then how do they drop next year?

Mr. ECKSTEIN. Smoothly, 5.7, 5.5, 5.3, and 5.0 percent.

Chairman PROXMIRE. 5.0 percent is what you would have at the end of the period, not the average?

Mr. ECKSTEIN. No; the average is 5.4 percent. You ask why is the improvement so late? All these figures have errative qualities, and next month's figures may easily make a liar out of me. We do know in August unemployment insurance claims are up substantially from last year. The comparisons had been favorable until lately and then they began to be unfavorable so there is some clue nothing very good was happening in the labor market prior to the program. As business recovers it will not quickly rehire people. Indeed in this recession more than in most, business tried to get production up before it gets its employment back up. So there is always some little delay between activity and employment. So we find it takes 2, 3, 4, 5 months before an improvement in the product market is reflected back in the demand for labor so I don't think we should say the program has failed or something goes wrong if the employment figures don't rise immediately.

Chairman PROXMIRE. So once again on the assumption everything works out well, that the administration is successful in putting into effect a system of controlling inflation, limiting it sharply, after this November 12 period, then you think it is possible that unemployment could go down as low as 5 percent by the end of next year?

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. I think that indicates the very serious nature of unemployment; perhaps this is a more serious problem in many ways than inflation. Well, 5 percent is still a high level, and that is the optimum; that is, if everything works; that is, if their policies do well, it is accepted by various groups in this society, which might not be the case.

Mr. ECKSTEIN. Well, the labor force now grows at the rate of over a million and a half a year. You are now entering a period of rapid productivity advance in the recovery phase. Where the manpower——

Chairman PROXMIRE. How much real growth do you calculate? Is that down there?

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. Real rate of growth, I see, 7 percent.

Mr. ECKSTEIN. Seven percent.

Chairman PROXMIRE. I see.

Mr. ECKSTEIN. For a recovery year, that is still not extraordinarily out of line; other recessions have shown higher figures.

Chairman PROXMIRE. All right, 7 percent real growth. Let's get the arithmetic on this, then. You have the labor force increasing at the rate of about 1½ percent net?

Mr. ECKSTEIN. A million and a half. It has actually been more. Well, in the current year it is more because you will have some of these people coming back into the labor force who had left it.

Chairman PROXMIRE. So you would say 2 percent. Then how large an increase in productivity?

Mr. ECKSTEIN. In the private economy, productivity should now rise between 4½ and 5 percent.

Chairman PROXMIRE. What does that mean in overall terms?

Mr. ECKSTEIN. Well, I have to add about three-tenths to allow for the shift out of agriculture into industry.

Chairman PROXMIRE. You have to add or subtract three-tenths?

Mr. ECKSTEIN. Let's take 5 percent as an overall figure.

Chairman PROXMIRE. It will be that big. How about increasing hours? If people are working longer hours, obviously you are going to employ fewer people.

Mr. ECKSTEIN. That is right.

Chairman PROXMIRE. And they are likely to work longer hours, are they not?

Mr. ECKSTEIN. In recovery, sure there is more overtime.

Chairman PROXMIRE. They are only working about 37 hours and a fraction now, I understand.

Mr. ECKSTEIN. Yes.

Chairman PROXMIRE. So if they work another hour, that would add an additional factor.

Mr. ECKSTEIN. Well, an hour is quite a bit. We only know what it is in manufacturing.

Chairman PROXMIRE. All right. Leave hours out, it is a negative factor, you add up 2 percent for your growth in the work force, 5 percent for your productivity increase, and it seems to me you stay exactly where you are. If you only have a 7-percent growth, how can you make any progress at all on unemployment?

Mr. ECKSTEIN. Well, you do. You can't quite see it in that aggregate view; the Government figures don't exactly jibe in their coverage in this regard. I think it is easier to explain unemployment through the use of Okun's law. Okun's law, as you know, simply relates the change in unemployment to the real rate of growth, and then the law itself short circuits the worry about varying hours and the varying productivity and the people going back into the labor force. Okun's law says that for every extra 1 percent of real growth, you lower the unemployment rate by about three-tenths.

Now, we have here a 7-percent real growth, and that is about 3 percent more than potential: that is, you need 4 percent to stand still in the long run; here we say we are going to have 7 percent, that is an extra 3 percent for 1 year; well, that extra 3 percent is just about enough to lower the unemployment rate by 1 percent.

Chairman PROXMIRE. Okun's law would satisfy it if everything remains the same. You have an unusual situation, you have a big increase of productivity and an increase in labor force, and again it adds up to very little progress on the unemployment front.

Mr. ECKSTEIN. You will get this progress, some of the increase in the workweek will have happened already. The long-run growth in the labor force is already really allowed for in the 4-percent potential growth. Five or 10 years ago, we would have estimated that at 3 to 3½ percent, so the acceleration of the basic population is already built into the potential figure. I don't believe that there is any reason to think that Okun's law will fail in this instance. It has been one of the few really reliable things we have, and it has also explained the recent record very well. So I think it is reasonable to project an unemployment decline of this order of magnitude.

Chairman PROXMIRE. All right; let me get into just one other area; it is quite different, but I think it is a demonstration of the great difficulties we are likely to have, and perhaps you can help us on it. We have discussed the fact that the wage-price freeze will cause some inequities and hardships. Take the coal industry as an outstanding example of this. I understand the coal mine owners have done very well over the past 3 years; wage contracts are due to expire in that industry at the end of September.

Negotiations have been underway with the coal unions. What do you think the Government policy toward these negotiations ought to be? What position should the unions and owners adopt?

Mr. ECKSTEIN. Well, the end of September is 45 days into the freeze, that means they have 35 or 40 more days to come up with some position on the coal case by then, and that is quite a long time. If they cannot come to any new principle by then, then the Government may well wish to ask the parties to resolve other issues and leave the basic wage package in a state of suspension.

Chairman PROXMIRE. It seems to me the business leaders are in quite a dilemma, and the union labor leaders have been negotiating in the past on certain assumptions on what is going to happen to the cost of living and negotiating on the assumption there would not be any limitation on prices and wages. Now it is a new ball game. How can we have effective negotiations during a freeze like this when you have a kind of an indefinite future beginning November 12?

Mr. ECKSTEIN. It creates practical problems of this sort all over the economy. But given the total rewards of the success of the package if you can really make this wage-price freeze succeed, if you can really achieve this change in the outlook that our assumption envisages, those practical problems—how does the coal industry coming through 6 weeks of freeze—are rather petty.

There are answers to the coal situation: there must be some way to delay for some weeks. After all, that is involved in the economic part of that particular bargain.

Chairman PROXMIRE. Of course, it is so important that we try to keep people working during this period and not do anything to develop an attitude that would make the coal workers feel they have got to strike, so that it is a tenuous and delicate and difficult thing to work out.

Well, thank you very, very much, Mr. Eckstein. As always, you have been brilliant and most helpful.

The committee will stand in recess until tomorrow morning at 10 o'clock when we will hear from Mr. Charles Schultze, the former Director of the Bureau of the Budget; Mr. Raymond Saulnier, who is the former Chairman of the Council of Economic Advisers under President Eisenhower; Ralph Nader, who needs no introduction; and Mr. Sheahan, who is probably the outstanding expert on wage-price guidelines. He wrote the book on it.

(Whereupon, at 12:20 p.m., the committee was adjourned, to reconvene at 10 a.m., Friday, August 20, 1971.)

THE PRESIDENT'S NEW ECONOMIC PROGRAM

FRIDAY, AUGUST 20, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senators Proxmire and Mansfield.

Also present: John R. Stark, executive director; James W. Knowles, director of research; Loughlin F. McHugh, senior economist; John R. Karlik, Richard F. Kaufman, and Courtenay M. Slater, economists; Lucy A. Falcone and Jerry J. Jasinowski, research economists; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

In organizing these hearings, we have made an effort to preserve balance. We are asking outstanding economists, as well as leading representatives of business and labor, and experts familiar with the problems of administering wage and price controls.

Today's panel reflects that. The first witness served as a top official of the Johnson administration and the second as a leading economic spokesman for the Eisenhower administration.

And we also have with us in this panel this morning, Mr. John Sheahan, who is an outstanding expert, perhaps the outstanding scholar, in the area of wage-price guidelines.

Mr. Charles Schultze has been as helpful to this committee as any man in the country. He is a brilliant analyst of public economic policy and, beyond that, he has always been extremely generous of his time and energy in helping us. We are grateful for it. He served as Budget Director during the Johnson administration and is currently a senior fellow at the Brookings Institution and professor at the University of Maryland.

Mr. Raymond Saulnier is a well-known professor of economics and a former member and Chairman of the Council of Economic Advisers in the Eisenhower administration. He is widely known as a brilliant and wise economist, especially in the area of public policy and he, too, has been unstinting in his willingness to help this committee.

Mr. Sheahan is the author of "Wage-Price Guideposts" which, as far as I know, is one of the most thorough and comprehensive studies of anti-inflation policy.

So we are delighted in having you gentlemen here this morning. Later we will hear from Mr. Ralph Nader.

Mr. Schultze, will you start? May I ask, gentlemen, if you could confine your remarks to 10 or 12 minutes, if possible? We have the majority leader here, and he and I are both anxious to ask questions, but at any rate do your best to hold your remarks down.

Mr. Schultze, go ahead.

STATEMENT OF CHARLES L. SCHULTZE, SENIOR FELLOW, THE BROOKINGS INSTITUTION [1]

Mr. SCHULTZE. Thank you, Mr. Chairman and Senator Mansfield.

I am pleased to accept your invitation to discuss the broad outline and major elements of President Nixon's new economic plan. A detailed evaluation of many of its components will have to await the unfolding of events and further information on how the administration proposes to carry out some of the detailed provisions of its program. But some broad judgments can be made at this time.

I think everyone must welcome with great relief the President's decision to take firm and vigorous action on the unemployment, inflation, and balance of payments fronts. To those outside the administration, it had been clear for some time that the original economic game plan was not working. The private economy showed no signs of rebounding of its own accord, and apart from a few statistical quirks the unemployment rate had been hanging stubbornly around 6 percent for more than half a year. Economic slack had produced some deceleration in the rate of inflation, but of very modest proportions, and expectations of continued inflation were rife, partly accounting for the failure of long term interest rates to come down. And despite the slack in the American economy, our trade balance had taken a serious turn for the worse, accompanied in recent weeks by a serious hemorrhaging of dollars.

The program announced last Sunday by the President addresses each of these problems directly. While the proof of the pudding will eventually be in the eating, it is already clear that the elements of this program have the potential of making important gains in each of the three problem areas. This week's reaction of the stock and bond markets shows that the financial community, at least, shares this hopeful view.

For the committee this morning, I would like to concentrate on the first two components of the President's program—the fiscal package of tax cuts and expenditure reductions, and the wage-price freeze. About the remaining component, the actions concerning the balance of payments and the international value of the dollar, I shall have less to say, partly since my own knowledge and experience in these areas is somewhat wanting and partly because their ultimate effects are still clouded by uncertainty over the eventual reactions of other countries.

Let me turn to the fiscal package.

With respect to the fiscal package there are three points to be made.

(1) On balance the proposals should provide welcome and significant stimulus to aggregate employment and output; (2) the particular

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[1] The views expressed here are those of Mr. Schultze, and do not necessarily represent those of the trustees, officers, or other staff members of the Brookings Institution.

pieces of the package, however, reflect, in my view, a wrong view of national priorities; and (3) a large part of the tax cuts will result in a permanent loss of Federal revenues—affecting the budgets of 1974, 1975, and beyond—at a time when we may need all the revenues we can get. Let me spell out each of these points.

First, the fiscal package should provide needed stimulus to economic activity. This fact is obscured by some of the statistics and the rhetoric with which the program is clothed. On paper the President proposes to reduce fiscal 1972 expenditures by $4.7 billion, slightly more than the $4.2 billion net revenue loss from his tax proposals. In the President's speech announcing the program, and in the explanatory material released by the White House, the statement is made that the tax reductions will not be inflationary because they will be balanced by expenditure cuts. This is, of course, economic nonsense. A program which really reduced expenditures dollar for dollar with taxes would not stimulate the economy, and would not increase the total jobs available.

Fortunately, however, the substance of the President's program contains much more economic sense than the rhetoric. In real economic terms, the measures he has proposed will effectively cut taxes by more than expenditures. Some of the announced expenditure reductions are on paper only; the 3-month postponement of the proposed effective date of revenue sharing from October 1, 1971, to January 1, 1972, merely reflects what would, at a minimum, have occurred in any event. The $700 million saved by delaying parts of the President's "special revenue sharing" proposals falls into the same category. Moreover, the $3 billion estimated revenue loss in fiscal 1972 from the 10 percent investment credit reflects the lag in tax collections relative to corporate tax liabilities, actual corporations will get a tax break of about $5 billion in fiscal 1972, of which only about $3 billion will show up in revenue loss this year. With respect to the fiscal effects of the revenue collections from the 10 percent import surcharge, several important points need to be made; if this surcharge is to be handled as it should, namely as a bargaining tool to get dollar devaluation, then it should be in effect only for a very short period—a matter of weeks or a few months—and should have virtually no fiscal impact. If, on the other hand, it should be in force for a longer period (running the risk of wrecking the international trade structure), its immediate domestic impact will be approximately neutral—the depressing effect on buying power, which results from collecting $2 billion taxes from those who do buy imported goods, should be roughly offset by the switch from imports to domestic production occasioned by the 10 percent added tariff.

In table 1, I have attempted to give a very rough estimate of the net fiscal stimulus emerging from the President's fiscal proposals. The time has been too short to make very precise estimates; but the general magnitudes are, I think, in the right ball park.

If you look at the table you will note that on an annual basis during the fourth quarter of 1971, assuming passage by that time, the first half of 1972, the fiscal stimulus runs between $5 and $7 billion annual rate.

(The table referred to follows:)

TABLE 1.—FISCAL IMPACT OF THE PRESIDENT'S FISCAL PROPOSALS

[Billions of dollars; annual rates; national income account concepts]

Items	Calendar years 1971 (4th quarter)	1972 1st half	1972 2d half
Real expenditure cuts:			
Federal pay postponement		−3.0	
Federal employment cut	−0.3	−.6	−1.2
Postponement of welfare reform		−.3	−4.5
Other deferrals	−.2	−1.1	−1.1
Subtotal	−.5	−5.0	−6.8
Tax reductions:			
Accelerate income-tax relief		2.3	2.3
Investment credit	[1] 5.5	5.5	2.8
Auto excise repeal	[1] 2.3	2.0	2.0
Subtotal	7.8	9.8	7.1
Net fiscal stimulus	+7.3	+4.8	+.3

[1] Does not take into account the retroactive features of the investment credit and auto excise tax repeal.

Mr. SCHULTZE. Now these numbers should be interpreted carefully. They don't measure the economic response, only the size of the fiscal stimulus.

The economic response will lag behind the stimulus. Moreover they do not reflect the impact of the program on actual tax collections of the Federal Government, but rather I think in a more meaningful way its impact on the accruing tax liabilities of individuals and corporations.

Despite the rhetoric about balancing tax cuts with expenditure cuts, the President's fiscal program quite appropriately provides a significant overall fiscal stimulus, when we compare its results with what would have occurred in its absence.

My second point has to do with the particular components of the President's proposals. While welcoming their aggregate stimulating effect, I do not believe they are at all well balanced from the standpoint of equity or national priorities.

In January the President announced a major liberalization of depreciation regulations for business firms, worth about $3 billion in reduced tax liabilities at the present time. The 10-percent investment credit adds $5 billion in additional tax relief for business. Given the great investment boom of the late 1960's, the current rate of business investment, and the state of excess capacity in large parts of the economy, I do not believe that the national priorities dictate this double tax relief addressed to business investment. Nor do I think that it will have the same job creating stimulus at the present time, as tax relief to individual consumers.

Other elements of the President's fiscal program exhibit the same kind of problems. The auto excise tax repeal represents a permanent loss of $2 billion in revenues. The important social programs which could have been financed in future years by that $2 billion are in effect being sacrificed in order to stimulate yet additional production of automobiles on already congested and polluted highways. On the expenditure side of his program, the President proposes to postpone the effective date of welfare reform for another year, from July 1, 1972, to July 1, 1973. While this would only reduce outlays by several hundred million dollars in the current fiscal year through administrative and "made ready" cost reductions, it would reduce the payments to the poor, principally the working poor, by $4 to $5 billion in the next year, fiscal 1973. Moreover, the proposal has unfortunate symbolic meaning, insofar as it explicitly puts the fight for welfare reform effort at the bottom of the priority list, while long-term stimulation of automobile production and private investment goes to the top.

A third and related point has to do with the permanent nature of part of the tax reductions proposed by the President. The auto excise tax repeal and 5 percent of the investment credit represent permanent tax losses of about $5 billion a year. While we need tax cuts at the present time, we need them badly, to help bring the economy out of recession, we will—once the economy has returned to full employment—need every dime of revenue generated by the present tax system to meet even a minimal estimate of national needs in the public sector. Almost every future projection of the fiscal dividend for the mid-1970's shows that it is very slim indeed, and far too small to be eroded by permanent tax cuts.

Indeed, it is undoubtedly the longer term effects of the tax proposals which led to the highly dubious recommendation to postpone the welfare-reform package. In reviewing his 1973 budget, in its formative stage, the President most certainly was faced with a difficult problem even before last week's decisions. Preliminary estimates of Federal expenditures most probably were significantly in excess of projected full employment revenues. And the President has repeatedly stressed his intention never to propose a budget in which expenditures exceeded full employment revenues. Hence a difficult budget paring job was already in prospect. Then, to this set of facts, was added the $5 billion or more revenue loss from the permanent 5-percent investment credit and the auto excise tax repeal. The problem became even more critical, from the President's view. Postponement until July 1973 of the welfare reform package, which fortuitously would lower estimated 1973 expenditures by the same amount as the loss from permanent tax cuts, was seized upon as the means out of this dilemma. Quite explicitly, therefore, a priority choice was made between autos and machine tools on the one hand and the poor on the other. The poor lost. This was pure priority choice, since the net economic impact of the decision was neutral—$5 billion in revenue losses were offset by $5 billion in expenditure cuts.

If the overall stimulus of the President's fiscal proposals is highly desirable, but the particular components are wanting on grounds of social priorities and excessive permanent loss of revenue, what alternatives are available which meet the highly laudatory Presidential objective of stimulating the economy, while avoiding the unwanted side effects of his proposals? There are such alternatives. One such set is laid out below:

(1) The Congress could attach to the law reinstating the investment credit, a provision in effect repealing the administratively instituted depreciation liberalization. This would eliminate a permanent revenue loss of about $3 billion, without significantly affecting the prospects for private investment over the next several years. As it now stands, the depreciation liberalization actions will be tied up in court review over

the next several years, and the businessmen will be hesitant to base investment decisions on its permanent validity. At the same time, a 10-percent investment credit this year followed by a permanent 5-percent credit should give a significant, and sufficient, boost to investment incentives.

(2) Do not enact the auto excise tax repeal.

(3) Enact the speedup in individual income tax relief, as proposed by the President.

(4) Inaugurate, as part of the fiscal package, an immediate program of relief for State and local governments hit hard by the loss of revenues accompanying the recession, make this relief based on an automatic formula. Unlike the Federal Government, these State and local governments cannot maintain their expenditures during periods of economic slowdown and revenue shortfall, but get caught in an economic vise which forces them to scramble about cutting highly needed public services. A program of general Federal aid, replacing their temporarily depressed revenues, would put about $4 billion a year into hard-pressed State and local services. But as the economy picked up, and State and local revenues rebounded, this particular aid would gradually taper off. This is not revenue sharing, nor should it be subject to the controversies which surround a permanent revenue-sharing bill. Rather, it is an income security measure for States and local governments, much in the spirit of unemployment compensation.

A relatively simple formula could be developed to accomplish this purpose, and I would be happy to discuss this further with the committee.

(5) Postpone for 1 year, part or all of the social security tax increases scheduled to take effect next January. In total these will add about $7 billion to the tax bill paid by workers and employers in calendar 1972 (assuming enactment of the social security provisions in H.R. 1). A fully employed worker, earning $10,000 per year will pay $175 extra in social security taxes next year (and his employer another $175). On the other hand, that same worker, assuming he headed a family of four, would get only about $80 in income tax benefits from the speedup in tax reliefs proposed by the President. If half of the scheduled social security increase were postponed, the fiscal impact would be a $3 billion reduction in tax liabilities.

(6) Continue work on the family assistance plan, already passed by the House in H.R. 1, retaining the effective date of July 1, 1972. Even if it cannot be completed by the end of this congressional session, as the Senate Finance Committee gives first attention to the President's fiscal package, passage of the family assistance plan by next March or April would still allow it to go into effect on or about the currently scheduled July date.

Table 2 shows the fiscal impact of these proposals, assuming that the other parts of the President's package are not changed. Aside from modest differences in timing, the fiscal impact is about the same as that proposed by the President during the next 12 months, and provides some net stimulus in the second half of next year, but two major differences between the two sets of proposals stand out: First, as the economy returns to full employment all the fiscal stimulus in the alternative package disappears. There is no permanent loss of revenues, relative to present tax laws and administrative regulations.

Repeal of depreciation liberalization roughly offsets the revenue loss from the permanent 5-percent investment tax credit. The acceleration of individual tax relief and the postponement of social security tax increases represent changes in timing, not permanent losses. The cyclical aid to State and local governments phases out as the economy moves closer to full employment, again leaving no net drain on the budget. Fiscal stimulus is provided, therefore, without giving away the long-term revenues we will sorely need in later years.

(The table referred to follows:)

TABLE 2.—ALTERNATIVE FISCAL PACKAGE

[Billions of dollars: annual rate: national income account concepts]

Item	Calendar years: 1971, 4th quarter	1972: 1st half	1972: 2d half
Expenditure reductions:			
President's proposals	−0.5	−5.0	−6.8
Less: Maintaining July 1, 1972 date of FAP		+.3	+4.5
Total, revised expenditure reduction	−.5	−4.7	−2.3
Tax reductions:			
Repeal depreciation liberalization	−3.0	−3.0	−3.0
Investment tax credit	5.5	5.5	2.8
Cyclical aid to State and local governments [1]	4.0	3.0	2.0
Postpone ½ of social security increase [2]		3.0	3.0
Accelerated income tax relief		2.3	2.3
Total tax reductions	6.5	10.8	7.1
Total, net fiscal stimulus	6.0	6.1	4.8

[1] Assumes the fiscal program is sufficient to drive the average unemployment rate for the 2d half of 1972 down to 5 percent, as a consequence of which the amount of cyclical aid to State and local governments would decline over the next 18 months.

[2] This particular estimate assumes that all of the tax rate increase now scheduled for Jan. 1, 1972, and ½ of the ceiling increase in H.R. 1 are postponed for a year.

Mr. SCHULTZE. The second set of differences between the two packages lies in their different priority choices. The alternative package does provide needed investment stimulus, but in a reasonable amount. The remaining fiscal stimulus then flows through State and local governments, individual taxpayers—via accelerated income tax relief—and workers—via postponement of the social security tax increase. Moreover, the alternative package does not set priorities in terms of providing permanent tax losses at the expense of the poor—it does not require the postponement of the family assistance plan for another year.

In summary then, the President's proposals would provide needed fiscal stimulus, but could well be modified to provide the same stimulus without the sacrifice of permanent budgetary resources and with a more balanced view of national priorities.

Let me turn now briefly to the wage-price freeze. As a means of beginning the fight to break the wage-price spiral, the President's 90-day freeze is to be welcomed. It will undoubtedly create much confusion and cause some short lived inequities. But these will be trifling compared to the alternative inequities caused by the combination of heavy unemployment and continued rapid inflation.

The purpose of the 90-day freeze is twofold: To break inflationary expectations through a sharp and dramatic action, revising the administration's prior stand on the question of directly influencing wages and prices; and, second, to buy time during which a longer-term incomes policy can be worked out.

This week's upsurge in bond prices testifies to the measures success, at least for the moment, in its first objective, changing inflationary expectations. But the real test of this policy will come at the end of the 90-day period. What longer term policy will have then been developed to replace the freeze which cannot be continued for a significant period?

It seems to me there are four possible lines of action which could be announced at the end of the 90-day period:

First, a continuation of the freeze for another short period. That I think would be very bad. It would be tantamount to a confession that the administration had been unable to develop a meaningful incomes policy. This would have a very damaging effect. Moreover, the inequities of a freeze—particularly one which has no effective enforcement machinery—grow worse and worse as time passes.

The second alternative possibility, an announcement that this freeze had worked, that the inflationary spiral had been broken, and that the freeze could be lifted without the substitution of any longer term incomes policy, except perhaps pious and generalized injunctions to business and labor to be good boys. This would also, I believe, be both naive and disastrous. However useful the freeze is to buy breathing room, it will not in 90 days break the back of inflation. I cannot really imagine that this will be the announcement we will hear at the end of the freeze period.

The third alternative, inauguration of full blown wage and price controls, enforced in detail, by law. Again I find it hard to believe that this administration would resort to such controls on a long term basis. I agree with what has been their view that this would put the economy in a permanent straitjacket, and ultimately poison domestic political life with the frustrations, pettiness, and ill-feeling that would accompany rigid detailed controls in peacetime.

The fourth alternative, announce, in quantitative terms, guidelines or standards for reasonable wage and price behavior. These standards would be basically voluntary in nature, but could be backed up by a Presidential statement that he would resort to his standby powers under the Economic Stabilization Act of 1970, hopefully as extended, to use the force of law against flagrant violation.

By this device, many of the advantages of wage and price controls could be achieved without most of their disadvantages. Detailed supervision over the pricing practices of each of America's 4 million businessmen, and minute inspection of every aspect of every single wage bargain would be unnecessary. No massive bureaucracy would be required. Flexibility for meeting individual situations could be retained. But flagrant violation of the wage-price standards could, as a last resort, be contained by the force of law. In an overheated economy this approach would not work. The pressure of demand would inevitably lead to all sorts of devices to circumvent the standard. But when the price and wage spiral exists in the absence of excessive demand, as unions strive to "catch-up" on the cost-of-living and in relationship to each other, and when business firms mark up prices to cover cost increases fully, even in a weak market, then the effective moderation of wage increases in major bargaining situations and of large administered price increases, should spread throughout the economy. Overheated demand will not, in these circumstances, drive nonunion wages up in relation to those won in major contracts, nor will the prices charged by small producers or retailers in competitive markets begin to outstrip the pace of advance in administered prices, at least in any generalized way.

In short the President has bought time to develop a reasonable set of wage and price standards. I believe that an equitable set of standards taking into account the legitimate interests of both business and labor can be developed. Finally, I believe that the standards can be applied flexibly, with primary reliance on voluntary cooperation, but with the "club" of mandatory controls in the background. Such standards won't work forever. But they could ease the economy out of the present spiral into a more stable future.

At this point, Mr. Chairman, may I interpolate my view that much of the criticism that we are hearing these days of the 90-day freeze strikes me as petty, and sour grapes. As I noted above a long period of freeze with little enforcement machinery would indeed be inequitable. But I find it hard to imagine that postponement of wage adjustments or needed price adjustments for a period as short as 90 days will really work serious injustice to anyone. It would be better for those who are spending their energy blasting the freeze to negotiate vigorously with the newly formed Cost of Living Council about the shape of the incomes policy which will emerge at the end of 90 days.

And I might say the same thing about a few members of the administration who are already violently attacking the critics with whom they are going to have to negotiate an incomes policy. Perhaps there should be a 90-day freeze on rhetoric.

Let me turn very briefly to the international aspects of the program.

As I mentioned earlier, this is an aim or an area in which I feel much less confident to speak than is the case with the domestic aspects of the program. There is, however, one major point I would like to make.

The 10-percent surcharge on imports is presumably a bargaining tool, designed to provide some leverage to the U.S. position in negotiation over devaluation of the dollar. It is the ABM of this economic package. If it is truly only a bargaining tool, then it need be imposed only during the critical stage of negotiation over exchange rate realinements. And, in turn, that means that it should not be in effect for more than several weeks, or several months at the outside, while talks proceed between ourselves and the Japanese, the Common Market countries, the U.K. and Canada. Should other nations come to believe that it is more than a bargaining tool, that it will be used to ease domestic political pressures for protectionist measures, then the fabric of international trade relationships so painfully built up in the postwar period can come unravelled at frightening speed.

Dollar devaluation is needed, and let's call it devaluation. And the United States does perhaps need additional leverage in the negotiations directed to this end. But whatever good might come from devaluation could be far more than offset by the proliferation of protective devices around the world, if any suspicion occurs that the 10 percent U.S. surcharge represents our long term response to balance-of-payment difficulties.

In summary, Mr. Chairman, as an evaluation of the President's proposals, this presentation has necessarily concentrated on areas where I believe the Congress could serve the public interest by modifying particular elements of those proposals. That fact should not obscure the point I made at the outset. The comprehensive initiatives undertaken by the President should be highly welcomed. He has begun a process which can very quickly result in significant progress toward three major objectives, the return to prosperity, the control of inflation, and the restoration of balance-of-payments equilibrium.

As the President himself pointed out, there is plenty of credit to go around, and if in an expeditious manner the Congress modifies some of his proposals—retaining the fiscal stimulus while securing greater equity and a better balanced set of priorities—there will still be plenty of credit available for the administration itself.

Thank you, Mr. Chairman.

Chairman PROXMIRE. Mr. Saulnier.

STATEMENT OF RAYMOND J. SAULNIER, PROFESSOR OF ECONOMICS, BARNARD COLLEGE, COLUMBIA UNIVERSITY

Mr. SAULNIER. Mr. Chairman, Senator Mansfield, in the circumstances it ill behooves me to associate myself with my friend, Mr. Schultze's proposal that we have a freeze on rhetoric, but I will be brief.

I appreciate very much the opportunity to participate in your committee's review of President Nixon's recently announced economic stabilization program. I shall be happy to respond to specific questions, but let me begin with a few brief comments.

1. With one exception, the foreign exchange side of the program strikes me as entirely reasonable.

First, it was a prudent move to close the gold window. As a practical matter, letting the dollar float against other currencies is the only way to find new rates of exchange that can be maintained with some hope of stability. And I do not expect the dollar to go to discounts much beyond those already established.

Second, my major reservation has to do with the import surcharge. For one thing, it has the effect of complicating the process of finding equilibrium rates of exchange. Moreover, there is a risk that whatever its merits as a negotiating asset, the surcharge will engender reactions from other countries that will complicate the problem of reaching agreement on new exchange rates and new machinery for settling imbalances in international payments. Hopefully, it will be removed soon—in my judgment, the sooner the better. It would be constructive for the Joint Economic Committee to encourage the administration to that end.

Third, I hope the arrangements designed to replace the now-abandoned U.S. dollar standard will involve pegged rather than unpegged exchange rates. A wider band of permissible fluctuation around par could be helpful, but 3 percent on either side of parity is surely the outer limit of what would be desirable. Naturally, it should be understood that pegs can be adjusted without the act becoming an international incident of great moment, and that they will in fact be moved up or down as circumstances require. It should not be too great a challenge to foreign exchange technicians to devise arrangements and understandings to help assure that result, and I suggest that they be asked to do so.

Fourth, the present flexibility of exchange rates should be taken as an opportunity to throw off the whole apparatus of restrictions on capital flows. These have been in effect now for about 8 years, all the time regarded as temporary, and it should be clear now that they are ineffective and counter-productive as an approach to meeting a balance-of-payments deficit. Actually, it will be impossible for the dollar to float to true equilibrium values while restrictions on international flows of capital are still in effect. I hope your committee will urge the administration to act promptly to remove them.

Fifth, it should not be difficult to devise satisfactory arrangements for holding international monetary reserves. This is another task for technicians. What is important is that reserves should function not only as a means of settling payment imbalances but also as a force for exercising discipline on the monetary and fiscal policies of nations participating in the system. The object should be to devise machinery that will have that result.

2. The immediate problem on the domestic side of the stabilization program is to make the statutory freeze on prices, wages, and rents, and the voluntary freeze on dividends, work effectively and equitably. This will require a hard line on exemptions. The granting of exemptions, even those with merit, will undermine the willingness of those not exempt to cooperate and ultimately make the whole program unworkable. I have been pleased to see that early rulings on key questions suggest a hard line is being taken. I hope your committee will support such a policy.

For the longer run the problem is to devise a follow-on approach that will be more viable than a freeze. Of course, the ultimate goal must be to eliminate controls altogether, and return to a free market, but it is inconceivable that the need for restraint will have disappeared in 90 days, and unthinkable that the freeze could be lifted in the face of continuing upward pressure on wages and prices without some alternative arrangement in its place. Obviously, plans must go forward at once—on a kind of crash basis—for an arrangement more flexible, more selective, and more equitable than a freeze. My preference is for something of the review board type rather than a system of specific, mandatory ceilings.

Your committee will, I am sure, be making suggestions in this connection.

3. Let no one delude himself that freezes or review boards put an end to inflation—they only suppress it temporarily. But they do provide time in which to apply fundamental correctives—the point is that the time be used productively. One need not be a hard-shelled monetarist to know that inflation is basically a monetary phenomenon and cannot be brought under control except in a context of non-inflationary monetary policy. Accordingly, it is absolutely essential to understand that a freeze on prices and wages will ultimately come to nothing—and the same applies to any other program of direct controls—unless accompanied by a policy involving money supply in-

creases consistent with stable prices. Considering that money supply has been rising for over 6 months at 10 to 15 percent a year, it is obvious that the road back to price stability must be a long one.

I have all along warned that money policy since early 1970 was essentially inflationary. However, now that we are on an inflationary money supply path, it is no time for the Federal Reserve authorities, in a burst of new found prudence, to apply monetary brakes abruptly. My suggestion is that they concentrate on short term money rates, not on monetary aggregates, orthodox monetarists to the contrary notwithstanding. In the circumstances, an escalation of short term rates, up to and possibly above 6 percent on 90-day Treasury bills—which seemed imminent 2 weeks ago—would surely start another disintermediation process, stop the housing expansion, and reverse the recovery. Fortunately, money rates and bond yields moved down in the past few days, particularly since the President announced his program. The object of Federal Reserve policy must be to encourage that trend.

4. Admittedly, a monetary policy designed to avoid disintermediation could, and probably would, slow the process of overcoming inflation. But not necessarily, and in any case it is a risk that has to be taken. There is a greater risk, however, which is that inveterate expansionists, of which there are a good number, will seize on direct controls as a shield behind which to pursue essentially inflationary monetary and fiscal policies. This has happened again and again elsewhere in the world in the wake of devaluations and behind the presumed protection of incomes policies. If it happens in our case, it can be forecast with complete confidence that the present freeze, and whatever else follows, will ultimately break down. Therefore, it is vitally important that your committee support not only a Federal Reserve policy that will avoid expansionist errors but a budgetary policy that will do the same. In this connetcion I believe it would be constructive to abandon use of the full employment budget concept. It should be clear by now that a large Federal deficit, even though it is expected to disappear at full employment, helps perpetuate inflation side-by-side with unemployment by worsening inflation psychology and putting upward pressure on interest rates.

I doubt that the fiscal proposals in the President's program will prove unduly expansionary or interfere with achievement of anti-inflation objectives. In particular, the resumption of the investment tax credit is a sound proposal. It will help revive a severely depressed capital goods industry. It will create jobs. It will promote higher productivity and help reduce costs. And by reducing costs it will help overcome inflation. All in all, a constructive step. I hope your committee will advocate prompt action by Congress on the President's tax and budget proposals.

5. My conclusion is that (*a*) provided the freeze is accompanied by an adequately disinflationary monetary and fiscal policy, (*b*) provided it is replaced in due course by more flexible and selective control arrangements, and (*c*) provided everyone cooperates, the President's stabilization program will put us in a position to overcome cost and price inflation and ultimately to resume growth, without the impediment of direct wage and price controls, at a rate consistent with our national potential.

The strategy of the program looks good to me. What is needed to make it work is cooperation—from the Congress, from the leadership of labor and business and from the whole body of Americans. If I may say so, Mr. Chairman, I believe the primary aim of your committee at this juncture should be to do everything it can to enlist the needed cooperation. This is not a matter in which we can afford to fail.

Thank you very much.

Chairman PROXMIRE. Thank you very much, Mr. Saulnier.

Mr. Sheahan, I understand you have about a 10-page prepared statement. I would appreciate it very much, you are kind of the anchor man here, in sort of an unfortunate position, if you could abbreviate your prepared statement as much as you can and we will print the entire prepared statement in full in the record and we will go through it very carefully.

Go right ahead.

STATEMENT OF JOHN SHEAHAN, PROFESSOR OF ECONOMICS, WILLIAMS COLLEGE, WILLIAMSTOWN, MASS.

Mr. SHEAHAN. I have addressed myself entirely to the wage price set of questions, and essentially agree with what has already been said. I think the freeze which is now in effect is an understandable reaction to a situation that was totally out of control, but that the worst possible next step would be to extend it.

We need a flexible economic system and we need flexible wages and prices. Even if the general freeze could be enforced for a longer period, it should not be. What is needed instead is a limited selective system directed at a few key sources of special difficulty. A general freeze is an abdication of the responsibility to tackle the difficult job of selective action.

The administration will deserve great credit if it comes out with a new program before the 90 days are up.

What should a new program be like? I would suggest thinking of something in between an all-out freeze and a system of guideposts as we knew it in the early 1960's. We should aim at something tougher than the guideposts in the way of enforcement but perhaps not try to cover the whole economy to the extent that they did.

The reason that a comprehensive system of controls is unnecessary and undesirable is that the great majority of labor and product markets in the United States are characterized by a reasonable facsimile of competition. Trade associations and union pressures abound, but in most cases they do not greatly change the course of wages and prices.

The other side of the coin is that there are a relatively small number of labor and product markets in which changes are much more arbitrary.

When the groups with the power to make arbitrary decisions act in ways that they consider necessary to defend themselves, they often encroach on the real income of the rest of the country. They impose a tax on the people who do not have such power: a tax which simultaneously transfers income to themselves and lowers real national income by distorting the structure of prices and wages.

Which group is competitive and which is not, and what to do about them? None of them wear white hats, and of course we are not talking about two sharply defined categories but about shadings of power that change constantly. But it might make the point more concrete to suggest some orders of magnitude and some plausible candidates for special attention. Within manufacturing, problems of market control are often associated with high degrees of concentration and difficulties of entry. Those industries in which the four firm concentration ratios are above 60 percent and are therefore likely sources of trouble do not constitute quite 20 percent of all our manufacturing industries and do not account for more than 20 percent of manufacturing value added. Within that 20 percent, some industries have little genuine market powers because of imports or competition from close substitutes, so less than 20 percent constitute serious problems.

But I would not think that manufacturing would be the first and most important target. I would nominate two other fields that could be worked on quite directly. They are medical fees and the pricing practices of industries in which the Government itself acts to enforce market control, perhaps especially in the oil industry and transportation.

On the side of labor, the majority of workers have mighty little bargaining power. It is surely nominal or nonexistent for workers in retail and wholesale trade, secretaries and officeworkers in general, migrant farm labor, nurses, workers in laundries and motels, and probably in a wide range of manufacturing such as canneries, textiles, and clothing, sawmills, and small-scale local manufacturing of all kinds. There is a world of difference between the pressures these workers can exert and what can be done by the printers, construction unions, coal miners, automobile and steelworkers, and the public service employees in some of the large cities. The differences can be seen readily enough in the wage rates that now exist and in the ways in which they have been moving.

When workers in well organized industries raise their wages they do not impinge upon the profits of the companies for which they work. They take away real income from the workers who have lower wages. The characteristic of the period through which we have been passing is that the better placed workers have been gaining at the expense of the poorer.

To divide workers into the privileged and the exploited, and industries into those which can defend themselves readily and those which cannot, is a treacherous exercise. But the differences are real. They cast an interesting light on the arguments by some unions and industries that it is unfair to pick them out for restrictions and leave the rest of the economy free. It is not the weak groups which make this complaint; it is the ones which have been raising their incomes at the expense of the rest. It is a false idea of equity to treat the weak and the strong exactly the same. And since a general economy-wide system of controls is neither workable nor desirable, to argue against selectivity is to hand the advantage to the strong.

But if there are a number of groups strong enough to extort special advantage from an uncontrolled economy, how could it be possible to get them to accept a reduction of their special advantages? What, if anything, might be done? I would like to consider that question under two alternative hypotheses: (1) That the administration genuinely wishes to moderate wage and price inflation without a permanently depressed economy, and has the political skill to enlist the cooperation of some of the stronger unions, and (2) the possibly more plausible assumption that the administration would like to do something but maybe not too much, and cannot get the unions to cooperate.

On the more optimistic assumption, the solution would not be difficult. Its general outline would surely be similar to the wage-price guideposts, moderately amended to take account of some valid technical criticisms raised in subsequent analysis.

It should be possible to take advantage of the fact that we have such high excess capacity now. If aggregate demand is stimulated, profits will rise very rapidly even with prices held stable and wages increasing.

This makes it possible in the intervening period to allow wages to rise somewhat faster than the long-term trend rate of increase in productivity. It is possible to offer something above the long-term trend and, at the same time, work down from the greatly exaggerated settlements that have been made in the recent past.

If I were a union leader I wouldn't readily give up any power to bargain independently, but I might agree to lower increases in money wages in return for going in other directions. I would particularly recommend that the Government stipulate guidelines for medical fees, block price increases in conditions of excess capacity in the concentrated industries, and to stop using governmental controls to back up arbitrary pricing in oil and transport.

If the optimistic assumption had any validity it would not be difficult to do these things and if some of them were done there might be more hope for genuine cooperation from the unions.

On the less optimistic assumption that something is to be done but that it is not possible to get any cooperation, it is still not necessary to throw in the towel. Without the cooperation of any union at all, the Government can bring down the price of oil, or at least stabilize it, by permitting American oil companies to bring in more of their external supplies. Similarly, the many Government agencies which regulate ratemaking could be directed to introduce somewhat more concern for the public in their decisions.

To raise airline rates this year, when airline load factors were perhaps as low as they have ever been in history, was a depressing example of a company-oriented decision adverse to efficiency as to stabilization. I was delighted to read of the activity of the Regulations and Review Board in intervening before the ICC to force reconsideration of proposed rate increases that would otherwise have been automatically approved, and I was disgusted last year when the Government supported Florida tomato growers in blocking imports of Mexican tomatoes for the specific purpose of raising prices in the United States. The battle goes on every day. If the administration wishes to do something more serious about inflation, the best place to start may be with the Government itself.

Beyond that, a national health system creates both the means and the responsibility to do something about norms for medical charges, the heavy governmental role in construction provides great possibilities for affecting wage trends and labor practices in this area, the use of subsidies and regulation of rates gives an important toehold in transportation, and a return to more active antitrust enforcement could increase the odds against arbitrary pricing in industry generally. None of that requires explicit cooperation from unions. But if something genuine were being accomplished in these areas, the chances of such cooperation might well improve.

The idea of a freeze is worrisome. It is as if the hard work of selecting the targets and working out special ways of coping with complex problems could be escaped by waving a magic wand. It is wrong to think that everything can be controlled, and perhaps even worse to try to do it. The most likely result would be a general failure that could discredit the selective effort that is needed. A selective effort in turn is unlikely to mean that inflation will be fatally stopped. But the rate of inflation should be reduced and some other objectives which are at least equally valuable could be served at the same time. Perhaps the most worthwhile goal is to cut down on the uneconomic wage and price changes that both hurt the weak and reduce real income: to use the powers of Government to define and promote a more coherent evolution of monetary claims in the interest of both efficiency and fairness.

Thank you.

(The prepared statement of Mr. Sheahan follows:)

PREPARED STATEMENT OF JOHN SHEAHAN

The 90-day freeze now in effect is an understandable reaction to a situation that was out of control. But perhaps the worst possible next step would be to extend it. The economy needs enhanced flexibility, and needs a flexible system of wages and prices to promote it. Even if a general freeze could be enforced for a longer period it should not be. What is needed instead is a limited, selective system directed at a few key sources of special difficulty. A general freeze is an abdication of the responsibility to tackle the difficult job of selective action.

The Administration will deserve great credit if it is able to present a system geared to the guidance of change *before* the stated period of the freeze is up. If it does not, we will be faced with the equally unhappy alternatives of letting accumulated pressure lead to a sharp jump in wages and prices immediately after the freeze, or of keeping what is essentially a negative and inefficient blanket control in effect indefinitely. It might be useful to plan on something like a two-year period of limited intervention. The basic problems are unlikely to disappear in two years, so something else will probably be needed afterward. But the best of programs will prove to raise some unnecessary headaches and to miss some objectives, so it may be preferable to plan on something that will come to an end and need rethinking fairly soon.

A comprehensive system of controls for the whole economy is unnecessary and undesirable because the great majority of labor and product markets in the United States are characterized by a reasonable facsimile of competition. Trade associations and union pressures abound, but in most cases they do not greatly change the course of wages and prices. The other side of the coin is that there are a relatively small number of labor and product markets in which changes are much more arbitrary. They are never completely free of market restraints, but the scope for setting charges higher than they could have been in a competitive context is sometimes fairly wide. When these groups defend themselves against what they consider to be encroachments on the earnings to which they are entitled, they take away from the rest of the society part of its real income. They impose a tax on the people who do not have such power: a tax which simultaneously transfers income to themselves and lowers real national income by distorting the structure of prices and wages.

Which group is which, and what to do about it? None of them wear white hats, and of course we are not talking about two sharply defined categories but about shadings of power that change constantly. But it might make the point more concrete to suggest some orders of magnitude and some plausible candidates for special attention. Within manufacturing, problems of market control are often associated with high degrees of concentration. Those industries in which the 4-firm concentration ratios are above 60 percent, and thus particularly likely to be able to control their markets include something under 20 percent of all manufacturing industries with almost exactly 20 percent of manufacturing value added.[1] But some of these cases have little effective control, either because of imports competition or close domestic substitutes. So the problem area within manufacturing is less than 20 percent of all industries, and is probably confined to that quite small list in which new entry is especially difficult. But manufacturing should probably not be the first target anyway. I would nominate two that may be both more important and easier to supervise: medical fees and the pricing practices of industries in which the government itself acts to enforce market control, perhaps especially in the oil industry and transportation.

On the side of labor, the majority of workers have mighty little bargaining power. It is surely nominal or nonexistent for workers in retail and wholesale trade secretaries and office workers in general, migrant farm labor, nurses, workers in laundries and motels, and probably in a wide range of manufacturing such as canneries, textiles and clothing, sawmills, and small-scale local manufacturing of all kinds. At any rate, there is a world of difference between the demands these workers can exert and what can be done by the printers, construction unions, coal miners, automobile and steelworkers, and the public service employees in some of the large cities. The differences can be seen readily enough in the wage rates that now exist and the ways in which they have been moving. Average hourly earnings in transportation equipment are double those in retail trade; when the former group forces through an increase in wage rates far above the trend of productivity improvement it is not taking money away from the large corporations, it is taking real income away from lower-wage workers. Workers in contract construction had average wages roughly 50 percent above the average for manufacturing in 1969, and have been widening the gap since. The characteristic of the period through which we have been passing is that the better placed workers have been gaining at the expense of the poorer.

To divide workers into the privileged and the exploited, and industries into those which can defend themselves readily and those which cannot, is a treacherous exercise. But the differences cast an interesting light on the arguments by some unions and industries that it is unfair to pick them out for restrictions and leave the rest of the economy free. It is not the weak groups which make this complaint: it is the ones which have been raising their incomes at the expense of the rest. It is a false idea of equity to treat the weak and the strong exactly the same. And since a general economy-wide system of controls is neither workable nor desirable, to argue against selectivity is to hand the advantage to the strong.

But if there are a number of groups strong enough to extort special advantage from an uncontrolled economy, how could it be possible to get them to accept a reduction of their advantage? What, if anything, might be done? I would like to consider the question under two alternative hypotheses: (1) That the Administration genuinely wishes to moderate wage and price inflation without a permanently depressed economy, and has the political skill to enlist the cooperation of some of the stronger unions, and (2) the possibly more plausible assumption that the Administration would like to do something but maybe not too much, and cannot get the unions to cooperate.

On the more optimistic assumption, the solution would not be difficult. The earlier wage-price guideposts, moderately amended to take account of some valid technical criticisms raised in subsequent analysis, would serve to provide a norm for wage settlements in those power-play negotiations where the public nearly always loses. If they could be applied only to automobiles and metals, transportation and public services—that is, if workers in these fields could be assured the right to raise their incomes at the same rate as national output per man but no more—a significant fraction of other negotiated contracts would line up on the same norm and the dimensions of the problem could be cut in half. If I were a union leader I would not agree to it unless something were also done to stipulate guidelines for medical fees, to block price increases in conditions of excess capacity in the concentrated industries, and

[1] Source: U.S. Senate, Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, *Concentration Ratios in Manufacturing Industry, 1963* (Washington, 1966), summarized and discussed in F. M. Scherer, *Industrial Market Structure and Economic Performance* (Chicago, 1970), chapter 3.

to stop using governmental controls to back up arbitrary pricing in oil and transport. But if the optimistic assumption had any validity it would not be difficult to do these things too. The essence of the question is whether or not the Administration believes in such efforts at stabilization and equity, and is willing to take the trouble of exerting pressure when it is needed. It would be needed. People do not give up privileged positions easily.

It is worth noting that a potentially helpful background factor at present is that productivity could increase at rates well above trend averages if demand were stimulated. We have enormous excess capacity and profits could rise rapidly even with fixed prices. This provides some extra lee-way, not present when the guideposts were put under such strain in 1965–66, to authorize wage increases while blocking price increases, without fear of squeezing profits and the capacity to invest. That extra room might well be used to allow unions which have not negotiated new contracts so far this year to make settlements for increases above any normal trend-line rate of productivity increase. That is, it seems both unfair and unnecessary to insist that negotiations in the immediate future be settled at rates that would be consistent with an economy that had eliminated inflation. This would mean that wage-price inflation will not be stopped cold. But that is probably an unrealistic goal at best, especially when it is necessary to increase the prices of imports. It sems too much to aim at complete stabilization, but a two-year program aimed at a progressive reduction of the rate of inflation could permit lower settlements, without inequity, before the period is over.

On the less optimistic assumption, that something is to be done but that it is not possible to get any cooperation from the union, it is not necessary to throw in the towel. Without the cooperation of any union at all, the government can bring down the price of oil, or at least stabilize it, by permitting American oil companies to bring in more of their external supplies. Similarly, the many government agencies which regulate rate-making could be directed to introduce somewhat more concern for the public in their decisions. To raise airline rates this year, when airline load factors were perhaps as low as they have ever been in history, was a depressing example of a company-oriented decision adverse to efficiency as to stabilization. I was delighted to read of the activity of The Regulations and Review Board in intervening before the ICC to force reconsideration of rate increases that might otherwise have been approved automatically on traditional regulatory grounds. And I was disgusted last year when the government supported Florida tomato growers in limiting imports of Mexican tomatoes for the specific purpose of raising prices in the United States. If the Administration wishes to do something serious about inflation, the best place to start may be with the government itself.

Beyond that, a national health system creates both the means and the responsibility to do something about norms for medical charges, the heavy governmental role in construction provides great possibilities for affecting wage trends and labor practices in this area, the use of subsidies and regulation of rates gives an important toehold in transportation, and a return to more active antitrust enforcement could increase the odds against arbitrary pricing in industry generally. None of that requires explicit cooperation from unions. But if something genuine were being accomplished in these areas, the chances of such cooperation might well improve.

The idea of a freeze is worrisome. It is as if the hard work of selecting the targets that matter most and devising ways to cope with individual cases could be escaped by waving a magic wand. It is wrong to think that everything can be controlled. and perhaps even worse to try to do it. The most likely result would be general failure that could discredit the selective effort that is needed. A selective effort, in turn, is unlikely to mean that inflation will be stopped completely. But it should be reduced, and some other objectives which are at least equally valuable could be served at the same time. Perhaps the most worthwile goal is to cut down on the uneconomic wage and price changes that both hurt the weak and reduce real income: to use the powers of government to define and promote a more coherent evolution of monetary claims in the interest of both efficiency and fairness.

Chairman PROXMIRE. Thank you very much, Mr. Sheahan and gentlemen.

Let me start off with Mr. Schultze.

Mr. Schultze, I think you have a very neat package in many respects. I was particularly impressed by your proposal that we try to tailor fiscal stimulus so that we get it now. In the first place, we all know we need it now; in the second place, your long-term analysis at the Brookings Institution has shown that the Federal Government itself could become an engine of inflation within 3 or 4 years by 1974, 1975, maybe earlier, especially if we try to go beyond present programs.

So that, as I understand it, what you are proposing is that we provide action in the fiscal area to get people back to work, and we do it in such a way that it would pretty much automatically phase out as we get to a point of rather full employment; is that correct?

Mr. SCHULTZE. That is correct; yes, sir, you summarized that precisely.

Chairman PROXMIRE. Then what I miss in your analysis, and it came through loud and clear in Otto Eckstein's analysis yesterday, is the notion that an element of stimulation above and beyond monetary policy and fiscal policy is the stabilization policy itself; that is, to the extent that you can instill in consumers confidence that the back of inflation has been broken, they will no longer save the 7½ percent of their income they have been saving, they will save maybe 6½ or maybe 6 percent, this additional spending should add a great deal of impetus to the economy, and is a factor that perhaps the monetarists and the fiscalists have ignored too much.

What would you think about that?

Mr. SCHULTZE. Well, like most economists, I have a double-barreled response to it. In one sense I agree with it. I think it is clear if you look at what has happened in the financial markets already, the mere announcement of the program has had a psychological effect, and, in turn, some of that will have a real effect in the sense that the lower interest rates and higher bond prices are going to have real stimulative effects.

I agree there will also be a psychological reaction on many decisionmakers in terms of being more willing to spend money and to make commitments.

On the other hand, it seems to me that ultimately this won't work unless there is some real payoff. Consumers, for example, insofar as they are worried by the insecurity of their own or their neighbors' unemployment, may be temporarily comforted by announcements, but will really react in the long run only insofar as there is real visible improvement.

Let me point out, Mr. Chairman, that when there is 6-percent unemployment at any one moment of time, that means there has been something like 25 percent of the labor force unemployed at one time or the other during the year, and in turn that 25 percent who have been unemployed one time or the other during the year, have been joined by relatives, friends, and neighbors. So while I agree with Mr. Eckstein there may be an important psychological impact, I don't think we can count on such an impact, and a program which had only an announcement effect and no real substance would give you a flash in the pan probably and then die out.

Chairman PROXMIRE. But you see what you are doing, as I understand it, is to assume it won't have any effect at all.

Mr. SCHULTZE. No, sir.

Chairman PROXMIRE. Am I wrong in that?

Mr. SCHULTZE. No, sir.

Chairman Proxmire. In other words, you are assuming, let's take the more optimistic assumption, and I admit right now they are pretty optimistic, that this freeze is going to work during the 90-day period, and after the 90-day period they can put something into effect that will hold down the increase in prices, and this is going to have a beneficial psychological effect through 1972. Mr. Eckstein's projection shows the economy progressing and with unemployment diminishing and the economy growing primarily, as I say, because of restored consumer confidence. Isn't it unrealistic to leave that confidence factor out if this is true, if they reduce their saving by only 1 percent; that is, go down from 7½ to 6½ percent, that this represents a stimulus of probably $7 billion?

Mr. Schultze. Well, again, I will not even attempt to deny and will agree that there could be a very important psychological effect. I think the real policy question is whether or not the real fiscal stimulus, combined with some psychological effect, will do too much.

Now, it seems to me if you look at the size of the real fiscal stimulus that I have laid out, its impact on the economy will clearly not be excessive. Even if it is as I have depicted, this will not be enough, in and of itself, to move the economy steadily back to a high prosperity era. Hence, the Congress, taking action on this program to provide the kind of fiscal stimulus in total that the President has recommended, is not, in my view, taking significant chances that it is going to overdo it.

Let me add one other point. In the alternative fiscal package which I have proposed, one of the major elements is a postponement of next January's increase in the social security tax increase. That need not be done until the very last days of the Congress. It might indeed be quite prudent in the case of that particular piece to wait, observe, look at events; and I think the Congress can act on this matter relatively quickly, particularly something like a reduction in taxes; wait until the last part of the Congress to make up one's mind firmly as to whether this part of the program should be put into effect or not. But I think the essential point comes back to a judgment as to whether or not the real stimulus, plus whatever psychological stimulus there is, will overdo it; and while nothing is impossible, I find it highly unlikely.

Chairman Proxmire. Mr. Saulnier.

Mr. Saulnier. I am not as much concerned, Mr. Chairman, with fiscal arithmetic as perhaps Mr. Schultze is. I think the problem is twofold. The acute problem was to do something about a foreign exchange situation that was deteriorating very rapidly. The United States was forced into action by a seriously deteriorating position of the dollar abroad. That was the acute problem. That in itself was enough to require a program.

Now, the second and more basic and continuing problem is to do something about inflation, and, believe me, if this program succeeds in reducing the inflation rate, there will be no cause to worry about the fiscal arithmetic. Whether the net effect will be umpty-ump billions or some other billions, no one can say, but one can be sure the effect will be strongly positive. But if it doesn't do something to bring inflation under control, more fiscal stimulus, more monetary stimulus, it will not only fail to be beneficial but will be actually harmful.

What we have here is a program that gives us a chance to overcome inflation. It gives us a handle on a situation for which there has not been a handle—at least nobody has found it, or been willing to grasp such handles as were there. But this program provides a handle, and if people get behind it and give it a chance, it will be effective.

Chairman PROXMIRE. Well now, let's come to that point. I think that you gentlemen all agree, all three of you, as I understand it, agree on approximately what we should do after this 90-day period is over, that the freeze should not continue, we should not have wage-price controls comprehensively, that we should not have a program doing nothing and saying that is enough.

You all agree we should have some kind of wage-price review board or some kind of wage-price guidelines. You differ somewhat on the details, but I think because you do have this basic agreement, and that was also the notion of Heller and Eckstein yesterday, we have a unanimity of opinion on it. I think it is very important that we try to zero in on the kind of postfreeze policy we should adopt so that we will have a constructive program and also so that the freeze itself will work so there will be more confidence that there is something coming.

Now, No. 1, let me list four ingredients that I think are vital to making this succeed and see if you gentlemen would agree with this. No. 1, labor and business must be in on the takeoff. They must be brought into full consultation; this must be worked out in a way in which they will agree. No. 2, any increases in wages should be based fundamentally on productivity increases, some allowance possibly for cost of living but primarily on productivity increases.

No. 3, any major announcements, any major decisions, on increases in wages or prices must be announced 30 days in advance or some period in advance to give the President an opportunity to bring the force of his office to bear so that he can act to dissuade any inflationary decisions.

And, fourth, a position taken, as I understand it, by a couple of you, I know by Mr. Sheahan, that we should focus primarily on the concentrated phases, the concentrated areas, of our economy; that is, on perhaps the hundred biggest businesses and the large labor unions. I would like you each to comment on that kind of program to see if you think you would go further than that or how you would put these into effect.

Mr. Schultze, go right ahead.

Mr. SCHULTZE. Well, I think I would first start by saying that I think those four points are right. I have maybe one modification or one addition. I don't think it is simply concentrated industries that you should concentrate on, concentrated industries that you should spend most of your attention on. I think, for example, Mr. Sheahan is quite right that there is a chance even without national health insurance through medicare, medicaid, in cooperation with the Blue Cross and Blue Shield, to do something about medical fees and about hospital charges, and I normally wouldn't call this a concentrated industry but this is an example of an area going outside of concentrated industry.

Second, in the same vein it seems to me, again really this supplements what Mr. Sheahan is saying, I think it is absolutely critical that these four points which relate to how the Government deals with business and labor, it is absolutely vital that the Government itself take action in areas where it has responsibility or to put this another way, any kind of an incomes policy is going to ask labor union leaders and businessmen to do what does not come naturally; namely, don't get the most for your members; namely, don't get the highest price increase which might be consistent with your way of looking at the market.

At the same time, if we are going to ask them to do that then the President is also going to have to stick his political neck out, and the Congress ultimately is going to have to at least not nitpick him to death, by taking some very difficult actions in areas where the Government has a major impact on prices and wages.

Mr. Sheahan has mentioned a few of those, the regulated industries, in the case of oil, I think there are many other cases where this is true, in the case of farm prices across the board. So I would add that to your list of four.

Chairman PROXMIRE. Mr. Saulnier.

Mr. SAULNIER. Mr. Chairman, I think the four points are very well taken, and I have absolutely no exception to take to them. I would like to add a fifth, and it is the point already referred to by Mr. Schultze. I have said repeatedly that I didn't think the Federal Government was really doing all it could do in the administration of its own programs to help bring cost and price inflation under control.

When I was here in this line of work I was chairman of a Cabinet committee called the Cabinet Committee on Government Activities Affecting Costs and Prices. It was established by President Eisenhower in the spring of 1959, and its purpose was to try to see to it that programs of the Federal Government were used to help promote the stabilization process—procurement, lending, loan insurance, stockpiling, quotas, the determination of wage rates under Davis-Bacon, the whole business.

What I would like to see the Government do is to establish quite a visible group with the specific mandate of using governmental programs in a way that will promote the success of the President's stabilization effort. It would be pretty late, but a lot of things are late, and in any case it would be a very useful step at this time. I hope your committee will encourage the administration to that end.

Chairman PROXMIRE. Mr. Sheahan.

Mr. SHEAHAN. Well, I am worried that we are all so close together and also somewhat reassured. The points you stated are essential and I think correct in all respects, though I would like to add with some footnotes.

On the point about labor and business being brought in on the formulation of the program, I would hope that efforts to do this are in process right now. With all the hostility shown in the last few days, it would be surprising if there were much willingness to cooperate on the part of labor. But I shouldn't think we would have to give up if labor did not participate. There are so many things that can be done in the government sector, there are so many things that can be done to check aggressive pricing by business and in the professions, that a fairly substantial program could be run and could do a great deal to help even if the unions do sit it out.

The point about linking wage increases to productivity increases is excellent. It is important that the administration make clear what it expects. All industries and all unions are being reasonable in everything they do, only their concept of what is reasonable hasn't had any norm against which they themselves could check. It is a particularly complicated business now because the American wage level, relative to foreign wage levels, became too high in terms of the relationship between our productivity and productivity abroad. A correction must include either a reduction in real income or a slice off what would have been a normal growth rate. To apportion the cost of adjustment is a delicate task but at least the Government should try to work out figures that add up, that take advantage of the present slack, and that make explicit the necessities of adapting to a lower real wage to adjust to the foreign side. Everyone would have a clearer idea of what is involved if the Government said what really seemed reasonable.

On the suggestion that major price and wage changes be announced in advance, that would be fine if what you mean are 100 corporations, 10 unions, and two or three professional associations. It is important to restrict this to areas of decision that the Government can watch, watch in the sense of knowing what is happening to the classifications of workers, watch what is happening as new products are introduced and prices are changed through a product change. Nothing is going to be simple. It would be a farce if the Government tried to maintain very extensive controls it could not effectively administer.

I would like to back up Mr. Schultze on the point that the problem area is not just manufacturing. It includes oil, and certainly medical care, and construction. If manufacturing had to be given up completely, I don't know that this would make a tremendous difference provided that we have the protection of competition from imports to restrain excessive domestic increases.

Chairman PROXMIRE. Before I get back to Mr. Schultze, my time is up, but I would before I yield to the majority leader, I would like to ask one question and you might deal with that, you and Mr. Saulnier, in view of the fact Mr. Sheahan has already mentioned it. Yesterday it was made clear by the leaders of organized labor that theirs is going to be a very, very hard kind of cooperation to get. Mr. Meany was emphatic, Mr. Woodcock was very strong in his statement, he is going to testify before this committee later on, but they made it clear that organized labor is very reluctant to go along on cooperation here. They feel that the inequities are very serious and real.

These are reasonable men, intelligent men. They, I think, have indicated, as you know, in 1962 to 1965, it was their cooperation primarily that gave us the stable wage costs. I think what we have to do is to develop something that is completely fair to labor. We have to recognize what their difficulties are and try to adjust to that.

How do we bring them into this situation, how can we, or is it possible to do that? Is it possible to win labor cooperation for some kind of a program that will be effective in holding down the cost of living?

Mr. SCHULTZE. Well, I obviously have no nice pat answer to that. It seems to me there are several very important points that bear on it. First it seems to me, it is terribly important to accompany any such program with a vigorous move toward a lower unemployment rate, so that real incomes can rise substantially even with lower money wage increases in an economy which is vigorously moving forward.

So a program which aims not only at controlling inflation but is vigorously moving toward higher employment, lower unemployment, seems to me to be able to get cooperation. I think part of the recent reaction has been all mixed up between disappointment over the high unemployment rate and the dissatisfaction over economic policy in general up to now, on the one hand, and the problem of the wage-price freeze.

Point No. 2, it seems to me that it is going to be paradoxically more possible to run an incomes policy if labor and business are consulted and negotiated with in formulating the policy but don't run it. By that I mean we should avoid like the plague a tripartite review board with a labor representative and a management representative and a public representative because in some cases at least, union leaders will find it possible to accept a particular wage settlement if they are forced to in terms of their relationships with their own members, but would never dare to agree to it directly.

That is the second point. Don't do it tripartite, you are more likely to get cooperation than not.

Finally, it seems to me that there must be on both sides during the 90 days, there has to be, some toning down of the rhetoric because much of what labor is griping about now appears to me to go beyond the 90 days. Many of the problems they raise are quite genuine problems. They are very serious problems, but they are not really all that big a problem for 90 days. Or as Mr. Sheahan said, it would be wonderful if you could get something out in 70 days.

So if we could get the rhetoric toned down now and negotiate in terms of what is going to happen after this period, we would be better off. Making that distinction, it seems to me, would be very helpful, and it is very confused now if one reads the statements.

Chairman PROXMIRE. Mr. Saulnier.

Mr. SAULNIER. Mr. Chairman, it is really hard for me to believe it would be impossible to design some kind of public group or body, including labor, including business, and including hopefully some representatives of the public generally, it is hard for me to believe it would be impossible to put together such a body. It should be possible to do so and if a spirit of fairness prevails in it, it will work.

Chairman PROXMIRE. Could I interrupt to say are you taking opposition to the position taken by Mr. Schultze that we should not have a tripartite board or we should have a consultative or advisory group to work together with the administering of it?

Mr. SAULNIER. Well, of course, the responsibility for administering the program must rest with government but government will have to work in this case with its constituencies, with the parties at interest in the matter, and that calls for some kind of a multipartite body.

I think what you will find is that there is a great deal of support for the program in the country. I listened to a report the other night of a survey that was taken in which a fairly substantial panel of people across the country were asked, "What do you think of the President's program?" And what the survey showed was that 85 percent of the wives of labor union members were favorably disposed toward the program. I hesitate to say they were enthusiastic, I don't know how you measure such things, but they were for it, and they were for it for the simple reason that they confront inflation every day in the grocery store, and they have had their fill of it, and they see a way to stop it with this program, at least to get started on a way of stopping it, and they are for it.

I think that is what labor leadership is going to find and I hope they will respond to it.

Now, just one technical point, Mr. Chairman. Your point No. 2 is that wages should be in line with productivity improvement, and on all technical grounds that is, of course, entirely sound. But what troubles me about it is that we start from a situation in which labor cost increases are vastly in excess of productivity improvement. It is hard to know just what the facts are, but average compensation increases are probably around 8 or 9 percent. On the other hand, productivity improvement, on a long-term basis, is somewhere around 3½, maybe not even that high. So we have such a gap here that to hope to close it in one fell swoop is asking too much.

I have never been a great enthusiast for gradualism, but the problem we have here of bringing wage increases back into line with productivity gains is so big we are going to have to work patiently and gradually to close the gap.

If I thought we could get wage increases stepped down over a period of time, under some kind of broad guideline approach, to the point where they would ultimately be in line with productivity improvement, I would be happy to see it take time to do it.

Chairman PROXMIRE. Do you want to add another word, Mr. Schultze?

Mr. SCHULTZE. Yes, just one illustration of the way to do that might be something like setting a standard which would allow wages to go up in line with productivity plus one-half of the prior year's cost of living increase, and to require business firms to absorb some specified percentage of cost increases. If you work through this it turns out that you do gradually within several years just about wipe out that excess of wage gains over productivity increases. Something like that might be in order.

Chairman PROXMIRE. Well, as chairman of this committee, I intend to ask the staff of this committee to very carefully study the 2,500-word statement by the AFL-CIO as to why they oppose this and I intend to study it carefully myself. We are having Leonard Woodcock up before us as a witness and we will certainly question him in great detail and do all we can to elicit from the labor movement and, as I say, they are reasonable, intelligent, and able people, exactly what kind of program they want.

They want to stop inflation, too, and we just cannot accept the situation in which they say they are not going to cooperate with the President. So nothing happens, and we are just determined to do all we can to find out what kind of a program they want and on that basis see if there is anything we can work out beyond that with the administration and with other people who are involved.

Senator Mansfield.

Senator MANSFIELD. Mr. Chairman, my questions will be brief, as will my comments, and I would hope that the answers would be approximately brief.

We were talking a good deal about industry and labor today, but we seem to have given little attention to people living on social security, retirement funds, annuities, pension plans, and the like, and I think they are entitled to some consideration as well as the other segments which comprise the population of this Nation.

Gentlemen, is there, in your opinion, an economic emergency which at this time calls for drastic action?

Mr. SAULNIER. My answer to that is definitely yes.

Mr. SCHULTZE. Yes.

Senator MANSFIELD. Mr. Sheahan.

Mr. SHEAHAN. Yes, sir; I agree.

Senator MANSFIELD. Is it possible to propose a policy which would not be inequitable?

Mr. SAULNIER. Senator, it would be a miracle if any program were devised in which inequities would be totally absent. What we have to strive for is a program that will be as equitable as possible, but there are inevitably going to be some inequities.

Senator MANSFIELD. Mr. Schultze.

Mr. SCHULTZE. I would simply add that it is possible to devise a program in which the small remaining amount of inequities are substantially less than what we get by doing nothing because we are now getting inequities which are both inflation and unemployment.

Senator MANSFIELD. Mr. Sheahan.

Mr. SHEAHAN. I very much emphasize that latter point. It would be hard to do anything worse than not do anything.

Senator MANSFIELD. On what authority did the President put into effect regulations governing wage, price, and rent controls?

Mr. SAULNIER. He acts in this case under a statute already enacted by the Congress.

Senator MANSFIELD. That is an obvious answer.

Mr. SAULNIER. Yes.

Senator MANSFIELD. Because I just want to bring out the point that the Senate twice, most recently several months ago, in its renewal of legislation giving the President standby wage-price and rent controls, did so unanimously, and he has that authority under statute until, I believe, April 1, 1972.

In your opinion, gentlemen, does what the President has advocated in the domestic field in many, if not all its aspects, differ from what the President has advocated down through the years?

Mr. SAULNIER. Senator, it is a substantial reversal of a position the President has previously taken. Now, I do not criticize him for that. On the contrary, I would commend the President for having insisted as long as he did that he wanted to overcome inflation without recourse to direct controls.

If the administration is to be faulted, it is to be faulted for not having pursued the policies that would have made it possible for them to overcome inflation without direct controls. But they didn't do it, and that is water over the dam. In the circumstances there was little for the President to do but to reverse his position.

Mr. SCHULTZE. I would simply note, Senator, that as I understand it there is more joy in heaven over one sinner converted than 99 who stayed in the fold.

Senator MANSFIELD. We are getting away from the road to Damascus. And I take it you would all agree with what Mr. Saulnier has said?

Gentlemen, how close last Sunday night, in your opinion, was the dollar to really plummeting way, way down?

How much time, in your opinion, did the President have left before he undertook to take drastic action?

Mr. SAULNIER. I think there was a very high probability, Senator, that by Monday the Federal Reserve Bank of New York and the U.S. Treasury would have been deluged with demands on the remaining gold supply. I think we were on the edge of a foreign exchange crisis that could never have been met except by closing the gold window.

Of course, one could have emptied the gold barrel, but interestingly enough, I haven't heard any suggestions that that should have been done or any complaints that the President did what he did. I think we were very close to the kind of crisis you are suggesting.

Senator MANSFIELD. Mr. Schultze.

Mr. SCHULTZE. I can't answer the question. I think what is really relevant is that it was bad enough fully to warrant the President's action. What would have happened otherwise I don't know except it clearly was warranted.

Senator MANSFIELD. Mr. Sheahan.

Mr. SHEAHAN. Well, I can't imagine the dollar plunging tremendously in value. If the exchange rates of European currencies rise 10 percent in relation to ours they are going to have a very difficult time competing with U.S. business in a free market. It was desirable earlier and it was very desirable that we finally took the step when we did. But I shouldn't imagine that it is right to picture it as if we are up against the wall about to be shot. The pressure has been building up and I am glad the President acted to release the exchange rate when he did.

Senator MANSFIELD. Well, I raised the question with a specific purpose in mind because we were told last Tuesday that we were within 2 weeks of coming close, in coming close to an answer to the question which you have just been asked.

Will the 90-day freeze be time enough to achieve economic stability? I take it, Mr. Saulnier, you think it might, and Mr. Schultze and Mr. Sheahan think it will not.

Mr. SAULNIER. Senator, I would like to be understood as believing that 90 days will not be long enough.

Senator MANSFIELD. It would not be?

Mr. SAULNIER. No.

Mr. SCHULTZE. Senator, to make sure——

Senator MANSFIELD. Yes.

Mr. SAULNIER. To make sure that answer is understood—and I think all of us would agree on this—none of us think you can break inflation by a 90-day freeze, but neither do any of us think you should extend the 90-day freeze. Rather, there is a need to come up with something else in the meantime.

Senator MANSFIELD. In other words, you can't reduce the 6 percent unemployment figure appreciably or the in excess of 5 percent inflationary figure appreciably within that time?

Mr. SCHULTZE. Or if you did and did nothing else it would just bounce back up again.

Senator MANSFIELD. All right.

If that is the case would it not then be up to the Congress and the administration to get together and decide on what a new economic policy should be?

Mr. SCHUTZE. Yes.

Mr. SAULNIER. Yes, indeed, without a doubt. Planning should go forward on a crash basis.

Chairman PROXMIRE. Involving the Congress, too?

Mr. SAULNIER. Involving the Congress, yes.

Chairman PROXMIRE. That is the reason we are having these hearings at this time.

Mr. SAULNIER. Right.

Senator MANSFIELD. May I say suggestions have been made over the past several months several times to the effect that it might be worth considering by the President if he were to form some sort of a congressional-Executive group composed of the chairman and ranking Republican members of the Banking and Currency Committees of both Houses, the Finance and Ways and Means Committees of both Houses, and the present committee, the chairman and his ranking Republican counterpart, so there could be better understanding and some functioning body which will be in existence which will prepare the way with plans for the situation which confronts us at the present time. Does that suggestion meet with any merit?

Mr. SAULNIER. I would be enthusiastic to see such a program launched.

Mr. SCHULTZE. Senator, without being able to comment on the particular form which congressional-Executive relationships should take in this period, I think your proposal meets one very major point; namely, that the worst thing that could happen is at the end of 90 days for the President to spring on the Congress a full blown proposal on a take it or leave it basis. By that I mean there must be some mechanism evolved to discuss this in a nonadversary relationship over the period.

Senator MANSFIELD. What would you think of such a mechanism being created in the meantime?

Mr. SCHULTZE. Excuse me, sir?

Senator MANSFIELD. What would you think of such a mechanism as I have mentioned being created in the meantime, coming together?

Mr. SCHULTZE. As I say, yours is, it seems to me, an appropriate way to do it. There may be others.

Senator MANSFIELD. There may be others but those are the individuals connected with, the most apppropriate committees connected in relation to the problem which confronts us.

What would be the result if the present freeze is jeopardized or undermined or fails? Go ahead, Mr. Saulnier.

Mr. SAULNIER. I think the result would be to reverse the recovery and to plunge us into another recession. That would come about, Senator, for the following one reason. If this program fails, and if people are going to have to say to themselves "this effort to control inflation has failed and the inflation rate is going to go up," you will find interest rates escalating, the bond market will dry up, the mortgage market will dry up, and that means there will be a constriction on investment in the economy, and we would start heading down again. Those are the stakes involved here.

Senator MANSFIELD. No. Schultze.

Mr. SCHULTZE. There are tremendous stakes involved. Whether the country would plunge into another recession or not I can't predict. I think I can predict that if this should blow up, if there should be violent confrontation politics and major flouting of the freeze, then it seems to me we have lost for a very long time in the future a golden opportunity to try to reconcile and have price stability and full employment, and everybody, literally everybody, must be interested in doing that.

So what would happen in the next 6 months I am honestly not sure but I do know that the consequences could be much worse than that in the sense of having lost maybe for many years the possibility of achieving these two great objectives simultaneously.

Senator MANSFELD. Mr. Sheahan.

Mr. SHEAHAN. I would certainly agree with all that. I take it that failure in this context means something like an explosion or showdown between the administration and the unions. Failure in the sense that the Governor of Texas may carry through his increases for school teachers or that the index may go up a percent or two, failure in that sense isn't terribly serious. In fact some rise in the index is practically inevitable because many import prices are being raised at least 10 percent and maybe more with exchange rate changes. It is wrong to think of the goal as an absolute halt to inflation. The only really desperate failure would be the one Mr. Schultz mentions that the union leaders decide they are absolutely incapable of cooperating with the administration, and that the administration take a rigid position that everything they have announced has to be followed to the letter without any adjustment or compromise. Both sides have to be willing to negotiate.

Senator MANSFELD. As I interpret what the unions, what Mr. Woodcock and Mr. Meany and others have said, while they have many questions in their minds I do not interpret their statements to indicate that they intend to do anything harsh within the 90-day freeze period announced which, I think, is in itself encouraging.

I think also that in view of the fact that inflation, unemployment, the recession which, in effect, faces this country today, and our international standing economically and financially, that the plans some of us had for getting the Congress out early this year may well have to go by the board because this question is too important, it affects every American in some form or other, and it is something in which I think the Congress can play a most important part. In order to remain on top of this situation it would appear to me as of this moment that we may well be in session for sometime beyond the end of the 90-day freeze period, and I say this with sadness, but I say it with firmness as well, because this question is not going to be ducked.

Mr. Schultze, you used the phrase that there ought to be a "90-day freeze on rhetoric."

I agree with you a hundred percent because I have been and am somewhat disturbed at the amount of personal acrimony which has already set in between labor and Government, between State governments and the Federal Government, and this morning between the U.S. Chamber of Commerce and Labor, and the apparent lack of understanding that unemployment, inflation, and dollar crises are national in scope, and must be met on that basis.

Everyone, myself included, will find serious, most serious, inequities, say, for example in the matter of the teachers who signed contracts last spring and who evidently will not get their raises next month. That, I think, is most inequitable, and other unions, which have signed contracts but which have not been put into operation because one small segment of the bargaining group has held out, and thereby created a most precarious situation as far as that particular unionwide contract was concerned.

There are serious inequities in the package announced by the President. I myself had, and have, grave doubts and on that basis, and this is repetition but I want it in the record, I raised some questions at the White House meeting on Tuesday morning last, and these questions expressing my own personal feeling were on the following subjects:

I raised the question, Why was a freeze not put on interest rates? The answer was that if that was done you would set a floor or ceiling, whichever way you wanted to define it, but that on Monday and Tuesday interest rates had gone down voluntarily from something above 6 percent to something below 6 percent, and Mr. Heller told us yesterday in this committee when he was asked that they were still going down.

Are they still going down today?

Mr. SAULNIER. I don't know about today, Senator, but they have been going down for the last few days, and a fortunate thing it is that they have been.

Senator MANSFIELD. Anyway, the record should show that was the reason which the administration told the Members of Congress who were called down last Tuesday that they did not consider or did not impose controls on interest rates.

I raised a question about the huge bonuses given executives, socalled executive bonuses in the large corporations. I was informed that they were cut, that they would not be paid during this particular period.

I raised the question about dividends, and the answer was that the administration called on all corporations to freeze their dividends at the rate at which they were at midnight Saturday last.

Then I raised the question, Why was not a freeze put on profits? The answer was that we are operating at about 72 or 73 percent of our industrial capacity at the present time. Some companies were making big profits, others moderate profits, some small profits, and some companies were going out of business. The question was then raised by the administaration in response to my question, How do you establish a criteria?

Gentlemen, how do you establish a criteria for a freeze on profits?

Mr. SAULNIER. Well, Senator, profits, because they are not a contractural return but are a residual, cannot be controlled the way contractural arrangements such as wages and prices can be controlled.

What can be done, and in the past has been done, is, after the fact, levy a tax against profits that are, on the basis of some stated standard, regarded as being excess. But that is a different approach; and let me add that in present circumstances, with profits down, it is not needed.

Mr. SCHULTZE. Senator, as an economist, I would have to say that if you have tough controls on prices that you should not have control on profits——

Senator MANSFIELD. Give us that again.

Mr. SCHULTZE. If you have tough control on prices you should not have control on profits. What you want to make sure is that if profits do rise they rise from higher efficiency or greater volume not from inflationary price increases.

The second point, however, leaving off my economist's hat, and trying to think like a negotiator, if, as a necessary price, if and only if as a necessary price of buying cooperation from other elements of the country it might be necessary to do something on profits, perhaps along the lines Mr. Saulnier suggested, it might be a price worthwhile paying. But I have to reiterate as an economist we are interested in stabilizing prices and getting reasonable increases in wages, and that the way profits flow is not what we are after.

Let me finally point out that at the present time profit margins, as a percentage of our national income or gross national product, are already at the lowest point in the postwar period so that it is primarily a political problem. As an economic problem it seems to me that we are after prices ultimately and that is the way to get at profits, through stable prices.

Senator MANSFIELD. What would you think of substituting profit sharing in industry as an alternative to the situations which have been developing down through the years?

Mr. SCHULTZE. Senator, I would hope that as one of the areas it is considering during this 90-day period of looking toward some kind of a longer run incomes policy that the Cost of Living Council and the Government in cooperation with the Congress, labor and business, would be giving very serious considerations to such things as profit-sharing arrangements, productivity bonuses, anything in which you are paying people additional income without raising prices or wages, and I think your suggestion, while there are no mechanical ways that I can come up with to do it, I think your suggestion is a most excellent one, and the Cost of Living Council should pay attention to it.

Senator MANSFIELD. It is not a new suggestion because I remember even as far back as before the Second World War there were scattered throughout this country various profit-sharing enterprises. One of them was located in Spokane, Wash., Mr. Eric Johnston, who later became the head of the Motion Picture Association here, you will remember him, a very fine gentleman, ran his business on that basis, had no trouble, had a high productivity rate, and had a good return on the investment in which all participated. It has been tried here and there, not on a large scale, but I think if you give the workers an interest in the business that you would get greater productivity and that the workers themselves would get more in the way of a tangible return.

Mr. SCHULTZE. It is my understanding, by the way, Senator, I am not familiar with the details, that Harry Bridges on the west coast, the longshoremen have worked out an arrangement in which they get in effect profit-sharing wages and it has worked very well from what I have heard.

Mr. SAULNIER. I would not want to be working as a longshoreman and depending for my wages sharing the profits of the shipping companies today.

Mr. SCHULTZE. They don't share the shipping company profits.

Mr. SAULNIER. And paying my grocery bills.

Let me point out, Senator that aggregate corporate profits in this period of inflation have not been going up but have been going down. Corporate profits before taxes in 1966 were $84 billion. In 1970 they were $75 billion. They are at a higher annual rate now, but still below the 1966 level.

In that same period, while profits were going down compensation of employees was rising from $435 billion to over $600 billion. So we have a distinct disparity here in this period in the behavior of total wage payments and total profits.

Senator MANSFIELD. And, of course, that is separate and apart from the 25 million Americans who are living on annuities, social security, and the like.

Mr. Sheahan, do you have something?

Mr. SHEAHAN. Yes, I would like to make a minor remark on some of this. It is certainly true that corporate profits in the aggregate are well down. But in the present context the fact that many corporations are having serious financial difficulties shouldn't be allowed to obscure a situation in which a fairly substantial number of companies are relatively immune. I am thinking particularly of drug and cosmetic companies, though not all of them by any means, and of General Motors' standard year in, year out, 20-percent return on capital, General Motors.

One of the troubles with the guideposts in the 1960's was that we had highly profitable corporations that were not raising prices but should have reduced them. The question is, Why just stabilizing prices is the right thing to do when your profits are rising very substantially? I should think that at some point corporations which have the benefit of special market positions might be induced to consider actual price reductions. That is to say excess profit can be identified in a number of cases, excess profits that last year in and year out.

Senator MANSFIELD. Yes, may I say that these statements and these questions, as I have indicated previously, have a purpose behind them, and the purpose is to put in the record the fact that these questions were raised when the White House meeting was held on Tuesday last, and to put in the record the answers as near as I could recall them, and your reaction to the questions as respected economists.

I mentioned yesterday that one thing which has not been mentioned much in the press or anywhere else was that in the President's package there was an announcement to the effect that he was going to cut foreign aid by 10 percent.

As the chairman of the, the distinguished chairman of this committee, said yesterday, it will be cut more, and it should be cut more because I think we are partly responsible, maybe in good part, for the position in which we find ourselves today.

For example, I note in a letter which came to me today—I don't know where it came from except, because it has got the U.S. Postal Service OH, Ohio, I guess. Outside, it is signed "Disgusted." It contains an AP article with no date, and I don't know what paper it comes from but it must be an Ohio paper. The headline says: "U.S. Has Paid $1 Trillion of NATO Defense Bill," and that headline is misleading. What it means, in effect, is that this country has spent over, well over, 1 trillion dollars out of a total NATO expenditure of one and a half trillion dollars on defense. But our expenditures include Vietnam and other parts of the world where the European nations themselves, except in small instances, have not become involved. But just think of it, over—this country since it has been a member of NATO, throughout the world has spent nearly one and a half trillion dollars on defense—no, excuse me, has spent more than a trillion dollars on defense, and most of that came from taxpayers, naturally. As far as Europe is concerned, in 1949 we were spending $13.5 billion or 72 percent of the $18.7 billion spent by all the NATO countries, and in 1970, I think, the figure was still at approximately $14 billion. But the record should be made clear that even if we withdrew all our troops and dependents from Europe that would not mean an automatic reduction of $14 billion because we would have to pay for troops stationed in this country.

In an area where you have 128 generals, one for every 2,300 men, an area where you have lieutenant colonels and colonels by the thousands, certainly is a waste area so far as American investments are concerned. But the point I am getting at is this: Not only in NATO but, as the President himself pointed out, we have expended $143 billion in foreign aid, and in Vietnam we have spent $130 billion. And I think if we will do a little tightening up on these investments—and I use the word "investments" advisedly, perhaps "adventures" in some instances would be better—that we could be in a better position then to clean our own house and put our fiscal resources in better order.

Thank you, Mr. Chairman, that is all.

Chairman Proxmire. Thank you very, very much, Senator Mansfield.

Senator Mansfield. First, may I ask unanimous consent to have the article put in the record, not the letter?

Chairman Proxmire. Without objection, it will be placed in the record at this point.

(The article referred to follows:)

U.S. Has Paid $1 Trillion of NATO Defense Bill

Brussels (AP): In the last 21 years, the 15 members of NATO have spent nearly $1½ trillion on defense. More than a trillion of that came from U.S. taxpayers.

A trillion is a thousand billions or a million millions. You get some idea of the amount if you add up the total value of all goods and services produced in the United States this year; it will just approach a trillion dollars.

Officials of NATO, the North Atlantic Treaty Organization, put at $1,469,396,000,000 the total defense outlays of these nations since 1949. Annual expenditures grew from $18.7 billion in 1949 to $106.4 billion last year.

The total for this year is expected to drop to $102.8 billion, because of a cut in U.S. defense spending. It is likely to start mounting again in 1971 because the Nixon administration plans to ask for more.

These are the 15 NATO members' defense expenditures both inside and outside the NATO area.

At NATO's annual meeting last week, 10 European allies agreed to make a modest start on sharing more of the burden. They will increase their spending by $1 billion over the next five years.

U.S. officials and congressmen have long complained about inequality. Of the total NATO outlay in 21 years, the United States has spent almost three quarters: $1,096,226,000,000. Much of this money, of course, has been spent in Asia, not in the Atlantic area.

The 12 European allies which maintain armed forces—Iceland does not—accounted for $373.17 billion. Canada spent $35.8 billion.

The European share in the spending remains roughly what it was 21 years ago. Of the $18.7 billion spent in 1949, the U.S. share was $13.5 billion, or 72 per cent. At that time Western Europe was still almost prostrate economically as a result of World War II. Aid under the Marshall plan was just beginning to flow in.

In 1970 the United States was spending $76.5 billion of the total $102.8 billion. Its share had risen to almost 74 per cent.

In the interval the European members had given up nearly all of their military spending outside Europe. They also became much more prosperous.

Military spending has hit heavily at the U.S. balance of international payments, so that Washington spends much more abroad than it takes in. West Germany has for years been helping to compensate for this my regularly undertaking to buy military equipment, services and treasury bonds in the United States.

Only a small portion of the sums spent have actually been used by NATO as an organization. The bulk paid out by the national government is for national purposes, only loosely coordinated by the alliance.

NATO refuses to disclose its own budget. It says only that over the life of the alliance about $4.2 billion has been spent on infrastructure—the building of airfields, communications networks, pipelines and other jointly used equipment.

Some additional spending was approved last week. All of it, like previous NATO spending, will come out of national budgets.

Chairman PROXMIRE. I want to thank you gentlemen very much. I might point out to you, in closing, that the economic indicators indicate why labor is very reluctant about wage-price guidelines, they look at what happened between 1962 and 1966. Manufacturing wage costs were stable pretty much through that period as a result of wage-price guidelines. I think wages did go up 3.2 percent for organized labor, they went up a little more for nonorganized labor but also the profits escalated from $55.4 billion in 1962 to $84.2 billion in 1966. In other words they went up by more than 50 percent, they went up at a fantastic rate. Profits are very volatile, you can take almost any period and prove anything, but during the period when wage-price guidelines were in effect organized labor feels that compared to what happened to profits they really took a beating.

First, they took a beating as organized labor and, in the second place, they took a beating because the distribution of profit was increased so enormously while they were foregoing a substantial wage increase.

I think this is one of the things we have to bear in mind. We may not be able to work out effective profit control but at least we ought to understand what is behind part of the labor's uneasiness about a wage-price guidelines system. Dr. Saulnier.

Mr. SAULNIER. Well, if I may say so, Mr. Chairman, that is a mixed comparison. In your figures you are comparing what happened to the volume of profits with a rate of wages costs.

Now, if you compare what happened to the volume of wage payments with the volume of profits you will get a more reasonable answer.

Chairman PROXMIRE. Well, of course, wages are a far greater component of income than profits. There is no question about that. You are dead right if that is the implication of your response. But nevertheless labor was concerned about the fact during this period you had an increase of about 60 percent in profits, an increase of maybe 15 percent in wages for organized labor or 16 percent, something of that kind, a tremendous disparity and, therefore, labor is wary about going into a situation in which once again guidelines might be used as a device for holding down costs for corporations and enable profits to increase and, of course, when you say you are not going to have an increase in dividends, I think anybody who has ever invested understands that doesn't mean anything because, after all, you can get your gain from capital gains and if dividends are not paid, those earnings simply go into the corporate treasury and increases the value of your stock. So the fact that the stock market is going up is of great benefit to investors and stockholders and gives them a greater income at the time that labor is forgoing additional income.

Mr. SAULNIER. Senator, a lot of stockholders have had a rapid education in these matters in the last few years. Stock prices today are below what they were in 1968 and early 1969, and in the interim they have been off as much as 30 percent, so that the average stockholder today, if he has been in the market for 4 or 5 years, is lucky if he is even with the board.

He is probably behind where he was in 1969.

Chairman PROXMIRE. What I am arguing is that you should look at this prospectively and understand why organized labor is somewhat uneasy and careful about going into the situation again.

Mr. Schultze.

Mr. SCHULTZE. One quick comment about any comparison. This comparison should be checked, but my recollection is during those precise years the increase in the real purchasing power of wages was the most rapid of the postwar period.

Senator PROXMIRE. Most rapid increase.

Mr. SCHULTZE. The real purchasing power during that period went up more than any comparable period in postwar history. It is subject to check.

Chairman PROXMIRE. It was a period of prosperity.

Mr. SCHULTZE. A period of very modest money compensation increase.

Chairman PROXMIRE. I understand Mr. Nader has been waiting, is about ready, but I think he wanted us to take a minute or two longer, so let me take advantage of this time to ask you about your responses to the priorities in this program. None of you gentlemen addressed yourselves to that. The President has obviously put a very high priority on automobiles. He has obviously put a very high priority on investments as compared to consumption. He may be right. It may be that in the short pull something like automobiles is the way to do it, it stimulates not only automobiles but steel and glass and textiles and many other things.

At the same time there is a very curious emphasis here because if there is one thing we don't need more of as a country it is automobiles, with pollution, congestion, all the problems involved in it. We would be better off with half as many as a nation.

Mr. SCHULTZE. As I indicated in my testimony I feel the total impact of the President's program is good but I think the priorities shown are bad. I think one could get the same total impact with a different set of priorities as I indicated.

Chairman PROXMIRE. Mr. Saulnier.

Mr. SAULNIER. Senator, I think you have to look at this program not in terms of the priorities of the tax package but in terms of its chances of overcoming inflation in our economy domestically, and, internationally, its chances of giving us a better foreign position. In that respect I am for it.

You can point to flaws in any tax package, but as far as the automobile excise is concerned I think there is good reason to believe that, in the absence of some action of that kind, what we would have been reading about in the newspapers in November, December, January, and February, would be substantially reduced sales of automobiles. Whether you get caught in the traffic jam or not, you have to be concerned about the impact of a sharp drop in auto sales on jobs.

A survey was taken by the Census Bureau in July which showed that consumer intentions to buy automobiles had turned down sharply from what they had been 3 months previously, and I read those numbers as meaning that auto sales by the end of this year would have been down at least 5 percent and possibly 10 to 12 percent.

My thought is that what the President's program is going to do is forestall that reduction. It will protect jobs in the auto industry, and, as part of the objective of doing something about unemployment, we have to acknowledge that that would be a plus.

Chairman PROXMIRE. Yes; I want to thank you very much. You have been most responsive and this has been one of the best panels that I have had the privilege of hearing since I have been in the Senate, and most timely.

Our final witness this morning is the distinguished Mr. Ralph Nader. I think that we are all aware of the great contributions that Mr. Nader has made to a greater appreciation of the role of the consumer. He has emerged in recent years as one of the most articulate and dedicated consumer spokesmen we have. We are honored to have you before us, Mr. Nader.

Do you have copies of your prepared statement?

STATEMENT OF RALPH NADER, ATTORNEY AT LAW AND CONSUMER ADVOCATE, ACCOMPANIED BY TOM STANTON, MEMBER, RALPH NADER'S PUBLIC INTEREST RESEARCH GROUP

Mr. NADER. Thank you, Mr. Chairman. The copies will be here momentarily.

Chairman PROXMIRE. All right.

Mr. NADER. I would like to introduce Mr. Tom Stanton, who will accompany me——

Chairman PROXMIRE. Senator Mansfield said he is very anxious to get back, he had to leave temporarily but he is going to try to return.

Mr. NADER (continuing). To discuss in any further detail the Domestic International Sales Corporation or DISC proposal that has been sadly lacking in the discussion, in the last few days' discussion, of the President's package.

I am grateful for the invitation to extend my comments on the aspects of the administration's new economic policies and proposals submitted to Congress.

It is not difficult to penetrate the semantic whirlwind, the facile assurances, and the insupportable economic reasoning which have been issuing from Government spokesmen this week if the administration's package is broken down into its constituent parts, confronted with its alleged objectives and evaluated within this context. First, however, it is appropriate I think to comment briefly on the processes of decision-making. Any governmental decision of this scope, Mr. Chairman, has legal aspects, political aspects, economic aspects, value aspects, human value aspects, and I think it is important at times to separate each one of these out insofar as that is possible and see where they add up.

The administration presents a fairly persuasive case against the prior signaling of its move with regard to the dollar, given the rampart speculation thereto in the internal money markets and other well-known variables. There is no excuse however, for the inordinate secrecy attending its other decisional preliminaries, particularly when there is a great need for public consideration and discussion and fact gathering. As my subsequent observations will illustrate, such preliminaries, both within and outside of Congress, might have retrained the most outrageously special interest features of the package. Beyond that, it is now clear that a number of corporate leaders knew in advance of portions of the package. Judging by its exceptional communique to dealers to start selling 1972 model cars with their new price increase immediately on receipt last week, General Motors knew what was coming by way of the price freeze and tried unsuccessfully to slide under the deadline. The public will never know probably what other early alerts there were and what other, if any, quid pro quos were agreed to in this ex parte, informal process of Government-corporate understanding.

I think there really has to be some limit, Mr. Chairman, to the Treasury's detachment from average citizens, and from economic groups in the middle- and low-income area that I think should have deserved at least equal consideration in these preliminary exchanges.

The process of secrecy also permits these policies to be announced or proposed with all kinds of projections for job development and inflation reduction that are not substantiated in any way by the Treasury other than their mere assertion. They are issued or proposed either as fiat or faith, depending on personal predilections of each particular Treasury official.

I think it is important also to add that if the Treasury was in a court of law with this degree of persuasion, it would be subjected to a summary judgment dismissal.

The declared objectives of the administration's proposals and actions are to increase employment, reduce inflation, and improve our competitive position in world trade. The proposed speedup of the $50 personal exemption increase for calendar year 1972 and the devaluation of the dollar should help one or more of these aims. The rest of the administration's package is grossly, and avoidably inequitable, and cynically indifferent to the needs for a progressive tax policy in actuality.

It will not result in more jobs that are needed and is harmful of consumer interests. Let us take these actions or proposals one by one.

1. The indefinite 10-percent import surcharge will become increasingly counterproductive the longer it is allowed to stay in effect. It will erode one of the few sources of price competition for many domestically produced goods, thus raising prices to the consumer indirectly as well as directly for the imported products purchased. It has a regressive effect on lower income families who purchase more of these cheaper goods. It may well encourage a retaliatory trade war. And as a Presidential action, the surcharge is of dubious legality under the Trade Expansion Act of 1962—a serious question into which the Congress should soon inquire.

I might also add the authority of the administration in the freeze also raises constitutional questions, and there are really important legal aspects to this whole move that should be explored before we give away entirely the arena to the economists.

It is possible that the surcharge will be revoked shortly, owing to the powerful opposition of the multinational U.S. corporations. Indeed, already representatives of General Motors, the Bank of America and other companies have voiced their displeasure publicly over this import surcharge. It could also be the surcharge is being used for short range tactical purposes in the negotiations over the dollar, and other trade matters (especially with Japan) which are commencing. Whatever may occur, the surcharge is no ally of the consumer or an anti-inflationary policy.

It may well be that the surcharge will be withdrawn within a month or two because its deployment seems to be hopefully and in part a tactical bargaining position.

Secondly, the tax policies and proposals have to be taken with the acceleration depreciation range (ADR) issued earlier this year by the Treasury. Taken together, the investment tax credit, the domestic international sales corporation tax windfall, and ADR, will amount to a massive tax relief to corporations of $9 billion in the first year of their operations. This is at the very least a 15-percent tax cut for large corporations especially, compared with the $1 billion one-time accelerated personal exemption cut for the average citizens or roughly 1.2-percent tax reduction, and just a one-time tax reduction, unlike the continual open ended corporation tax reduction.

Chairman PROXMIRE. What were those figures again for the individual and for the corporations on the percentage tax reduction?

Mr. NADER. Taking together with the ADR depreciation windfalls—they must be taken together——

Chairman PROXMIRE. That is the depreciation guidelines put into effect effective January 1?

Mr. NADER. Yes, announced January 1, yes, and issued finally in final form, in June.

Chairman PROXMIRE. But made retroactive?

Mr. NADER. Yes, the investment tax credit, the tax windfall for corporate exports and accelerated depreciation policies of the administration will amount to a massive tax relief to corporations of $9 billion in the first year of their operations. This tax relief or this corporate welfare program can be compared to a $1 billion one-time accelerated personal exemption cut for the average citizens or taxpayers, or roughly 1.2-percent tax reduction.

Chairman PROXMIRE. You are saying, tax relief for corporations is $9 billion and tax relief for individuals is $1 billion. Tax relief for corporations is indefinite, more or less permanent, and the tax relief for individuals is a 1-year, one-shot?

Mr. NADER. Exactly. This is of course per se grossly inequitable. The only possible justification left for the administration is to provide its evidence that such a discrimination will trickle down more purchasing power and produce more jobs.

In other words, the only conceivable justification for the administration's action is if it can prove that even though it is grossly inequitable, the leverage of its application to corporate investments will produce more jobs and a better economy.

The Treasury has absolutely no studies available to make this justification, not to mention the weakness of its case when compared with more effective alternatives such as strong antitrust enforcement, corporate excess profits tax, a reduction in personal income tax to increase consumer demand in an underutilized economy, and Federal expenditures in effective manpower training, mass transit systems, and other job-creating activity of high social utility. These alternatives, coupled with anti-inflationary policies toward interest rates, would improve the efficiency of the economy and permit consumer demand to direct productive decisions much more than the corporate welfare program of the administration.

In particular, the proposed investment credit of 10 percent for fiscal 1972 and 5 percent thereafter will provide a tax subsidy of from $4 billion to $2.5 billion annually to big business. That is because of the reduction from 10 to 5 percent. This proposal comes on top of the ADR depreciation regulations which are supposed to become a tax subsidy of $3.9 billion annually to corporations. And once again DISC, Domestic International Sales Corp., is resurrected to provide an annual tax windfall of almost a billion dollars to the large exporting corporations.

Taken together, these tax breaks amount to over $9 billion annually; by comparison, in fiscal year 1970, the last year for which published data are available, corporations paid a total of only $35 billion in Federal income taxes. In short, the President is using the excuse of a mismanaged economy and the resultant crisis atmosphere to cut corporate taxes by 15 to 20 percent. And corporate profits this year are already running at the rate of the early 1969 prerecession period (second quarter profits are up 12 percent over second quarter 1970). It would have been a triumph of honesty in public information if the President had so stated the facts in his dramatic announcement of last Sunday night. However, the message was clear to Wall Street, where stock prices jumped 30 points in the first day of trading.

Look at these corporate tax bonanzas one by one. The so-called ADR depreciation regulations were announced by President Nixon last January. These regulations are supposed to provide an annual $3.9 billion tax windfall to corporations by allowing them to write off machinery and equipment faster than it is actually used up. President Nixon termed ADR a reform to create jobs and growth. However, since his pronouncement, the regulations have been subjected to healthy pubic scrutiny. It is now fairly well agreed that ADR will have no significant short-term effects for at least 18 to 24 months.[1]

That estimate does not include the delay due to reluctance of business to rely on ADR unless the regulations are upheld by the courts. A lawsuit currently in Federal district court, to be argued by Dean Bernard Wolfman of the University of Pennsylvania Law School, charges that the regulations constitute an unlawful usurpation of congressional taxing powers by the Executive. The Treasury estimates that ADR, if legal, would cut corporate taxes by about 6 percent, just that one move.

It is dismaying to observe the administration attempt to impose a big business investment tax credit in addition to the expensive depreciation subsidy. The investment credit of 10 percent for fiscal 1972 and 5 percent thereafter would provide, to repeat, a tax subsidy of from $2.5 billion to $4 billion annually to corporations.

Prof. Robert Eisner, a prominent economist specializing in the study of determinants of capital investment, finds the investment credit unwarranted. I insert for the record a letter written this week to the New York Times by Professor Eisner.

(The letter follows:)

NORTHWESTERN UNIVERSITY,
COLLEGE OF ARTS & SCIENCES,
Evanston, Ill., August 16, 1971.

EDITOR,
New York Times,
New York, N.Y.

DEAR SIR: After maintaining a do-nothing, "prosperity-is-just-around-the corner" policy as long as it politically dared, the Nixon Administration has now done something. What it has done in the main is to return, with a vengeance, to the protectionist, help-the-economy-by-helping-the-rich policies for which Republicans have generally been distinguished.

A free market for the dollar abroad makes good economic sense. The freezing of the markets for wages and prices in this country at this time will generally deprive the average worker of any gains from productivity and will lower his real standard of living. He will pay more for Japanese radios, television sets and cars both because of the reactionary 10 per cent surcharge on imports and the likely depreciation of the dollar against many foreign currencies. Yet his own wage and salary rates will be frozen. The proposal to repeal the 7 per cent excise tax on autos is a step in the right direction, increasing real purchasing power by lowering prices, but by restricting the excise tax repeal to automobiles it offers most help to the relatively rich who buy the preponderance of new cars.

The equipment tax credit has one small desirable feature, a promised reduction from 10 per cent to 5 percent after one year. For this will offer business some incentive to spend now when the economy needs stimulus without offering a maximum permanent give-away. But it remains a huge multi-billion dollar tax concession to essentially large, capital-intensive business while welfare reform and direct efforts to aid our cities and aid the poor and put the unemployed back to work are delayed or abandoned.

The Nixon Administration talks of cutting Federal employment and foreign aid but there is no mention of the major drain on our resources and in dollar outflow: the billions spent for troops and bases in Southeast Asia, Korea, Europe and elsewhere.

President Nixon has made it perfectly clear that he is afraid that standing pat economically will lead to political disaster in 1972. How much his political

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[1] Economist Dale Jorgenson, speaking on behalf of A.T. & T. in favor of the ADR depreciation regulations, concluded that "There is a general consensus that the [economic] impact will not be an immediate one; that the average lag in investment expenditure requires about 18–24 months." It should be noted that Mr. Jorgenson believes that the regulations will have beneficial long-run effects, although other economists differ sharply with him on the value as compared with other economic measures of similar cost.

fortunes will be helped when the full dimensions of his help-the-rich program become clear may prove another matter.

Sincerely yours,

ROBERT EISNER,
Professor of Economics.

BIOGRAPHICAL NOTE

Robert Eisner is a professor of economics at Northwestern University in Evanston, Illinois, and a research associate of the National Bureau of Economic Research. He is a member of the Executive Committee of the American Economic Association and a Fellow of the Econometric Society. He has devoted a major part of his career to study of the determinants of business investment. His studies on the subject include: "Determinants of Capital Expenditure" (1956); "A Distributed Lag Investment Function," Econometrica (1960); "Determinants of Business Investment" (with R. H. Strotz) in "Impacts of Monetary Policy" (1963) for the Commission on Money and Credit; "A Permanent Income Theory for Investment: Some Empirical Explorations" (1967); and "The Aggregate Investment Function" for the International Encyclopedia of the Social Sciences (1968). He has also published a number of articles and testified on tax depreciation before congressional committees, including the Joint Economic Committee earlier this year.

Mr. NADER. He notes that the investment credit is:

A huge multibillion dollar tax concession to essentially large, capital-intensive business while welfare reform and direct efforts to aid the cities and aid the poor and put the unemployed back to work are delayed or abandoned.

As Professor Eisner noted in his earlier statement of opposition to ADR, which I introduce for the record:

* * * one of the last places where I would think that government intervention, help or subsidy is called for is in the investment decisions of the great bulk of American industry. There is no need for a handout to American industry to persuade them to do what should be in their own interest, that is have the optimal capital and investment policies for their own efficiency and profits.

(The full text of the above quoted matter follows:)

Prof. ROBERT EISNER,[1]
Evanston, Ill., April 12, 1971.

Re the asset depreciation range system.

COMMISSIONER OF INTERNAL REVENUE,
Washington, D.C.

DEAR SIR: The comments set forth below relate to the proposed asset depreciation range regulations that were announced on January 11, 1971 and published in the Federal Register on March 13, 1971. I shall focus on several premises of the asset depreciation system which are either mathematically false or contrary to generally accepted economic principles and data.

1. The "Statement by the President" of January 11, 1971, announcing the ADR system declares, "A liberalization of depreciation allowances is essentially a change in the timing of a tax liability. The policy permits business firms to reduce tax payments now, when additional purchasing power is needed, and to make up these payments in later years." An accompanying statement by then Treasury Secretary David M. Kennedy declares, "It should be kept in mind that a liberalization of depreciation allowances primarily involves a postponement of the tax payment, and that this payment will eventually be added to government revenues."

THE ADR SYSTEM WILL CAUSE PERMANENT REVENUE LOSSES

These statements are false. At the worst they represent a conscious effort on the part of some to deceive the public. At best they represent a confusion between the consequences of the "liberalization" in depreciation for a single asset or

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[1] Mr. Eisner is a Professor of Economics at Northwestern University, and a Research Associate of the National Bureau of Economic Research, neither of which institutions are of course in any way responsible for the views expressed herein.

assets of a single year or even a limited number of years and the permanent "liberalization" envisaged in the proposed system.

The incorrectness of the Administration's claims regarding the ADR system is illustrated arithmetically by a succession of numerical examples set forth in Appendix A. The example relevant to the current issue is given in Table A-3, which indicates not only that the initial tax savings due to the ADR system are never paid back, but that they have added to them further savings as the years go on. Indeed, while there is a hump in tax savings (i.e., in the tax loss to the Treasury) during the transition to the ADR system, after this period the annual tax savings resume an upward path equal to the per cent rate of growth of equipment acquisitions.

The Statement of the Department of the Treasury of January 11 is thus grievously misleading in suggesting that "these changes will result in a reduction in Federal revenues of $0.8 billion in the fiscal year ending June 30, 1971, and of $2.7 billion in fiscal 1972, rising annually thereafter to a peak of $4.1 billion in fiscal 1976 and falling thereafter to $2.8 billion by fiscal 1980." For the sentence should have continued "and rising thereafter." I do not have available the detailed figures on which the Treasury made its estimates but it is easy to reconstruct their broad outlines. Ignoring the additional loss to the Treasury due to the new first-year convention, which acts as a further speed-up, we might reconstruct the Treasury figures roughly in Table 1 by assuming initial expenditures for equipment of $75.656 billion in 1971, growing at a 5 percent per annum rate in money terms (which may well prove to be conservative if inflation persists) and further assuming for simplicity that all equipment previously had a depreciation life of ten years and will now have a depreciation life of eight years and all is subject to sum-of-the-years-digits depreciation. We can then note in Table 1 that tax savings are $0.7 billion in 1971, rise annually to a peak of $4.4 billion in 1976, fall thereafter to $1.5 billion by 1981, and do in fact rise thereafter. The annual tax savings finally stabilize at a 5 per cent growth rate and, year after year, amount to 1¼ per cent of annual equipment acquisitions.[2]

TABLE 1.—ANNUAL TAX SAVINGS RESULTING FROM SWITCH FROM 10 YEAR TO 8 YEAR LIFE FOR SUM-OF-YEARS-DIGITS DEPRECIATION CHARGES ON TREASURY ASSUMPTION OF $75,656 MILLION OF EQUIPMENT ACQUISITIONS IN 1971 AND 5 PERCENT PER ANNUM GROWTH THEREAFTER (HALF-YEAR CONVENTION)

[Millions of dollars]

Year	Depreciation charges		Tax saving (48 percent of (3)−(2))
	10 year life	8 year life	
(1)	(2)	(3)	(4)
1 1971	$6,878	$8,406	$733
2 1972	20,289	24,588	2,064
3 1973	32,996	39,478	3,111
4 1974	44,962	53,010	3,863
5 1975	56,152	65,118	4,304
6 1976	66,526	75,729	4,417
7 1977	76,042	84,769	4,189
8 1978	84,658	92,160	3,601
9 1979	92,330	97,819	2,635
10 1980	99,010	102,710	1,776
11 1981	104,648	107,845	1,535
12 1982	109,880	113,237	1,611
15 1985	127,201	131,037	1,865
20 1990	162,344	167,304	2,381
Sum to 1980	579,843	643,787	30,693
Sum to 1985	1,158,089	1,239,699	39,173
Sum to 1990	1,896,094	2,000,250	49,995

Thus, whatever one's view of the economic consequences of the Asset Depreciation Range system, there should be no mistake about its arithmetic. It is not a change in the timing of tax payments. It is not a matter of reducing

[2] The exact calculations are based upon equation (4.26) and (4.27) in the mathematical supplement to my article, "Depreciation and the New Tax Law," *Harvard Business Review*, January–February 1955. This does not take into account the change in the first year convention, the new salvage provision and the fact that equipment lives are varied rather than all equal to the assumed mean. All of these factors, as well as the fact that some firms still apply straight-line depreciation, produce further tax savings, beyond our estimates.

tax payments now in return for tax liabilities in the future. It involves a permanent, repeating and accumulating loss in tax revenues year after year, a loss which will ultimately grow along with the general rate of growth of the economy and in particular the rate of growth in money terms of equipment subject to tax depreciation. The statement by the President issued on January 11, referring to the ADR system, declared, "The policy permits business firms to reduce tax payments now, when additional purchasing power is needed, and to make up these payments in later years." The concluding clause in that sentence, "and to make up these payments in later years," is false. There is no knowledgeable expert in the Treasury or out of it who can stand by this statement. It is unfortunate that such a flat contradiction of what is an unambiguous matter of arithmetic and mathematics, was issued in the name of the President of the United States.[3]

2. In the Department of the Treasury press conference of January 11, 1971, then Secretary of the Treasury Mr. David M. Kennedy declares, "The reform of depreciation policy will encourage business to increase its investment in new machinery and equipment. . . ." Dr. Paul W. McCracken, Chairman of the President's Council of Economic Advisers declares, "These basic changes would also have a favorable impact on the market for capital goods in 1971." In answer to a question by a reporter, ". . . can you qualify the impact this move will have on investment levels in the next years? And the remainder of this year and 1972," Mr. Edwin S. Cohen, Assistant Secretary of the Treasury for Tax Policy, declares, "We think this will have a substantial impact on investment in plant and equipment but I wouldn't make an effort to quantify it." Dr. McCracken said, "It's impossible, of course, to do anything more than form some kind of judgment about this. The impact here will build fairly slowly."

THE ADR SYSTEM IS UNLIKELY TO HAVE MUCH EFFECT ON CAPITAL INVESTMENT

The fact is that there is little evidence that "liberalization" of depreciation allowances of this type will have much effect on investment. There are strong arguments why it should not be expected to have much effect, and certainly almost no effect over the short period when a stimulus to investment is, according to some, considered desirable. There are essentially two justifications for the argument that increased depreciation allowances for tax purposes will increase investment. As Dr. McCracken put it himself, these are that the increased depreciation allowances will increase "the cash flow and the rate of return."

The first of these justifications is in considerable contradiction, at the level of the economy as a whole, to fundamental economic theory and analysis of a free enterprise, profit-oriented system. For under such a system, business decision-makers, unlike bureaucrats in some managed economies, are expected to spend not on the basis of the money that they get or are allotted but on the basis of what will increase profits (or reduce losses). There is little point to investment by a firm faced with excess demand and falling utilization of capacity. To argue that American business would increase expenditures for plant and equipment on the basis of cash flow rather than profit expectations suggests a surprising lack of faith in and understanding of the nature of a profit economy. To suggest that a firm with expectations that additional plant and equipment would add to profits (or reduce losses) would not make such expenditures unless cash were in hand or "flowing in" is to argue that our prided capital markets have ceased to function. It is of course true that certain firms, particularly small ones, are forced to allow their investment to be limited by cash flow and sources of credit which are closely tied to such cash flow or to profits. It may properly be the concern of government to remove and reduce imperfections in capital markets that cause these constraints to be felt by small firms. But this is hardly true of the bulk of large American industry which accounts for the bulk of plant and equipment spending. I have devoted a major part of my career to study of the determinants of business investment and have written extensively on studies involving both interviews of business executives and fairly elaborate statistical or econometric investigation of the actual relations between business spending and the variables

[3] Administration spokesmen have made another logically distinct argument, however blurred in rhetoric, that the tax loss to the Treasury now will ultimately be recouped as a consequence of higher income in the future. This is an argument that could be made for any tax cut. Its applicability here is particularly dubious because of the limited and questionable stimulatory effect of this liberalized depreciation as discussed below. To the extent that this proposal proves a substitute for other, more effective stimulatory and growth-inducing measures, it may actually still further lower future tax payments along with future incomes.

which might affect them. There is little or no sound evidence, I can assure you, that cash flow as such affects the long run rate of investment. What influence it or past profits have is related largely to smaller firms and perhaps, in the case of fluctuating profits, to the timing of investment. But in regard to the timing, as Dr. McCracken acknowledges, "The impact here will build fairly slowly. It takes time for these decisions of course to be changed."

The second justification for the argument that increased depreciation allowances will stimulate investment relates to the "incentive" effect or the influence on expected rate of return on investment. This argument is in principle a stronger one but the magnitude of the effect may readily be exaggerated. I have no independent calculations at this time, but we may note Dr. McCracken's estimate that the new measures "will mean roughly a percentage point increase in rate of return." However, the fact is that business investment has shown itself to be relatively uninfluenced by analogous changes in the cost of capital as measured by the rate of interest and this, as is well understood in modern economics. involves the relative magnitudes of fluctuations of expected rates of return and costs of capital. The question of how much any given change in the expected after-tax return on capital will induce a substitution to more capital intensive production is a matter of what we call the elasticity of substitution, influenced by technological as well as other considerations. The evidence is accumulating that long run substitution possibilities are significant, but far from unlimited. and that short run substitution is decidely smaller. While in all fairness, it must be stated that the elasticity of substitution, or the expected effect from any given percentage change in expected rate of return, remains uncertain in current economic analysis, there is no agreement that the effect is likely to be large and it is interesting that, on a matter that is critical, Dr. McCracken was not prepared publicly to offer any estimates of what the effect would be. I would suggest that the best estimates would indicate that the effects, particularly in the short run, would be small, involving a considerably smaller increase in capital expenditures than the loss in tax revenues associated with the increased tax depreciation, and there are a number of studies [4] which have indicated as much.

THERE ARE BETTER WAYS TO STIMULATE CAPITAL INVESTMENT

But what must be stated most directly is that, if the objective were to increase investment spending, economic analysis makes clear that a far more effective device, dollar for dollar of tax loss to the Treasury, would be some form of direct investment subsidy or tax credit. And here, I might add, the subsidy should be structured in such a way as to offer a maximum incentive effect rather than maximum cash flow to firms and tax loss to the Treasury. Thus. far better than the general 7 per cent tax credit for equipment spending in previous law would be a much higher tax credit, say 14 per cent or 28 per cent or even 56 per cent, restricted as far as possible to equipment spending that would not have been undertaken in the absence of the tax credit or subsidy. This might be done by applying the credit, for example, only to investment in excess of some average of previous investment (with appropriate adjustments for new firms) or to investment in excess of some per cent (probably more than 100 per cent) of depreciation charges, which are themselves a weighted average of past investment. Such a system would have the advantage, if more business investment were desired, of concentrating the rewards or tax benefits where they would really count rather than squandering the bulk of the lost tax revenues for investment which would have been undertaken anyway.

In this connection it should be stated, however, that the proposition that business investment should secure tax benefits and special encouragement is exceedingly dubious. While our tax structure is far from neutral as it stands, it is not at all clear that the whole structure of taxes, including in particular preferential treatment to capital gains, has not already distorted the free market in the direction of greater business spending for plant and equipment. Is there really a considered judgment that more spending for business equipment is desirable rather than spending in, for example, research and development, on-the-job training, or improvement of management efficiency (or even business structures)?

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[4] See, for example, papers by R. M. Coen and by R. Eisner, "Tax Policy and Investment Behavior: Comment," *American Economic Review*, June 1969, pp. 370–379 and 379–388.

ADR IN EFFECT DISCRIMINATES AGAINST IMPORTANT TYPES OF INVESTMENT

But beyond this, why stimulate business equipment spending rather than investment in human capital, in education, in health, in basic research? Is it even clear that we want more plant and equipment spending, that is, accumulation of capital for the future, rather than greater private consumption or greater enjoyment of leisure or greater government investment in public goods and the general welfare? I am not one that believes that the free market, or the imperfectly free markets that we have in our economy, should never be influenced by government. But I am a firm believer in the view that government should be restrained in its intervention and should only interfere with private markets when there is a clear indication that they are not functioning appropriately and that interference in the public interest is called for. This might apply to those economic activities that involve what economists call external diseconomies, such as air and water pollution. This may also apply where capital markets are notoriously imperfect, as in the market for human capital; investment in the potential of individual human beings is frequently beyond their own means and too risky for an individual outsider. But one of the last places where I would think that government intervention, help or subsidy is called for is in the private investment decisions of the great bulk of American industry. There is no need for a handout to American industry to persuade them to do what should be in their own interest, that is have the optimal capital and investment policies for their own efficiency and profits.

BALANCE OF PAYMENTS CONSIDERATIONS DO NOT SUPPORT THE ADR SYSTEM

It is broadly hinted, although rarely systematically argued, that increased or liberalized depreciation allowances are somehow necessary to make American firms competitive with foreign firms that receive such subsidies from the public purse. This argument, I must insist, is based upon a profound misunderstanding of the nature of international trade and international economic relations. In the first place, American industry is generally able to compete very well abroad. The United States has had positive net exports, that is, has exported more than it has imported in goods and services (on National Income Account) for every one of the last twenty-five years from 1946 to the present. Preliminary figures for 1970 put that surplus at $3.6 billion. In fact, despite the drain of government spending for military activities in Southeast Asia and for the support of large armed forces in foreign countries, the United States has been tending over the years to be a net investor abroad and acquirer of long term foreign assets. And if there were a problem in our balance of payments, particularly of foreign countries acquiring more in the way of American currency than they wish, the clear economic answer would be changes in the relative prices of American and foreign currencies rather than distortion of our own economy. Inasmuch as the dollar has become the reserve currency of the world, such adjustments would essentially be undertaken by foreign countries concerned with their excessive (or deficient) accumulation of dollars. But for the economy as a whole it must always be true that as long as exchange rates are reasonably appropriate, a nation will find itself exporting those goods in which it has a *comparative* cost advantage and importing those goods at which it is at a *comparative* cost disadvantage. A tax subsidy to capital-intensive industries can only give them a comparative advantage over less captial-intensive industries. We then find ourselves not increasing total exports but exporting more of those products that receive the greatest tax subsidies, particularly capital-intensive manufacturing, and exporting less (or importing more) of less capital-intensive output such as, for example, agricultural products. The American people should not be deceived. Measures of this kind cannot help the American economy as a whole by forcing foreigners to buy an even greater excess of products from us over what they in turn send to us, for we are not likely to be able to impose this, even if it were desirable. They result ultimately in more sales by some American producers at the expense of sales by other American producers.

POSSIBLE ADVANTAGES OF ADR IN THE PUBLIC UTILITY AREA ARE LIMITED BY ACCOUNTING AND RATE-MAKING RESTRICTIONS

I might close this particular discussion by calling attention to a curious irony as well as inconsistency in Administration proposals to date. There is something to be said, where we are concerned with combating inflation as well as stimulating the economy, for tax subsidies that tend to lower costs and hence lower prices in a reasonably free market. Liberalized depreciation allowances might ultimately have some slight beneficial effect in this direction by lowering capital costs after taxes and hence bringing down prices. Yet in the one area where this might be most likely to occur, that is in the area of public utility investment, there are restrictions on accounting and rate regulations which operate to prevent regulated utilities from passing the tax savings from liberalized depreciation on to ultimate consumers. Such restrictions prevent the operation of this price-reducing effect. Ironically such restrictions also tend to reduce the presumably desired impact on investment. For one way in which liberalized tax depreciation would encourage investment is precisely by what it is called in economic theory an "output effect," that is, bringing about an increased demand and expansion as a consequence of the lower prices of final product, thus stimulating investors to acquire the increased capital to produce the increased output.

THE ADR SYSTEM IS DESTABILIZING

Finally, it may be noted that faster depreciation tends to be pro-cyclical rather than counter-cyclical. For the faster is depreciation, the greater the tax savings attributable to current and recent investment. That means that with faster depreciation, the tax savings will be greatest in boom times when investment has been high and least in recessions or depressions when investment has been low. A correct, automatic stabilizing policy would give more tax relief in recessions and less tax relief in booms. "Liberalized" or faster depreciation then has exactly the opposite effect, giving more tax relief in booms when it is not needed and less tax relief in recessions when it is needed.

CONCLUSION

It should be clear then that the current "liberalizations" of tax depreciation—coming on top of a long series of liberalizations of which the most notable were in the Revenue Act of 1954 introducing sum-of-the-years-digits and double-rate declining tax depreciation, in 1962 with the major revisions of estimated lives, and in subsequent years with the failure to enforce the reserve ratio test—are not in the public interest. First, they have been falsely presented as involving only a change in timing of tax payments, thus suggesting that the Treasury would lose tax revenues now but gain them back later from the affected taxpayers. Second, as a measure to increase business investment it is dubious at best, slow in its effects, and particularly costly to the Treasury in terms of the amount of increased investment which may result for each dollar of tax loss. Third, it represents a distortion in existing markets and an alteration of the distribution of income and command over resources which is particularly unjustified in view of all of the competing needs for investment in human capital, public goods, and the atmosphere in which we live. Fourth, its presumed value in terms of competition with foreign producers is fallacious; it can at best help some American producers at the expense of other American producers. Fifth, it will contribute to rather than counteract cyclical fluctuations, stimulating booms and deepening depressions.

For these reasons, the Asset Depreciation Range proposals should be withdrawn. I question whether any special equipment investment incentive is socially desirable but, if the objective is to increase investment spending, some form of direct investment subsidy or tax credit is a far more effective device, dollar for dollar of tax loss, than is the ADR proposal.

APPENDIX

The effect of the permitted speed-up in depreciation by 20 per cent (aside from the new initial year convention which represents an additional speed-up) may be more readily illustrated arithmetically by considering a switch from a five-year life to a four-year life. To do so we shall construct several numerical examples involving the very simple straight-line method as well as the more liberal and realistic sum-of-the-years digits depreciation.

Let us first assume a firm that acquires $180 of equipment early in 1971 and none in subsequent years. It should be noted readily that with regard to such acquisitions of a single year, as shown in Table A–1, four-year-life, straight-line depreciation is higher and taxes are saved for each of the first four years, but this is all cancelled out in the fifth year. With sum-of-the-years digits depreciation, tax saving occurs in only the first two years, 1971 and 1972, and there is a payback in 1974 and 1975, the last two years of the original five-year period. In both cases there is what amounts to an interest-free loan, a far from insignificant matter, but the "loan" is paid back by the end of the originally estimated period of life of equipment.

There are very few substantial firms, however, that acquire equipment in one year and then never again. Indeed such a firm could obviously not last very long. And for the economy as a whole as well as for the substantial firms that account for the bulk of spending, equipment purchase is a repeated process, perhaps fluctuating but generally considerable and, in the long run, growing. In Table A-2 we assume, however, a firm whose acquisitions are still not growing but are merely constant, year after year, at $180. With straight-line depreciation we then see tax savings, as a consequence of the speed-up of depreciation permitted in the ADR system, of $4.32 in 1971, $8.64 in 1972, $12.96 in 1973 and $17.28 in 1974. In 1975 the tax savings come to an end, in the sense that they are not repeated, but there is never any "payback," as long as equipment purchases stay constant, which implies that the firm replaces its expiring equipment. The firm has thus received tax savings of $43.20 which it keeps. There is apparently some disposition to refer to these tax savings as interest-free loans. They are indeed the most desirable kind, interest-free loans which are never to be paid back. Semantics aside, a mathematician would be hard-pressed to distinguish a permanent, interest-free loan and a pure gift.

TABLE A-1.—DEPRECIATION CHARGES FROM A SINGLE YEAR'S ACQUISITIONS, EFFECTS OF 20 PERCENT "LIBERALIZATION" OR CHANGE FROM 5 YEAR LIFE TO 4 YEAR LIFE, STRAIGHT LINE AND SUM-OF-THE-YEARS DIGITS DEPRECIATION

($180 of equipment purchased early in 1971)

	Straight line depreciation			Sum-of-the-Years-digits depreciation		
Year	5 year life	4 year life	Tax saving (48 percent of (3) (2))	5 year life	4 year life	Tax saving (48 percent of (6) (5))
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. 1971	$36	$45	$4.32	$60	$72	$5.76
2. 1972	36	45	4.32	48	54	2.88
3. 1973	36	45	4.32	36	36	0
4. 1974	36	45	4.32	24	18	−2.88
5. 1975	36	0	−17.28	12	0	−5.76
6. 1976	0	0	0	0	0	0
Total	180	180		180	180	

TABLE A-2.—DEPRECIATION CHARGES FROM A STEADY STREAM OF ACQUISITION, EFFECTS OF 20 PERCENT "LIBERALIZATION" OR CHANGE FROM 5 YEAR LIFE TO 4 YEAR LIFE, STRAIGHT LINE AND SUM-OF-THE-YEARS-DIGITS DEPRECIATION

($180 of equipment purchased early in each year beginning in 1972)

	Straight line depreciation			Sum-of-the-Years-digits depreciation		
Year	5 year life	4 year life	Tax saving (48 percent of (3) (2))	5 year life	4 year life	Tax saving (48 percent of (6) (5))
(1)	(2)	(3)	(4)	(5)	(6)	(7)
1. 1971	$36	$45	$4.32	$60	$72	$5.76
2. 1972	72	90	8.64	108	126	8.64
3. 1973	108	135	12.96	144	162	8.64
4. 1974	144	180	17.28	168	180	5.76
5. 1975	180	180	0	180	180	0
6. 1976	180	180	0	180	180	0
Total			43.20			28.80

The situation is, of course, analogous for sum-of-the-years digits depreciation, although the tax loss to the Treasury totals only $28.80 for a firm buying $180 of equipment per year, the lesser amount being due to the fact that sum-of-the-years digits depreciation is already considerably more rapid, in terms of a weighted average of depreciation charges by period, than is straight-line depreciation, and hence there is less further saving available from a corresponding speed-up.

In Table A–3 we turn to a more realistic case. This is the one assumed by the Treasury analysts, in which equipment acquisitions are growing at a 5 per cent per annum rate in money terms. It is then apparent that the tax savings of the first four years are not only never paid back; they have added to them further savings in later years. Indeed, while there is a hump in tax savings (tax loss to the Treasury) during the period of transition, before any of the assets subject to ADR have exhausted their depreciation, after this period the annual tax savings resume an upward path equal to the per cent rate of growth of equipment acquisitions.

TABLE A-3.—DEPRECIATION CHARGES FROM A STREAM OF ACQUISITIONS GROWING AT A 5-PERCENT RATE, EFFECTS OF 20-PERCENT "LIBERALIZATION" OF CHANGE FROM 5-YEAR LIFE TO 4-YEAR LIFE, STRAIGHT-LINE AND SUM-OF-THE-YEARS DIGITS DEPRECIATION

		Straight-line depreciation			Sum-of-the-years depreciation		
Year	Equipment acquisitions	5-year life	4-year life	Tax saving (48 percent of (4)—(3))	5-year life	4-year life	Tax saving (48 percent of (7)—(6))
(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
1971	$180.00	$36.00	$45.00	$4.32	$60.00	$72.00	$5.76
1972	189.00	73.80	92.25	8.86	111.00	129.60	8.93
1973	198.45	113.49	141.86	13.62	152.55	172.08	9.37
1974	208.37	155.16	193.96	18.62	184.18	184.18	6.96
1975	218.79	198.92	203.65	2.27	205.39	208.62	1.55
1976	229.73	208.87	213.84	2.39	215.66	219.05	1.63

Mr. NADER. Furthermore, even if the administration is committed to provide tax rewards for conventional business investment decisions, are there not means of applying the investment credit to provide economic stimulus at far less cost? The most simple modification in the administration proposal would be to apply the investment credit at 10 percent this year, and 5 percent next year, with termination the year after. There is concern about stimulating the economy this year. Conditions in 2 years may be as different as they were 2 years ago, when the administration sought repeal of the 7-percent credit. The need to stimulate the badly managed economy in the short run should not be used as an excuse for a perpetual tax concession to big business.

The fact that the administration went whole hog in its proposals further supports the contention of a growing number of critics including Prof. Paul Samuelson that this move was a bonanza for big corporations while citizens receive a tiny 1-year tax reduction.

Another modification in the administration's expensive proposal would be to apply the investment credit on an "incremental" basis. There is no need to subsidize industry for the bulk of investments which take place in the ordinary course of business. A substantially higher rate of tax credit could be applied just to equipment spending which would not have been undertaken in the absence of the tax subsidy. Again, I draw attention to Professor Eisner's April 12 letter opposing ADR.

Finally, it should be noted that the term "job development tax credit," as applied to the investment credit is a political deception of serious proportions. The investment credit will stimulate purchase of capital equipment, thereby making industry less labor-intensive than otherwise would be the case and in some cases even reducing jobs.

The proposed reduction in Federal employment by 5 percent in 1 year will cost roughly 150,000 jobs. When Tom Stanton attempted to learn how many jobs the administration felt would be created by the investment credit, he was given a remarkable runaround. I cite this illustration to indicate that the Treasury Department has not minimally disclosed studies to substantiate this extremely ambitious projection in job development and other economic resurgencies in its enactments or proposals submitted to the Congress.

Stanton called the White House press office which led to a referral to the Treasury Office of Public Information. A Treasury public information officer then suggested he call the Council of Economic Advisers, saying that the job development figures were "not produced in Treasury as far as I know."

A Council of Economic Advisers official stated that "the estimation of jobs created is difficult. If the figures were developed, they should have been developed in the Treasury."

The call to an official of the Treasury tax policy branch brought the response that "there are no figures for release at this time."

As Mr. Stanton concluded, trying to pin the administration down was about like "trying to nail a 4-foot slab of jello to a wall."

The administration was not content to add the expensive investment credit subsidy to the depreciation windfall. It has further attempted to resurrect the DISC (Domestic International Sales Corporation) proposal as a means of reducing corporate taxes by yet an additional billion dollars a year. You may recall, Mr. Chairman, that the Congress did not approve the DISC proposal when it was proposed some months ago. The DISC idea is a proposal virtually to exempt export profits from income taxation. As with the investment credit and the depreciation regulations, DISC will primarily benefit large corporations. The Commerce Department estimates that about 100 of the largest U.S. firms account for over half of all U.S. exports. This means that over half of DISC's windfall benefits will automatically go to those same large corporations.

As Chairman Russell Long, Democrat, Louisiana, noted when the DISC giveaway failed last year, the Senate Finance Committee decided that the proposal would cost more than the administration estimated, and "wouldn't do nearly as much good as the administration hopes." [1]

The administration announced Sunday night that "DISC will increase export sales roughly $1.5 billion a year." This is the same kind of exaggerated estimate presented by the administration last year. The staff of the Congressional Joint Committee on Internal Revenue Taxation found no basis for such optimism. Their more sober analysis sets the likely export gain at $300 to $480 million per year. In other words, the taxpayer is expected to incur a burden more than twice as much as the incremental export sales are likely to be generated by that proposal.

I introduce a copy of that important report into the record, with your permission.

Chairman PROXMIRE. Yes, without objection it will be printed in the record.

(The information follows:)

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[1] *Wall Street Journal*, Dec. 1, 1970, p. 7.

[Confidential Committee Print]

ANALYSIS OF TREASURY DOMESTIC INTERNATIONAL SALES CORPORATION (DISC) PROPOSAL

(Prepared for the use of the Committee on Ways and Means by the Staff of the Joint Committee on Internal Revenue Taxation, July 13, 1970)

TREASURY DISC PROPOSAL

I. GENERAL EXPLANATION OF PROPOSAL

General

In order to encourage exports, the Treasury would provide a special tax incentive. The proposal would take the form of an exemption from U.S. tax for a new type of U.S. corporation known as a Domestic International Sales Corporation, or a DISC. The essential requirements for qualification as a DISC are that most of the corporation's gross receipts and assets must be export related. The proposal is referred to by Treasury as a tax deferral proposal on the basis that although a DISC's profits are exempt from U.S. tax when earned by it, the profits, if they are actually distributed to the DISC's shareholders, are taxable to the shareholders at that time. (Whether the proposal represents exemption or deferral is discussed in Part II.)

The basic idea of the proposal is to encourage a domestic corporation which either is engaged in exporting or which hopes to enter into exporting, to set up a new corporation, a DISC, to carry on its export sales. (Individuals also could be shareholders of a DISC.) The parent corporation in this case would be allowed to sell its export products to the DISC at less than the arms length price generally required in the case of sales to a foreign sales subsidy—so that part of what is presently considered the U.S. manufacturing profit attributable to the export products could be treated as foreign profits of the DISC and accorded tax exemption or deferral rather than being treated as part of the currently taxable profits of the parent corporation. Without regard to the regular pricing rules, a DISC would be permitted to earn up to the greater of 4 percent on sales or 50 percent of the combined income from the manufacturing and selling of the exports (plus in either case an amount equal to 10 percent of its export promotion expenses).

The DISC then would sell these export products for use abroad. The profits from these sales—including the manufacturing profits allocated to it—would be accorded U.S. tax exemption or deferral, whether or not subject to foreign tax, so long as the profits were invested in specified types of "export assets."

One type of export assets in which the profits of a DISC could be invested are those concerned with its export business—such as the working capital, machinery, and office facilities employed in this business, assets of foreign sales or services branches primarily engaged in marketing (or leasing) U.S. exports, and stock or securities of controlled foreign corporations primarily engaged in marketing (or leasing) U.S. exports.

In addition (and probably more significantly), *a DISC's profits could be loaned back to the parent manufacturing company (or any other U.S. corporation) without affecting the tax-exempt or tax-deferred status of the profits.* (If a foreign subsidiary were to make such a loan, it would give rise to tax as if the loan were a dividend.) The loan of a DISC's profits to the parent corporation (or other U.S. corporation) would be permitted so long as the cumulative amount loaned does not exceed the amount of the parent (or other) corporation's assets considered as being related to its export sales. The parent corporation's assets treated as export related would be the same proportion of its assets which its export sales are of its total sales.[1] (A limitation likely to be reached if at all only after many years, since profits of the DISC are likely to be small relative to the export-related asset value of the parent and these assets are likely to continue growing.)

A loan of a DISC's profits which qualified when made would remain qualified for a period ranging from 10 to 20 years.[2] In addition, there would be no restrictions on the use of the loan proceeds by the borrowing corporation.

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[1] For this purpose, the following type of assets would be taken into account: Existing plant, equipment, machinery and supporting production facilities; contemplated investment for the year in which the loan is made in new plant, machinery, and supporting production facilities; inventory; and research and development expenditures for the prior year.

[2] Under the proposal the length of the term for which a DISC's profits may be loaned is limited by reference to the type of assets of the borrowing company taken into account. If the DISC's profits are loaned with respect to plant and equipment assets, the term of the loan may not exceed 15 years. If the loan is made with respect to *contemplated* investments in plant and equipment, its term may not exceed 20 years. If the loan is made with respect to research and development expenditures or inventory, its term may not exceed 10 years.

All of the income received by a DISC would be accorded U.S. tax exemption or deferral generally as long as 95 percent of its gross receipts and assets are export derived or used. Exemption or deferral would be available for, in addition to directly related export income, income from transporting export goods (either in the United States or abroad), and dividends received from controlled foreign corporations primarily engaged in marketing U.S. exports. The exemption or deferral also would be available for interest received on loans made by the DISC of its profits to its parent corporation (or other U.S. corporation) and for interest on temporary U.S. bank deposits but in these two cases the DISC is automatically deemed as having distributed these two types of interest as a dividend to its parent corporation.

Dividends paid by the DISC generally would be subject to U.S. tax in the hands of the parent corporation or other shareholder. (These dividends would not be entitled to the corporate dividends received deduction, but unlike dividends from foreign corporations, would be eligible for the $100 dividend received exclusion allowed individuals.) Dividends distributed by a DISC attributable to the interest income which it is required to distribute would be treated as U.S. source income and thus fully taxable to the U.S. parent. Other types of dividend distributions by the DISC, however, generally would be considered as foreign source income. This would allow the U.S. parent to offset its U.S. tax on these dividends by foreign taxes (either any which may have been paid by the DISC or those paid by the parent corporation on other foreign income). To the extent these foreign taxes were of sufficient magnitude, a DISC's profits would be exempt from U.S. taxes not only in the hands of the DISC itself, but in the hands of the U.S. parent corporation as well.

Qualification requirements

To qualify as a DISC, at least 95 percent of the domestic corporation's gross receipts must be from exports and export related investments or activities. Qualifying export and export related receipts would include those derived from the sale or rental of export property for use abroad and the performance of ancillary and subsidiary services by the DISC, from loans of DISC profits to U.S. corporations, from dividends from controlled foreign corporations primarily engaged in marketing U.S. exports, and from interest on export financing obligations, including obligations issued, guaranteed, or insured by the Export-Import bank.

Where a DISC met this gross receipts test, all of its income (except that it is required to distribute the interest income) would be treated as exempt export income which could be invested in export assets or loaned to the U.S. parent or other U.S. corporations.

The second major requirement which a corporation must satisfy to qualify as a DISC is that 95 percent of its assets must be export related. In addition to assets which are directly export related, the qualifying assets for this purpose would include assets of foreign sales and services branches, and stock or securities of controlled foreign corporations, primarily engaged in marketing U.S. exports, export financing obligations, obligations issued, guaranteed, or insured by the Export-Import bank, obligations arising from loans of the DISC's profits to its U.S. parent (or other U.S. corporation), and temporary U.S. bank deposits.

As long as a DISC's profits were put into these qualifying types of assets, they would continue to be tax exempt.

Special pricing rules

As indicated previously, special pricing rules would apply with respect to the purchase of goods by a DISC from a related manufacturer (or the sale of goods by the DISC on behalf of a related manufacturer). The effect of these special pricing rules would be to allow a portion of the profit of an export sale which is presently considered to represent manufacturing profits from U.S. sources to be treated as if earned by the DISC and thus be accorded tax exemption or deferral.

Under these special rules, a DISC would be allowed to earn income equal to the higher of 4 percent of its sales or 50 percent of the combined manufacturing and sale income arising on the DISC's sales. In addition, in each case a DISC could earn an additional amount of exempt income equal to 10 percent of its "export promotion expenses."

Effective date

The proposal would take effect for taxable years beginning on or after July 1, 1971.

II. PRIMARY CHARACTERISTICS OF PROPOSAL

Differences in Tax Treatment of a DISC and a Foreign Subsidiary

The Treasury has indicated that the primary purpose of the bill is to correct features of our income tax which encourage the transfer of production and sales activities abroad at the expense of U.S. production for export. Under existing law, U.S. companies can organize wholly owned foreign subsidiaries to manufacture and sell abroad and generally defer their U.S. tax liability on the foreign earnings of these subsidiaries until the earnings are distributed as dividends to the U.S. shareholders. On the other hand, U.S. companies manufacturing for export or engaging in export selling are subject to U.S. income on a current basis.

It is, of course, true that export income of a U.S. manufacturer is currently subject to U.S. tax while a foreign subsidiary is exempt and its earnings are subject to U.S. tax only at such time as they are distributed to its U.S. parent. Under the Treasury proposal, however, a DISC would, in a variety of ways, be accorded more favorable tax treatment than a foreign subsidiary of a U.S. company.

First, under the Treasury proposal, special pricing rules would be applied in determining the amount of profit a DISC would be considered as earning on property sold to it by its parent corporation (and to sales of property by the DISC subsidiary on behalf of the parent corporation). These rules would, in effect, attribute to the DISC a significant proportion of the profits attributable to the parent's manufacturing activities. These special rules would apply only to a DISC and would not be extended to a foreign sales subsidiary.

The general rule provided by the Internal Revenue Code (sec. 482) requires that sales between a parent corporation and its subsidiary must be made at an arms length price. Generally, this is the price which the parent would have charged an unrelated third party for the products. Where a U.S. manufacturing parent sells its products to a foreign sales subsidiary which then sells the products to the ultimate consumers, the effect of this rule essentially is to limit the amount of the profit on the transaction which can be earned by the foreign subsidiary to the profit on the "sales" element. In other words, the manufacturing profit on the transaction cannot be channeled into the foreign subsidiary by means of a less than arms length sales price.

The special pricing rules under the Treasury proposal would treat a DISC as if it earned a larger proportion of the profits on its sales of its parent's products by permitting the DISC to purchase goods from its parent at less than an arm's length price. Under the proposal, the DISC could earn either an amount of profits equal to 4 percent of its sales or, if higher, it could earn 50 percent of the combined income arising from the manufacture and sale of the products sold through the DISC. In addition, in either case a DISC would be allowed to earn an additional amount of profits equal to 10 percent of its export promotion expenses.

The special pricing rules which would apply to a DISC would have the effect of according tax exemption or deferral to profits that presently are considered to be manufacturing profits derived from U.S. sources. In other words, what is presently considered a U.S. source manufacturing profit could be channeled into the DISC and thereby exempted from U.S. tax when earned by the DISC and, in addition, treated as foreign source income when distributed by the DISC. Where the rule relating to 4 percent of sales governs, it is possible in many cases that the special pricing rules would treat the DISC as if it earned the entire profit on the transaction.

It may be argued that special pricing rules of this nature could be promulgated administratively without any statutory change. If this were done under the existing statutory authority, however, presumably it would appear that the special pricing rules would have to be promulgated with respect to all intercorporate transactions, and not just with respect to sales to DISC's. The DISC proposal contemplates a statutory change authorizing the special pricing rules which would be applicable only to sales to DISC's.

A second area in which more favorable treatment is accorded to a DISC is in the ability of a DISC to loan its tax-exempt profits to its U.S. parent corporation (or any other U.S. corporation) without affecting the tax-exempt status of those profits. As previously indicated, the only limitation on the amount of a DISC's profits which could be loaned to its U.S. parent is that the amounts loaned cannot exceed the same proportion of the parent corporation's assets which its export sales are of its total sales.

Under present law, a controlled foreign corporation is not permitted to loan its profits back to its U.S. parent corporation (or other U.S. corporation) without tax consequence. A loan of this nature by a foreign corporation is viewed as the equivalent of a dividend, and accordingly, when a controlled foreign sales subsidiary makes such a loan, it is taxed to the U.S. shareholders of the corporation as if it were a dividend paid to them.

The Treasury proposal by allowing a DISC's profits to be loaned to its U.S. parent corporation accords to a DISC more favorable tax treatment than is presently accorded to a foreign subsidiary of a U.S. corporation. In other words, in the case of a foreign corporation, exemption of its profits from U.S. tax continues only so long as the profits are not brought back to the United States either as an actual dividend or as a constructive dividend. In the case of a DISC, however, the exemption of its profits from U.S. tax would continue even though those profits were made available to its parent corporation through what may be viewed as a constructive dividend.

Third, a DISC ordinarily need not engage in any specific activity in a foreign country and therefore is not likely to bear the burden of foreign income taxes borne by a foreign subsidiary. In order to achieve deferral of U.S. tax on its profits, a foreign subsidiary in the usual case has to pay a current foreign tax on those profits. In its testimony, the Treasury indicated its studies show that for 1964 the average effective foreign tax rate on subsidiary operations abroad of U.S. businesses was approximately 38.6 percent. Thus, on the average a foreign subsidiary has to incur a current tax burden of approximately 39 percent in order to achieve deferral of the not more than 9 percentage points of net U.S. tax which will be owing on the profits (after allowance of the foreign tax credit) when they are distributed to the U.S. parent.

A DISC, on the other hand, would be granted current exemption from U.S. tax on its profits at what may be a zero current foreign tax cost. This is likely to occur since the DISC could arrange to have the sale of this property occur in the United States (since this would not result in U.S. tax) and in this manner have no income exposed to foreign tax. Thus, it would be substantially more advantageous for a company to conduct business through a DISC rather than conducting it through a foreign subsidiary since the DISC need incur no current tax burden on its profits. To the extent a foreign subsidiary enjoys the benefits of special provisions in the tax laws of the foreign country which lower its current tax burden, the comparative advantage of a DISC on this point decreases. (A DISC in this case would remain more advantageous, however, until the foreign subsidiary's foreign tax burden reached zero, or the level of foreign taxes which a DISC might bear.) On the other hand, to the extent a foreign subsidiary pays a tax above 39 percent, the comparative advantage of a DISC on this point increases.

Tax exemption or deferral for DISC profits

As previously indicated, the Treasury views its proposal as according tax deferral, rather than tax exemption, to a DISC's profits. While it would appear that as a matter of form, the proposed treatment technically can be viewed as tax deferral, from a substantive point of view, the proposal in the case of a firm with a moderate growth rate would appear to be substantially the equivalent of tax exemption for the DISC subsidiary's earnings accruing for a period of time.

The proposal is viewed by the Treasury as one of tax deferral because the DISC's profits become subject to U.S. tax if they are distributed to the parent corporation, or other shareholder of the DISC, as dividends. This is analygized to profits earned by a foreign subsidiary; they too are exempt from tax in the hands of the foreign subsidiary but are taxed when distributed to the U.S. parent. This has been commonly referred to as deferral since the profits are taxed when they are brought home.

As indicated in the preceding section, however, a DISC's profits can be made available to its parent corporation as loans for use in the United States in much the same manner as if they had been distributed as a dividend, but without subjecting them to U.S. tax. On the other hand, a foreign subsidiary which loaned its profits to its parent for use in the United States would be treated as if it paid a dividend which would be subject to tax.

The Treasury proposal would permit a DISC to make its tax-exempt profits available to its parent corporation subject to two limitations. First, once the parent corporation's export-related assets were no greater than the loans received from the DISC, then the subsidiary to remain a DISC would have to distribute its earnings currently to its parent (unless it could find some other corporation to loan its earnings to which also engaged in export business). As long as the DISC so operated, however, the amount previously loaned to the parent would remain free of tax. This limitation, however, is never operative if the parent corporation continues to expand its export-related assets at as rapid a rate as the DISC earns profits and loans them back to the parent. It would appear that this would be a moderate rate of growth which should not be difficult for a successful company to attain.

The second limitation on the loans from a DISC to its parent corporation arises from the fact that the loan itself cannot be made for more than 10 years in the case of loans for research and development expenditures and inventory; 15 years for existing plant and equipment; and 20 years for proposed new plant and equipment. However, at the end of the term of years, whether it is 10, 15, or 20 years, a new loan can presumably be made to the parent replacing the old loan. If the discussion here were with a company which continues to expand its business at the moderate rate suggested above, the first limitation would not become operative in this case since the export-related assets would be large enough to account for not only a renewal loan with respect to the earlier year's profits of the DISC but also large enough to account for a loan of the current year's profits of the DISC as well.

What this analysis appears to suggest is that in the case of a parent corporation which continues to expand its assets used in the production of exports at the same or a higher rate as the profits derived from these exports by its DISC subsidiary, the profits of the DISC loaned to the parent can, in effect, be free of tax for an indefinite period of time. In this type of situation, the Treasury proposal appears to be the equivalent of tax exemption.

Where the parent company's export-related assets do not continue to expand, the Treasury proposal nevertheless would appear to grant exemption to profits earned by the DISC subsidiary up to the time the first limitation came into operation; that is, up until such a time as the loans to the parent equalled the export-related assets of the parent. This exemption equivalency for the non-growth company assumes, of course, that the DISC will distribute its current earnings to its parent.

DISC Proposal is not Incremental

To obtain the benefits provided by the DISC proposal, a corporation is not required to increase its exports. A corporation presently engaged in exporting may channel its existing exports through a DISC subsidiary and thereby exempt or defer U.S. tax on the portion of its export profits which may be allocated to the DISC under the special pricing rules. In other words, the tax benefits granted under the DISC proposal are not conditioned on any increase in export sales.

It should be noted, however, than an incremental approach to the granting of tax benefits under the DISC proposal would involve significant complexities, such as the determination of an appropriate base period, the appropriate adjustments in the base period which would be necessary, and the development of safeguards to protect against avoidance of the incremental requirement by the substitution of "new" exports of a different corporate entity for prior exports of an existing corporate entity. In addition, an incremental approach raises questions as to whether it is equitable to deny benefits to companies which maintain their present level of exports while granting benefits to other companies for reaching the same levels.

Exporters Treated More Favorably than Producers for Domestic Market

The Treasury proposal would provide more favorable tax treatment to the U.S. manufacturer engaged in exporting than is accorded to a comparable U.S. manufacturer which sells its products only in domestic markets. As indicated in a subsequent section on revenue effects, it appears that the DISC proposal would on the average be about the equivalent of providing a 10 percentage-point reduction in the corporate tax rate for export profits.

As previously indicated, the principal effect of the proposal is to allow a U.S. manufacturer which routes its export sales throught a DISC subsidiary to receive current exemption from U.S. income tax on the sales profit and on all or part of the manufacturing profit attributable to the exported goods—a current exemption which in substance may have many of the attributes of permanent exemption from U.S. tax. A manufacturer producing solely for the domestic market, on the other hand, receives a similar exemption—it is subject to full current U.S. taxation on its manufacturing profits as well as its sales profits. Thus, even though two U.S. companies manufacture the same products and are similar in other respects, the fact the one company exports its products while the other company sells its products in domestic markets will result in significantly different U.S. tax burdens for the companies—the company marketing its products domestically will be subject to full current U.S. taxation while the exporting company will not be subject to tax on the "sales" portion of the profit on its exports as well as all or part of the related manufacturing profit.

Uneven Application of DISC Proposal

As previously discussed, the principal effect of the special pricing rules which would be available under the DISC proposal is to treat a DISC subsidiary as if it earned on sales of its parent company's products, not only the sales profits, but in addition part or all of the manufacturing profit. This rule would have a quite uneven application in the case of different types of companies.

First, the proposal would grant to large, integrated manufacturing companies substantially greater tax benefits than would be available to small, non-integrated manufacturing concerns. If a large, integrated manufacturing company sold its export products through a DISC subsidiary, the manufacturing profit which could be earned by the DISC would include all of the profit components which would arise at each stage of the integrated company's operations to the extent the final products involved are sold abroad by the DISC. Accordingly, the amount of profit, at least one-half on which could be allocated to the DISC subsidiary, would be substantial in relation to the selling price of the product. On the other hand, a small, non-integrated company, which perhaps is engaged only in an assembly operation or the manufacturing of components, would receive on the sale of its export products through its DISC subsidiary only the small amount of profits attributable to its single stage of operation. The profits arising at the other stages of the manufacture of the total product would have been earned by the other manufacturers performing the other stages necessary to completion of the total product and thus could not be allocated to the DISC. As a result, the amount of the profit in this case which could be earned by the DISC would be substantially smaller in relation to the sales price of the goods than in the case of the large, integrated company.

Second, the Treasury proposal also would provide substantially smaller benefits to independent exporting companies than it would to manufacturing companies which were able to establish their own DISC subsidiary. An independent exporting company which qualified as a DISC would not be permitted to earn any of the manufacturing profit on the export goods it sold since it would be selling these goods for unrelated manufacturing companies and thus would be able to earn only such an amount as general market conditions permitted it to. In other words, general market conditions and forces would determine the amount of profits the independent exporting company could earn since the special intercompany pricing rule would not be applicable. The DISC subsidiary of a manufacturing company, however, would not have to purchase its goods at market prices from its parent manufacturing company, but rather could purchase those goods at less than the market price so that part of the parent company's manufacturing profit could be earned by the DISC. Accordingly, the relative tax benefits made available by the proposal would be substantially greater where the DISC was a subsidiary of a manufacturing company, rather than an independent export company.

III. ECONOMIC IMPACT OF PROPOSALS

Background of balance of payments and trade

Between 1960 and 1966 our balance of payments deficit was on a general downward trend both on a liquidity basis and on an official reserve transaction basis.[1] On a liquidity basis the deficit increased from $1.4 billion in 1966 to $3.5 billion in 1967 and then showed a small surplus in 1968 before recording a $7.2 billion deficit in 1969.

Of perhaps more significance than the absolute numbers is the change in the character of the balance of payments in the past few years. Since 1965, the balance of payments surplus or deficit has become increasingly dependent on capital flows. The increased inflow of foreign capital has partially offset the deterioration in the balance in the current or noncapital account. As shown in Table 1, the deterioration in the current account is due primarily to a decline in our merchandise trade surplus. The merchandise surplus was $6.8 billion in 1964 and $5 billion in 1965, but declined to $600 and $700 million in 1968 and 1969 (first line of Table 1).

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[1] The official reserve transaction basis reflects essentially changes in liabilities to foreign official holders while the liquidity basis includes foreign nonofficial holders as well as official holders.

TABLE 1.—U.S. BALANCE OF PAYMENTS, 1960–69

[In millions of dollars]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
Merchandise trade [1]	4,906	5,588	4,561	5,241	6,831	4,951	3,926	3,860	626	690
Exports	19,650	20,107	20,779	22,252	25,478	26,447	29,389	30,681	33,598	36,487
Imports	−14,744	−14,519	−16,218	−17,011	−18,647	−21,496	−25,463	−26,821	−32,972	−35,797
Travel (including fares)	−1,238	−1,235	−1,444	−1,596	−1,499	−1,613	−1,627	−2,144	−1,877	−1,980
Receipts	1,025	1,057	1,070	1,133	1,357	1,545	1,785	1,881	2,030	2,333
Payments	−2,263	−2,292	−2,514	−2,729	−2,856	−3,158	−3,412	−4,025	−3,907	−4,313
Military	−2,752	−2,596	−2,449	−2,304	−2,133	−2,122	−2,935	−3,138	−3,103	−3,378
Receipts	335	402	656	657	747	830	829	1,240	1,427	1,504
Payments	−3,087	−2,998	−3,105	−2,961	−2,880	−2,952	−3,764	−4,378	−4,530	−4,882
Dividends and interest	2,689	3,398	3,889	3,984	4,686	5,088	5,140	5,646	6,045	5,806
Receipts	3,752	4,405	4,999	5,309	6,142	6,817	7,282	8,008	8,978	10,237
Payments	−1,063	−1,007	−1,110	−1,325	−1,456	−1,729	−2,142	−2,362	−2,933	−4,431
Other services and transfers, including Government grants	−1,730	−2,020	−2,023	−2,058	−2,003	−1,941	−2,057	−2,047	−2,040	−1,877
Current account total [2]	1,873	3,136	2,536	3,269	5,883	4,364	2,446	2,179	−349	−739
Direct investment	−1,674	−1,598	−1,654	−1,976	−2,328	−3,468	−3,639	−3,154	−3,025	−3,060
Bank claims	−1,148	−1,261	−450	−1,536	−2,465	93	253	−475	269	−528
Nonbank claims	−394	−558	−354	158	−1,108	340	−443	−760	−1,134	−41
U.S. transactions in foreign securities	−662	−762	−969	−1,105	−677	−759	−481	−1,266	−1,266	−1,380
U.S. Government capital, net (excluding unscheduled repayments)	−1,158	−1,621	−1,774	−1,987	−1,799	−1,819	−1,963	−2,427	−2,518	−2,130
Foreign capital	419	1,398	1,707	1,016	812	492	2,961	3,366	8,833	4,485
Errors and omissions	−1,156	−1,103	−1,246	−509	−1,118	−576	−489	−1,007	−642	−2,924
Balance on liquidity basis	−3,901	−2,371	−2,204	−2,670	−2,800	−1,335	−1,357	−3,544	168	−7,221
Balance on official reserve transactions basis	−3,403	−1,347	−2,702	−2,011	−1,564	−1,289	266	−3,418	1,638	2,708

[1] Balance-of-payments basis.
[2] Including unilatural transfers.

Source: Treasury Department.

TABLE 2.—PERCENTAGE CHANGE IN MERCHANDISE EXPORTS, IMPORTS, AND BALANCE, 1961–69[1]

	1961	1962	1963	1964	1965	1966	1967	1968	1969
Percentage change in—									
Exports	2.3	3.3	7.1	14.5	3.8	11.1	4.4	9.5	8.6
Imports	−1.5	11.7	4.9	9.6	15.3	18.5	5.3	22.9	8.6
Balance	13.9	−18.4	14.9	30.3	−27.5	−20.7	−1.7	−83.8	10.2

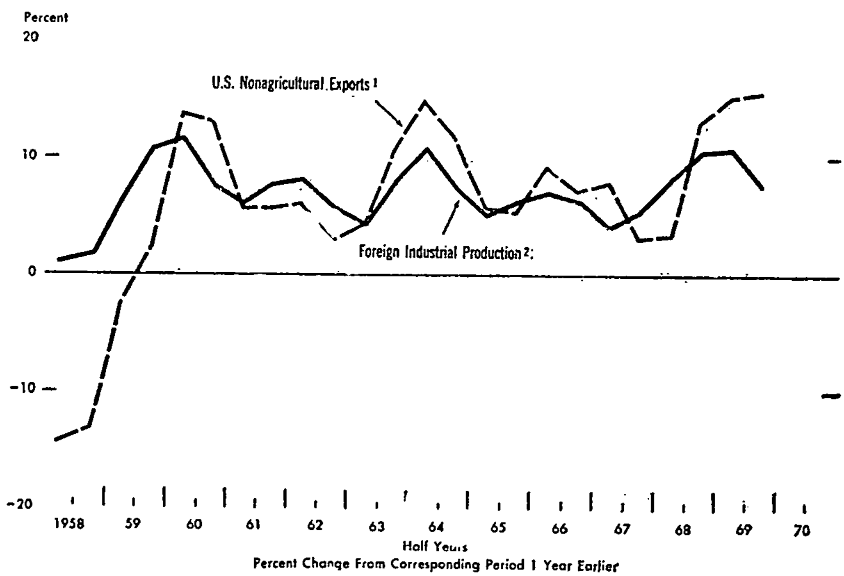
[1] From table 1, percentage change from previous year.

The decline in the merchandise surplus has been due primarily to a rapid growth in imports, or more accurately, to a much more rapid growth in imports than in exports. This can be seen by reference to Table 2 which shows the percentage change in merchandise exports, imports, and balance for the period 1961 to 1969. The most striking point the table shows is the rapid increase in imports beginning in 1965. In that year they increased 15 percent over the prior year, and in 1968 they increased 23 percent over the prior year which resulted in a decline in the balance of nearly 84 percent in 1968. In 1969 the rate of increase in imports slowed down appreciably and the balance improved by 10 percent. The 1969 pattern appears to be continuing into 1970.

Significant reasons for this pattern of changes in exports and imports is suggested by the correlations apparent in Charts 1 and 2. Chart 1 compares the percentage change in U.S. nonagricultural exports with the percentage change in industrial production in major foreign countries. The correlation shown suggests that the level of U.S. exports is closely related to the demand for U.S. products generated by the level of economic activity in other countries. The correlation in Chart 2 suggests that the level of U.S. imports are quite sensitive to the rate of change of GNP in the United States.

CHART 1

Percent Change in U.S. Nonagricultural Exports and Percent Change in Industrial Production in Major Foreign Industrial Countries



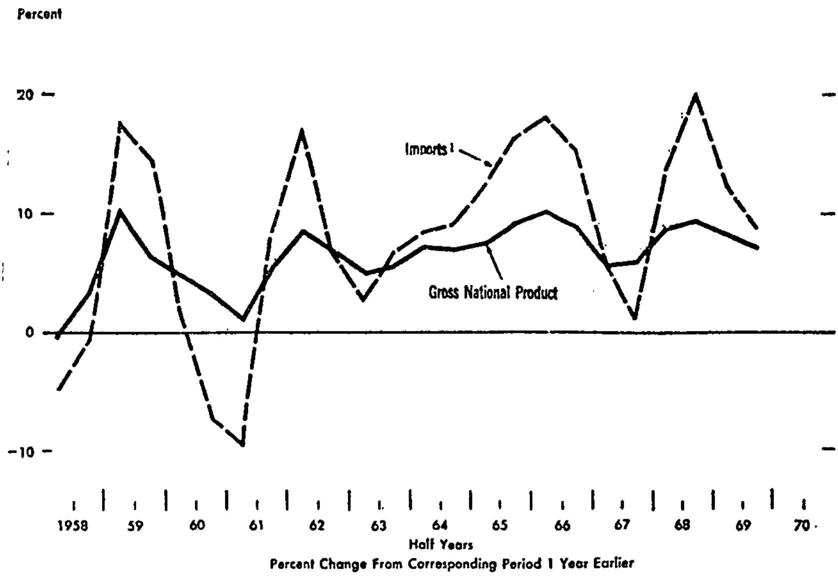
1. U.S. nonagricultural exports are adjusted to exclude automotive exports to Canada, aircraft, and temporary effects of U.S. strikes.
2. Industrial production in Canada, Japan, United Kingdom, Germany, France, and Italy, weighted by these countries' percentage shares in U.S. exports.

U.S. Department of Commerce, Office of Business Economics

70-3-14

CHART 2

Percent Change in U.S. GNP and Percent Change in U.S. Imports



1. U.S. imports are adjusted to exclude automotive shipments from Canada to the United States and temporary effects of U.S. strikes.

U.S. Department of Commerce, Office of Business Economics 70-3-15

Moving to our balance with particular countries reveals that the deterioration in recent years has been concentrated in a few countries. The balance with most of our trading partners has remained relatively constant since 1960 but has deteriorated very sharply with Canada, Japan, West Germany, and Italy as shown in Table 3. In all of these cases, the decline in our trade balance has been due to a much more rapid growth of imports than of exports, rather than any decrease of exports.

TABLE 3.—MERCHANDISE EXPORTS FROM THE UNITED STATES, IMPORTS TO THE UNITED STATES, AND BALANCE BY COUNTRY, 1960–69

[In millions of dollars]

Country	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969
Japan:										
Exports	1,447	1,837	1,574	1,844	2,009	2,030	2,363	2,635	2,954	3,490
Imports	1,149	1,055	1,358	1,498	1,768	2,414	2,963	2,999	4,054	4,888
Balance	298	782	216	346	241	(−334)	(−600)	(−364)	(−1,100)	(−1,398)
West Germany:										
Exports	1,275	1,343	1,581	1,582	1,606	1,650	1,674	1,706	1,709	2,118
Imports	897	856	962	1,003	1,171	1,341	1,796	1,995	2,721	2,603
Balance	378	487	619	579	435	309	(−122)	(−249)	(−1,012)	(−485)
Italy:										
Exports	715	873	892	1,090	951	891	909	973	1,121	1,262
Imports	393	376	452	492	526	620	743	856	1,102	1,204
Balance	322	497	440	598	425	271	166	117	19	59
Canada:										
Exports	3,810	3,826	4,045	4,252	4,915	5,643	6,660	7,165	8,072	9,138
Imports	2,901	3,270	3,660	3,829	4,239	4,823	6,125	7,107	9,005	10,390
Balance	909	556	385	423	676	811	535	53	(−933)	(−1,252)

Part of the overall deterioration in our balance of trade as well as our rapid increase in imports from the countries mentioned above can be understood by comparing the increases in prices of exports of the United States with the increases in prices of exports of these countries. As Table 4 shows, U.S. export prices have increased about 15 percent since 1963, whereas they have increased only 5 percent for Japan, 3 percent for West Germany, and 1 percent for Italy. (Canada's export prices have increased 19 percent since 1963).

The increase in U.S. export prices has also been greater than the increase in import prices which increased 12 percent since 1963, with the result that exports have been discouraged relative to imports. Moreover, domestic prices have generally increased more rapidly than import prices; for example, the consumer price index for commodities has increased about 16 percent since 1963 compared to 12 percent for import prices.

TABLE 4.—EXPORT AND IMPORT PRICE INDEXES FOR SELECTED COUNTRIES 1960 TO 1969

[Indexes of price in U.S. dollars; 1963 equals 100]

	1960	1961	1962	1963	1964	1965	1966	1967	1968	1969 [1]
United States:										
Export prices	99	101	100	100	101	104	107	110	111	115
Import prices	103	101	99	100	102	104	106	107	109	112
Japan:										
Export prices	105	101	98	100	101	101	101	101	102	105
Import prices	100	100	97	100	102	99	101	100	100	103
France:										
Export prices	98	98	99	100	104	105	108	107	106	108
Import prices	102	100	99	100	102	104	105	104	102	105
West Germany:										
Export prices	94	100	100	100	100	102	103	102	100	103
Import prices	102	103	101	100	100	103	104	103	101	104
Italy:										
Export prices	102	98	98	100	103	101	99	99	98	101
Import prices	100	97	97	100	103	104	105	106	107	107
United Kingdom:										
Export prices	96	96	97	100	102	104	108	108	101	105
Import prices	99	97	96	100	104	106	104	100	103	105
Canada:										
Export prices	106	102	100	100	101	103	107	109	113	119
Import prices	99	98	97	100	101	102	103	103	105	109

[1] Third quarter except Italy which is second quarter.

Source: International Monetary Fund, "International Financial Statistics."

In addition to the recent more rapid inflation in the United States than in other countries, the sharp increase of imports in recent years can be attributed to the growing imports of foreign manufactured consumer products, such as compact autos and transistor radios. (In the case of Canada, a substantial portion of the increase of imports was autos and parts). U.S. merchandise exports are generally characterized by a high technological content (as measured, for example, by research and development expenditures per dollar of sales), the bulk of this merchandise being accounted for by machinery, transportation equipment (including aircraft) and chemicals.

Effect of DISC on exports

A. Price effect

If DISC is to give rise to any significant increase in exports through a reduction in prices, it would appear that there would need to be a pass-through of the tax-savings in the form of reductions in the price of exported goods. (Moreover, for the *dollar* amount of exports, to increase the *physical* volume must not only increase but must increase by substantially more than enough to offset the price reduction.) The Treasury is apparently expecting an increase in exports to occur for reasons other than from price reductions. These are discussed below.

The Treasury estimates that the annual revenue loss from DISC would be from $450 to $600 million. The magnitude of the export increase which would result if the entire $600 million were reflected in lower export prices depends on the responsiveness of exports to price decreases. The measure of this responsiveness is referred to as the price elasticity of demand. This is simply the ratio of the percentage change in the quantity of exports to the percentage change in price. A price elasticity of —1.0 would mean that the increase in volume of exports is in direct proportion to the decrease in price. For example, a 10 percent reduction in prices would result in a 10 percent increase in the volume of exports but no change in the dollar value of exports because of the proportionate price reduction. With such a price elasticity, a $600 million decrease in revenues which was reflected in price of reductions would result in no improvement in the balance of payments. It would require a price elasticity of —2.0 to make up for the price reduction and give rise to as large an increase in exports as the revenue loss.

There have been several studies of the elasticity of exports and the general consensus is that it is fairly low.[2] The studies show a range of price elasticity for exports of —1.0 to 2.0. A recent study was done by Hendrick S. Houthakker and Stephen P. Magee, a current member of the Council of Economic Advisers and a former staff member, respectively.[3] Their conclusion was that the price elasticity of U.S. merchandise exports is about —1.5, i.e., a 1 percent decrease in price would yield a 1.5 percent increase in the quantity of exports. This would imply that with the $600 million revenue loss estimated by the Treasury, the DISC proposal would give rise to an increase in exports of about $300 million. In the explanation presented by the Treasury to the committee, it is indicated that the DISC proposal is expected "to generate over time a level of exports a billion dollars or more greater than might otherwise develop." [4] The statement does not indicate how long a time interval is expected before the billion dollar increase in exports can be expected. It does make it clear, however, that the Treasury is depending upon effects other than export price reductions to account for most of the expected improvement in exports.

One possible reason for the insensitivity of U.S. merchandise exports to price changes is that U.S. exports are generally higher-priced goods which reflect advanced technology and are not directly competitive with goods produced abroad, at least in the early stages of exporting. This explanation, called the product cycle theory, holds that the United States tends to export new technologically advanced products. After exports have developed a sufficient overseas market, overseas production becomes profitable. In the meantime, the United States has developed another new product and the cycle begins again. This process is not particularly sensitive to price changes of U.S. exports and hence the low price elasticity observed for U.S. exports.

B. The effect of trying harder to export

The Treasury presentation indicates that DISC would increase the profitability of exporting and thus induce exporters to take steps to build up their export market. It is thought that because of the small size of the export sector compared to the domestic market, top management in most companies is not aware of, and does not give priority to the development of, the export market. The Treasury feels that the DISC proposal will focus the attention of top management on this area of increased profitability. Presumably the steps which management would take would involve product development, promotion, financing, delivery, service and similar activities. The effect of this is expected to be the allocation of greater attention, effort and resources to the export market with a consequent increase in exports. As Secretary Kennedy said in his testimony before this committee: ". . . and companies would be encouraged to develop long-range export strategies. Indeed, I believe this shift in taxation would help signal to industry that improved export performance is a national objective of high priority; it would help build the consciousness and attitudes toward exports that this country has been sorely lacking." [5]

The possible magnitude of the effect of increased effort in these areas is difficult to evaluate. There really are no data available that would provide accurate

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[2] See the following:

(1) Ball, R. J., and K. Marwah, "The U.S. Demand for Imports, 1948–1958," *Review of Economics and Statistics,* 44 (1962), 395–401.

(2) Junz, H., and R. R. Rhomberg, "Price and Export Performance of Industrial Countries, 1953–1963," *IMF Staff Papers,* July 1965.

(3) Houthakker, H. S., and S. P. Magee, "Income and Price Elasticities in World Trade," *Review of Economics and Statistics,* 51 (1969), 111–125.

(4) Kreinin, M. E., "Price Elasticities in International Trade," *Review of Economics and Statistics,* 49 (1967), 510–516.

(5) Prais, S. J., "Econometric Research in International Trade: A Review," *Kyklos,* 15 (1962), 560–577.

[3] "Income and Price Elasticities in World Trade," *Review of Economics and Statistics,* May 1969.

[4] Materials Relating to Domestic International Sales Corporation Proposal to the U.S. Treasury Department Presented to the Committee on Ways and Means, on May 12, 1970, p. 11.

[5] Ibid., p. 11.

assessment of how much exports might be expected to increase as a result of the expenditure of additional funds or effort for export promotion. In this connection, the staff does not know the basis for the Treasury estimate that over time exports will increase by $1 billion because of the proposal. Several considerations are relevant even though they cannot be quantified.

First, several witnesses including the Chambers of Commerce, the National Association of Manufacturers, and the National Foreign Trade Council testified before this committee that DISC would provide a significant incentive for export expansion. Others submitted similar comments to the Treasury and Commerce Departments indicating that they would undertake additional export promotion efforts as a result of DISC.

Second, provision of additional services, etc., in connection with exports can be viewed as providing a better product at the same price. In one sense this is equivalent to providing the same product at a lower price, and (as indicated above in connection with price effects) the response to this is not likely to be large. On the other hand, to the extent that the effort takes the form of new product development and promotion, it may result in a somewhat larger increase than the section on price effects suggests.

Third, if there is virtually no price change and no income change in other countries, there may not be sufficient demand for the U.S. exports to permit any significant increase as a result of the additional effort to promote exports; the size of the market may be the limiting factor. To the extent that U.S. exports are made more competitive with those of other countries or those produced in the foreign country, however, such efforts could improve somewhat the competitive position of U.S. exports.

Fourth, many countries have restrictions which would apply to increased U.S. exports by the companies which are now doing most of the exporting. For example, restrictions on the amount of electronic components or automobiles that can be imported. These restrictions are one of the reasons why U.S. firms have set up manufacturing subsidiaries abroad.

Of course, even if greater effort in developing and promoting exports would be successful, it does not necessarily follow that the DISC proposal is the most efficient way to obtain it. For example, something along the lines of the Commerce Department export promotion program might yield a greater increase in exports per dollar spent than the tax incentive provided through DISC. Also, provision for the refunding of State and local excise taxes (both direct and indirect) on exports (along the lines of H.R. 13713 introduced by Chairman Mills) might also yield greater results than the DISC proposal. Similarly, a broader border tax program which not only provided refunds for exports but taxes on imports might yield greater results. Another possibility would be to permit marginal or incremental cost pricing for sales by a U.S. corporation to its overseas subsidiaries. This would provide greater profits eligible for present law deferral to the subsidiary and reduce the total tax payable on the sales.

Effect of DISC on plant location

The Treasury position on the effect of DISC on plant location, as stated by Secretary Kennedy is, ". . . our tax system does tend to create an unnecessary drag on exports and actually gives some incentive to manufacturing abroad rather than in the United States.[6] . . . Perhaps more important over time, basic decisions on the location of new investment facilities at home or abroad would be affected and companies would be encouraged to develop long-range export strategies."[7]

A large number of factors which determine whether a U.S. company will locate a plant overseas or export from a U.S. plant makes an evaluation of the impact of DISC on plant location quite speculative. While it appears clear that the DISC proposal would have some effect in encouraging the location of plants here rather than abroad, whether or not this is a significant factor is difficult to determine. In part, such a determination depends on the importance of tax differences as a cost element in the selection of plant location. In addition, the effect depends on the extent to which it is possible (if DISC would make it profitable) to produce in the United States and export in view of the current and possible future restrictions on U.S. exports imposed by other countries.

It is, of course, not sufficient to say that if the tax under present law is lower on a plant overseas than it is for exports from the United States, then DISC, by reversing this relationship, will make it more profitable to locate in the United States.

[6] *Ibid.*, p. 8.
[7] *Ibid.*, p. 11.

The effect of DISC depends on the relative size of cost differences including those in no way related to taxes. For illustrative purposes, assume that the rate of profit before taxes on sales would be 8 percent in two cases, one involving foreign investment and one involving domestic investment. Assume also that the overseas rate of tax is 40 percent and the U.S. rate of tax is 50 percent. The simplified illustration shows that the use of DISC in the case of the domestic investment would increase the after-tax rate of return by 1.2 percent of sales.

	Overseas	United States Present law	United States DISC
Before-tax rate of return on sales	8.0	8.0	8.0
Tax expressed as percent of sales	3.2	4.0	[1] 2.0
After-tax rate of return on sales	4.8	4.0	6.0

[1] Assumes ½ of profits or 4 percent of sales exempt under DISC and the remainder taxed at 50 percent.

The question in evaluating the cost effect of DISC on plant location is then whether the cost differences between the two locations is greater than this tax saving of 1.2 percent of sales. For example, if costs were 2.5 percent of sales higher in the United States (so that the before-tax rate of return were 5.5 percent instead of 8.0 percent) the after-tax rate of return under DISC would be 4.75 percent or would still be lower than that from the overseas plant. The point made here is simply that where cost considerations determine plant location, the effect of DISC on after-tax profits is likely to be relatively small compared to other cost elements. Consequently, the impact of DISC on plant location is not likely to be large.

Moreover, the cost considerations are not the only determinants of the choice between overseas plants and U.S. exports. In some instances, plants are located overseas because of tariffs (which are costs) or quotas or requirements that certain articles or a portion thereof be produced within the country. In addition, plants are located overseas as part of a marketing strategy which includes the provision of a wide range of services which my be best provided by local facilities. In many instances, the overseas plant location may also be defensive in nature; if the U.S. firm does not produce in the local market, a local firm may do so. This pattern of U.S. overseas production following exports which initially dominated a market and then having their position eroded by local firms, is part of the product cycle theory referred to above. These U.S. manufacturing affiliates abroad also provide a market for U.S. exports which otherwise might not be as large.

In evaluating the desirability of DISC as a means of increasing domestic employment (by encouraging plant location in the United States) there are, of course, other ways to increase employment. Easier monetary policy, training programs, or direct expenditures are alternatives to which the committee may wish to compare DISC—a cost effectiveness point of view as far as employment is concerned.

Revenue effect

The Treasury estimate of the revenue loss from DISC is $450 to $600 million a year. This estimate was arrived at as follows:

	(In billions)
1. Estimated U.S. export sales in fiscal year 1972 (current level, $40,000,000,000)	$46
2. Sales deemed nonqualifying because they represent less than 50 percent U.S. content	—2
3. Export sales assumed qualifying	44
4. Assume 75 percent participation (admittedly high)	33
5. Estimated DISC profit after application of 4 percent and 50 percent of profit limitations [1]	1.4
6. Tax applying a 48 percent rate	.72
7. Reduction by a "guess" as to the offset by companies using Western Hemisphere Trade Corporation or which have tax reduction from foreign tax credit	—.12 to .27
8. Estimated revenue loss	.45 to .60

[1] On approximately $7,000,000,000 of agricultural sales, the profit rate is about 1 percent. The $1,400,000,000 implies a rate of profit on sales after limitation of 5.1 percent on the $26,000,000,000 of nonagricultural exports or about 10.2 percent before limitations. The 10 percent figure can be compared with the rate of 9 percent for 1968.

While this estimate involves some rather broad assumptions, the absence of specific data appears to make this necessary. This revenue loss is estimated by the Treasury to produce "over time" an increase in exports of $1 billion. A question for consideration in this respect is the relative benefit of a program which costs 45 to 60 cents in revenue for each dollar of eventual increase in exports. In addition, the revenue loss would occur fairly soon, since it applies to present exports, but the increase in exports would occur over time. Consequently, the revenue cost per dollar of increased exports might well be higher than the 45 to 60 cents for a considerable period of time.

Questions can also be raised about the estimate of the "over time" $1 billion increase in exports. As indicated previously an analysis of price effects suggests a $600 million reduction in revenues would increase exports by something like $300 million. It is not at all clear that the other ways in which it is believed that DISC will increase exports can be expected to account for the remaining $700 million.

The major impact of the revenue loss from DISC would, of course, be concentrated among the major exporting companies. The Commerce Department estimates that roughly 100 of the largest U.S. firms account for the majority of our exports, more than 50 percent, although this a rough quess.[9] They would presumably receive approximately their proportionate share of the tax reduction. If they account for 50 percent of our exports, they would, of course, receive about $300 million out of $600 million.

Another way of viewing the revenue loss is, if the revenue loss were translated into a rate reduction, how large would it be. The Treasury estimate of the revenue loss assumes that the DISC profit after the 4 percent and 50 percent limitations would be $1.4 billion for participating exporters. Presumably the profit before application of the 50 percent limitation would, therefore, be between $2.8 billion to $3 billion. The $600 million revenue loss represents 21 to 20 percent respectively, of these amounts. Applying these percentages to the 48 percent corporate rate indicates that the tax reduction from DISC is equivalent to about a ten percentage point reduction in the corporate rate from 48 percent to 38 percent on export profits.

Mr. NADER. The cost of DISC by the administration has also been challenged as unrealistic. The administration claims a cost of $600 million, while some members of the House Ways and Means Committee convincingly argue that the cost will be closer to $955 million annually. DISC is a billion dollar boondoggle. Its inclusion with the President's other tax proposals highlights the tendency to clothe special interest tax cuts in the garb of economic stimulation. The absence of any available Treasury study to support its export gain predictions under present conditions either shows that the Department doesn't want the public to know what it is doing or the Department itself doesn't want to know what it is doing to the public. In either case this committee should find out.

Chairman PROXMIRE. Let me ask at this point do you take the position, Mr. Nader, that recognizing that there are inequities involved in this tax, perhaps the approach was wrong? Would you concede there would be any job creation as a result of this, any substantial job creation?

Mr. NADER. Well, in reply to your general question, there already is very elaborate export promotion, export risk insurance, and other activities which have been going on by the Federal Government to strengthen exports overseas. Anybody who has gone to the U.S. Embassies, for example, wonders what part of it is not engaged in the promotion and facilitation of American exports so there is a great deal of that kind of promotion and backed up with trade shows and the like.

Now we come to an additional type of subsidy, and that raises two

[9] Companies do not generally report data on exports for competitive and other reasons, so accurate data are not available.

questions. Is it worth it, quite apart from the philosophical aspects, and what it does to reduce incentives for efficiency, is it worth it in terms of what it reaps compared to what it costs?

Chairman PROXMIRE. Also you have the fact that you are going to get, I would hope, a substantial stimulation for exports by the devaluation of the dollar.

Mr. NADER. That is right. And that is another point that has to always be integrated into all of these discussions. Many of these proposals that are so, I think, unacceptable, are designed to meet objectives which are not substantiated, that the devaluation of the dollar will help immeasurably to accomplish that objective particularly in the import-export trade.

Mr. Stanton has a comment on that, Mr. Chairman, if you will.

Chairman PROXMIRE. Yes, sir.

Mr. STANTON. Mr. Senator, the DISC export incentive is very inefficient. Even accepting the Treasury export gain of a billion and a half dollars, we have to note American exports in 1969 were $37 billion; in other words, the administration is proposing to increase exports using their questionable figures by about 4 percent. In order to do this they are applying the DISC export tax subsidy to the entire 96 percent of exports which already would have been undertaken in addition to the 4 percent to be induced. This is a very inefficient subsidy, if one is really attempting to promote exports.

Mr. NADER. The same philosophy, Mr. Chairman, that prevails with the investment tax credit—give it to all the corporate boys no matter whether they were going to make these sales or invest in this equipment or not, that is about the crudest, the most inefficient, the most wasteful, and, in terms of its impact on the average citizen, the most inequitable approach you can imagine.

We have got far more selective economic tools and knowledge to put to bear on this kind of policy to make it achieve the objectives that it is supposed to be achieving.

Chairman PROXMIRE. Wouldn't that be especially true if you make it retroactive to April 1, as the indications are it might well be? Secretary Connally made some kind of a statement that this would be done if we put the investment credit into effect, and I understand some Members of Congress have indicated that is what they favor. Do you see any justification, any justification for making this retroactive? Wouldn't that be a complete total windfall with obviously no stimulation whatsoever?

Mr. NADER. I couldn't agree more. They have refused to approve a retroactive impact on wage settlements, but they are going right ahead with this.

In addition to these corporate windfalls, in the tax area, the administration proposes abolition of the automobile excise tax. Before the Congress accepts this proposal, which will cost $2.3 billion in the remainder of this fiscal year alone, it should carefully consider what the Nixon administration has already done for the automobile industry:

1. On June 22 of this year the administration adopted a set of accelerated depreciation regulations, which are now being challenged in the courts, which would allow the auto manufacturers to depreciate their purchases of capital equipment 20 percent faster than they could

before. These regulations were made retroactive to January 1 of this year which granted the industry an extra windfall since the regulations apply to purchases made before the auto manufacturers knew whether or not they would be adopted. Since the auto industry invests substantial regular amounts in capital equipment and machinery, this tax break is even more valuable for them than for corporations in general.

2. The President has now proposed a tax investment credit which he and his Treasury Secretary euphemistically refer to as a "job development credit" of 10 percent for 1 year (until August 16, 1972), and 5 percent thereafter. Again, because the auto industry tends to be a capital-intensive industry, this proposal is especially generous to it.

3. In addition, the President has imposed a 10-percent surcharge on imports which has had the effect of dampening what little price competition the American automobile industry faces; namely, foreign cars. With the surcharge of 10 percent added to the prices of the one-sixth of the auto market which foreign imports now control, the only beneficiaries will be Ford, GM, and Chrysler, not the American consumer.

4. As a final act of beneficence for the auto industry, the administration is in the process of negotiating a devaluation of the dollar which, according to newspaper reports (Washington Post, Aug. 19, 1971, p. 1) will amount to around 12 percent. What this means for the auto industry is that once the temporary surcharge of 10 percent is lifted, prices of foreign cars will permanently increase by around 12 percent.

I don't mean to denigrate the dollar devaluation but I am trying to add up all of these policies in terms of what they are doing to an excessively high-profit industry in a record sales year with record profits in the formation, and I might add with 20,000 more UAW jobs in May employed in the industry than in May of the previous year 1970.

Rarely has any government done so much for an industry in so short a time.

Finally, the auto industry apparently will be only slightly affected by the 90-day wage price freeze. The Wall Street Journal reported yesterday that—

> The auto industry's large wage increases late last year have largely been covered by a series of hefty price increases on 1971 models. This fact alone makes the companies more fortunate—at least for the moment—than those firms locked into a combination of recent wage increases and frozen, or rescinded, prices.

Even if the auto industry were not to raise its prices, the proposal of the President is misplaced in terms of national priorities. In the United States there are over 100 million registered vehicles; about 9 million cars are sold each year; profits for the industry this year (especially for General Motors) are substantial; the problems of air pollution and traffic congestion caused by these vehicles are enormous. It is difficult to ascertain a reason for stimulating increased purchases from this industry. It has been having a record year in sales and employment, and profits are up substantially. In addition, the UAW itself does not approve of the President's domestic proposals. In order to counter what one of your prior witnesses stated just a few moments ago on the state of the auto industry in terms of sales, I would like to introduce for the record a speech of President Lee A. Iacocca of Ford Motor Company just this last Monday which indicates what an enormously successful sales year has been going on by the auto industry. I would like to just quote one paragraph from Mr. Iacocca's speech:

In spite of the slow pace of economic recovery this year, and even with a 7 percent auto excise tax, car sales have been bouncing along all year at or near an annual rate of ten million. We have been saying since last December that U.S. car sales will come in at a record level of 9.7 to 10 million for the full year. For a year in which the economy has been lagging well behind expectations, that is pretty good news.

And that is the industry, Mr. Chairman, that the present administration has singled out for its most preferred treatment, not the industries that are having difficulty in employment, not the areas where there are job developments to be generated, and not the area where low-income people desperately need jobs and could get jobs, but, yes, in the area of automobile production.

(The full text of the speech follows:)

Following is the text of remarks by Lee A. Iacocca, president, Ford Motor Company, at a national news preview of the company's 1972-model cars at the Ford Automotive Safety Research Center, Dearborn, Mich., on Monday, August 16, 1971:

Until 8 p.m. yesterday, this was going to be a press conference about our 1972 models.

I had my speech for today all ready on Friday. It would have been a good speech on Friday, if I do say so myself, but it's not so good for Monday. Before I toss it, though, I'd like to read you a few excerpts.

"Given current levels and trends in productivity, wage rates and currency exchange rates—and those are the three basic factors—American industry is losing its competitive edge in world markets.

"This fundamental problem is reflected in our national balance of payments deficit, in the fact that the U.S. is likely to import more goods than it exports this year for the first time since 1893; in the shaky position of the dollar in world banking circles; and in the persistence of relatively high unemployment. But, it's not just the auto industry's problem; it's the nation's problem." That's what I was going to say.

Here's another paragraph:

"In my opinion, there is no one way to solve this problem, but we can solve it if we find the right combination of ways. This country has no greater need than to get together quickly and put together a program that works. Some things we in industry can do on our own. Most things will require action by the government as well. And it would also help if the unions would recognize that the jobs of their members are at stake."

I won't take you through the whole program I was going to suggest, but here's one item:

"It's clear that the yen and the mark and some other currencies are undervalued relative to the dollar, and that something will have to be done to get exchange rates evened up and to find better ways to keep them even."

One last quote from Friday's speech:

"Finally, I believe the competitive edge of American industry will be restored simply because it must be restored."

I've given you enough from Friday's speech to make it clear that in our judgment the country needed action and strong leadership by the President of the United States.

The American economy has been in serious trouble and heading for worse. Something had to be done. What the President has done and has asked Congress to do adds up to one of the boldest and most far-reaching changes in economic policy that has ever been launched, in this country or anywhere else. It will have tremendous consequences, not only in the United States, but throughout the world.

Some of the specifics are highly controversial. But there can be no quarrel with the broad goals and the general thrust of the program—to increase jobs, to increase productivity, to control inflation, to protect the dollar and to gain a fair shake for American industry in world markets. Ford Motor Company will cooperate fully with the spirit and the letter of the President's program.

In our judgment, the most important and constructive feature of the whole program is the proposal to restore the investment tax credit, initially at 10 per cent and then at 5 per cent on a permanent basis.

In the long run, the key to providing more jobs for American workers, to keeping costs and prices down and to restoring the competitive vitality of American industry in world markets is to increase the rate of growth in productivity.

The key to higher productivity is a sustained high level of capital investment. One of the secrets of Japan's success is its very high level of capital investment which, last year, amounted to 40 per cent of its gross national product. In the United States, on the other hand, capital investment amounts to only 14 per cent of GNP.

American industry cannot compete with Japanese industry if that difference persists. Restoration of the investment tax credit will serve the dual purpose of stimulating investment and helping industry to absorb rising costs. It will not be a windfall for business, but a way of keeping American jobs in America. We hope that when Congress reconvenes, it gives top priority to enacting this proposal.

We also welcome the President's proposal to repeal the discriminatory 7 per cent excise tax on passenger cars. This tax, the 10 per cent excise on light trucks, the 7 per cent tax on truck parts and the telephone excise are the only surviving remmants of the excise taxes imposed to help finance the Korean War. Repeal of the automotive taxes has been overdue for years. Repeal at this time would provide a badly needed stimulus to the economy and, as the President observed, would help provide more jobs and get the unemployment rate down. We hope that Congress will move quickly to repeal not only the passenger car excise tax but also the taxes on light truck parts.

When these taxes come off, we will immediately reduce both our prices to our dealers and our car and light truck sticker prices by the same amounts. We have no authority to commit our dealers to similar action—but if I know anything about competition between dealers, the retail customer will get the full benefit of excise tax repeal. This means that car prices will come down, on the average, by nearly $200 per unit and this in turn will stimulate car sales and employment in the auto industry.

Excise tax repeal will help to get the economy moving again but it will not help to achieve the crucial goal of improving productivity and getting American costs back in line with costs abroad. In addition to stimulating capital investment, this country must also find ways to bring labor settlements down to more reasonable levels and, equally important, to improve the performance of the industrial labor force.

As you know, the President announced that he will establish a Cost-of-Living Council, within the government, to work with labor and industry to achieve long-range cost/price stability. There's no doubt that the Council's most important job will be to develop new approaches to restraining the growth in unit labor costs. If it fails in this task, the national economy will be right back where it started, whatever else may be done to improve the competitive position of American industry in world markets.

As for the effect of the 90-day price/wage freeze, it appears from what the President and Secretary Connally have said that it means just what it seems to mean—current prices are frozen for the next 90 days. This seems to say that we'll have to absorb all the costs increases we've already experienced on our 1972 models and we don't see how we can do this.

But we heard what the President and the Secretary said. We also heard Secretary Connally say that today's level of corporate profits is unacceptable, and we agree.

As the President stated last night, the purpose of both the temporary suspension of gold sales to foreign governments and the temporary 10 per cent import tax is to impress on other countries the need for reforming the international monetary system and eliminating unfair discrimination against American industry, particularly in the form of unrealistic currency exchange rates.

At Ford we've always been free traders and we still are. We believe free trade can be made to work, but we know that it won't work unless it's really free in both directions, out as well as in, and for investment as well as for commodity trade. We recognize that under current practices, it's a lot freer coming in than going out.

It has been obvious for some time that the mark, the yen and certain other currencies are substantially undervalued relative to the dollar. This places American industry at a serious disadvantage and is a basic reason for the growing foreign penetration of U.S. markets. We hope that other countries will respond constructively to the President's initiative by joining with the United States to find a better way of keeping exchange rates in balance and to provide equal opportunity for American industry in world markets.

Again, however, I want to emphasize that productivity is the key to a strong competitive position for American industry. Whatever other nations do to even the rules of the game at this point in time will not help in the long run unless American industry is able to compete on even terms and to keep its costs in line with costs in other countries.

That's all I have to say right now about the President's message, except to mention that the auto industry was the only industry singled out for special attention. The President's reason for requesting repeal of the auto excise tax is that each 100,000 additional cars that are sold means 25,000 more jobs. What this suggests is that good news about car sales is of some considerable importance to the nation as well as to Detroit.

It's been easy to find bad news about the economy and the auto industry this year, so I'd like to remind you that good news is not so hard to find either.

In spite of the slow pace of economic recovery this year, and even with a 7 per cent excise tax, car sales have been bouncing along all year at or near an annual rate of 10 million. We've been saying since last December that U.S. car sales will come in at a record level of 9.7 to 10 million for the full year. For a year in which the economy has been lagging well behind expectations that's pretty good news.

In spite of the rise in imported vehicle sales, Ford's U.S. car and truck sales during the first half of 1971 set a record of nearly 1.6 million units—up 7.5 per cent from last year. For a period in which the imports were increasing their bite of the car market to a new high of 16 per cent, that's not bad either.

From our own special point of view, just about the best news of the year is that Lincoln-Mercury Division is really on the move—at long last. Mark III sales were up 37 per cent in the calendar year through July, Lincoln was up 10 per cent. Mercury was up 7 per cent. At the other end of the market, Capris are selling as fast as we can bring them in and Comet is coming on strong. Overall, Lincoln-Mercury sales were up 23 per cent in the first seven months over the same period last year. From where I sit, that kind of good news is hard to beat.

There's even some good news in the small car segment of the U.S. car market where—if you believe some of the reports you hear—the imports reign supreme. The truth is that during the first seven months of 1971, domestic small cars outsold imported cars by a margin of 54 per cent to 46 per cent of the segment.

As a matter of fact, domestic small car sales have grown even faster than imported car sales. Through July, domestic small cars were up 44 per cent from last year, while imports were up 30 per cent.

There's no sense pretending that we're overjoyed because the imports are now taking only 16 per cent of the market. Nevertheless, its a fact that the Pinto and other domestic subcompact cars have kept the imports from capturing an even larger share of the home market. Our surveys show that 40 per cent of Pinto buyers would have bought an import if the Pinto had not been available and one-fourth of Pinto buyers are trading in imported cars.

Ford sold more small cars in the U.S. during the first seven months of 1971 than any other manufacturer—foreign or domestic—in spite of Pinto engine shortages resulting from a two-month strike in England.

When you put the good news about car sales up against all the complaints about the automobile as public enemy number one, you have to conclude that everybody is fed up with cars—except all the people who buy them and can't get along without them. I suppose there are a few people who have stopped driving, but I haven't met one yet.

Until somebody shows me a more versatile way to get around, I'll continue to have faith in the future of the automobile. Improved public transit is needed and is coming and we're all for it. In fact, we're pushing pretty hard to sell some of our own better ideas for public transit. But there are too many things that public transit can't do for it ever to make much of a dent in the demand for cars.

What I am saying is that there is going to be plenty of good news about the auto industry for a long time to come. When you look at the whole world, as we do, the growth potential is simply fantastic. The automobile industry has a lot of knotty problems, but one of its biggest problems on a worldwide basis is the kind of problem that makes all the others easier to solve—how to expand capacity and output to catch up with the unfilled demand for cars and trucks.

Turning from the long run for the world auto industry to the short run for the American auto industry, we think that 1972 is going to be a very good model year. Before I heard the President's message last night, I was planning to tell you that it should be the best model year in history for car sales in the U.S.—though maybe not the best for sales of domestically manufactured cars.

If the excise tax is removed, as the President proposed, and if the 10 per cent import tax is applied to car imports for a substantial part of the year, then the 1972 model year will very probably be a record year for domestic car sales as well as for total car sales.

If it's a good year for the American auto industry, it just has to be a great year for Ford.

In spite of the growth in small car sales, one customer in five still thinks the intermediates are the best buys available. We've got the best-riding and best-looking intermediates we've ever built and the only new entries in the intermediate field.

We've got a brand new Thunderbird and I think you'll agree with us that we've done the impossible by making the Mark IV an even quieter, more luxurious and better looking car than the Mark III.

Each of these new cars, by the way, is virtually all-new, from the ground up and the inside out—even though we've preserved the unique styling themes of both the Thunderbird and the Mark III.

As far as the other cars are concerned, we've concentrated on engineering improvements too numerous to mention.

Even though we've put more into engineering than into sheet metal, I think we have the handsomest line up of new models—from top to bottom—that we've ever had. And, in spite of all the changes in the car market, I haven't yet noticed that people have stopped responding to good looks.

I've covered a lot of ground and taken a good deal of time, so now I'll stop talking and start answering questions you may have.

Mr. NADER. I would advise or suggest that you read Mr. Iacocca's statement for another reason. He delivered it, I believe, only minutes after Treasury Secretary Connally's press conference.

Chairman PROXMIRE. May I say we have invited Mr. Iacocca to testify.

Mr. NADER. Yes.

Chairman PROXMIRE. But we just got word a few minutes ago that he declined. We will have somebody else from the automobile industry.

Mr. NADER. Yes. He delivered it minutes, Mr. Chairman, after Treasury Secretary Connally's press conference and he didn't deliver it orally but delivered it by a prepared statement. This displays a remarkable prior knowledge or a pretty good idea, going back to the prior week, of what the Federal Government planned for the auto industry, and it is already on the public record that Mr. Connally had spoken on the phone to the President of General Motors, James Roche, last week, and General Motors gave completely unprecedented advice to their dealers that they can immediately sell new cars on receipt a number of weeks before their inaugurals in late September with the new price increases. Fortunately this failed, but again it indicates why ex parte, why such communications with a few elite corporate executives, and why such little communication with the other branch of the Government, the U.S. Congress, not to mention the rest of the American public and other smaller groups and labor unions——

Chairman PROXMIRE. This is a very serious charge you are making, Mr. Nader, and I want to be sure I have got the documentation that you want to provide to the committee to support it. You say judging by its exceptional communique to dealers to start selling 1972 model cars with their new-price increases immediately on receipt last week, General Motors knew what was coming by way of a price freeze and tried unsuccessfully to slide under the deadline.

Now, as I understand it, the Secretary of the Treasury specifically said that he did talk to Mr. Roche but that that conversation was confined entirely to pricing policy, and it is a fact, as you said, that they did make this advice to their dealers, but I wonder if it is proper to jump to the conclusion they had foreknowledge there was going to be a price freeze simply on the basis of that action.

Mr. NADER. Two replies to that statement, Mr. Chairman. First of all, the burden of proof is on the Treasury to state that no other Treasury officials in any way conveyed these kinds of implications or intimations to auto executives. After all it is not just Treasury Secretary Connally who will talk to an auto executive.

Second of all, in just discussing pricing with Mr. Roche, you can pretty much indicate what was coming. After all it wasn't discussing the pricing of the additional incremental cost of hood ornaments, it was discussing pricing in the context of what Mr. Connally wanted to find out.

Chairman PROXMIRE. You see what shocks me is that this was the best kept secret from the Congress that I can recall. I received a letter. I didn't receive it until Monday, from the White House, in response to an appeal that several of us in the Senate had made, that the administration put into effect much of the program they did put into effect. We wanted a freeze, we wanted to cut loose from gold, we wanted stimulation of the economy through the investment tax credit, and so forth. We got back a letter saying they were not going to do it, they had no intention of doing it, the economy was doing well and, of course, as we all know the President of the United States on August 4 in a press conference announced he was not going to do any of these things.

So it comes as a very great shock, if you could demonstrate that this was conveyed to private officials so that they could take advantage of it and make substantial profits or make gain out of this.

As I take it then your fundamental argument is that General Motors did issue this unprecedented advice to their dealers, that is it.

Mr. NADER. And the admitted call to Mr. Roche last week, and another bit of circumstantial evidence which is very interesting. Both Treasury Secretary Connally and Under Secretary Charles Walker have been saying that this policy as it applies to the auto industry in terms of the investment tax credit and abolition of the excise tax and the like will increase sales of cars by 500,000, and that that will produce 125,000 new jobs.

Now, everybody that I can ascertain indicates that that exact figure was obtained from the auto industry prior to the announcements on Sunday and Monday, and what is very interesting about that figure is, first of all, that it is totally unsubstantiated and, second of all, that it does not take into account that increased production, if that should be the case, will be absorbed at those levels very heavily by overtime payments.

Now, I mentioned this fact to Under Secretary Walker last evening, and said, "I have noticed you have used this 125,000 extra job figure on the basis of one new job for every four cars sold."

Senator MANSFIELD. The information given to me was that it was based on—no, you are right, excuse me, I am thinking of the one in six which is entirely right. Excuse me.

Mr. NADER. I said, "My information from the auto industry, which tends to be quite reliable, is that these increased sales will be taken in by overtime payments." It is much cheaper for the auto companies to just give overtime and they have that plant, they have that kind of expansive capacity and plant and asked him what would that do to his figure of 125,000. And in his quick style of response he said, "if it is going to be absorbed by overtime payments it will be fewer new jobs created, won't it."

And then he said, "But it will be more overtime for workers."

Those two comments, I think, indicate to me, first of all, that that figure was just thrown out as a very impressive press conference figure and, second, that it indicates the low priority attached to the administration's proposals in terms of helping the unemployed, in helping the underemployed, in helping the millions of Americans who don't have anywhere near the status of auto workers in the policies that have been extended by Congress and issued this last week.

To continue, of equal importance, the President's proposal is misplaced in terms of equity. Now I realize Treasury Secretary Connally has said, "Well, everything is going to have to be inequitable, there are always inequities in a price-wage freeze and the like." Well, the real question is how much inequity, who bears the burden and what is avoidable?

Lower prices for new cars, at least for the next 90 days, constitutes a saving for those Americans who are wealthy enough to afford them in the first place. According to the President this class consists of 8 million Americans. On the other hand the tens of millions of less fortunate Americans who would have been assisted by welfare reform and the benefits of effective and equitable revenue sharing have been asked to pay the price of the Nixon tax-cut program.

Even putting the question of equity aside, it makes more sense, does it not, to put a dollar in the hands of low-income families, who will have a high propensity to spend, who will spend it rather than the higher income family who will buy a new car and who will be inclined to save part of it. It makes more sense to cut personal income taxes by the equivalent of the auto excise tax, letting consumers decide what they want to buy. Rather the administration is saying in effect that they, the consumers, should buy more cars. In the alternative, keeping the auto excise tax and putting its revenues into a mass transit program would also employ new workers rather than afford more overtime to auto workers if more cars are sold due to abolition of the auto excise tax.

These are some alternatives. The administration oftrepeated figure of 125,000 new auto workers jobs, if the auto tax is abolished, is as phoney as a new car's chrome ornamentation. They cannot support this figure with any hard data.

The prospect of what will happen to car prices after the 90 days are over should make Congress extremely reluctant to repeal the auto excise tax. The auto industry has been notorious for its lack of competition in prices. The Nixon administration has assured the auto industry that foreign competition will be placed permanently at a substantial disadvantage. The auto manufacturers have the power to raise prices by 7 percent after the freeze and still maintain a favorable competitive advantage over imported cars. Should this happen, then the effect of repeal of the excise tax would be to take $2.3 billion in revenues and pour into the profit statements of GM, Ford, and Chrysler, and of course, the dealers would have additional flexibility to combine variables at the retail level to mask their slice of the auto excise tax gap. I might say once again that President Iacocca of Ford noted that while he would assure that Ford would pass on the savings, that he could not control his dealers, and anybody who knows the ample ways the dealers, particularly in trade-in cars when they are selling new cars and all the different aspects of the trade-in package that there are, the enormous flexibility that this provides the dealers to mask their slice of the auto excise tax.

The net effect of this change when combined with the President's proposed cutback in Federal expenditures would be decreased aggregate demand, hence more recession. This is so because currently the Government is spending the $2.3 billion. Should this money be transferred to the auto manufacturers it is clear that they would retain some, distribute some as dividends, and spend the rest on investments. However, they would not spend the 100 percent of the $2.3 billion which is being spent right now.

The prospects of this bonanza have not been unnoticed on Wall Street where the stocks of the auto manufacturers have skyrocketed upwards.

The risk of the President's proposal resulting in higher auto prices and decreased demand can best be avoided by continuing the auto excise tax. There are several other ways to cut taxes which are more equitable and more likely to result in increased aggregate demand. Professor Samuelson has pointed out again and again this is not a demand-push inflation. This is a cost-push inflation. There is a lot of unused capacity. I believe the figure is 73 percent of productive capacity in this country is being used.

It seems clear that the administration has no plans for forcing the auto manufacturers to insure that repeal of the excise tax would be passed along to the consumer. In his television speech of Sunday night the President did say:

> "I shall insist that the American auto industry pass this tax reduction on to the nearly 8 million customers who are buying automobiles this year."

However, the President did not elaborate then nor has any administration spokesman explained since, how this is to be accomplished. In fact, the White House explanation (which was printed in the New York Times, August 16, 1971) of the President's new policies implies that the administration intends to rely on voluntary efforts by Detroit to keep car prices down. Specifically, the White House explanation stated:

> "It is anticipated that all of this tax reduction will be reflected in lower automobile prices. This will mean an average reduction in new automobile prices of $200 per car * * *

On Monday, as I mentioned, Ford President Lee Iacocca conceded that his company could not control the dealers in this regard. Congress should not have faith in the use of moral suasion to prevent rising prices in the auto industry. Congress should also accept no delay by the automobile industry in compliance with safety and pollution standards already long overdue, with such government largess going to the industry. Notice many of the loopholes, Mr. Chairman, that are available to the auto companies even under the freeze. New products are exempted from the freeze.

The auto companies claim that these cars are new products. There are ways of making standard equipment optional equipment which is a hidden price increase, and although it may not be likely they will make any of these moves in the 90 days you can imagine the hidden techniques that are utilizable after the 90 days are up if the freeze on prices is not made rigorous and scrutinized to make sure that no indirect violations are present.

For the past 17 years the Congress has acquiesced in executive initiatives to shift the burden of taxation away from corporations, and especially large corporations. Here is where we get into rather serious and significant constitutional problems about the division of powers, separation of powers, about the power of the Congress, the power of the executive branch, about the legality of some of the moves such as the import tax surcharge under the Trade Expansion Act and the like, and I would hope that legal specialists on these questions would come forth before this committee and provide their commentary.

But to give just a short rundown of this gradual trend which has just been accelerated, not initiated, in recent days: first, in 1954 the Congress passed legislation enabling companies to depreciate their machinery and equipment at accelerated rates.

In 1962 the Kennedy administration adopted new regulations shortening the lives of many different types of machinery enabling even faster writeoffs.

Also, from 1962 to 1969, Congress enacted the 7 percent investment tax credit, which among other things, was supposed to make our industries more competitive abroad and thus help solve the balance-of-payments problem. The decision of the Nixon administration to devalue the dollar is an appropriate measure of the efficacy of the investment tax credit in solving our balance-of-payments problem.

In 1964 the corporate tax rate was lowered in stages to 48 percent from 52 percent.

In June of this year the administration adopted new reglations of questionable legality which allowed corporations to depreciate qualified machinery and equipment 20-percent faster than was previously allowed.

Now the Nixon administration has proposed yet another raid on the Treasury by corporations for the benefit of corporate institutions. This is in addition to the tens of billions of dollars in lost tax revenues which corporate America has received in the past 17 years due either to the generosity of Congress or the Executive acting alone.

Obviously the Government must raise a substantial amount of revenue each year to pay for its functions. To the extent that corporation taxes are lowered, whether directly by decreasing the rates or indirectly by IRS regulations, credits, and accelerated depreciation, other taxes must be either increased or remain at artificially high levels. The taxes on personal income of the individual in the United States—though filled with exemptions, exclusions, deductions and exceptions, mostly for the wealthy—bear heavily on the average taxpayer. The time has come for the Congress to restore the imbalance or, at the very least, to insure that it is not further distorted.

I might just add one more point, apropos of some of Senator Mansfield's prior positions. We have to always ask the question whether these investment tax credits are given too much of a burden in the balance-of-payments problem, or whether we should continually redirect attention to military expenditures abroad in Western Europe and reduction of other nonessential expenditures. That is one of the problems with concentrating so heavily on narrow, though important, administration proposals because we tend to avoid the other approaches which are so desperately necessary not just for long-run change for the better but also short-term change, such as a concentrated and vigorous antitrust policy.

Deep in the offices of the Federal Trade Commission are studies showing that if the concentrated industries such as copper, aluminum, steel, detergents, oil, cereals, autos, were broken up along guidelines already espoused by former administration antitrust officials such as Donald Turner and by many economists writing in this area throughout the country the estimate of the FTC is that there would be a price reduction of 25 percent.

You can imagine what this would mean for our competitive position overseas.

The more Federal crutches, the more Federal subsidies, the more Federal overlooking of the competitive drive and the competitive structure of our economy, even though it mouths these objectives in words, the more inefficiency will be built in steel, will be built in other industries that are finding it more and more difficult to compete with their counterparts abroad.

I think it is very significant that big steel in this country took over 10 years to adopt a demonstrably more efficient process for steelmaking which was first developed by a tiny Austrian firm in 1953. This is a classic case of the goliath type inability to be flexible and to be highly competitive within the domestic economy which, of course, radiates aboard in terms of more less efficient export potential.

Thank you, Mr. Chairman.

(The following information was subsequently supplied for the record by Mr. Nader:)

STATEMENT BY PROFESSOR MARTIN DAVID REGARDING ASSET DEPRECIATION RANGE SYSTEM

MARTIN DAVID,
207 Du Rose Terrace, Madison, Wis., April 1, 1971.

Re depreciation allowances using asset depreciation range system.

COMMISSIONER,
Internal Revenue Service,
Washington, D.C.

DEAR SIR: I present the following statement in opposition to the Treasury's proposed regulations on depreciation. My views attempt to represent the public interest. I am qualified to speak with expertise on this subject by seven years of teaching in the field of taxation at the University of Wisconsin, intensive study of the Federal income tax provisions related to capital gains (published by the Brookings Institution), and a year's experience as fiscal economist for the Office of Tax Analysis of the U.S. Treasury. My work at the Treasury contributed to the depreciation reforms of Revenue Procedure 62-21. It is clear that all tax law, regulations, and procedures must be periodically reviewed. An academic scholar such as myself can conduct such review without being influenced by political pressure or special interests. I find the proposed regulations to be totally unacceptable from the point of good tax administration, appropriate measurement of business income, and the legislative mandate given to the Internal Revenue Service.

The regulations published by the Treasury on March 12 violate the public interest, the integrity of business accountancy, and the already fragile equity of the tax system. Adopting the system proposed upsets the balance of legislative and executive power, undermines tax morality, and will lead to uncontrollable grants to American businesses through the tax system. The proposed regulations muzzle the watchdog of the public, the Internal Revenue Service, and will prevent the Service from carrying out adjustments in depreciation charges that will generate additional revenues of $4 billion by 1976.

Two major arguments buttress these assertions: 1) The Treasury has moved beyond the powers given to it by the Internal Revenue Code. 2) The Treasury has failed altogether to demonstrate deficiencies in the present system.—Indeed many criticisms levied at the present depreciation system can be shown to reflect a misunderstanding or ignorance of the economics and flexibility of enforcement that are now embodied in the regulations and revenue procedures related to depreciation.

The Statute and "Reasonableness".—Section 167 of the Internal Revenue Code provides: "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade of business, or (2) of property held for the production of income." The legislative intent behind this rule is clear. On the average depreciation charges should reflect normal costs of doing business, in terms of physical deterioration, and an allowance for the loss of utility of equipment that comes from changing markets and economic conditions.

Reasonable depreciation is thus tied to the historical cost of assets and their expected life. (See Appendix I.) Under existing procedures the Internal Revenue Service monitors depreciation; IRS questions charges that do not reflect reasonable wear and tear and obsolescence. Tolerance for error is built into the present system for monitoring depreciation deductions. No business can be faulted or assessed additional taxes if depreciation charges are on average consistent with the period of time that assets are physically used or available for production.[1]

The Importance of Reasonable Depreciation.—Many persons are not aware of the significance of appropriate depreciation charges. Two points can be demonstrated:

(1) Excessive acceleration of deductions for depreciation beyond the true cost of obsolescence and wear and tear results in a *permanent tax loss.* If the dollar cost of assets grows, excessive depreciation results in a growing annual tax loss. That loss increases inexorably at the same rate as business investment.[2]

(2) In the past excessive charges for depreciation have been converted into capital gains (resulting in two types of tax advantage). Alternatively gains can be postponed by various non-recognition features of the Internal Revenue Code. Thus even on a single asset, tax reductions from increased accleration of depreciation may not be recovered during the period that the asset is held by the taxpayer. Three separate legislative decisions in connection with Sections 1245 and 1250 have attempted to remedy the damage to the tax system caused by excessive depreciation.[3]

The magnitude of plant and equipment investment implies that enormous changes in tax liability result from seemingly small departures from the criterion of reasonableness. The proposed Treasury ADR system implies tax reductions of at least ten percent when the system is fully operative in 1976. That ten percent does not adequately reflect the impact of the ADR system for two reasons: (1) The impact of changed depreciation practices is concentrated in a few capital-intensive industries. Others get little benefit. (2) The most recent surveys of industry depreciation practices indicate that reductions in depreciation charges are appropriate and would be imposed on business by the IRS under present rules. The proposed policy would thus reverse implications of established rules.

[1] See Tax Depreciation and the Reserve Ratio Test. U.S. Treasury Research Report No. 2.

[2] The argument is spelled out by R. Eisner in his statement to you and can be found technically described in Robert Eisner "Accelerated Amortization. Growth and Net Profits," Quarterly Journal of Economics (November 1952) 533–44.

[3] See M. David, Alternative Approaches to Capital Gains Taxation, Washington: Brookings Institution, 1968, Ch. 6.

We have stressed the "reasonableness" that underlies present law and have indicated the large role that depreciation plays in tax liabilities. Now we indicate why the ADR system, as proposed, is unreasonable, *ultra vires*, and indefensible as responsible tax administration.

The Proposed ADR System. The proposals by the Treasury involve two major changes:

A. The reserve ratio test will be eliminated as a norm for reasonable depreciation practice.

B. Lives up to twenty percent shorter than those announced as guidelines by the Treasury in 1962 may be used on assets acquired after December 31, 1970 provided that the taxpayer segregates those acquisitions into "vintage accounts".

What do these changes imply?

THE ROLE OF THE RESERVE RATIO TEST

The reserve ratio test is *the* tool by which Internal Rvenue Service agents determine that a need for taxpayer audit of depreciation practices is necessary to maintain reasonableness. The reserve ratio test is a mechanical device to assure that charges for depreciation *on the average* are consistent with the period for which assets are held. Taxpayers can not be questioned because of isolated, infrequent, or accidental patterns of asset holding which do not conform to depreciation taken. Taxpayers can be asked to reduce depreciation taken when it has been excessive for assets taken as a whole.

With out the reserve ratio test the Internal Revenue agent can not question depreciation charges. Indeed taxpayers are assured by the new regulations that use of the ADR system will protect them from any scrutiny on depreciation charges. Elimination of the reserve ratio test changes the depreciation system from one in which the taxpayer must be able to demonstrate reasonableness and consistency of depreciation practices to one in which revenue agents can not question patently unreasonable depreciation practices.

Eliminating the reserve ratio test creates a schedular capital cost recovery system. Taxpayers are not encouraged to use reasonable practices. Taxpayers are encouraged to use depreciation rates determined administratively by the Treasury. I maintain it is as difficult for the Treasury to establish reasonable lives or rates as it would be for the government to dictate wages or prices. The consequences are equally bad—incorrect wages, prices, or tax lives distort investment patterns and lead to inefficiency in our productive capabilities. (The logic that supports the reserve ratio test as a tool for enforcing reasonable depreciation is presented in Appendix 2.)

SHORTER GUIDELINE LIVES

Let us examine the basis for the second major proposal before us—shortening the life of newly acquired depreciable assets by twenty percent. The Treasury offers no new evidence that a reduction in the average life of depreciable assets is required by the facts of the market. Furthermore the Treasury fails to point out that the guidelines issued in 1962 were themselves speculative and reflected more rapid write-offs than was the practice in seventy percent of the nation's largest corporate enterprises. (See Appendix 3.) Since few industries have had an opportunity to experience a full replacement cycle under the 1962 guidelines, the Treasury has no basis in fact for asserting that the 1962 guidelines were unreasonably long. Conversely, it can not establish that indiscriminate use of lives 20 percent shorter than existing guidelines is a reasonable allowance for wear and tear and obsolescence.

The Treasury's extension of non-recognition of gain on the retirement of assets further compounds the unreasonableness of lives that are unrealistically short and administrative procedures that render the IRS impotent in matters of depreciation on future asset acquisitions under the proposed ADR system.

It is clear that any firm anticipating net taxable income will move to the shortest ADR life for assets acquired during that year. The effect of the ADR system is to increase the "gaming" and manipulation of the tax system by business enterprises.

Irrelevant Rhetoric.—Arguments for change in the present depreciation system that have been presented by the Treasury and the Alexander Task Force are largely irrelevant for the purposes of this hearing. There are many complaints about depreciation that I will not attempt to answer because they imply radical changes in tax structure that can not be enacted by an executive fiat.

The following points need to be made:

(1) An unrealistic shortening of depreciable lives is not a suitable substitute for replacement cost depreciation (although I doubt that such a system would be desirable).

(2) Failure to monitor depreciation with a reserve ratio test is not a substitute for Congressional action to reduce the corporate profits tax burden or otherwise alter U.S. tax on business relative to those on individuals.

(3) Meddling with sound administrative rules on depreciation does not produce the same export competitiveness that is available to foreign enterprises through a value-added tax system with export rebates.

(4) The need to stimulate economic activity can be effected through a wide variety of fiscal programs that consider the national priorities and overall equity in the tax structure. The proposed ADR system does neither.

I make these four points because it appears that the President and the Secretary of the Treasury would like to alter the tax structure to promote some of these objectives by introducing the ADR system. The means they have chosen is not appropriate to the ends, and there is no reason why taxpayer equity, taxpayer morale, the enforceability of good law, and the public purse should suffer from badly conceived policy.

Unsubstantiated Argument.—When arguments that basically require a new Congressional mandate are stripped away from the discussion of depreciation one discovers a shocking lack of evidence in favor of the ADR system and radical changes in statements made by this administration within the last 12 months.

One assertion that is made in defense of shorter lives is that for an asset with a given life the erosion of value is greater than what is permitted by the accelerated patterns currently available. No evidence from the marketplace is given for this assertion. Counterarguments can be made in the case of many items of capital—computers, automated production lines, and office buildings—where the efficiency, real product, and output associated with capital rises for a period of time after installation so that the capital can not really be said to depreciate at all in the early years of its life. The burden of proof that existing acceleration is inadequate must be on the Treasury as must be proof that existing guideline lives are too long.

A second assertion is that the present depreciation system does not allow the taxpayer the possibility of reducing lives as he adopts new technology and new processes. This assertion is false and reflects a failure of the Treasury to appreciate the flexibility underlying the guideline form of the reserve ratio test incorporated in Rev. Proc. 65–13. Mr. Pollock presents this point in his statement to you.

A third assertion (in the Treasury's January 11th press release) contends: "taxpayers' past retirement and replacement practice to be an unreliable guide in our modern industrial society in establishing reasonable allowances for future depreciation and obsolescence." This statement is altogether unsupported and it is the primary argument for giving away more than $2.7 billion dollars a year for the indefinite future beyond Fiscal 1972 (see Mr. Eisner's statement at this hearing). In fact if the administration of depreciation charges suffers as much as I anticipate, the true revenue loss will be at least twice the Treasury's estimate.

The vision that the Treasury is trying to conjure, of a world in which capital assets are becoming obsolete at an increasing rate, can not be supported by fact. The economic infeasibility of the SST is a good example of just how difficult it is to make a radical shift in technology—the implication is clear. Jet airframes that have been depreciated under a guideline of 6 years will undoubtedly be flown two or three times as long.

As a taxpayer I and every other American have the right to know how an expenditure of four billion dollars, or more, is justified. Furthermore I have the right to ask why should tax relief go to large corporate enterprises that are free to raise prices and escape their tax burden while individuals suffer. The corporate income tax in this country has slipped from being the second largest revenue producer to the third and every taxpayer needs positive proof that this change in tax structure is desirable from the point of view of national goals and justice.

Treasury Statements on the Reserve Ratio Tests.—The Treasury Department in a widely circulated document on depreciation policy in July, 1970, asserted that abandoning the reserve ratio implied an arbitrary system of capital allowances. Moreover it suggested that pressure would be continuously exerted on the Treasury and Congress to "liberazie" those allowances. The report stated:

"In view of the admittedly great diversity of replacement policies among firms in the same industry and the still greater diversity between industries, an arbitrary system of capital allowances would necessarily result in inequalities in the tax treatment of private investment." Furthermore "If the reserve ratio test were abandoned and all taxpayers permitted to use guideline lives, some undeterminable revenue loss would doubtlessly result as those taxpayers now constrained from using the shorter guideline lives by the reserve ratio test would adopt them." And lastly the report avers: "If the reserve ratio test is abandoned and replaced by a system of arbitrary capital allowances, . . . by new regulations, the Congress and the Treasury Department would be thrust into the role of arbiter of industrial asset replacement policy." [4]

These statements, the fact that the former Secretary of the Treasury has specifically objected to abandoning the reserve ratio test, and the failure of the Treasury to provide hard facts on the need for reform imply that the ADR proposals must be set aside as unsupportable.[5]

Evaluation of Past Depreciation Changes 1962 and 1965.—Prospective changes in technology weer considered in drafting the 1962 guidelines and far more aggressive depreciation practices than the average followed in an industry became the norm or guideline life. By perimtting companies to move immediately to the guidelines in 1962 for depreciation on all depreciable equipment companies were invited to make use of short-lived innovative capital assets.

In order to claim that a prospective revision or guideline lives that entails a further 20 percent reduction in the depreciation period is not appropriate the Treasury must bring convincing data to bear that equipment *not yet installed, technologies not yet developed*, and *products not on the drawingboards* in 1962 comprise such an important fraction of the nation's future product that the critical review of technology of the early 1960's is obsolete. No evidence of this kind can be produced for *all* guideline lives and *all* taxpayers. In fact a recent survey indicated that obsolete equipment was significantly reduced—from 20% to 13% between 1962 and 1968.[6]

Contrary to the Treasury's assertion, the 1962 depreciation reform did relieve American industry from a depreciation system based on the hindsight. New equipment acquired in the past eight years and retired within the guideline life would not cause a company to fail the reserve ratio test today. An enterprise will fail the reserve ratio test and have depreciation charges reduced according to a "facts and circumstances" review by agents when depreciation, euipment turnover, and new investment are not consistent.

American industry has not responded consistently to depreciation reform. Three years after the inception of the guidelines the Treasury reported that 60 percent of corporations with assets of $10 million or more would fail a test indicating that corporate depreciation charges and retirement practices were *moving toward* consistency. The Treasury press release (February 19th, 1965) announced that a major reason for this inconsistency was the practice of some businesses of charging more than 100 percent write-offs in group accounts.

The liberalization of the reserve ratio test in 1965 gave industry another *prospective* opportunity to make their future retirement conform with current depreciation charges based on a higher rate of capital turnover than historical experience.

The Treasury's stated reason for the ADR system is to provide taxpayers with flexibility in their depreciation practices. To the extent that flexibility is based on valid changes in capital acquisition and retention, there is no new policy in the Treasury announcement. The guidelines of 1962 were elective and taxpayers were encouraged to demonstrate need for shorter depreciation periods by a review of facts and circumstances *and* by tables of downward revision in lives based on the reserve ratio test.

Indeed, as the statement by Mr. Richard Pollock makes clear, the guideline form of the reserve ratio test makes possible a *prospective* adjustment in depreciation for radical changes in technology or product lines.

Timing of the Treasury Changes. Because of the generous *additional transitional allowance* incorporated into the 1965 changes in the reserve ratio test, almost all of the companies that did not meet the test were given a period of grace. Grace was needed because taxpayers did not maintain reasonable deprecia-

[4] "Tax Depreciation Policy Options," Congressional Record, July 23, 1970, E6966.
[5] "Report of the President's Task Force on Business Taxation," September 1970, p. 20.
[6] Tax Foundation, *Depreciation Allowances*, p. 28.

tion from 1962 to 1965; it was not in their interests to do so. Neither is it in the interest of the Treasury to make any further concessions at this time.

The additional tolerance permitted in 1965 was to be reduced ⅓ in the first half guideline life after 1965 and ⅔ in the remaining period to the length of a guideline life. For many manufacturing industries the reduction in additional tolerance is now entering the more rapid decrease associated with the latter period.

It is quite clear that it is in the self interest of companies that have not pursued a reasonable depreciation policy to press for the abolition of the reserve ratio test at this time. A number of companies have been skeptical that the test would ever be applied—yet they have not been able to refute the simple logic underlying the reserve ratio system. For the Treasury to yield to the self-interest of particular companies at the expense of the average American business by abolishing the reserve ratio test is unthinkable.

The proposed unreasonable extension of depreciation charges of $2.7 billion in the next fiscal year is larger than any other tax aid offered by the government for commerce and transportation in 1969. It is over 33% of the estimated tax aids for those industries taken together with agriculture.[7] No need can be demonstrated for this aid within an equitable tax framework.

Conclusions.—The unbiased observer is forced to conclude that the proposed ADR system is an unprecedented step towards arbitrary and capricious tax law. Students of European tax systems have concluded that such arbitrariness leads directly to willful tax evasion and erosion of revenues.[8]

The Treasury has not made a convincing brief for change in the present administrative arrangements, nor has it evaluated the impact of past changes affecting depreciation.

As the Treasury has neither established that it has the authority nor provided documentation for this major change, one must conclude that distastrous litigation and Congressional countermanding of the proposed procedures will follow if they are not withdrawn.

Appendix 1

GENERAL PRINCIPLES OF DEPRECIATION

Every farmer, businessman, tax auditor and accountant recognizes that the cost of producing his goods or services is greater than the costs of physical ingredients. Every year the physical facilities and machines that are part of the manufacturing process are subject to wear and tear and may become more expensive to operate. In addition, as time passes the processes incorporated into existing machinery can be superseded by new technologies. Finally, there is the unhappy prospect that machinery geared to produce for the demands of today cannot be successfully converted to meet the desires of the market place a year, two years, or five years from now.

The first of these hidden costs in the product, physical wear and tear on machinery, equipment, and plant, can be predicted from mortality studies and past experience. (There are some difficulties in speaking of wear and tear in connection with items that must be periodically rebuilt as part of their regular maintenance and where after a period of time it is difficult to speak of the original asset, as its character has been substantially altered by maintenance repairs and improvements. Blast furnaces are a good example of this type of asset.) What is clear is that physical wear and tear lessens the productivity of a piece of capital and reduces its ability to produce income for the owner. To reflect that loss of earning capacity a charge must be made against current income.

Loss of productivity and earning power also occurs because of the obsolescence factors cited earlier. Changes in consumer demand and changes in technology will alter the dollar value that particular items of capital can contribute to earnings. These sources of economic cost are much more difficult to isolate than the physical wear and tear on equipment. Nonetheless, such obsolescence is painfully real to the entrepreneur who discovers that his shopping center is no longer in an area of peak consumer demand; the manufacturer who discovers that carpets are more cheaply produced by a new type of loom; or the airline that discovers that their propeller craft cannot operate as efficiently, quickly, or with as large a payload as comparable jet craft.

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[7] Treasury press release, June 2, 1970, pp. 26–27. The comparison excludes the now repealed tax investment credit.

[8] G. Schmölders, Das Irrationale in der Offentlichen Finanzwirtschaft Hamburg, 1960.

THE IDEAL DEPRECIATION SYSTEM

To recognize the loss in value of capital that is associated both with the on-going production of the business enterprise and with the passage of time it is necessary to estimate the decline in the value of the firm that results from the processes that we have just discussed. Ideally, depreciation charges should reflect the difference between value of the firm's depreciable assets at the beginning of the year and their value at the end of the year. This concept is easy to apply for some kinds of machinery like automobiles and trucks. A ready second-hand market exists and it is quite possible to determine that my 1966 automobile depreciated $200 within the last twelve months. However, for many assets that are not easily moved and that have been specialized to production needs of their current owner in a particular application it is impossible to recover any value from a second-hand market.

Thus the entrepreneur is faced with a situation in which the original cost of an item is clear. Ultimate salvage value that is often nominal in relation to the original cost can also be determined. The value of the equipment in the interim between purchase and salvage is highly questionable.

To solve this problem, accountants, and after them the tax law, have allowed a reasonable cost deduction from the company's current income in lieu of a more precise valuation of the dollars of return that can be ascribed to the company's depreciable plant and equipment.

We all need to be reminded of the general spirit of the depreciation rule that is built into Section 167:

> (*a*) General Rule.—There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence) (1) of property used in the trade of business, or (2) of property held for the production of income.

The legislative intent behind this general rule is obviously that the cost ascribed to depreciation shall be neither more nor less than what can prudently be considered the changing value of the capital stock of a business enterprise.

This rule, as we all know, has been implemented both by a set of legislative formulas and regulations. The formulas specify the *pattern* of depreciation, (straight line, double-declining balance, and sum-of-the-year's digits). The regulations specify the accounting procedures that must be used for aggregates of assets and the *period* of time over which patterns of depreciation are to be applied. There is nothing in the regulations or the revenue procedures to date which is intended as anything other than an implementation of the Section 167 requirement that "there shall be allowed as a depreciation deuction a reasonable allowance . . ."

In discussing depreciation deductions it is easy to lose track of the interconnections between 1) the period or length of life, 2) the depreciation pattern, 3) rules for the treatment of salvage values and 4) first-year depreciation, and the resulting allowance for reasonable costs associated with physical wear and tear and obsolescene. A given pattern can be made to result in more rapid writeoffs as depreciable lives are shortened and the writeoff is concentrated in a small interval of time. Alternatively, more writeoffs early in a given period of time can be achieved by using one of the accelerated formulas and in some instances by using aggregated systems of depreciation for group assets.

The public is, rightfully, concerned with the *amount of depreciation cost deductions* that are permitted in any year and reasonableness applies to the *amount* of those deductions, not to the formula by which they are derived. Therefore it is important to keep in mind the overall operation of the system, not the principles that govern any facet. The overall depreciation cost deduction should be consistent with the notion that businessmen are permitted to deduct an amount that reflects the loss in value of the capital equipment from physical wear and tear or obsolescence.

Our experiences with the tax system for the last decade underscore the need for focusing on the overall effect of the depreciation system. The enactment of Section 1245, Section 1250 and recent discussions concerning the expensing of exploration and drilling expenses in the oil industry were forced by the fact that when excessive depreciation costs are charged or when an excessive write-off of expenses is allowed there results, after a period of time, a substantial reporting of gains on the sale of assets. Indeed these gains are often capital gains because of the operation of Section 1231. In that instance an excessive charge against ordinary income taxable at ordinary rates is converted into a subsequent amount that is taxable as a capital gain. Congress has legislated against this conversion of income into a form that is taxed at a favorable rate. Congres has now expressed itself on three occasions that excessive charges for depreciation costs should not result in capricious tax reduction.

In Appendix 2 we discuss the history and philosophy of the Treasury's changes in depreciation in 1962 and indicate why the system outlined under Revenue Procedure 62–21 and the subsequent procedure 65–13 constitute an implementation of the intent to have a reasonable depreciation system.

Appendix 2

HISTORY OF PRESENT DEPRECIATION PROCEDURES

Problems in assessing depreciation before 1962

We have made it clear that the depreciation charge rests upon both the pattern for allocation of charges over the life of the investment and upon the period of time that is associated with the pattern. The accelerated patterns available today (double declining balance and sum-of-the-year's digits) reflect a situation that can be demonstrated for some assets. Namely, the loss in value of the asset is greatest in the early years of the life of the asset and is attentuated at a later time. Remarkably little factual evidence is available to support acceleration for the bulk of industrial assets and many firms use straight-line depreciation for reporting income to shareholders. That fact is suggestive of a discrepancy between fact and the accelerated patterns legislated by Congress in 1954.

It is also clear that the pattern of acceleration which is quite appropriate for many items of machinery and equipment used in manufacturing is unsuitable for the depreciation of real property in hotels, residences, and non-specialized buildings. Congress recognized this fact in its recent modifications of Section 1250 in connection with the 1969 tax reform act.

Corresponding legislative action concerning the life or period over which depreciation patterns were to be taken has never been effected. There are good reasons for the lack of legislative action. Taxpayers have a tremendous diversity of business operations that can not easily be catalogued or described under a single rubric. Lathes that one businessman can successfully use for an indefinite period to provide simple maintenance of equipment become physically inaccurate and unusable in the hands of another manufacturer within five years as a result of continuous operation in the production of extremely precisely machined parts. The computer in use in one business record keeping operation is as good today as it was ten years ago because the company has not grown and the information required in customer billings is elementary. In another firm the same computer is obsolete as competitive pressures have now forced the industry to give on-line information as to parts inventories, delays expected from job scheduling and similar kinds of sophisticated information. It was quite right, therefore, for Congress to eschew the assignment of depreciable lives to individual assets. It thereupon became the task of the Interval Revenue Service auditor to ascertain that reasonable depreciation deductions were being taken and that the pattern was combined with an asset life that reflected the actual use of equipment in business operations. Some businesses became equally sophisticated in about depreciation charges. Some businesses became equally ophisticated in justifying their practices by careful studies of the mortality of equipment.

For many other businesses, however, the matter of depreciation was problematic. There were a limited number of assets. The business did not have experience with operating those assets over a long period of time. The revenue agent questioned depreciation charges in order to make a good showing on the dollars of tax revenue that he had contested. As a consequence, depreciation became an area in business taxation that was more subject to harassment. misunderstandings, inequities and inappropriate treatment of the taxpayer than any other single item of business tax law.

The 1962 depreciation reforms

To respond to this situation, in 1962 the Treasury attempted a systematic overhaul of the entire depreciation mechanism. The overhaul began with a careful assessment of the only guidelines that had been set for the depreciation of equipment, *Bulletin F*. The overhaul did not end there. The Treasury sought to change the relationship between the Revenue agent and the businessman, to establish some simple mechanisms for monitoring "a reasonable allowance for depreciation", and to assure that businesses would not be caught in a lock-step with insufficient depreciation shackling the investment policies of the firm and preventing a desirable rate of capital renewal and replacement.

Three principles lay at the base of the 1962 depreciation reform:

(1) The myriad of nominal lives in *Bulletin F* were replaced by a concept of broad lives appropriate to aggregates of assets employed in different industries.[1]

In the process of revising *Bulletin F* lives the Treasury reviewed depreciation practices of progressive comparative companies as well as the likely change in those practices that would result from technologies still in the development stage. The overall impact of the Treasury action was to reduce lives in *Bulletin F* (that in some cases were not justified by any connection with the objective fact) from approximately 19 years on the average to something approximating 13 years. As a result there was a substantial once-and-for-all reduction and shrinking of the period of time over which depreciation of assets was to be taken. Corresponding to that shrinking was a substantial increase in the annual rate of depreciation charges that could be taken by the firm.

(2) The second major principle of the 1962 depreciation reform was to provide a "fresh start" for every business operation with respect to the justification of its depreciation charges. Companies that had been pursuing a conservative policy for replacing and depreciating their equipment and had been rightly held to that policy by revenue agents, could turn over a new leaf, greatly increase the turnover of their capital equipment, take correspondingly greater depreciation allowances and do so without question from the revenue agent. This feature of the 1962 reform was extremely important. It placed each company in the position of being able to reassess its investment practices without prejudice from the tax agent. It also implied that the criterion of "reasonable depreciation charges" had to be met in terms of the prospective behavior of companies following 1962 rather than their retrospective behavior in earlier years.

(3) The third principle underlying the changes in depreciation in 1962 was the principle that each taxpayer should be free to tailor his depreciation charges to his own individual use of plant and equipment. Legal studies by the Treasury undertaken at the time and the experience of other countries who have statutory systems for determining the depreciation charges convinced both economists and lawyers that there was nothing to be gained from forcing all business depreciation practices into a single unbending legislative mold. Indeed, the experience of countries like Italy and Canada was that legislated systems tended to impose great tax costs on some industries and apply subsidies to others. It levied heavy taxes on those firms who experience high turnover of equipment and subsidized those who maintained inventories of old machinery. To be neutral the tax law should not encourage any of these practices.

The chief instrument through which the Treasury executed and monitored its system of individualized reasonable depreciation for each taxpayer was the reserve ratio test. The reserve ratio test provided a yardstick by which each taxpayer could determine whether his practices were reasonably consistent with depreciation charges and, if practices were not consistent, he was encouraged to reduce depreciable lives if that was appropriate, or told to increase lives and reduce depreciation charges if equipment was being held substantially beyond the period implicit in depreciation charges. Furthermore a lengthening of depreciable lives was prospectively applied and did not attempt to recover excess depreciation claimed in past years. Thus companies were freed from the responsibility that had been imposed by revenue agents prior to 1962 to repay a portion of the excess charges on earlier depreciation via penalty rates.

There is no better way to summarize the substance of the 1962 depreciation reform than to quote Secretary Dillon at his press conference on July 11, 1962: "The fundamental concept underlying the new procedure is that the depreciation claimed by a taxpayer will not be disturbed if there is an overall consistency between the depreciation schedule he uses and his actual practice in retiring and replacing his machinery and equipment. Demonstration of this overall consistency will be based on broad classes of assets. Guidelines are established for each of these classes . . . to assist in the determination of appropriate depreciable lives.

[1] The only reason for maintaining the terminology of asset lives was to communicate the results to the public. In fact the Treasury in effect pushed all users of depreciable property towards depreciation for aggregate accounts of assets involving many individual items and a multitude of individual lives under a single rate appropriate to that group of assets.

"The Central objective of the new procedure is to facilitate the adoption of depreciable lives even shorter than those set forth in the new guidelines . . . provided only that certain standards are met and that subsequent replacement practices are reasonably consistent with the tax lives claim."

There has been no legal or economic analysis of the reserve ratio test, as it was modified by revenue procedure 65–13 that indicates a major flaw in the principles on which the Treasury proposed to monitor reasonable depreciation charges. The Treasury's Research Study No. 2, *Tax Depreciation and the Need for the Reserve Ratio Test*, indicated that an exhaustive study of a wide variety of business depreciation situations found the reserve ratio test a reasonable tool for monitoring depreciation deductions in almost every eventuality.

Appendix 3

History of the 1962 Guidelines

In the review of depreciation practices that was undertaken in 1961 to provide a basis for Revenue Procedure 62–21, the Treasury exhaustively searched all available information in this country and in foreign countries that would establish a reasonable basis for the depreciable lives of assets. Individual data were available on more than a thousand of the nation's largest corporations. Depreciation practices reported on a dozen different categories of depreciable assets for tax purposes were available from an analysis of corporation income tax returns. Special investigations and conferences with spokesmen for a large number of industries were undertaken. As a consequence the guideline levels set in 1962 were established in such a way as to reflect the useful life of equipment in those firms of an industry that were aggressive in the turnover of their equipment and the adoption of innovative capital.

In no case was a guideline life set at a level that would be less advantageous to a company than the practice adopted by companies at about the thirtieth percentile in the industry. Where additional technological information indicated that an approach based on current industry practice was too conservative, a further reduction in lives below the thirtieth percentile mark was undertaken. This implies that by going to guideline lives in 1962 seventy percent of every industry would be forced to substantially increase its turnover of equipment and change its investment practices. Given that the average depreciable life for manufacturing industries under the 1962 guidelines was 13 years, we have not yet had a sufficient passage of time since 1962 to determine whether those 70 percent of all businesses will be able to carry out the aggressive policy of replacement that was consistent with their adoption of the new guideline. (See Table 1 of Richard Pollock's statement at these hearings.)

Biographical Note

Martin David is a professor of economics and chairman of the Social Systems Research Institute at the University of Wisconsin. He received his A.B. degree with honors from Swarthmore College in 1955, and his M.A. and Ph. D. degrees in economics from the University of Michigan in 1957 and 1960, respectively. He began teaching at the University of Wisconsin in 1961, became a full professor in 1967, and Chairman of the Social Systems Research Institute in 1970. During the years 1961 and 1962, he was a fiscal economist for the Office of Tax Analysis in the U.S. Treasury Department. He has written more than 30 articles on tax and economic questions, including a series of articles on capital gains taxation.

[From the Nation, Nov. 9, 1970]

Buying Exports—The Billion-Dollar Subsidy

(By Tom Stanton, a member of Ralph Nader's Public Interest Research Group)

DISC is a billion-dollar program currently under consideration by Congress. A billion dollars is two-thirds of the 1971 budget for the Office of Economic Opportunity and more than five times what we spend for the entire federal judicial system. President Nixon vetoed the 1970 Education Bill because, in his view, it was $453 million too expensive. DISC will cost twice as much.

Yet, almost no one in the general public knows what the DISC proposal is about. This is especially remarkable because DISC has been approved by the House Ways and Means Committee as a part of the 1970 trade bill, and is currently under study by the Senate Finance Committee.

The purpose of DISC is to encourage U.S. exports and thereby improve this country's balance of payments. Under the program, exporters will be allowed to set up dummy corporations to receive their foreign sales income. These ghostly entities, which have been given the name Domestic International Sales Corporations (DISCs), will receive an indefinite deferral—in effect an exemption—from U.S. taxation. A DISC's accumulated untaxed profits can then be put at the disposal of the parent company by means of intra-company transfer at low interest rates.

The Treasury Department hopes that DISCs, once they are fully operational, will yield $1 billion to $1.5 billion in new exports at a cost of $630 million annually. This optimistic estimate would mean that the American taxpayer will subsidize export corporations by more than 40¢ for each $1 of increased export sales.

The nonpartisan staff of the Congressional Joint Committee on Internal Revenue Taxation does not share the Treasury's optimism. In a report which is confidential and unavailable to the public, it estimates that DISC will be of only indefinite value in promoting an export psychology among corporate executives. According to the committee's calculations, even if the entire tax subsidy were to be passed on to overseas customers as lower prices, only a maximum of $480 million annually in new export sales would be likely to result from the tax subsidy, which may amount to $955 million each year. Some members of the House Ways and Means Committee see an eventual annual cost of more than $1 billion. Then taxpayers would be subsidizing export corporations in the amount of $2 for each new $1 of export revenue!

Economists and tax lawyers in both government and private enterprise, who have studied the proposal, generally find that the DISC tax incentive is an inefficient as well as costly way to improve our balance of payments. That is because DISC confers its benefits without requiring an exporter to increase his exports by even a single dollar. He will receive a huge tax benefit for simply doing what he is already doing.

In 1969 American exports totaled $36.5 billion. Even under the most optimistic Treasury estimates, DISC will not increase these exports by more than 4 per cent ($1.5 billion). This means that 96 per cent of the benefits of DISC will be used to pay corporations to continue already profitable exports.

DISC is also advocated as a measure to remove tax discrimination against domestic exporters, who do not have the benefit of lower overseas taxes paid by foreign subsidiaries of U.S. corporations. The Treasury Department estimates that foreign incomes taxes on American-owned firms are levied at a rate of about 39 per cent, as contrasted with the 48 per cent U.S. tax rate. Since the DISCs are to be virtually exempted from U.S. taxation, the result will be to offset the current 9 per cent tax preference with a 100 per cent tax exemption. Thus DISC provides a subsidy which expensively overcorrects the problem it solves.

Although the tax subsidy will be borne by the taxpayers as a whole, the benefits of DISC will go primarily to the 100 largest corporations which already have the bulk of the export trade. These companies will also receive proportionately more benefit because of special pricing rules which allow the parent to sell exports to the DISC subsidiary at less than market prices, so that profits from the parent manufacturing company can be attributed to the untaxed DISC. Consequently, a DISC is far more valuable to a large, integrated company than to a small exporter.

Indeed, only the larger export corporations can afford the sophisticated legal and professional talent required to establish and operate a DISC. The DISC proposal consists of 40 pages of complex legal language and introduces at least a dozen new tax concepts.

DISC's legal and economic complexity has also impeded effective public scrutiny of the measure. Although it has been the subject of considerable discussion and reworking among Treasury officials and members of the business community, members of the general public—who will be paying for DISC with higher taxes—have remained unaware of the proposal.

Since DISC is a tax subsidy and not a direct cash subsidy, it will also remain sheltered from regular public scrutiny in the future. As a self-perpetuating part of the Internal Revenue Code it will not be subject to Congressional review as a part of the annual appropriations process. Thus, even if DISC should fail to be an effective means of promoting exports—as quite possibly will be the case—the expensive subsidy will continue year after year. DISC will annually shift a $1 billion tax burden from large corporations to ordinary taxpayers. The corporations are thoroughly familiar with the proposal; only the taxpayers are not.

[From the Journal of Commerce, Aug. 23, 1971]

OEP Shifts Its Position on Insurers—Firms Now Able To Renew Policies at Present Rates

(By Leah Young, Washington Bureau)

Washington, Aug. 22—The Office of Emergency Preparedness informed insurance associations on Friday that companies would be able to charge renewals at prevailing rates even if this meant individual business and public customers would be getting rate increases during the wage-price freeze.

The OEP directive is a turn-around from the agency's original position that insurance is a contract and if insurance rates are frozen then new contracts could not include rate increases.

The OEP reversal is based on a question and answer prepared for the Cost of Living Council. It verifies what this paper reported last week—that the insurance companies had asked Commerce Secretary Maurice Stans to lay the question of insurance rates before the Cost of Living Council and that the council voted that rates for insurance could be raised if a "substantial portion" of that class of insurance had been contracted for at the higher price during the 30 days preceding the Aug. 15 announcement of President Nixon's 90-day wage-price freeze.

Interestingly, as late as Friday afternoon, the Cost of Living Council press spokesmen were still denying that any decision on insurance had been reached.

On the other hand, a Commerce Department source assured The Journal of Commerce again on Friday that the decision to go ahead and allow the insurance companies to charge higher rates if the rate increases were in effect prior to Aug. 15 was made even before the Thursday evening meeting of the Cost of Living Council.

NEW DEFINITION

The question and answer was drawn up by OEP to accommodate the new definition of insurance rates. Insurance rates were declared to be under freeze as soon as the Cost of Living Council was established. OEP had defined rates to mean individual rates and the insurance companies insisted rates meant state rate hikes, not individual renewal rates.

The question drawn up by OEP to a direct query said: "Where insurance policies are being renewed at a higher rate that has been in effect prior to Aug. 15, is the price of an individual policy frozen at the old rate or may the new rate apply across the board since it was in effect prior to Aug. 15?

The answer that OEP gave today, presumably modified to conform with control directives, stated: "yes, policies can be renewed at the higher price since that was the prevailing price for that product for substantial transactions, if that was the prevailing price for that product for substantial transactions prior to Aug. 15 in the month period ending Aug. 14."

[From the New York Times, Aug. 17, 1971]

III. Restoring Prosperity

The most dubious part of the President's ambitious program is the series of fiscal measures on which he relies to promote full employment and to reorder budgetary priorities.

Mr. Nixon will ask Congress to provide an immediate 10 per cent "job development credit"—that is, an investment tax credit—to be followed one year from now by a 5 per cent investment tax credit. In the coming year, this would give business an estimated tax cut of $3 billion on top of the $3.9 billion tax reduction companies are getting from the liberalized depreciation of plant and equipment already put into effect by the Treasury. These concessions represent a significant shift in benefits to business as against other groups in the society, especially when combined with the postponement of outlays for welfare reform and revenue sharing.

The President, however, is proposing to speed up personal income tax exemptions to permit taxpayers to deduct an extra $50 for each exemption a year earlier than planned. He also wants to repeal the 7 per cent excise tax on automobiles, with the understanding that all the savings will go to auto buyers.

Mr. Nixon's proposed tax cuts and the planned reduction in Federal budget outlays—a reduction that passes too much of the sacrifice on to Federal civil service employes in the form of deferred pay increases and staff cuts—are designed to roughly offset one another in total fiscal terms, adding little net stimulant to the budget.

However, the prospects for swift Congressional clearance for welfare reform and revenue sharing were not bright even before the President asked for slow motion on both programs. On balance, therefore, it appears likely that the tax cuts will give the economy at least a temporary shot in the arm.

Basically, the Administration apparently decided that the rapid growth of the money supply in the last year, together with the huge deficit in the Federal budget, has already gone as far as necessary to provide fuel for economic expansion. To go further, the President and his advisers believe, would simply add to inflation.

Paradoxically, the wage-price freeze and the prospect of an income policy to check inflation may prove the most powerful instrument the President has adopted for reducing unemployment. It is fear of inflation and of future monetary credit crisis, more than any other factor, that underlies the determination of businesses and consumers to build up their liquid holdings, rather than to increase their expenditures on goods and services—and hence, on human labor. A successful program to stop inflation may liberate the American economy from the liquidity trap in which it has been caught. It may provide the impetus needed to get the economy moving again.

[From the New York Times, Aug. 22, 1971]

On Taxes: Skepticism

(By Lee Silberman)

Mr. Silberman, a first vice president of Shearson, Hammill & Co., Inc., often writes on tax subjects.

While the general reaction to the tax proposals in the President's program to spur economic revival is that they should be good for business, the men whose business is taxes are not sure the package will turn out to be quite as attractive once the contents are examined closely.

True professional tax men are congenital skeptics, whether they occupy high-rent space at a prestigious accounting firm or a financial officer's niche in the corporate executive suite. But they have a nose for the unexpected, born of periodic bruising encounters with tax examiners and frequently vexing voyages of sought-after tax legislation on Capitol Hill and the nation's state houses.

What some tax practitioners are mainly leery of is the possible negative static that may result when the proposition to reinstate the investment tax credit is unwrapped in Congress next month.

Chances are that the proposed 10 per cent "job development" tax credit, as it is known in its latest reincarnation, won't be terribly controversial per se. After all, Congress is an old hand in dealing with the investment credit, which was originally imposed (though at a lower basic 7 per cent rate) in 1962, suspended with some exceptions between Oct. 10, 1966, and March 9, 1967, and then generally repealed April 18, 1969.

What some tax men worry about is that the reconstituted credit would now be laid on in the same tax year in which businesses have become beneficiaries of the new liberalized tax depreciation allowances. In most years that the investment tax credit was in effect it was an important stimulant to business spending for plant and equipment and has been proposed anew to prod the current sleepy pace of capital spending.

The credit is potent medicine being computed as a percentage of the purchase price of new machinery or equipment expected to be in use at least eight years and applied directly as a reduction of tax liability. (The permitted credit is proportionately less on shorter-lived gear).

The net effect of a faster write-off and reinstatement of a 10 per cent investment tax credit in the words of one tax practitioner would be a "generous dollop of whipped cream ladled on top of an already liberal serving of ambrosia." He adds:

"Congress could find it all too cloying and decide that something had to give, if not the tax credit then the depreciation rules, at least in part."

The new faster write-offs could just be ripe for legislative tinkering. The Treasury, it will be recalled, pushed through the more liberal treatment of depreciation last spring, effective retroactively to the start of the year, under its rule-making authority after several consumer groups contended that the change was too blatantly beneficial for business not to be promulgated without Congressional approval. Some of the complainants have since pressed their challenge in the courts.

There seems to be no denying that the new liberalized system of depreciation allowances does indeed afford substantial tax benefits. Formally designated Asset Depreciation Range (A.D.R.), the system's principal appeal, according to the accounting firm of Lybrand, Ross Bros. & Montgomery, generally lies in the flexible range of years over which assets may be depreciated.

The A.D.R. approach thus allows the taxpayer to choose a depreciation period that may be as much as 20 per cent lower or 20 per cent greater than the "estimated life" over which the assets' usefulness had previously been projected on the basis of permitted guidelines.

For example, a $400,000 piece of equipment with a 10-year guideline life may now be written off on a straight-line basis by as much as $50,000 annually (eight years), rather than the $40,000 under the old standard.

Depreciation, of course, is an expense used in computing tax liability in contrast to the investment credit's direct reduction of the tax itself. Thus, as 10 per cent the proposed "job development" tax credit would give rise to a far more significant $40,000 tax reduction, which for a corporate taxpayer in the 50 per cent bracket would be the equivalent of $80,000 in pre-tax depreciation write-offs.

The belief that the new A.D.R. procedure coupled with the 10 per cent tax credit would be a little much is shared by a tax expert at another major New York accounting house. He says:

"Taken alone, each is exciting enough. Combining the two would be an absolute windfall."

Ironically it's precisely this kind of tax largesse that is fueling doubts among some tax men about the tax credit's ultimate fate. It is not unlikely, they reason, that the Administration's moves with respect both to the new depreciation policy and tax credit proposal will become a partisan issue in Congress with a result that the outcome may be uncertain for some time.

Following a pattern first used by President Kennedy in the earlier imposition of the investment credit, President Nixon has proposed that the new 10 per cent version apply retroactively to purchases of new equipment placed in service on or after Aug. 16, 1971, the day following his announcement of his emergency economic package, subject to later Congressional ratification.

Tax practitioners note, however, that as long as the new proposal is beset by uncertainties this head-start approach will lose much of its effectiveness for corporations.

"Few corporations are going to make sizable purchase commitments simply on the basis of hope that Congress will adopt the credit," says a New Jersey certified public accountant. "Even if Congress does go along you can't ever be sure of the final rate. Meantime, it's always possible that the economy will have recovered sufficiently and by the time the issue comes to a vote everyone will have agreed that reinstatement of the credit is not necessary."

Conversely, another possibility is that demand forces in the economy will continue low so that businesses will see little need to expand their investment in capital goods.

Several rather technical factors may act to dampen a corporation's enthusiasm for the new credit, tax men point out. The law, for one thing, permits a seven-year carryover of unused investment tax credits with a result that many companies still have the carry-forward credits generated when the 7 per cent incentive was in effect. By the same token, many corporations are still entitled to claim the old credit for the first time against equipment purchases to outfit new buildings that were in the process of construction at the time the old 7 per cent credit expired.

Toward much the same end, the law provides that the investment tax credit may be used to reduce a company's income tax only after that liability has been previously reduced by any foreign tax credit that it has generated in its activities abroad. However, some companies have excess foreign tax credits that they have yet to use before getting mileage from unused investment tax credits accumulated in 1969 and before.

What happens if a company that is still making use of investment credit piled up at the earlier 7 per cent rate also were to find itself in a position to claim the new credit at the higher 10 per cent rate?

Because the law limits the amount of such carryover that can be applied in any one year it is conceivable the company would still have some of the vintage credits to use up. This company then faces the prospect of claiming both credits at varying rates.

Do the older credits simply run out unused? Practitioners note that they won't have the answers to this and many other questions that will inevitably arise under an essentially complicated law provision until the Treasury finally writes the pertinent regulations. But the regulations won't appear until Congress enacts the underlying amendments. Of course, nobody knows when that will be in the case of the proposed 10 per cent "job development" credit.

Are tax practitioners troubled by this kind of run-around, and more broadly by President Nixon's new bout of tax tinkering aimed at rehabilitaing economic recovery?

In no way. A New York specialist says: "There's good reason why the voluminous 1969 Tax Reform Act also called the Tax Accountants and Lawyers Relief Act of 1969. Considering the inflation that has since intervened I would say we are ready for a sequel."

[From the Washington Evening Star]

COUNSEL FOR TAXPAYERS—SLIGHT TAX RELIEF FOR "LITTLE MAN"

(By E. Edward Stephens)

Dear Counsel:

We have two children, file joint returns, and take the standard deduction. Our only income is a $10,000 salary. What benefits will we get if Congress goes along with the tax changes recommended by President Nixon on Aug. 15.

Minimal benefits. Businessmen and corporations will do far better.

You'll get nothing in your 1971 income tax return, but you'll get a little help next year. Unfortunately, however, the reduction in your income tax will be less than the increase (already scheduled under present law) in your Social Security tax. Net result: Your 1972 total tax will go up, not down.

Under present law, the personal exemption is to be $700 for 1972 and $750 for 1973 and subsequent years. President Nixon merely wants Congress to give you the $750 exemption starting in 1972 instead of 1973.

Present law provides that the standard deduction will be 14 percent of adjusted gross income for 1972, and 15 percent of adjusted gross income for 1973 and years following (but no more than $2,000). The President simply recommends that you get the 15 percent deal starting in '72 instead of '73.

So your tax saving will be only for one year, 1972. Based on your $10,000 salary, your '72 income tax would be $57 less because of the proposed changes. That's all there is for you in the Nixon-recommended Job Development Act of 1971.

This is not to say that you'll have less to pay next year. Under present law, your Social Security tax will be $62.40 higher next year. So you'll end up by paying at least $5.40 more than you're paying the federal government this year.

And chances are excellent that our '72 Social Security tax will be raised. Under one of several proposals now before Congress, the 1972 tax would be hiked another $72. If this is enacted, our total federal tax for '72 will be $77.40 more than it is this year, in spite of tax "reductions" recommended by the President.

Businessmen and corporations will fare much better. The cornerstone of President Nixon's proposed tax restructure is reinstatement of the "investment credit," repealed April 18, 1969, at his request. This will help businessmen and corporations generally, the largest benefits going to corporations that make heavy investments in machinery and equipment. It's an indirect subsidy.

Under the proposed changes, you'll get a "job development credit," formerly called "investment credit," if you acquire new U.S.-manufactured business machinery and equipment after Aug. 15, 1971. This credit comes right off the top of your income tax. It can run as high as 10 percent of your first year's outlay, and 5 percent of subsequent expenditures.

Generally, the job development credit will follow the pattern of the investment credit. But there are important differences. For instance, you get no credit if the machinery and equipment is used, or if it was "predominantly" produced outside the United States.

The Treasury Department states that total tax savings for people who aren't in business will be $2.3 billion dollars. And, says the Treasury, the job development credit will cut business income taxes by $7 billion in fiscal 1972 and 1973 alone. But the $2.3 billion saving is a one-shot deal, whereas the multibillion-dollar savings from the job development credit go on and on.

[From the Washington Post, Aug. 23, 1971]

THE PRESIDENT'S PRIORITIES—SOME REFLECTIONS

It is obvious that the most basic of the President's three economic goals set forth last week is that of increasing employment. Indeed, to some extent the other two goals are means to achieving that end. Reducing the balance of payments deficit is important mainly because the existence of the deficit limits the government's ability to follow economic policies that are conducive to domestic prosperity and high employment. Mitigating inflation is important in itself—people are unequally victimized by rapid price rises—but the existence of inflation also aggravates the balance of payments problem and makes it harder to achieve high employment. Getting people back to work, however, increases their well-being directly.

Increasing jobs necessarily entails finding some way of increasing spending for goods and services, since people have to be paid to do something or make something. There are a lot of different ways, however, in which the powers of the federal government can be used to increase spending. The particular ways chosen by the President reflect his views about what kind of spending is most important.

The first choice the President had to make was whether to try to increase public or private spending. He chose the private, although many would argue (we think rightly) that this country's needs for improved public services are far more urgent than its needs for more of those things the private sector produces.

If the President had opted for more public spending, there would have been at least two logical programs from his point of view to expand: aid to the poor and aid to state and local government. The President had already given high priority—at least verbally—to improving the lot of the poor by reforming the welfare system. He could have seized this opportunity to fight harder for his Family Assistance Plan, perhaps increasing the benefit levels and moving forward the effective date. Such an effort would have had a strong economic as well as humanitarian rationale—the poor spend all of their income, so, giving them more money has a strong stimulative effect on the economy. State and local governments are also hungry for funds to run schools and hospitals and pay policemen. The President could have used this chance to push harder for his revenue sharing plans or to ask Congress for some form of emergency aid to meet urgent state and local needs.

But the President rejected the public spending alternative and chose instead to try to stimulate private spending by means of tax reduction. Here again there were choices: (1) taxes related to personal income could be cut to give consumers more money to spend, (2) excise taxes could be cut to make products cheaper for consumers to buy, or (3) business taxes could be cut in an effort to stimulate more business spending. Actually the President proposed a degree of each.

His first tax proposal involves moving forward to January 1972, the personal income tax cuts already on the books for a year later. We see nothing wrong with this since the cuts are already law. Moving them up will increase consumer spending power—although it will not help those too poor to pay income tax—without entailing any new losses of federal revenue for the years ahead.

His second proposal is to repeal automobile excise taxes. We *do* see a lot wrong with that. The auto industry is not exactly withering away—its profits have been relatively high and this year was expected to be a good one even without the additional stimulus. Cutting the excise tax may sell more new cars, but it will certainly also cut federal revenue. The President's proposal represents an explicit choice of private cars over public services as an appropriate object of expenditure.

Third, the President proposed reinstating an investment credit to induce business to increase spending for plant and equipment. Again we think this is a questionable decision, especially in the magnitudes proposed. It means a nontemporary loss of revenue to the government, and a major easing of the tax burden on business. Moreover, it is not obvious that much more investment will take place than would have taken place without the credit. Firms with substantial over-capacity—and there are many—will not be induced to add more by a tax credit.

Altogether, as Charles Schultze, former budget director, pointed out in testimony Friday, the President's tax proposals would mean that about $5 billion of revenue a year would be permanently eliminated from the resources available to support public services in the future. While the President's tax cuts reflect questionable priorities, they might still be regarded as a tolerable price to pay for rapid fiscal stimulus, however, if they were not offset by almost equal cuts in expenditures. Apparently, the administration felt it would be impossible to get its tax cuts through Congress without appearing to cut spending by roughly the same amount—nonsensical and self-defeating as this may seem.

True, some of the spending cuts are more apparent than real. But the principal one is both real and entirely unfortunate; namely, postponement of the effective date of welfare reform from June, 1972, to June, 1973, or almost two full years. The implications of this welfare decision for the poor can only be described as catastrophic. Welfare benefits are being cut back in state after state, partly as a result of taxpayer backlash against the poor, partly in expectation that the welfare system would soon be federalized. Nor can we see any economic justification for delaying welfare reform. If the administration is worried about excessive fiscal stimulation in 1973, it could make some other move, such as eliminating the investment tax credit.

The priorities reflected in these aspects of the President's program, reflecting as they do, a preference for private over public spending, can hardly be said to be unique to Mr. Nixon. The Democratic Congress, after all, in the so-called Tax Reform Act of 1969, reduced federal revenues substantially despite all the urgent need for publicly financed improvements in the quality of American life. In a sense you could say that the President is merely reinforcing that congressional shortsightedness. What remains to be seen is whether Congress, faced with this new set of proposals, will not now begin to question these priorities.

[From the Wall Street Journal, Aug. 23, 1971]

Many Firms Anticipating Controls, Raised Prices, and Reviewed Wages Before Freeze

(By Ralph E. Winter and Jim Hyatt, Staff reporters of the Wall Street Journal)

CONTINGENCY PLANNING

Imagine the surprise of top line executives at a major Midwest industrial products company a few weeks ago when they picked up the latest memo from their boss. It read:

"Wage and price controls are closer than ever. Are you prepared?"

The memo was well ahead of President Nixon's freeze on prices and wages, and the prophetic boss didn't mince any words. He told his men: "Don't come cry on our shoulders if you wake up some morning and find that price and wage controls are in effect. Get ready now."

In one form or another, that was the message flowing from scores of executive suites in the weeks—and, in some cases, months—just prior to the President's economic bombshell. In anticipation of some type of controls, countless companies rammed through any price increase they thought had even a remote chance of sticking. And many firms were busy overhauling their white-collar salary structures, on the assumption that salary ranges rather than all currently effective salaries would be frozen.

Said one chief executive only four days before the President's announcement: "I've just finished a meeting with all of my top people. We went through everything—the salaries of everybody from foremen on up and the prices on every product line we have—to be sure we have the flexibility to keep operating the way we think we should if controls come."

BEYOND THE FREEZE

The administration's program, which freezes wages at present levels and confines prices to the level at which "substantial transactions" occurred in the month prior to Aug. 14, made some of these corporate anticipatory attempts ineffective—at least for the 90-day freeze period. But many executives, looking beyond the three-month freeze, says their prior moves may very well help them deal with any program of restraints that may follow the current freeze.

"We're assuming that whatever comes next will give us a certain degree of flexibility," says one chief executive who recently finished broadening his white-collar salary structure by 10 percent. "We're hoping that the administration won't do any more than confine us to our existing pay policies when the freeze went into effect."

Many companies had been nudging their prices up for some time. For example, the pointed corporate memo from the Midwestern boss told his line executives to report "what specific pricing actions and the timing thereof you propose." In the words of one insider, this boss had also been telling his men that if they "tried a price increase and it didn't stick, to turn around a month later and try it again."

A FLURRY OF LETTERS

Numerous other concerns, which had posted higher list prices only to find the market wouldn't support them, had begun discounting while sticking to the higher posted prices. Their thinking, whether it proves to be valid or not, was that a higher posted price might be advantageous if controls indeed came about.

What set off the scramble to keep prices up and broaden white-collar compensation ranges? A number of factors appear to have been at play. A major element was a flurry of letters and telephone calls from outside compensation consultants to corporate officials. For example, the executive who called a meeting of his top people four days before the freeze says he reacted to a letter from his firm's consultant who declared the possibility of controls had lately become "very real."

Businessmen were also mindful of the fact that President Nixon's once adamant opposition even to "jawboning" was replaced only a few days before the freeze by an "open mind" attitude toward a review process, provided that process could function without stifling the economy.

Companies also say feedback from their lawyers and trade lobbyists in Washington was warning them to expect restraints of some sort. And the steel industry's hefty settlement with labor—followed almost immediately by an 8 percent price-boost announcement—made believers out of some previous skeptics. "That was the bomb that convinced me that things weren't going to continue the way they had been," says a New England corporate president.

JUMPING THE GUN

What will come after the 90-day freeze, of course, remains to be seen. Most companies that were gearing up for some type of controls figured they couldn't do much about blue-collar wages because specific terms were spelled out in union contracts. This situation, however, didn't necessarily hold true for office and professional workers. By broadening white-collar salary structures, a number of companies hoped to give themselves added leeway in granting raises, in part because the profit punch has caused the pay of some employees to rise at a slower rate than that of union members.

Typical of what some companies were doing in anticipation of some type of controls is the case of a large Midwest electronics and metal-products concern. Said a personnel man a few days before the freeze: "We're reviewing our salary schedules and structures to make sure they provide us the running room we need in the event there is some sort of freeze." He added that the concern ordinarily goes over its schedules at the first of each year, "but knowing what we suspect we know, we're making the adjustment now instead of waiting until the first of the year."

Reflecting such concern, compensation consultants say they were deluged by inquiries from their clients and others who were interested in either broadening their salary ranges. or in cases where no formal structure existed, drafting specific plans. Previous government control programs, they say. permitted companies to grant pay raises within previously existing salary schedules but required special permission to go beyond the existing plan's framework. Special permission was also required in cases where no orderly plan was already laid out.

OFF TO THE LIBRARY

Consultants say all the planning probably hasn't been wasted. "The plans haven't gone down the drain," says Bob Knoch, a principal at Stanton Associates Inc., St. Paul. After the freeze, he suggests, companies probably will be allowed to apply their revised salary schedules "and if controls come in, they'll be that much better prepared." Mr. Knoch contends that companies without such formal plans might well find it impossible to make salary adjustments without government approval.

The mere talk of wage and price controls—both before and during the freeze—tends to be somewhat self-serving for consultants. "It means business for them if they can get people scared," says one top executive at a Midwestern company who received an urgent letter from his firm's consultant just before the freeze was declared. "It runs up the meter."

Whatever the prospect of some kind of controls after the freeze, many a corporate personnel man has lately been scurrying to the library to read up how wage and price restraints worked during World War II and the Korean war. "I've been a vice president for five years and in labor relations since 1949, but I didn't know anything about the policy aspects of controls because I was a peasant when they were last in effect," says Edward L. Lannigan, an executive at Cleveland-based Reliance Electric Co. who's lately been studying the whole controls subject.

Some observers note with irony that corporate hedging against the possibility of some kind of controls has helped fuel inflation and probably helped bring about the freeze. One auto-products concern, for example, says it was so convinced a year ago that wage and price controls were imminent that it made price increases earlier than usual.

For those companies looking beyond the freeze, the whole question of policing any controls program is causing considerable concern. For example, the chief executive of one consumer-products company that has just boosted its white-collar salary ranges worries that federal enforcers might demand a rollback if they stumble across a warning letter from his concen's consultant that triggered the salary move.

"You know, the more I think about it, the more it worries me," this man says. "I'm going to get that letter right now and take it home with me and burn it."

[From the Journal Herald, Dayton, Ohio, July 5, 1971]

Corporate Tax Break

(By D. J. R. Bruckner)

The Administration's new business tax rules—called the accelerated depreciation range (ADR) system—distort the tax system. Treasury put them into effect June 22. It tried to in January, but protests from members of Congress and public interest groups inducted it to delay. Now some of these protesters intend to sue in an attempt to void these new rules.

ADR is really a corporate tax break, continuous and cumulative, worth $3.9 billion a year for the next decade on the average, and probably more therefter; it is the biggest tax break of its kind in history and was instituted without congressional action. Treasury announced it, but it was mostly concocted under direction of the White House staff.

At the heart of ADR is an option allowing U.S. businesses to depreciate, or write off their assets against income for tax purposes, either 20 percent faster or 20 percent slower than writeoffs allowed under 1962 Treasury guidelines.

Those guidelines, and a set of standards called the Reserve Ratio Test, were established in an attempt by government to roughly relate depreciation to the real usable life of plant and equipment, and the actual time an asset was used by business. ADR eliminates the Reserve Ratio Test and accelerates depreciation, which is already the great bookkeeping game these days.

If a business has equipment which it uses for 10 years, it can write off against income in eight, or in 12 years, as it chooses. Since tax is calculated and paid annually, a spread of four years in 10 can make great difference in a corporation's cash flow. The White House claims this gimmick will stimulate investments and jobs, and thus the economy.

Most economists say this is nonsense; investment is undertaken with the prospect of increased sales and profits, and investment is drawn as needed from capital markets. One suspects the ADR will simply increase profits. The tax break will grow with a boom and contract with a recession, which is an effect precisely opposite the White House's claim.

Thus, corporate net income for tax purposes will always be severely understated as compared with net income for, say, a stockholders' report or any other report in which the corporation wants to look good. Treasury rulings and legal changes in the last 20 years had already introduced gaps between real income and taxable income; the ADR system challenges the very concept of a tax on the real income of business.

Treasury's statement on ADR talked at length about the difficulties of administering Reserve Ratio Tests and old guidelines; it amounts, in fact, to a confession of administrative breakdown. So, under the new rules, there will be an office of industrial economics, (OIE), to determine from tax returns and studies how guidelines, repair allowances and other tax-determing criteria can be updated.

These fellows just have to be kidding. Business has been startlingly successful ever since 1954 in obtaining tax breaks from a large, stubborn, conspicuous Congress, you can just imagine what kind of influence it will be able to bring on a small, unprotected, bureaucratic OIE—which has the power to recommend rule changes, changes which mean tax savings and increased cash flow.

Thomas F. Field, director of the public interest lobby Taxation with Representation, raises some philosophical questions about all this: "We seem to have moved far from the basic concept of tax on income," he says. "Are income taxes really fair any more? Whatever happened to the idea of income tax as envisioned by the liberal reformers of the early 20th Century, the idea of the fairest, most equitable, efficient tax? Should not Congress consider present tax laws and rules in the light of that question? Or should it consider moving to an entirely different type of taxation?"

Disturbing question. Income tax still appears to be the fairest. Well, the idea looks that way, The practice looks otherwise more and more, for some privileged and influential people.

[From the Washington Post, June 28, 1971]

Give Poor a Tax Break

(By William Raspberry)

Dear Mr. President:

If I understand your proposal for liberalizing tax deductions for depreciation of plants and equipment—and I'm not at all sure that I do—it is a scheme for encouraging manufacturers to replace aging equipment and, thereby, increase capital outlays and quite possibly jobs.

In short, the $3 billion-a-year tax break is aimed at stimulating the nation's lethargic economy.

The trouble with your proposal, which some opponents, including Ralph Nader, have branded outright illegal, is that is direct benefits would accrue only to the rich, the owners of big companies. The rest of us would have to have faith that the big businessmen would reinvest the savings and "trickle down" to us such benefits as increased employment.

Faith being an increasingly scarce commodity, let me suggest, sir, that if you are serious about wanting to use tax breaks to stimulate the economy, you are starting at the wrong end.

Big business might well decide to reinvest the tax savings that your proposal would provide; then again it might decide to increase dividends to stockholders. That is much to "iffy" a cure for a very sick economy.

But if there is any certainty in the universe, it is that poor people will spend at least all the money they have; they really haven't a choice.

This being the case, my proposal is that you move to grant a tax break to poor folk.

The "trickle down" effect of tax breaks for big business is a matter of big business options; the "trickle up" effect of tax breaks for the poor would be a certainty. Poor folks, if they obtained such breaks, could be counted on to buy more television sets, cars, furniture—whatever the manufacturers manufacture—and everyone would be happy.

Poor folks would be happy with their new purchasing power, and big business would be happy with its increased income. (Why should a businessman care whether his bank account grows fatter through tax breaks or through increased sales?)

Nor should there be much difficulty in working up a proper rationale for such a policy.

Your justification for the $3-billion tax break is that, since equipment purchases come out of a business' profits, it is fair to permit businessmen to deduct the cost of such purchases for tax purposes. Depreciation is simply a device for deducting such costs over a period of years rather than all at once. Your proposal would permit a businessman to shorten by 20 per cent the period over which equipment would depreciate to the point of theoretical worthlessness.

Administration spokesmen acknowledge that not all equipment wears out. or becomes outdated, at the same rate. But to work out item-by-item depreciation schedules would be too burdensome, they say.

What you propose, in effect, is to let each individual businessman decide for himself his own depreciation rate. That strikes me as a little risky, but that's another question.

The justification for my own scheme is based on the common knowledge that poor people pay too much for nearly everything, whether appliances, loans, rent, groceries—or taxes. They also get the worst of governmental services: schools, police and fire protection, sanitation, and so on.

Any competent government statistician could work up figures to show by approximately what percentage poor people pay more and get less. That would furnish the basis for granting a tax abatement of 30 per cent or whatever the figure turned out to be.

The attractive feature of my scheme is that it is calculated to work itself out of existence. A poor family that got a 30 per cent tax break might soon find it possible to move to a neighborhood that offered better schools and police protection, which would reduce the need for the income tax abatement.

More important, the things they would buy with their newly available cash would lead to more production, which means more jobs. And with more jobs open to the poor, there would be fewer of them and, therefore, fewer people getting the tax break.

The result would be more of everything for everybody, and more taxes for the government. If you move quickly enough to institute my scheme, it might start to show results in time for the 1972 elections.

In any case, I'll leave the timing and the details to the experts on your staff. I am, after all, just a newspaper guy.

[From the Nation, June 21, 1971]

Mr. Nixon's Tricky Bonanza

(By Ralph Nader)

Mr. Nader, author of Unsafe at Any Speed (Grossman), has made a national reputation as a champion of consumer interests. He is the founder and director of the Public Interest Research Group, with offices in Washington, D.C.

BILLION-DOLLAR TAX SUBSIDY

Washington.—"Make it complex and make it dull" is the sure formula for putting unjust government policies into effect with little public or Congressional notice. A perfect example of the technique was provided by the Asset Depreciation Range (ADR), announced on January 11 at the San Clemente White House. It sailed out and through the press corps with the efficiency of a mimeograph machine, giving the reporters, and therefore, of course, their readers, little reason to suspect the enormous unilateral power of the executive branch which the move embodied, or the great revenue bonanza—more than $3 billion a year—it augured for large corporations. Although this tax gift transgresses the constitutional separation of powers, there is every indication that the Treasury Department is about to issue regulations to enact the ADR system.

Three billion dollars is a considerable amount of money, even in this era of astronomical expenditures. It is more than the entire amount budgeted next year for the Environmental Protection Agency. The President's welfare reform proposals were to have cost only $2.1 billion. Total U.S. aid to preschool, elementary and secondary education for next year is priced at only $3.6 billion.

The foundations for this expensive tax subsidy were laid by a Presidential task force, led by John Alexander of President Nixon's former Wall Street law firm. Last September, that task force recommended basic changes in the tax laws concerning depreciation write-offs. Businesses were to be allowed to recover their capital costs in a short time rather than according to the actual useful life of the machinery written off. The task force noted explicitly that Congressional action would be required for a change to capital cost recovery system from the depreciation deductions currently allowed by Section 167 of the Internal Revenue Code.

The Administration doubted that such a proposal would fare well with the legislators. Only two years earlier President Nixon had asked for a repeal of the investment tax credit, a device that is generally considered a more effective economic stimulus than accelerated depreciation schedules, and the White House did not want to lose face, either by asking for a reinstatement of the investment credit, or by asking Congress for the less efficient ADR.

It was therefore decided that the task force recommendations would be implemented, so far as possible, by administrative fiat. On January 11, 1971, President Nixon announced that he had approved basic changes in depreciation policy. As Don Oberdorfer of *The Washington Post recalls*, "the news release and the briefing by Treasury officials was dry-as-dust, and most reporters found themselves scratching their heads and wondering what the story was all about."

The Administration was relying upon the complexities of tax law to protect itself from public debate as to the value and propriety of this multi-billion-dollar tax subsidy. Presenting ADR as an accomplished fact, the President made statements which have since been studied and found to be erroneous. Mr. Nixon declared that "A liberalization of depreciation allowances is essentially a change in the timing of a tax liability. The policy permits business firms to reduce tax payments now . . . and to make up these payments in later years."

Prof. Robert Eisner of Northwestern University, an economics expert on the determinants of capital investment, made this blunt rejoinder: "There is no knowledgeable expert in the Treasury or out of it who can stand by . . . the concluding clause of that sentence. . . . It is unfortunate that such a flat contradiction of what is an unambiguous matter of arithmetic and mathematics was made in the name of the President of the United States." The Treasury itself has acknowledged the arithmetic cost of the tax break by estimating an annual revenue loss of $3 billion and upward.

There is reason to believe that the Administration knew of the defects in the multi-billion-dollar tax subsidy before it made the announcement. In a confidential memorandum of December 11, 1970, a senior Treasury Department attorney—the Acting Assistant Secretary for Tax Policy, Mr. John Nolan—warned the White House that considerable revenue could be given to business, but that there were limits. He stated his serious fears that breaking the link between tax depreciation and the useful life of the machinery in question would involve an unlawful extension of executive authority. Exactly a month later, the President's ADR system did precisely that. The proposed system shortened guideline tax lives by 20 per cent. It also abolished the reserve ratio test—a correction factor based on the validity of earlier depreciation deductions—which was the link between those guidelines and the actual life of equipment in the hands of the taxpayer.

There is a disturbing word for an attempt to get a tax break that your attorney says is illegal. When Sen. Edmund Muskie released Mr. Nolan's secret memorandum to the press, he set off a display of bureaucratic fireworks. The Acting Assistant Secretary claimed that he had later telephoned the White House to say that he had changed his mind. Perhaps so, but President Nixon made no reference to this change of mind when the matter came up with the press. Rather, he told reporters that he had received memos from other people in support of his position. He acknowledged that legal opinion differed on the matter of authority, but concluded: "Now I, as President, and I may say, too, formerly one who practiced a good deal of tax law, I considered that I had the responsibility to decide what the law is. And my view is that while they had expressed a different view, that the correct legal view . . . was to order the depreciation allowances."

In the weeks following the President's exercise of legal judgment, more than a dozen tax authorities across the country expressed their view that the multi-billion-dollar tax break is illegal. These men include Boris Bittker, Sterling professor at Yale, Dean Bernard Wolfman of the Pennsylvania Law School, Oliver Oldman of Harvard Law School, and Mortimer Caplin, former Commissioner of Internal Revenue.

Shortly before President Nixon spoke on January 11, the Secretary of the Treasury was formally served with papers notifying him that a suit had been filed to enjoin the ADR system. Attorneys at the Public Interest Research Group had been following the activities of the President's task force with considerable interest. The task force recommendations entailed a fantastic loss of tax revenues with the promise of only limited benefits to the country as a whole. One of these attorneys, Tom Stanton, expected to submit comments before Congress if the recommendations were proposed as legislation. The White House decision to act by administrative fiat meant that there would be no airing of the pros and cons through such testimony before Congress.

Working on the basis of an early report to the Washington *Star*, Stanton and Sam Simon, also of the Research Group staff, filed suit on January 11 and thus generated the necessary public discussion. They contended that the Administrative Procedure Act required that an agency such as the Treasury publish advance notice of its intentions in the Federal Register. The agency was then required to allow public participation through the submission of data, views and arguments about the proposals. No mention of public participation was made by the President or by the Secretary of the Treasury at a subsequent press conference on January 11.

However, shortly after the suit was filed, Treasury officials called in the press to explain that the President's announcement of "approved changes" did not mean that there would be no public hearings. The Treasury had simply forgotten to mention them. Attorneys Stanton and Simon withdrew their motion for preliminary injunction when the government attorney presented affidavits from the Commissioner of Internal Revenue and the Assistant Secretary for Tax Policy assuring that hearings would be held.

On the very day that the motion was withdrawn, Asst. Secy. Edwin Cohen announced through the press that the possibility of any basic changes in the proposed regulations was "remote." He added: "We don't anticipate changing our mind. As a very practical matter, a businessman can rely on this going into effect, in its broad outline."

In short, the Assistant Secretary—who had served large business clients for thirty years as a Wall Street attorney—was assuring his constituents that the public would remain powerless to prevent the $3 billion tax subsidy, regardless of the merits of the case, or what was brought out at the forthcoming hearings. Like its budget, the Treasury's prejudgments come big.

The public hearings were finally held on May 3, 4 and 5. The hearing room was packed with spectators, primarily attorneys from businesses favoring enactment of the regulations. The hearing panel sat at a long and imposing table in front of the hall. Edwin Cohen, the senior official present, was flanked by his two deputies, by Commissioner Randolph Thrower of the Internal Revenue Service, and by nine other Treasury and IRS officials. Among supporters of the Treasury position were speakers representing the U.S. Chamber of Commerce, the Association of American Railroads, AT&T, and the textile industry. On the other side were such speakers as Dean Bernard Wolfman on behalf of Common Cause, Nathaniel Goldfinger of the AFL–CIO, George Wiley of the National Welfare Rights Organization, John Kramer of the Council on Hunger and Malnutrition, and economists Robert Eisner of Northwestern, Martin David of Wisconsin, and Richard Pollock of the University of Hawaii.

Mr. Cohen and his colleagues remained true to his word. The hearing was conducted in an atmosphere of strong partisanship. Witnesses in favor of the ADR system—almost always speaking on behalf of clients—were complimented on their expertise and the fine cases they had presented. Witnesses against the proposals were roughly cross-examined and tested for their verbal agility rather than for their expert knowledge.

Dean Wolfman had come on behalf of Common Cause to discuss his serious concern that the proposals were illegal. He was deliberately scheduled for late in the day, and finally spoke at six o'clock, after reporters had left to write their stories. As Sen. Birch Bayh put it, the hearing was a "charade."

During testimony at the hearings, I urged that Mr. Cohen's prejudgment had been so overt as to constitute a violation of the Treasury's own Minimum Standards of Conduct. Those provide that, "an employee shall avoid any action . . . which might result in, or create the appearance of: . . . (d) Losing complete independence or impartiality; . . . or (f) Affecting adversely the confidence of the public in the integrity of the Government."

As a lawyer, Mr. Cohen knew that members of the public do not yet have standing formally to invoke the Minimum Standards of Conduct against an official acting to the contrary. Thus, he has not removed himself from further participation in ADR decisions. But his response at the hearings, it seemed to me, did reflect his dawning realization that the simultaneous roles he was playing of proponent, advocate and judge might be too heady a mix for administrative fairness.

The ADR controversy continues. It is almost certain that the Treasury will issue ADR regulations in final form. After that, a group of concerned plaintiffs will probably have to take the Treasury to court. Most likely, some modifications will then be made by the Treasury to avoid the most blatant evidence of illegality. On the other hand, the revenue loss will surely be close to that promised by Mr. Cohen.

The Treasury responded to the White House in the December 11th memorandum that "you inquired whether these are the maximum we could do." The Treasury has steadfastly done the maximum for the White House; it remains to be seen whether it can be moved to serve the citizen taxpayer with similar zeal. For the first time those citizens had a presence at a Treasury hearing. Numerous lawyers and groups who became involved in the ADR issue on the public's side are now determined to change the ways whereby Treasury makes such decisions.

Chairman PROXMIRE. Mr. Nader, this is another most impressive presentation, and I must say you have had one of the most incisive and comprehensive criticisms of the fiscal part of this program that I have heard.

You hit that phase of the program very hard, you certainly paid your respects of it. I can see, it is quite clear, how you feel the Congress ought to handle it, but how about the overall program, how about the fact that the President did call for a freeze? To the extent that that freeze is honored for 90 days, we do have surcease from inflation to a very considerable extent. More important we have the basis now for moving ahead to a situation in the future where we can reduce the increases in the cost of living; we should be able to substantially. And how about the fact that we have cut loose from gold, and we have permitted, we do permit, our dollar now to achieve the position the free international market calls for?

It seems to me that the President has made some constructive and useful proposals and that at least the freeze part of it ought to be good news for the consumer.

Would you agree with that or not?

Mr. NADER. I think there is no question that the dollar devaluation was a very good move. It will be good for the economy in a very representative sense, and it, of course, was long overdue.

I think also the small tax reduction in personal incomes will also generate some kind of consumer demand.

But I think the package cannot be treated as a whole, Mr. Chairman, it has to be treated——

Chairman PROXMIRE. Let me get back then to the freeze, and the policies that we would hope would come out of the freeze. We have had now five witnesses, every one of whom has agreed we should develop out of this freeze a system of wage-price guidelines, a system in which we can reduce the impact of inflation; a system in which we can get at the concentrated power of big companies and big unions to increase the cost of living, and it seems to me the President has created the kind of situation which is absolutely necessary to achieve that.

The freeze aspect, do you think that is useless or not?

Mr. NADER. Let me discuss the freeze aspect. First of all, it is, I think, a partially effective psychological move which is important in any economic policy. I don't think we can make any further favorable judgments on it either as a temporary freeze or what is going to happen afterward until we see what is going to happen afterwards.

I think we can make the following judgments, however, given the facts available to us.

One, it was unnecessarily inequitable. Wages frozen, wages are very easy to freeze; you have an ally in terms of the employer.

Prices are frozen with major gaping loopholes which I will note in a moment, for the consumer. Profits are not frozen, nor is there a substitute of an excess profits tax.

Chairman PROXMIRE. You have five successive economists who unanimously agreed that you cannot effectively freeze profits. Maybe they are wrong, but these are men, I think you would agree, of considerable objectivity and fairness and ability.

Mr. NADER. Yes, but you remember one of them stated a substitute in terms of administrative feasibility is a corporate excess profits tax instead of freezing prices flatly.

Chairman PROXMIRE. He said that but that of course has great problems too.

Mr. NADER. Well, so does any price-wage freeze have very serious problems.

Chairman PROXMIRE. All right.

Mr. NADER. What I am saying is when you freeze prices with loopholes, when you don't freeze interest rates, and you don't freeze profits, and you give a 15-percent tax reduction to corporations you are, in effect, opening the ceiling to profits. You are not even keeping the lid on, you are opening the ceiling.

Chairman PROXMIRE. But you are not opening the ceiling if you effectively freeze prices. That was Charles Schultze's response. He said the essence of getting at profits is to have an effective system of holding down prices and he indicated this would accomplish that.

Mr. NADER. And the key word was "effective," if you can have it effective.

Let me give you some preliminary loopholes that anybody can notice on a cursory glance. One, raw agriculture produce is exempt. We know why it was exempted at the farm level but it was exempted all the way to the supermarket level, which means that fresh fruits and vegetables, eggs, and other fresh produce that go all the way to the consumer are not going to be frozen. This also means that those companies that sell both processed food goods and fresh fruits goods will be able to in effect camouflage any price increases in the areas that are frozen by increasing them in the fresh produce area.

I might also say that this policy has a dietary effect insofar as elasticity here, the prices of fresh fruits and vegetables and other fresh produce are going to develop a reduced demand by the consumer.

Here is another loophole.

Chairman PROXMIRE. You assume a tremendous amount of monopolistic control here or at least oligopolistic control that I think is hard to show certainly at the farm level or even at the wholesale or retail level.

Mr. NADER. It is not so much monopolistic control as simply the ability to increase prices in an area where the freeze is not on. You see there is no competing factor here. This also will hold true if there is a longer freeze than 90 days and a lot of companies will just hold back for the 3 months. But I do want to note that new housing, for example, or products that are considered new are exempted. You know how many products are labeled new and described as new stylistically and by names that are not really new. Many of the all new cars are about 85 percent exactly what their predecessors were a year before.

Chairman PROXMIRE. How in the world do you get at that? The reason I presume they are exempted is because you don't have any base.

Mr. NADER. Yes.

Chairman PROXMIRE. They say the price will be the highest price at which the goods sold in volume during the 30 days preceding August 14. So if you have a new product you don't have any basis for computing what that ought to be, do you?

Mr. NADER. Insofar as that is true that indicates how iffy Mr. Schultze's statement was in terms of the difficulty of effectively freezing prices. Insofar as it isn't true, it is going to require a lot of governmental manpower to analyze the validity of the standards that these products are new even if they are the old thing.

Here is another loophole, dental, medical, legal, and other professional fees, they are frozen under the guidelines but if anybody can show me how to freeze those kinds of fees with the enormous flexibility to, in effect, say well, this is a case of one, this is a different situation, quite apart from the administrative difficulties of policing these fees, I would like to see it.

Chairman PROXMIRE. Let me ask you, Mr. Nader, what would you have done, supposing you were President of the United States and you had this problem, what would you have put into effect?

Mr. NADER. You mean across the board?

Chairman PROXMIRE. Well, what would you do about the fact that we have a tremendously difficult inflationary period and Members of Congress, Senator Mansfield and myself, called for some action for a long, long time, the Congress almost unanimously, I guess unanimously, made it possible for the President to do this. Under those circumstances what would you put into effect? What would work better to hold down prices and slow inflation?

Mr. NADER. I must say I am a devotee of the Samuelson approach here. His proposals make the most sense to me, not only in terms of their quantitative impact such as tax cuts on a personal income basis in order to stimulate demand to take up excess capacity, and in terms of avoiding investment tax credit and accelerated depreciation and other nonselective and inefficient ways of increasing production and employment, and to keep the welfare reform program not postponed, which will generate more money to the poor, high propensity to spend, to keep the Federal expenditures at a level and put them, you would say, in areas of high job creation and high social need.

Chairman PROXMIRE. Are you saying that you would not have put in any kind of control on prices or limit on prices or freeze or anything of that sort, wage-price guidelines?

Mr. NADER. If I were to, I would freeze it all the way, prices.

Chairman PROXMIRE. Would you freeze it all the way? You say if you were to, would you put that into effect? Would you put in a comprehensive limitation on prices of any kind?

Mr. NADER. If it was 2 years I would say no. Given the present situation, given the crisis point of the bottom falling out of the dollar, and everything that supposedly has been happening in Zurich and elsewhere in the past 2 weeks there is probably a good case to be made for an across the board price freeze, profits, interest, wages.

Chairman PROXMIRE. There are two areas you particularly criticized, the exemption of profits and new products and I can't see where with an across the board freeze what you can do about a new product.

If it is a new product you don't have a basis on which you can provide your standard and the other is raw food, unprocessed food, I should say, that has come from the farm and is moved to the supermarket. Those are the two areas. What would you do there?

Would you simply provide that the farmer has to sell at a particular price or would you say the wholesaler and retailer prices are frozen even though the cost of the product, the price of the farm product, may go up very sharply?

Mr. NADER. You would have to have admittedly a complicated mechanism to take care of such hardships as small farmers with a decreasing tolerance as it goes down the economic chain to the supermarket. I don't recommend a permanent freeze by any means. I don't think it is going to work. I think it is extremely rigid. It is an administrative monstrosity, it will make prohibition look like a picnic in terms of dodging compliance and all the cheating and blackmarket that will go on. But in terms of a temporary respite, to give longer range controls and longer range policies such as advocated by Professor Samuelson to be put into effect, then if there is to be a freeze it should be an equitable one.

Chairman PROXMIRE. All right, then you would favor a freeze but you say this is not equitable.

Before I yield to Senator Mansfield, let me ask you just about one other area. You very strongly criticized the surcharge on imported cars, and that criticism has been joined in by a number of others. However, Mr. Eckstein yesterday gave what I thought was the best explanation for it that I heard. He said that this was absolutely essential, we have to have it if we are going to have any bargaining position here at all. He said without it that the Japanese might very well have the power to maintain the present value of the dollar, exchange rate on the dollar, maintain their undervalued yen and this tax is essential to having any bargaining position, and that his view is that the administration took it as a temporary measure, strictly as a bargaining chip, but they have to have it, there is no way to get away from it.

Mr. NADER. I think I agreed with it in my prior remarks, Senator. As a temporary bargaining tactic it can be justified, particularly with regard to the three countries where we have relatively serious trade imbalances in the first 6 months of this year, Canada and Japan and West Germany, but as longer range policy it opposes all of the arguments that favor free trade.

Chairman PROXMIRE. Senator Mansfield.

Senator MANSFIELD. Thank you, Mr. Chairman, Mr. Nader, I must apologize for coming in late in your testimony but reading from your statement am I to assume that on the basis of your proposed modification of the administration's proposal, that is vis-a-vis the investment credit that you are suggesting that the 10 percent be allowed for the first year, 5 percent for the next year, and then after that that it be terminated?

Mr. NADER. No, Senator. What I meant was that if the administration believed in the investment tax credit and its objectives, they would not send it up to Congress indefinitely. They would have a cutoff period, because their concern is for the short term period.

Senator MANSFIELD. What is your position on the repeal of the investment, or the administrations proposal on the investment credit, say, with the modification which you proposed, would you favor it on that basis?

Mr. NADER. No, I would not, Senator.

Senator MANSFIELD. Ten, five, five, and five?

Mr. NADER. No, I do not, Senator, I think it is extremely inefficient in its own declared objective of producing jobs, and it is a handout to companies that are going to invest any way. It doesn't discriminate between the investments to be made any way and those which would not be made if it wasn't there.

Chairman PROXMIRE. How would you feel about a situation, as a trade if we would knock out the accelerated depreciation guidelines which you have protested so vigorously and so effectively and in return for that put into effect investments credit?

Mr. NADER. Half a loaf, that would be my position. I think both should go. I think——

Chairman PROXMIRE. If the best we can get is the investment credit as a trade you might feel that might be desirable?

Mr. NADER. You mean as a choice between the two?

Chairman PROXMIRE. Yes, that is right. We don't live in a world where we get everything we want.

Mr. NADER. As a choice between the two, the investment tax credit. It is like a choice between Scylla and Charybdis.

Chairman PROXMIRE. Senator Mansfield.

Senator MANSFIELD. I take it, Mr. Nader, you are also opposed to the liberalization provisions for business which were put into effect earlier this year, I believe, by the administration?

Mr. NADER. Yes, Senator. Opposed to it on, first of all, the grounds that it was not within the authority of the Internal Revenue Act administered by the Treasury Department. This was an unauthorized act in that Congress did not provide for it.

Senator MANSFIELD. There is a question about that. That question was discussed but no final answer was arrived at.

What you are saying, in effect then, is that business is being given double tax relief based on this earlier depreciation allowance and this investment credit now?

Mr. NADER. That is right. The largest corporate tax cut in modern history.

Senator MANSFIELD. Now, what is your position on moving the income tax reduction forward by 1 year?

Mr. NADER. I would favor that. I would basically favor generating demand that would produce more jobs from that approach, Senator, more tax cuts for consumers who have a relatively high propensity to spend, which means that the poor would come first in terms of the tax cut expenditures.

Senator MANSFIELD. After all, they are the ones who furnish the main spring for our economic system, and there are so many of them, they have so little.

I believe that you stated or at least indicated that you would shift the excise tax relief away from the auto companies into the tax reduction field to give adequate relief to the lower income groups.

Mr. NADER. Yes. If there is going to be a demand for products built up with the abolition of the auto excise tax, why not keep the auto excise tax and reduce personal taxes across the board and generate $2.3 billion worth of demand for whatever consumers wished to buy.

That is far more equitable. It includes a potential 100 percent universe of the citizen taxpayers instead of just a small proportion of those who happen to buy new cars next year.

Senator MANSFIELD. Mr. Nader, we were told at the White House that the reason for the emphasis on the auto industry was that one out of every six persons working in the United States, either directly or indirectly, depended upon that industry for jobs. I am thinking of mining, glass making, aluminum work, and steel, things of that sort. On the basis of your research would that figure hold up?

Mr. NADER. It would not, Senator. That figure is based on an input-output analysis that provides a high leverage of job development with every incremental unit of demand for automobile purchases, demand for new autos and, as I mentioned earlier, the Treasury Department cannot substantiate the figure that for every four new autos sold this year there will be one new job because it does not know how much of this will be absorbed by overtime payments. It is my information from the auto industry that there is an expansive spread here to expend production simply by adding overtime, and that would not produce new jobs.

I can say, for example, that probably one out of every six people in this country is engaged in food industries, if not more, and there are much more specific input-output ratios that would improve the leverage for a $2.3 billion expenditure by consumers in terms of job development, that is where it is needed, that is where people are not working, where there are unemployed or underemployed throughout the economy.

Now the United Auto Workers informs that in May they had 20,000 more workers in the auto industry than they had the previous May 1970.

Senator MANSFIELD. 20,000 more.

Mr. NADER. 20,000 more, and President Iacocca of Ford, as I noted earlier, stated as of last December they knew it was going to be a 10-million-plus car year and there never has been a more booming car industry, booming sales, high profits, high employment, and the administration wants to pile that on even more.

Senator MANSFIELD. How many fewer workers are there in the steel industry as a comparison?

Mr. NADER. I don't know those figures.

Senator MANSFIELD. I understand that the number has decreased for a number of reasons, a slack off in domestic market, the importation of steel from Western Germany, Japan, perhaps other places, and even though a contract has been signed, and the capacity available, because of the lack of orders many of the steelworkers have not been able to return to work.

Do you think that in view of the situation which confronted this country in relation to the delicacy—well, in relation to the pressure really, which was being exerted against the dollar since last May or April, with unemployment at around 6 percent on the average, with inflation around 5 percent, I understand if you want to break it down a little more minutely over the last few months maybe around 7.2 percent, with no relief in sight overall, do you think it was necessary that something be done at this time to try to cope with these three factors?

Mr. NADER. Yes, certainly, Senator.

Senator MANSFIELD. But you would differ with the order of priorities and you would advocate the imposition of controls all the way across the board, I believe, to use your words?

Mr. NADER. Yes, sir; and much more effective alternative policies that would do the job better than investment credit and accelerated depreciation and the DISC proposal.

Senator MANSFIELD. Could you do that in a 90-day period?

Mr. NADER. Well, that could be put into effect rather quickly. For example, you wouldn't defer the welfare reform, that does not come into effect right away but it comes into effect in a short range; the corporate excise profits tax, the control of interest rates more vigorously, which is a prime source of inflation, there are a lot of rather short-term fiscal policies that can be put into effect. I think the administration took just the easy way out in terms of what they thought was the least amount of resistance.

Senator MANSFIELD. Well, so far as welfare reform is concerned, it had passed the House, hearings had just begun in the Senate, but it was doubtful it would be brought up this year. So far as revenue sharing is concerned, another item postponed, it was my understanding that hearings of some kind, not definite as yet, are being held in the House Ways and Means Committee and nothing in the way of an accomplished piece of legislation is in the works at this moment, so the postponements I don't think mean too much, in view of the actualities or the realities of the moment.

I only have one more question of Mr. Nader, and that is this. I too, have been impressed with Professor Samuelson. Could you furnish for the committee a copy of the testimony to which you referred so that those of us who are interested could study it more carefully?

Mr. NADER. Senator, these have been statements that he has made in articles over the last few years. Is he going to come down and testify before the committee?

Senator MANSFIELD. Is Samuelson going to testify?

Chairman PROXMIRE. I beg your pardon.

Mr. NADER. Is he going to testify?

Chairman PROXMIRE. Professor Samuelson was invited to testify but he won't be able to do it. He sent his regrets, he was just too tied up.

Senator MANSFIELD. May I say I saw Professor Samuelson on the radio or TV early this week and I had hoped he would amplify his remarks, but what I gather you are referring to is as to consistency on the part of Professor Samuelson which goes back several years.

Mr. NADER. Yes; and articles he has written in the New York Times and other journals. I think, Mr. Chairman, he would be very willing to submit a statement for the record.

Chairman PROXMIRE. Yes; we can certainly do that and maybe we can persuade him to come. We have had people who first said no and changed their minds. We will certainly try to get him. He would be a topflight witness.[1]

Senator MANSFIELD. Thank you, Mr. Chairman.

Chairman PROXMIRE. It is very late and I certainly apologize to you and others who have been here. This is one of the longest sessions I can recall, it is 1:20 p.m., but I don't think I can let you go without asking two questions, one because you have been so active, aggressive, and effective in helping the consumer get a better break. Do you think it will be possible to police the price freeze at the retail level and what are some of the things the consumers should be looking for to assure they are not being bilked under these circumstances?

Mr. NADER. Well, I think what they should be looking for is last week's prices in their daily newspapers, as a beginning comparison of supermarket prices. They should become much more alert to precisely what kind of brands they are buying, at what rates they are buying in order to avoid the very easy slide that obviously produces a changed price upward.

They should also be alert to the greatest potential for increase which is the area of raw agricultural produce.

Chairman PROXMIRE. That is one area where they can do nothing about it.

Mr. NADER. Can't do much about it? We have a student who has been working for us and has developed a pricing comparison scheme with a simple computer program in the District of Columbia and he claims with simple modifications this same system which is now going to be used to determine the difference in prices between supermarkets of identical canned goods and products, that this same system could be adapted to consumer goods monitoring the compliance of supermarkets under the price freeze, and if you would like him to prepare a summary statement of his proposal I can certainly have him do it.

Chairman PROXMIRE. We would like that very much. It would be very helpful. We would certainly like to have it; we would do all we can to publicize it.

(The following information was subsequently supplied for the record:)

[1] Professor Samuelson's subsequent testimony of Sept. 23, 1971, is printed in pt. 4.

Citizen Monitoring of the Price Freeze

The recent price, rent, and wage freeze has caught the nation without an active monitoring system. The Office of Emergency Preparedness, the administrators of the policy, has taken only a passive role in the direction of violators, depending exclusively on complaints to initiate action. If consumers of this nation are to be virtually the sole monitoring agent of the price freeze, as presently designed, they should join forces and implement methods to systematically check the nation's markets for violators. In addition, information collected during the price freeze can be compared to prices after the freeze has been rescinded, providing information on the ultimate effectiveness of the program.

The established agency to compare retail prices over periods of time is the Bureau of Labor Statistics, in its compilation of the consumer price index. The bureau's policy of not releasing prices by store and brand name grossly inhibits its utility for detection of violators. The consumer price index also has limited use in timely analysis of the effectiveness of the new economic policies, as reflected in the retail market. The vast majority of the goods and services priced by the BLS are not surveyed in all the cities on a monthly basis, but only once every three months.

To provide the needed sources of price information, consumers can organize local price surveys. A network of price surveys could be developed across the nation, with perhaps ten or more areas surveyed. Groups of approximately 30 volunteers in each area could survey a cross section of consumer items early in the price freeze period, numerous times during the course of the freeze, and after the freeze has been rescinded. With a list of items drawn up, volunteers could survey prices in retail outlets, and phone in the results to some central location in their area. There the price information on appliance, drug, apparel, grocery, and other products would be entered into a computer for fast data analysis. The computer can search for price raises, and point to the more flagrant violators. Such a system would place the minimum burden on the volunteer surveyors, who would spend no more than 45 minutes surveying the store and phoning in the results. The computer would do the "busy work" of tabulating and printing the results in a matter of minutes. The information collected by each area would be used not only for localized enforcement, but could be combined with other surveys throughout the nation to determine the overall effectiveness of the price freeze.

Such a system of price surveys has been conducted within the last month in Washington, D.C. In a project to compare prices between grocery chains, members of four local consumer groups collected over 5,000 prices. With this raw data processed by the computer, the consumer groups were able to release a comprehensive guide to Washington's best and worst grocery buys. The methodology developed over the three surveys can be directly applied to monitoring prices during the price freeze.

Detailed instructions about how to conduct price surveys, put in the hands of localized consumer groups, can greatly facilitate implementation of an active price monitoring system. Also, the computer that can be used to analyze the price data can be distributed to participating groups. The program uses less than one minute of machine time, so it is possible to have the time donated, or purchase the time at five to ten dollars per survey.

The surveys could channel the individual efforts of concerned consumers into a unified force to serve as an independent source of information. It seems vitally important for citizens themselves to monitor prices during and after this period of price freeze, to check the information that will be disseminated by the administration on the effectiveness of its own programs, especially on such a politically controversial issue.

An outline of the methodologies that can be used to monitor the price freeze, and the computer program to analyze the information will be made available to any group desiring to implement the program in their own area.

The surveying techniques were developed under a summer project for Ralph Nader to compare prices between retail outlets, such as grocery stores. The program can both compare prices between stores, and monitor the price freeze.

For further details contact: Mark Frederiksen, P.O. Box 19367, Washington, D.C. 20036, Phone: 202-833-3400.

Highlights of the July 29, 1971, Food Price Study

Consumer Action Staff, U.P.O.; Consumer Action Committee, District of Columbia Democratic Committee; and Virginia Citizens Consumer Council

METHODOLOGY

On July 29 and 30 members of four District area consumers groups surveyed prices in 77 retail grocery outlets, representing eleven chains in Washington, D.C., Virginia, and Maryland, and several independent inner-city grocery stores.

Prices of 45 items were compared among the supermarket chains. In addition there was a 17 item comparison of chain convenience stores, independent stores, and Safeway. The lists evolved from a local study of what inner-city residents buy, other market surveys, and industry sales figures.

The list of items for the supermarket was divided into two types:

(1) Items that can vary in quality among stores (fresh meat, produce. and store brand items).

(2) Brand-name items which show no quality variations between stores.

Twelve of the items fell in the first category, the majority—33—fell in category two.

The survey priced items in at least two stores of each chain except Acme where only one store was surveyed. One chain (Safeway) had 17 of its stores surveyed.

As it is exceedingly difficult to form a list of even 45 specific items that will be in all stores, the survey had to develope a procedure to handle the cases where an item was not available on the survey day. For such cases, which affected only three chains two of which were missing three or less items, the median price of the missing item in all the other stores was used in the calculation of the totals. Totals based on one or more of these substitutions are so labeled.

To speed results, a computer was used to analye the data, and print the results. With the help of a computer, it would be easy to process and publish price surveys within a 24 hour period.

CHAIN SUPERMARKETS

Of the eight supermarket chains studied, Memco's total was found to be the least expensive for the 45 items surveyed. Pilot surveys conducted on July 1, and 15 also found Memco to be the least expensive.

Next in total price came a cluster of five stores-Pantry Pride, Giant, A&P, Safeway, and Jumbo—all within 0.8% of each other. The average total within this group of stores was 4.4 percent higher than Memco.

Grand Union ranked seventh out of eight and was 7.2 percent above Memco, and 2.8 percent above the cluster of five stores.

Acme's total was highest, 10.3 percent above Memco, and 5.4 percent above Safeway on the items surveyed. The Acme store surveyed did not have eight of the items, so the median prices for the missing were used in calculation of Acme's totals. A separate analysis compared only the 37 items both Acme and Safeway had and found Acme to be 6.9 percent more expensive than Safeway. The two pilot surveys also found Acme to be the most expensive of the major chains.

The prices obtained for the Consumer's (Co-Op) chain are excluded, as it strongly believed that its management learned of the items in the surveyed, and as a result lowered prices on 16 of the items. Results from the previous surveys showed that Consumer's was just below Grand Union.

Though not open to the public, a military commissary was compared on the 25 items both the commissary and Safeway carried. The commissary was found to be 17 percent lower than Safeway. On items with possible quality differences the commissary showed a 25.6 percent savings over Safeway, but on the branded items it was only 12.4 percent less than Safeway.

CONVENIENCE STORES

Twenty-nine "convenience" stores, representing 7–11, High's, District Grocery Stores (D.G.S.), and independent grocery stores in the inner-city, along with three Safeway's were surveyed on 17 items. On the total prices of the 17 items, 7–11 and High's were within 0.2 percent of each other, and on the average 23.2 percent higher than Safeway. About half of the items were priced 29–40 percent higher than Safeway.

The District Grocery Stores' prices averaged 13.5 percent higher than Safeway, in addition prices of four fresh meats were compared to Safeway, and were found to be four percent lower on the day of the survey. Two of these four meat cuts were on sale at D.G.S., however.

The results for the small independent stores in the inner-city ("mom and pop" stores) surprised many. Prices in these stores were on the average one percent less than the chain convenience stores (7–11, and High's), but still were 21.6 percent higher than Safeway. The four fresh meats surveyed in these stores were 8.6 percent higher than in Safeway.

SELECTIVE SHOPPING

The survey results showed that shoppers could achieve the greatest savings in their food store dollars by dividing their purchases among several stores, buying each item in the store where it has the lowest price. Even in cases where the 45 and 17 item list showed totals only pennies apart among competing chains, totals for individual items varied greatly. The Safeway and A & P totals, for example, were only two cents apart for a list of 45 items, but 24 of these 45 items differed between the chains.

If a shopper bought the 45 supermarket survey items by selective shopping, a 4.75 percent savings under Memco's price would result. Of course, the added expense of travelling great distances between stores to get the best bargain might negate the money saved. In many cases, however, shopping areas have several major chains very near each other. In Oxon Hill, Maryland for example, where four major chains are very close to each other selective shopping during the survey would have resulted in a 3.3 percent savings over the lowest store in the area. It should be noted that the inner-city has the least potential for selective shopping, as there are relatively few areas with two or more competing stores in close proximity. Some suburban areas, too, have this problem.

PRICE RANGES AND VARIATIONS

Of the supermarket products surveyed, the products showing the widest price range were fresh produce and meats (example: White potatoes price range was 78 percent from lowest to highest). The median price range for the items was 20 percent. Only one item, milk, showed the same price in all the supermarkets surveyed. Briggs hotdogs had the largest price variation (38 percent) of the branded items on the day of the survey.

In the convenience stores, some items showed relatively low increases over the Safeway price. 7–11 and Highs were competitive with Safeway on milk and bacon, but were 33 percent higher on Maxwell House instant coffee, and 56 percent higher on Campbell's chicken noodle soup.

The D.G.S. and independent stores proved higher than Safeway on milk (22 and 30 percent respectively), but proved competitive on Wonder bread. Again, Campbell's chicken soup topped the list showing a 44 percent increase over Safeway in D.G.S., and a 62 percent increase in the independent stores.

Comparisons within chains showed slight price variations among branches, but showed no correlation to geographic region. Both the highest and lowest Safeway stores in the survey were in the inner-city.

The chains operating in the inner-city showed only a 0.5 percent variation in survey totals. The absence not only of the lowest chain (Memco) but also several of the other chains, and the relative lack of areas with potential selective shopping make the inner-city supermarketing scene greatly different from the suburbs.

It should be stressed that this was a PRICE survey. Other considerations for which consumers patronize a store, such as the quality of service, selection of brands and house brands, convenience of location, ease of parking, hours of service, home delivery and extension of credit, were not considered. On the basis of price alone, however, it is clear that consumers can save money in purchasing food store items by shopping carefully.

Recommendations for Action

Following our initial joint comparison shopping projects, we have the following recommendations for the four groups in the best position to follow up on the results:

TO CONSUMERS

Act on the results of the shopping survey by spending your money where you get the most value for your dollars. Stop paying excessive prices for products you can buy cheaper elsewhere. In particular, with major chains' new late night and, in some cases, Sunday hours, think carefully before venturing into high-priced "convenience" stores unless you know you won't be paying a premium price there.

Join our members in conducting additional comparison shopping surveys on a regular basis in the future. To volunteer, contact any of the survey's sponsors.

TO FOOD STORES

Lower prices where they are grossly above your competitors.

Reconsider your location policies, particularly in cases where major chains have abandoned the city to concentrate on and serve only the suburbs.

Voluntarily provide current prices of specified items to consumer groups and the press for timely publication that will help shoppers make wise buying decisions and comparisons.

TO GOVERNMENT AGENCIES

Change the procedures in "market basket" food store surveys that state and federal agencies currently conduct so that comparative price information gathered with our tax money is made available in a useful form to the people who pay for it.

Provide funding for comparison shopping projects to be staffed largely by workers to be hired under the recently passed Public Service Job legislation.

TO NEWSPAPERS

Provide detailed comparative food price information on a regular basis to your readers. Daily stock market listings affecting only a small minority of readers are given pages of space while objective price information that would be helpful to nearly all of your readers is not provided on foods. This is done in Hawaii now.

The consumer groups which carried out this survey stand ready to provide ongoing help, provided adequate funding is available, in compiling such price information.

Assign top reporters to investigate the discrepancies in prices and quality that exist in area food stores and to provide ongoing coverage of the issues related to food store reform at the expense, if necessary, of the innocuous gap that dominates food and women's pages today.

Food price study—July 29-31, 1971

A. & P	Median prices of 6 stores.
Acme	Oxon Hill Plaza, Oxon Hill, Md.
Giant	Median prices of 9 stores.
Grand Union	Median prices of 3 stores.
Jumbo	Median prices of 4 stores.
Memco	Median prices of 2 stores.
Pantry Pride	Do.
Safeway	Median prices of 17 stores.

NOTES

The lowest prices for each item are followed with an "L."
The highest prices for each item are followed with an "H."
Items that are on sale are followed with an "S."
If an item is not available in a store, the median price for that item will be used to calculate the sub-totals and totals. These sub-totals and totals are followed by an "N," and are not directly comparable to other totals based on stores having all the items.
Prices reported by shoppers from the Consumer Action staff, United Planning Organization; Consumer Action Committee, D.C. Democratic Central Committee; Virginia Citizens Consumer Council; and Maryland Consumers Association.

CHAIN SUPERMARKETS, FOOD PRICE STUDY JULY 29-31, 1971

	High	Low	Median	A. & P.	Acme	Giant	Grand Union	Jumbo	Memco	Pantry Pride	Safeway
Items with possible quality variations:											
White bread, enriched, 1 lb., store brand	$0.23	$0.20	$0.20	(LS)0.20	0	(LS)$0.20	(L)$0.20	(H)$0.23	(L)$0.20	0	(LS)$0.20
Buns, hamburger, 8 buns, store brand	.34	.27	.30	.33	$0.33	.29	.29	.30	(L).27	(H)$0.34	.31
Bananas, 2 lb., Chiquita	.30	.20	.29	.25	(H).30	.29	.29	(L).20	0	.26	.29
String beans, 1 lb	.39	.25	.29	.29	.29	.29	(H).39	(LS).25	.29	.33	.29
Potatoes, white, 5 lb. bag, U.S. 1	.69	.39	.59	(H).69	0	.59	(H).69	.49	(L).39	(H).69	.59
Carrots, 1 lb	.29	.24	.29	(H).29	(H).29	(H).29	(H).29	(L).24	.27	(H).29	(H).29
Chuck roast, boneless, 1 lb., U.S. Choice	.99	.75	.95	(LS).75	(S).79	.95	.96	.79	0	(H).99	.95
Spareribs, pork, 1 lb	.89	.69	.81	.79	(H).89	.79	.85	(L).69	.83	.84	.79
Pork chops, center cut, 1 lb., loin	1.45	1.09	1.29	(H)1.45	0	1.29	1.29	(L)1.09	1.23	1.29	1.29
Chicken, frying, 1 lb., cut up	.47	.35	.45	.39	(H).47	.45	.45	.45	(L).35	(LS).35	.45
Milk, whole, grade A, vitamin D, ½ gal., store brand	.59	.59	.59	(L).59	(L).59	(L).59	(L).59	(L).59	(L).59	(L).59	(L).59
Eggs, large, 1 doz., Grade A	.59	.49	.50	.50	(H).59	(L).49	.53	.53	.50	(L).49	(L).49
Subtotal				6.52	(N)6.62	6.51	6.82	5.85	(N)6.16	(N)6.66	6.53
Rank				4	6	3	8	1	2	7	5
Items with no quality variation:											
Cream sandwich cookie, 15 oz., Oreo	.53	.49	.51	(H).53	(L).49	(H).53	(H).53	.51	(L).49	.52	.51
Rice Krispies, 13 oz., Kellogg's	.59	.54	.54	(L).54	.57	(L).54	.55	(H).59	(L).54	(L).54	(L).54
Applesauce, 15 oz., jar, Motts	.29	.25	.26	(H).29	0	.26	.27	(H).29	0	(L).25	.26
Fruit cocktail, canned, 17 oz., Del Motte	.33	.25	.30	.31	(H).33	.31	(S).27	(H).33	.29	.29	(LS).25
Grean beans, cut, canned, 16 oz., Del Monte	.32	.25	.27	(H).32	(L).25	.28	.29	.30	.27	.27	(S).25
Sugar, 5 lb., Dominio	.73	.69	.69	.70	(L).69	(L).69	(H).73	(L).69	(L).69	(L).69	(H).73
Instant rice, 11 oz., Uncle Bens	.45	.41	.44	(H).45	0	.44	(L).41	(H).45	.43	.43	.44
Grits, 24 oz., Quaker	.33	.27	.28	.28	(H).33	.28	.29	.31	.30	(L).27	.28
Spaghetti thin 1 lb., Muellers	.31	.27	.27	(L).27	(H).31	(L).27	(L .27	.29	(L).27	(L).27	(L).27

Instant coffee, 6 oz., Maxwell House	1.29	1.05	1.08	(L)1.05	(H)1.29	1.09	1.10	(L)1.05	1.07	(L)1.05	1.09
Tea bags, 48 bags, Lipton	.69	.55	.61	.61	(H).69	.61	(L).55	(H).69	(S).57	.61	.61
Shake N'Bake for Pork, 2⅜ oz	.29	.23	.24	.24	(H).29	.24	.27	.25	(L).23	.24	.24
Cooking oil, 24 oz., Wesson	.69	.58	.59	.59	(H).69	.59	.59	.63	.59	(L).58	.63
Bacon, 1 lb., Briggs	.89	.69	.89	(H).89	(H).89	(H).89	(H).89	(S).75	(L).69	(S).79	(H).89
TV dinner, chicken, 11½ oz., Swanson	.69	.58	.63	.63	(H).69	.63	.65	.65	(L).58	0	.63
Hotdogs, all meat, 1 lb., Briggs	.95	.69	.77	(LS).69	(H).95	.85	.85	(S).75	.76	.79	(S).75
Butter, 1 lb., Land O'Lakes	.77	.84	.85	.85	(H).87	.85	.86	(L).84	.85	.85	.85
Margarine, stick, 1 lb., Blue Bonnet	.38	.36	.36	.37	(H).38	(L).36	.37	.37	(L).36	(L).36	(L).36
Ketchup, 14 oz., Heinz	.33	.29	.30	(H).33	.30	.30	.30	(H).33	(L).29	(L).29	.30
Mayonnaise, 32 oz., Hellmann's	.79	.69	.73	.73	(H).79	.73	.79	(H).75	(L).69	.72	.73
Peanut butter, creamy, 12 oz., Skippy	.49	.45	.47	(L).45	(H).49	(L).45	(H.)49	(H).49	.47	(L).45	.47
Sirup, 12 oz., Log Cabin	.45	.38	.40	(H).45	(H).45	.39	.42	(H).45	.39	(L).38	.39
Baby formula, liquid, 13 oz., Enfamil	.35	.30	.32	.33	0	.32	.33	(H).35	(L).30	.31	.32
Soup, tomato, 10¾ oz., Campbell's	.14	.12	.12	(L).12	(L).12	(L).12	.13	(H).14	(L).12	(L).12	(L).12
Pork and beans, 16 oz., Campbell's	.18	.15	.16	.16	(L).15	.16	.16	(H).18	.17	.16	.16
Orange juice, frozen, 12 oz., Minute Maid	.57	.51	.55	(S).53	0	(LS).51	.55	(H).57	.55	.53	(H).57
Soda, 1 6-pack, 6-12 oz. cans, Coke	1.05	.99	1.03	1.01	0	1.03	1.03	1.03	(L).99	(H)1.05	1.03
Bleach, 1 gal., Clorox	.59	.49	.55	.55	(L).49	.55	.55	(H).59	.52	.54	.55
Detergent, laundry, 49 oz., Tide	.83	.69	.76	(S).76	(LS).69	(S).76	(S).76	(H).83	(S).76	.79	(S).76
Detergent, dish, 32 oz., Ivory	.95	.78	.79	.79	(H).95	.79	.82	(S).83	(L).78	.79	.79
Toilet paper, 1 ply, 1 1000-tissue roll, Scott	.18	.15	.15	(L).15	.17	(L).15	(L).15	(H).18	(L).15	(L).15	(L).15
Toothpaste Crest 6.75 oz. with Floristan	.89	.69	.80	.79	(H).89	.75	.81	(S).81	(L).69	.79	.81
Aspirin, 100 tablets, Bayer	.89	.68	.71	.69	(H).89	.69	.79	(H).89	(L).68	.69	.73
Subtotal				17.45	(N)18.69	17.41	17.78	18.20	(N)16.79	(N)17.19	17.46
Rank				4	8	3	6	7	1	2	5
Total		[1]21.86		23.97	(N)25.31	23.92	24.60	24.05	(N)22.95	(N)23.85	23.99
Rank				4	8	3	7	6	1	2	5
Total	25.31	22.95	24.08								

[1] Selective shopping list.

CONVENIENCE STORES JULY 30, 1971

	High	Low	Median	Safeway	7-11	High's	D.G.S.	Independent
Bakery and cereal:								
White bread (1 pound, Wonder)	$0.35	$0.29	$0.30	[1] $0.29	[2] $0.35	$0.31	[1] $0.29	$0.30
Sugar Frosted Flakes (10 ounces, Kellogg's)	.51	.39	.47	[1] .39	.49	[2] .51	.45	.47
Subtotal				.68	.84	.82	.74	.77
Rank				1	5	4	2	3
Dairy:								
Milk, whole (½ gallon, store brand)	$0.77	$0.59	$0.63	[1] $0.59	$0.63	[1] $0.59	$0.72	[2] $0.77
Eggs, large grade A (1 dozen, store brand)	.69	.49	.67	[1] .49	.67	.65	.67	[2] .69
Subtotal				1.08	1.30	1.24	1.39	1.46
Rank				17	37	2	4	5
Staples:								
Sugar (2 pounds, Dominio)	$0.49	$0.37	$0.45	[1] $0.37	$0.45	$0.45	$0.41	[2] $0.49
Instant coffee (2 ounces Maxwell House)	.73	.55	.69	[1] .55	[2] .73	[2] .73	.69	.69
Subtotal				.92	1.18	1.18	1.10	1.18
Rank				1	3	3	2	3
Nonfood:								
Bleach (1 quart, Clorox)	$0.34	$0.24	$0.31	[1] $0.24	$0.33	$0.31	$0.26	[2] $0.34
Detergent, laundry (20 ounces, Tide)	.49	.38	.49	[1] .38	[2] .49	[2] .49	.44	[2] .49
Aspirin (24 tablets, Bayer)	.45	.33	.45	[1] .33	[2] .45	[2] .45	.37	[2] .45
Sanitary napkins (box of 12 regular, Kotex)	.55	.48	.55	[1] .48	[2] .55	[2] .55	.51	[2] .55
Subtotal				1.43	1.82	1.80	1.58	1.83
Rank				1	4	3	2	5

Processed meat:								
Bacon (1 pound, Briggs)	$0.99	$0.89	$0.95	[1] $0.89	[2] $0.99	$0.95	[1] $0.89	$0.95
Hot dogs, all meat (1 pound, Briggs)	.99	.75	.89	[1,3] .75	.95	[2] .99	.89	.89
Subtotal				1.64	1.94	1.94	1.78	1.84
Rank				1	4	4	2	3
Miscellaneous:								
Peanut butter (12 ounces, Peter Pan)	$0.63	$0.45	$0.59	[1] $0.45	$0.59	[2] $0.63	$0.53	$0.59
Soup, chicken noodle (10½ ounces, Campbells)	.26	.16	.25	[1] .16	.25	.25	.23	[2] .26
Mustard (9 ounces, French's)	.25	.18	.25	[1] .25	[2] .25	[1] .25	[1] .25	[2] .25
Orange juice, frozen (12 ounce, Minute Maid)	.73	.56	.57	.65	.65	[2] .73	[1] .56	.63
Soda, 1 6-pack (6 12-ounce cans, Coca-Cola)	1.19	1.03	1.09	[1] 1.03	[2] 1.19	[2] 1.19	1.08	1.09
Subtotal				2.39	2.93	3.05	2.65	2.82
Rank				1	4	5	2	3
Total				$8.14	$10.01	$10.03	$9.24	$9.90
Rank				1	4	5	2	3
Total	$10.03	$8.14	$9.46					

[1] The lowest price.
[2] The highest price.
[3] Items on sale.

Note: Safeway, median price of 3 stores; 7–11, median prices of 9 stores; High's, median prices of 7 stores; D.G.S., median prices of 6 stores; independent, median prices of 7 stores.

Source: Prices reported by shoppers from Consumer Action staff, U.P.O.; Consumer Action Committee, District of Columbia Democratic Committee; Virginia Citizens Consumer Council; Maryland Consumers Association.

Price differences between Safeway and convenience stores, July 29, 1971, percentages show how much higher than Safeway's price the convenience store price was—

	Percent		Percent
7–11:		*High's:*	
Milk	7	Milk	0
Bacon	11	Wonder bread	7
Orange juice	14	Bacon	8
Coke	15	Coke	15
Kotex	15	Kotex	15
Wonder Bread	20	Sugar	22
Sugar	22	Orange juice	28
Frosted Flakes	25	Clorox	29
Hot dogs	27	Tide	29
Tide	29	Frosted Flakes	30
Peter Pan	31	Hot dogs	31
Instant coffee	33	Eggs	33
Bayer	36	Instant coffee	33
Eggs	37	Bayer	36
Clorox	37	Mustard	39
Mustard	39	Peter Pan	40
Chicken soup	56	Chicken soup	56
D.G.S.:		*Independent:*	
Orange juice	−2	Wonder bread	4
Wonder bread	0	Coke	6
Bacon	0	Bacon	7
Coke	5	Orange juice	10
Kotex	6	Kotex	15
Clorox	8	Hot dogs	18
Sugar	11	Frosted Flakes	20
Bayer	12	Instant coffee	25
Frosted Flakes	15	Tide	29
Tide	16	Milk	30
Hot dogs	18	Peter Pan	31
Peter Pan	18	Sugar	32
Milk	22	Bayer	36
Instant coffee	25	Mustard	39
Eggs	37	Eggs	40
Mustard	39	Clorox	47
Chicken soup	44	Chicken soup	62
Fresh meats:		Fresh meats:	
Chicken	−27	Chuck roast	4
Chuck roast	−11	Spare ribs	9
Pork chops	0	Chicken	9
Spare ribs	4	Pork chops	11

Chairman PROXMIRE. The final question is you raised some legal and constitutional questions about portions of the policy. You are participating in a court challenge on accelerated depreciation announced earlier this year. Can you be a little more specific, Mr. Nader, about the legal questions you referred to today and do you intend to challenge any part of the President's package yourself?

Mr. NADER. Yes, I would like to make some comments. I consider the trend here in the administration a very serious encroachment on the congressional powers, and I would hope that Members of Congress would share that concern in the forthcoming few weeks.

Chairman PROXMIRE. Specifically.

Mr. NADER. Specifically, the accelerated depreciation arrangement which permits a faster write-off than the accelerated depreciation provisions that have been already in effect. They permit an accelerated depreciation faster that the life use of the equipment. That, in the judgment of former Internal Revenue Commissioner Mortimer Caplin, and the leading tax experts at Yale Law School, University of

Pennsylvania Law School, and others throughout the country, that action is not authorized by the Internal Revenue Act at all.

Chairman PROXMIRE. How about the constitutionality and legality of the freeze itself?

Mr. NADER. Now so far as the constitutionality and the legality of the freeze itself I have no details to offer. I have had no time to study the issue at all but I would hope this becomes also a source of inquiry for the committee.

Chairman PROXMIRE. Any other parts of the new program? Accelerated depreciation as you have told us was put into effect quite some time ago, the new program.

Mr. NADER. Yes; the other one is the import surcharge.

Now, the authority here cited in the administration's statements is the Trade Expansion Act of 1962 which states, the citing is 19 United States Code, section (b), it states:

> The President may, at any time, terminate in whole or in part any proclamation made under this subchapter.

Now the Trade Expansion Act was passed by the Congress to increase international trade and to reduce trade barriers. Whether or not this can be construed to increase a surcharge on imports is certainly a serious question to probe. I am not prepared at this time to make a judgment either way.

Chairman PROXMIRE. Hasn't that been done by a number of other countries under GATT, under the treaty itself? Didn't Canada do it in 1962? Didn't other countries do it?

Mr. NADER. Yes, there is a provision in GATT which indicates obviously if there is an emergency situation and the like there can be deviation from the provisions. However the question here is not whether the United States can do this. My question is whether the administration can do this without the authority of Congress under the Trade Expansion Act of 1962, and that, I think, deserves inquiry.

Chairman PROXMIRE. Do you intend to bring any legal action on that?

Mr. NADER. Pardon.

Chairman PROXMIRE. Do you intend to bring legal action yourself?

Mr. NADER. No; not on that for two reasons. One, I don't think the import surcharge is going to be around very long (though it is important to make that legal determination for future action), so it may be mooted by the time a suit is filed.

Second, there are very serious problems of standing, of citizens having standing to sue, and that is why there is so much reliance on the Congress to do what the citizen simply cannot do under the present legal system.

Chairman PROXMIRE. One other point: How about the contractual obligations to pay higher salaries and wages? Contracts have been entered into in good faith by both parties and agreed to prior to this freeze. What authority or right has the President got to void or to pospone those?

Mr. NADER. Well, certainly the Constitution has a provision protecting the sanctity of private contracts, and if the President is going to have sufficient authority to override that he is going to have to show, I suppose, to the appropriate adjudicative body, if it ever comes to that, that there really was an emergency which counteracts that particular constitutional provision by other constitutional provisions that grant him these powers elaborated through statutes. You see it is basically two sources here, one, that says thou shalt not interfere with private contractual rights, and arrangements, and the source that says thou shalt be concerned about the state of the Nation in serious times, and then statutes based on that constitutional authority.

As far as I am concerned I think that there are some very strong cases to be made here. Let's assume that the President does have authority, does he have as much authority as the following case study, where a union contract is signed a year ago and it provides for wage increases in direct proportion to productivity increases of labor, and during the 90 days the productivity increases go on, the wages are not increased, and they are not to be retroactively applied, which means a clear windfall to the corporation in violation of the contract between union and management. That goes pretty far.

Chairman PROXMIRE. Mr. Nader, I want to thank you very, very much. You have been most helpful and we deeply appreciate it.

Mr. NADER. Mr. Chairman, there is just one more point Mr. Stanton would like to make for the record.

Chairman PROXMIRE. All right, Mr. Stanton.

Mr. STANTON. Sir, you asked two questions dealing with the investment credit in contrast with the ADR system. One question dealt with, Would a consumer favor the accelerated depreciation regulations or whether he would favor the investment credit?

Chairman PROXMIRE. We wanted to know whether you would favor it.

Mr. STANTON. We would favor it. I would suggest the more important question is which of the two devices would be more effective in stimulating the economy, and I believe there is general unanimity, even including Treasury economists who, before this became a political issue, had the misfortune to publish papers that the investment credit is far more effective as a stimulus to the economy, particularly in the short run than the ADR system which, as even a leading proponent of the system explained, would take at least 18 to 24 months to have any impact whatsoever.

The second question was with respect to why we should have retroactivity to April 1 with respect to an investment credit. On January 11 of this year, President Nixon announced that he had that day approved certain changes in the administration of the tax laws which were the ADR system. At a press conference that afternoon the Secretary of the Treasury, David Kennedy, stated that the administrative route was selected rather than going through Congress because, and this is almost a direct quote, they wished to avoid the uncertainties of the legislative process.

It turns out that avoiding the uncertainties of the legislative process is not a luxury but an actual violation of constitutional separation of powers, as has been charged by approximately a dozen leading tax law professors across the country.

On April 27, Secretary Connally was concerned about the increasing uncertainty in the business community as to whether or not businessmen should rely on the regulations. At that time in a speech to the Chamber of Commerce he stated flatly as a means of inducing at least some investment decisions that were there, and investment credit, it would be retroactive to April 1. In that sense then, as a means of inducing the business community to make prospective investment decisions the April 1 date does have some validity.

Chairman PROXMIRE. I understand that but after all the Secretary of the Treasury speaks for himself.

All he can say is he will do his best, he can't very well speak for me or any other Senator.

Mr. STANTON. Yes, sir; I agree completely.

To complete the history, on June 22 the Treasury finally published the final regulations of the ADR system artificially making them retroactive to January 1 of this year. Almost immediately thereafter on the same day the business community was informed that a law suit was pending. Within about 10 days a law suit was filed in Federal district court and it will be argued by the dean of the Pennsylvania Law School, Dean Bernard Wolfman, which is some indication of the seriousness of the law suit.

To our best information there has been no substantial or no significant business reliance on the ADR system which requires certain very difficult accounting proceedings. In terms of stimulating the economy I respectfully suggest that the ADR system could be replaced with an effective investment credit along the lines suggested as the half a loaf position, and this would be much more effective.

Chairman PROXMIRE. Thank you, gentlemen, very, very much.

The committee will reconvene at 10 o'clock Monday morning to hear Paul Porter, George Taylor, and Mike DiSalle, three very experienced administrators of the past price administration and I am sure with a great deal of wisdom on the present problem.

Thank you, very much.

(Whereupon, at 1:35 p.m., the committee was adjourned, to reconvene at 10 a.m., Monday, August 23, 1971.)

THE PRESIDENT'S NEW ECONOMIC PROGRAM

MONDAY, AUGUST 23, 1971

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

The committee met, pursuant to recess, at 10:05 a.m., in room 1202, New Senate Office Building, Hon. William Proxmire (chairman of the committee) presiding.

Present: Senator Proxmire.

Also present: John R. Stark, executive director; Loughlin F. McHugh, senior economist; Richard F. Kaufman and Courtenay M. Slater, economists; Lucy A. Falcone, research economist; and Walter B. Laessig, economist for the minority.

OPENING STATEMENT OF CHAIRMAN PROXMIRE

Chairman PROXMIRE. The committee will come to order.

Today we continue our hearings into the President's new economic program. In the past 2 days, we have heard from five distinguished economists who gave some extremely valuable insights. We have also heard from a very able consumer spokesman, Mr. Ralph Nader.

Today we turn to some of the outsanding experts in the country on the subject of wage and price administration. They are the officials who handled the responsibility on a day-to-day basis in previous emergencies.

It is clear from our own observations and the testimony to date that there are extremely difficult problems involved in administering a freeze and even more troublesome ones waiting in the wings for the end of the freeze period on November 12. I can think of no one whose contributions could be more valuable than those of our three witnesses here today. We are very proud and very pleased to have you gentlemen appear before us.

Our first witness is Paul Porter, who served as a Deputy Administrator in the OPA in the early days of World War II and later as Associate Administrator of the War Food Administraton. In 1943 and 1944, he was an Associate Director of the Office of Economic Stabilization. Finally, he served as Administrator of the OPA in 1946. He has served in many other distinguished capacities and is presently one of Washington's outstanding lawyers.

Mr. George Taylor is a professor of labor relations at the Wharton School, University of Pennsylvania, where he has served since 1949. He was vice chairman and chairman of the War Labor Board from 1942 to 1945 and he was chairman of the Advisory Committee, Office of War Mobilization, in 1946 and 1947. He became chairman of the War

Stabilization Board during the Korean war and is still a member of the President's Commission on Labor and Management Policy.

Our witnesses will be joined by Michael V. DiSalle, formerly mayor of Toledo, Director of Price Stabilization in the Korean war, Director of Economic Stabilization in 1952. He later served as Governor of Ohio and in many other distinguished roles in an outstanding career. He, too, is presently practicing law in this city.

Gentlemen, we are delighted to have you. Mr. Porter, will you start off?

STATEMENT OF PAUL PORTER, ATTORNEY AT LAW, WASHINGTON, D.C.

Mr. PORTER. Thank you, Mr. Cha[illegible]

I am glad to accept the committee's in[illegible] no prepared statement but I have over the weekend done a little research, and I have some statistics that I would briefly like to refer to reflecting the experience that George Taylor and I shared, and later Mike DiSalle, attempting to administer wage and price control.

First of all, let me say I endorse and support the President's policy for the 90-day wage and price freeze. As I shall subsequently observe, what happens after 90 days, I think, is the critical and important thing.

Now both OPA and OPS issued price freezes which remained in effect throughout the period of regulation, although subsequently modified by special regulations and exemption procedures. In each case this freeze came after a 6-month period of very severe inflation, and was intended to prevent further inflation at the cost of some injustice until a more detailed pattern of regulation was begun and the necessary bureaucracy was assembled.

For example, in the 6 months following Pearl Harbor, December 1941 through May of 1942, the Consumer Price Index increased at the rate of 1 percent a month. In May of 1942 prices were ordered frozen at the March 1942 levels by the general maximum price regulation.

Chairman PROXMIRE. Mr. Porter, when you say prices increased at the rate of 1 percent a month, are you talking annual rate or was that the actual increase for each month?

Mr. PORTER. Actual increase for each month.

Chairman PROXMIRE. The annual rate was around 12 percent?

Mr. PORTER. Yes, sir. After the General Max, as it was popularly known or unpopularly known, I might say, the next 12 months the rate of increase was slowed down to about 0.65 percent per month so it did work, but the greatest proportion of those increases——

Chairman PROXMIRE. What you did was you cut it in half, is that right?

Mr. PORTER. I am talking about after the general maximum price regulation of 1942 was put into effect, and the rate was then 1 percent a month, slowed down to 0.62 percent a month.

Chairman PROXMIRE. So, from 1 percent to 0.62 would mean it was cut about in half.

Mr. PORTER. Cut about in half and the biggest proportion of that, Mr. Chairman, represented agricultural commodities which were not then under regulation.

Chairman PROXMIRE. I see.

Mr. PORTER. Now, in April 1943 there came the hold-the-line order, and over the next 3 years the rate of inflation was slowed down to 0.18 percent or a total of 6.6 percent for a period of 37 months, which at the time was a very commendable record.

During the period of June 1946 to March 1947 prices were decontrolled very rapidly, and after VJ–Day, the lid was taken off practically completely.

During this 9-month period the Consumer Price Index increased 17.3 percent or an average of nearly 2 percent per month.

Now, the Second World War experience in rents shows even a greater stability than prices in general, and I take particular pride in this because I was the first Federal Rent Administrator being appointed in March of 1942. By August of that year we had over 400 defense rental areas under regulation. We not only froze the rents but we rolled them back. In the 6-month period following Pearl Harbor, rents had increased at the unbelievable rate of 32 percent per month. You recall the housing shortages at that period, the influx of the labor supply into the congested shipyard areas and defense plants, but during the 1 year following the general freeze rents declined, actually declined, at the rate of 0.14 percent as opposed to an increase of 0.65 per month in the Consumer Price Index. And in the 3 years following the hold-the-line order rents increased only slightly as opposed to 0.01 percent per month as opposed to 0.18 percent per month in consumer prices.

Chairman PROXMIRE. You say 0.01?

Mr. PORTER. 0.01.

Chairman PROXMIRE. And this was one one-hundredth of 1 percent.

Mr. PORTER. Precisely.

Chairman PROXMIRE. In other words, practically stable.

Mr. PORTER. Well, rents remained under control during the initial period of decontrol, and increased only by six one-hundredths of 1 percent per month from July of 1946 to March of 1947 at a time when the Consumer Price Index was going up at the rate of about 2 percent per month.

Then came decontrol but from March 1947 through December 1948 when controls were eased to allow increases in rents, rents increased at about a half of a percent per month or a total of 8.6 percent in the year and a half period, but the increase between June and December of 1947 was more than the entire prior 8-year period under controls.

In other words, the rent control was held at about 1 point during the period of the war.

Now, if at this point I may indulge in a little personal reminiscense I would like to volunteer gratuitous advice to my friend John Connally, because the role of a price controller as Mr. DiSalle will verify, as well as Mr. Taylor, is not a happy one. My secretary dug out over the weekend what I consider one of my most priceless momentos. It was from Headlines, a publication of the National Real Estate Association on the occasion of my resignation from the Stabilization Board and return to the private sector. There was this tribute that was paid to me:

Farewell to Porter.

Paul Porter has announced his resignation.

He'll probably beat the bouncer to the door by a hop and a skip. Eight million small property owners will cheer the bouncer.

He was a faithless public servant. He was given vast discretionary power by a trustful Congress.

He was given a blueprint of fair procedure in dealing with rents. Rents were to go up if taxes and costs went up. The directive was clear. He followed no part of it.

Paul Porter had in his hands the saving and welfare of eight million small owners of rental properties, mostly one- to four-family homes.

He chose to ignore every tenet of decency and good faith.

In no area did he increase rents in spite of increased taxes and costs.

His kangaroo court gave relief almost solely to owners who invested more capital, which as I read the statute is what we were supposed to do.

He misrepresented facts to Congress when he said that owners had better income by reason of more tenants when 90 percent of the owners had not.

He ridiculed millions of small people, whose property the Government had seized and held, in their utter helplessness.

He compelled owners living on reduced incomes from services rendered, to subsidize tenants whose incomes were doubled or tripled.

He was the polished demagogue, the stooge for left wing planners of a proletarian dictatorship.

I consider this, Mr. Chairman, one of my priceless mementos because rents did not move——

Chairman PROXMIRE. Are you saying, Mr. Porter, that your advice to Mr. Connally is to be tough, to provide no exceptions, to insist on full and complete enforcement right across the board?

Mr. PORTER. For the first 90 days, yes, and thereafter as long as he can get away with it. [Laughter.]

Chairman PROXMIRE. Very good.

Mr. PORTER. I have commented on rents and I am sure that your very capable expert staff has these data but I have a table here that I would like to offer for the record that shows the behavior of prices beginning with December of 1941 through December of 1948, and I think this statistically reflects in a rather dramatic way the impact of the general maximum price regulations and the hold-the-line order, and I will ask Mr. DiSalle to update that when he assumes jurisdiction.

Chairman PROXMIRE. Without objection, we will print that in the record at this point.

(The table referred to follows:)

	December 1941	May 1942 (general maximum)	May 1943 (hold-the-line order)	June 1946 (beginning of decontrol)	March 1947 (most items decontrolled)	December 1948
CPI [1] all items	110.5	116.0	125.1	133.3	156.3	171.4
CPI [1] rents	108.2	109.9	108.0	108.5	109.0	119.5
WPI [2] all items	93.6	98.8	104.1	112.9	149.5	162.2

[1] Source: "Consumers' Prices in the United States 1942–48," Bureau of Labor Statistics Bulletin No. 966. 1935–39 = 100

[2] Source: Bureau of Labor Statistics Bulletin Nos. 718, 736, 759, 920, March 1948 and December 1948 releases. 1926 = 100

Mr. PORTER. During the Korean war, as Mr. DiSalle can testify, the experience was somewhat similar. Prices were relatively stable in the first half of 1950, prior to the North Korean invasion in June.

Beginning in June, however, retail prices increased at a rate of over 1 percent per month while wholesale prices increased by over 1.5 percent.

Now, Mr. DiSalle then ordered a general freeze under the general ceiling price regulation, as it was then called, which was instituted in 1951, January 26, 1951, to remain in effect until March of 1953. At that point there was no significant inflation following decontrol, and I have here a brief summary of the behavior of the Consumer Price Index, the housing or rent index from February of 1950 through March of 1954, to show the Consumer Price Index, using February of 1950 as 104, it rose to 114.8 by March of 1954, which was a relatively stable movement pricewise. Housing which included shelter as well as rents moved from 104.6 in February of 1950 to 118.9 in March of 1954.

The parallels to the current situation are obvious. A general freeze on prices was invoked in each case to stabilize the situation followed by the issuance of more selective controls to alleviate the inherent arbitrariness and the inequities of the general freeze. In brief, I think that a freeze buys the time necessary to work out further controls after gathering the staff necessary to enforce them.

But, as I have indicated in this tribute paid to me by the real estate association, both OPA and OPS were unpopular agencies. The reaction of organized labor in the current wage and price freeze as well as the confusion surrounding it, indicates that controls in 1971 will probably not differ in popularity from earlier occasions, that is, from the business community and labor. I do hope they receive general public support. And the issuance of controls in peacetime, I think it can safely be predicted, perhaps will meet more public opposition than did the earlier controls in wartime where a certain degree of sacrifice could be demanded.

Now, the points of difference between the contemporary situation and those of the wartime situation are equally obvious.

The rate of inflation which triggered the present controls is far less than the approximately 1 percent a month that was present in the prior cases of Korea and World War II. The most recent Consumer Price Index shows an annual rate of change of 3.9 percent for the 6 months ended in July. The wholesale price index, however, shows the seasonally adjusted annual increase of 4.7 percent for the 6-month period ending in July and that is the highest rate in recent years.

The increase in wholesale industrial prices in July, for example, was 0.7 percent, which is the fastest monthly rise since 1965.

Now, I think that the important difference, Mr. Chairman, is that the necessity for controls during the OPA and OPS was created by a wartime situation in which demand far exceeded supply. As a matter of fact, we used to maintain at the agency a chart, which I was unable to find, and I would have it updated each month, called the inflationary gap. I am sure Mr. Taylor and Governor DiSalle are completely familiar with the inflationary gap. These data were taken from the Bureau of Labor Statistics and represented the measure of available consumer purchasing power as against available goods and services, and during those war years there was an unprecedented rate of savings above income, 20 percent above income for a period of 3 years.

Now, the major problem in holding down prices in these years involved the uncontrolled products such as agricultural goods which were in short supply and whose costs increased at an extraordinary rate. And I am sure we can all recall the grave difficulties we had with our subsidy program efforts to maintain a stable cost of living.

For example, all food prices increased by 17.6 percent between May of 1942 and May of 1943, 17 percent in 1 year. Some foodstuffs were brought under control during that period, but those that were not controlled before October 1942 showed a price increase of 62.3 percent.

Chairman PROXMIRE. What period was that?

Mr. PORTER. That is before October 1942, and in a 1-year period.

Chairman PROXMIRE. One year period ending October 1942?

Mr. PORTER. One-year period ending October 1942. Foodstuffs which remained——

Chairman PROXMIRE. How much of the food production was not under control, what proportion, a third of it, half of it?

Mr. PORTER. Over half, Mr. Chairman.

Chairman PROXMIRE. Over half, and that half increased 62 percent?

Mr. PORTER. Sixty-two percent.

Chairman PROXMIRE. In 1 year.

Mr. PORTER. Yes.

Chairman PROXMIRE. How does that square with the figures you have given us before on the increase of cost of living in view of the fact that you have more than half of the food increasing 62 percent in price?

Mr. PORTER. I think the Consumer Price Index will show the components, rent is 25 percent or it was then. That was the important thing, keeping—25 percent of the wage earner's income went for rent or shelter, and my mandate was to keep that down and other costs would be more easily controlled, wage levels, et cetera. Food probably about 30 percent, maybe a little more. I am sure Mr. Taylor must remember those figures, around 30 percent is my recollection. But there were certain foodstuffs that were, remained uncontrolled throughout the year that showed a fantastic increase of 73 percent during that same period.

Now, it is my understanding that no such inflationary force reflecting shortages in supply appear just now. Indeed, the major inflationary force appears to be wage settlements which, in turn, are followed by price increases. In other words, as I think some of the economists, and I am no economic pundit, put it, that in the war days there was a demand push that created inflationary pressures. Today there appears to be the cost push, and I think this leads to the thing that I hope that this committee, Congress, as well as the Cost of Living Council will give careful consideration to during the next 90 days.

In November of 1970, and I am talking now about recent wage settlements, in November of 1970, the United Auto Workers obtained a settlement with General Motors involving a 25-percent increase over 3 years. The Ford settlement followed the same lines, and Ford immediately announced its third price increase on 1971 cars. A price increase of 3.9 percent on 1972 models was announced by GM while Ford was considering a 5-percent increase. Now, presumably these increases have all been canceled following the repeal or the recommended repeal of the automobile excise tax and the wage-price freeze, but even a higher settlement was given to the rail workers by Congress in December of 1970, 13.5 percent increase retroactive to January 1970. The rail workers subsequently negotiated a 42-percent increase over 42 months.

The can industry settlement in the spring of 1971 set the pattern, as we know, for subsequent agreements. It gave the workers a raise of approximately 31 percent over 3 years, including an unlimited cost of living clause, escalation clause. Following the wage increase, the wholesale price index for cans increased from 115.6 percent in April to 124.3 percent in March. And the aluminum settlement was patterned after the can settlement. Shortly after that, aluminum wire and cable prices rose by 5 percent, and the aluminum industry has planned, according to information that I have obtained, to increase prices of fabricated products by 6 percent in September.

And we also know, of course, that in July the postal workers reached an agreement with the newly independent postal corporation involving a billion-dollar increase in labor costs.

Now postage rates, as we all know, have steadily gone up in the past and a new increase reflecting these higher labor costs is probably inevitable.

Also in July the Communication Workers of America signed a new agreement with the Bell System which gave them a 33.5-percent raise over a 3-year period. Perhaps in anticipation of such a settlement Bell had obtained rate increases, and this is in the long lines department, of nearly a half a billion dollars in 1970 and the first 2 months of 1971. As of late February 1971 the Bell System had pending before the various State regulatory bodies applications for almost $2 billion additional rate increases; the exact figure is $1,946,900,000.

And, as we know, the most recent wage settlement was in the steel industry. The new contract price for a 31-percent raise over 3 years. The larger steel companies immediately announced plans for an 8-percent increase across the board. This is in addition to the steel price increases which took place earlier this year.

Now, Mr. Chairman, the reason I made reference to these wage increases, it seems to me that after the 90-day freeze and the moratorium, that the critical issue will be for some mechanism, for some policy, that some legislative authority be developed which will deal with the problem of dominant power in industry and dominant power in labor of making these kinds of agreements which have created this cost-push type of inflation. There have been suggestions that a selective price control system may be the answer. I do not know. I do not have the wisdom other than to suggest the problem, but it seems to me that possibly, and I know this is anathema and a red herring to most labor and large industry, certain antitrust concepts may be involved here, and that is when a dominant, strong union, doing its job as best it can on behalf of its constituency, gets together and forces a wage increase of the settlement of the magnitudes that I have referred to, and immediately thereafter it is reflected in the price level, that calls for the wisest consideration that I think the Congress and the administration can muster. Mr. Taylor will well remember during his days on the Wage Stabilization Board collective bargaining was still in process, but under no circumstances would we permit a price increase as the direct result of a negotiated wage settlement. We said the collective bargaining process had to be exhausted, we would take a look at it and if industry could possibly absorb all or part of a wage increase, we would require them to do so.

As Mr. Taylor can say with all of his experience and expertise, I think that that contributed somewhat to the moderation at the bargaining table on both sides, a characteristic which has been lacking in the recent settlements to which I have referred and which, in my view, are responsible for the problem we are facing today.

Mr. Chairman, I would be glad to undertake to answer any questions.

Chairman PROXMIRE. Thank you very much, Mr. Porter.

Mr. Taylor, go right ahead.

Mr. TAYLOR. Shall I proceed?

Chairman PROXMIRE. Yes.

STATEMENT OF GEORGE W. TAYLOR, PROFESSOR OF ECONOMICS, UNIVERSITY OF PENNSYLVANIA

Mr. TAYLOR. I sort of agree with Mr. Porter about the worthwhileness of the freeze that was undertaken. I do differ with him with respect to waiting until the end of 90 days before mechanisms are considered to deal with gross inequities. Especially is this true with respect to some current labor agreements. People do feel that there are such great inequities involved in the arbitrary cutoff date. I am not talking about the substance of our policy but a procedure.

You can say that this immediately leads into bureaucracy. Well, you do not control wages and prices without some bureaucracy. It cannot be done solely on a voluntary basis. The voluntary approach indicates that those who are good fellows are at a disadvantage compared with those——

Chairman PROXMIRE. Are you saying you have to develop that enforcement bureaucracy during this 90-day period and not wait until the end and put it into effect after the freeze, more than we have now, sort of an OPA?

Mr. TAYLOR. Some due process for people to express their feelings, deep feelings, about gross inequities.

Chairman PROXMIRE. You are calling for it right now?

Mr. TAYLOR. I never like to take steps 1, 2, and 3 until I've thought out 8, 9, and 10. Maybe step 4 has not been thought out in this case. At step 4 people with a grievance should have a forum before which they could express their dissatisfaction.

Chairman PROXMIRE. Well, at the present time, as I understand it, the administration's feeling is that the OEP, the Office of Emergency Preparedness, is some kind of a forum of that sort.

Mr. TAYLOR. I understand.

Chairman PROXMIRE. You feel that is inadequate?

Mr. TAYLOR. I do feel this is inadequate. The freeze involves very technical complex questions.

Chairman PROXMIRE. And you think they should provide this kind of forum, this kind of opportunity for people to take their inequities and complaints, that should be developed within a matter of days, is that right?

Mr. TAYLOR. Indeed, and out of the complaints that would arise from the claimed inequities there might be the straw from which you can build a policy based upon an analysis of what is taking place.

Chairman PROXMIRE. I see. So that the kind of forum in which you develop a more permanent arrangement would merge out of the complaints that you received, that processing those complaints, the inequities that you experienced rather than the freeze itself.

Mr. TAYLOR. At least they would be real complaints and not imaginary ones so that the 90-day period could provide a means of really more carefuly evaluating the nature of the problem.

I understand the desire not to have a bureaucracy but when you get into these fields some bureaucracy, it seems to me, is unavoidable.

So, I do have that footnote to Mr. Porter's statment.

Mr. PORTER. Mr. Chairman, I would like to say that I did not intend to imply—I agree with Mr. Taylor—that everybody should sit on his hands during these 90 days. Obviously, gross inequities should be considered but I think more importantly planning for what is called phase 2 should move rapidly forward, that is what I intended to say.

Chairman PROXMIRE. I think both of you gentlemen are in agreement on that but I think Mr. Taylor's position is that there is now no opportunity for people with a grievance to have a hearing and to have something evolve out of it and on the basis of it develop an experience which will permit a fairer ruling or a fairer enforcement in the future. That is not in existence, that phase at the present time, is that right?

Mr. TAYLOR. That is my step 4. I think Mr. Porter and I would both recommend that after 90 days a solid step 5 should be ready. I think we can get too complacent about going through the 90 days without due process and that people, rightly or wrongly, will develop strong feelings about inequities not covered during the 90-day period.

Chairman PROXMIRE. I think Congress will be back, having been out in their States, be back, with a tremendous number of complaints. I was out in my State this weekend, and by and large they approve it, the polls showed they approved it, they wanted it, they were fed up with these inflationary conditions and feel the President has done the right thing. But many people are very unhappy about the inequitable position they have been put in and, as you say, there is no place to go.

Mr. TAYLOR. Exactly so, and this can boil up a great deal in the 90-day period.

The same thing applies to strikes about which I am going to talk a little bit later. It is one thing to say "Don't strike," but then you have to provide an alternative means for developing the differences that are at issue. This cannot be in limbo either, and it is one thing to say, "Don't strike" but quite another thing to say, "Go before this Board and present your case." It is related to the first point that I made.

Of course, judgments can differ on whether you can freeze for 90 days without recourse made available to those who have grievances. I think it is a very dangerous approach to assume.

Chairman PROXMIRE. Well, whether you can or not I take it your conclusion is you will have a better situation after 90 days if you meet the legitimate objections in some way.

Mr. TAYLOR. Indeed.

Chairman PROXMIRE. At least, hear them and try to find out what they are and try to modify the situation after the 90-day period is over in view of the difficulties.

Mr. TAYLOR. Indeed, this is the basic to the comment I have made, and I am sure Mr. Porter would add that to his—or I am not sure.

Mr. PORTER. George, I used to have a big pennant back of my desk which saved me an awful lot of time. It read in letters that high, "Now take my case", if you have some citizens with a price grievance, he would usually say, "I am against inflation but now take my case," and he would look up at my sign. [Laughter.]

Mr. TAYLOR. When I was talking over with my colleagues here about what I was going to say I said this could be like yesterday's newspaper, and Mr. Porter said, "No, it could be archeology." On the other hand, sometimes you get something out of yesterday's newspaper if you are discerning enough.

The big difference, I think, on the wage side and the strike side in World War II, and the Korean war was simply this. We had a no-strike agreement for World War II, which we did not have for the Korean war.

The trouble when you have the right to strike and wage settlement by formula is that you have two methods for determining what the proper wage is going to be. They give different answers. This was true in the Korean war, as my colleagues know. The Wage Stabilization Board at that time set up a formula based on the old Little Steel formula with modifications. But the right to strike was maintained and it was legal. Unions could opt for taking the formula or the strike, whichever served their interest the better. The Wage Stabilization Board broke up when the steel workers decided not to follow the stabilization program, guides, guidelines, but rather to exercise their right to strike. This is probably the most difficult and disturbing aspect when a free country goes into the business of limiting the latitude of both unions and management in respect of the prices which they charge for their services and products.

Fortunately, in World War II there was a summit conference, you know, right after Pearl Harbor in which labor and management and the Government got together and agreed upon the conditions under which there could be a voluntary revocation of the right to strike.

Now, the circumstances were then different than they presently are, I understand that. But it is well to recall that the labor representatives said:

> We will give up the right to strike if you establish a tripartite board on which we sit, and we will accept the majority ruling of that board as a substitute for the strike.

Well, as I look back on those archeological days, the power behind the agreement was that when a strike did occur it was the responsibility of the labor leaders to get it settled. I must say many of them did valiant service in taking on that responsibility and going out and saying, "We agreed not to strike."

It was quite different in the Korean war. The wage policy then established by the Wage Stabilization Board, because of the retention of the right to strike, was in reality comparable to the voluntary guidelines of more recent vintage where the right to strike was also retained.

I believe that in a country such as ours the way to limit the right to strike is by agreement of those whose right is directly affected and who, in the last analysis, have to make the no-strike program work. This is what is so distressing to me about the announced inability of the organized labor movement now to cooperate. We ought to be able to cooperate. This kind of cooperation has to be rebuilt, as it had to be rebuilt during the Korean war when all the labor representatives at all levels pulled out from cooperation with the Government. It was extremely critical that this cooperative endeavor again be reestablished.

Chairman PROXMIRE. Refresh my memory on that. I do not recall that. You say during the Korean war the labor leaders pulled out of cooperation with the Government on price stabilization?

Mr. TAYLOR. They did indeed. May I be personal about this?

Chairman PROXMIRE. Yes, I wish you would.

Mr. TAYLOR. Mr. Truman had asked me to be Chairman of the Wage Stabilization Board during the Korean war. I felt unable to accept because you cannot run a wage stabilization program with the right to strike at the same time. The two routes give different answers. Well, some things happened and the labor movement all said:

> We will not cooperate with any governmental agencies at all.

They pulled out from all of the agencies, I have forgotten the year, would you remember that—1951, and I remember the President saying:

> Our big job here goes far beyond wage stabilization. It is that an important segment of our population feels that it is at odds with our Government.

The job then was to get the labor representatives to return to cooperate with the Government. This we succeeded in doing.

But then, we were unable to get a firm agreement on a wage policy.

Chairman PROXMIRE. Let me just interrupt to say, Mr. Taylor, the trouble I am having with your suggestion of trying to fit it into the present situation is that the administration has asked that unions not strike, they just asked they not do it, with no penalties, no law, and they just said, "We hope you will not strike." Now during this period you say you should substitute something for the strike. It is awfully hard to see how you can substitute anything under these circumstances. You have a freeze which means no increase in wages. How do you negotiate that? After the period Secretary Connally, who is the expert in this area, says "We do not know. We do not know." So, there is no way you can negotiate something where you have a government which is in a position to stop an increase but have not indicated what it is going to do about it so I do not see how you can substitute any action for the strike now at the same time we are in such a weird and unusual and almost unprecedented situation. I do not know, I do not see what labor can gain by a strike now.

Mr. TAYLOR. Well, they can stop work.

Chairman PROXMIRE. They can stop work. What does that gain them, how do they negotiate?

Mr. TAYLOR. I do not know.

Chairman PROXMIRE. It seems to me management is in a position where they cannot very well agree to a wage increase.

Mr. TAYLOR. I understand.

Chairman PROXMIRE. If they do they cannot reflect their increased costs in their prices.

Mr. TAYLOR. Senator, the problem goes deeper than the union because it involves the people in these factories and plants and so forth, all of whom have been led to expect——

Chairman PROXMIRE. Now, addressing yourself on the present situation where you have a freeze that is going 90 days, with no notion of what is going to happen in the future but a freeze on wages and prices, what kind of recommendations would you make that you think would be realistically acceptable to organized labor?

Mr. TAYLOR. Well, the second part I do not know. This is a bargaining——

Chairman PROXMIRE. That is what we have to live with.

Mr. TAYLOR. Except for this.

Chairman PROXMIRE. We have to recommend something.

Mr. TAYLOR. There should be available a forum by which these disputes which should, that could, erupt into a strike would be worked out well enough so that the problem could be faced. It could very well be that modifications of the freeze in the 90-day period would be a desirable thing to do in order to avoid exceedingly gross inequity. But this is a matter of high policy, and I understand the difficulties of it. But this is not an easy situation either.

Chairman PROXMIRE. So you are saying as Paul Porter told us and I thought there was a kind of fundamental principle, that many people can accept with enthusiasm, no exceptions, you have got to be tough during this 90-day period, you are saying well, you have to look at the practical situation here and you may have to make some exception even during the 90-day period, is that not right?

Mr. TAYLOR. You can be tough but if you are wise or foolish about being tough the results are quite different. I do not think toughness in itself is necessarily a virtue.

Chairman PROXMIRE. Well, certainly during 90 days, if we cannot have a situation where we stabilize wages and cut into this wage-push inflation we have during the 90-day period we do not have much basis for winning public support, do we, for this program?

Mr. TAYLOR. You do not win public support if some people are going to be so adversely affected in their position by virtue of an arbitrary date. If a wage increase, for example, was quite valid on one day and the next day it is not, it is going to be very difficult with that group of people to say——

Chairman PROXMIRE. Maybe we can do better if we get to specifics. Can you think of any group, the teachers, for example, are one group, the Government workers in Texas and in other States, or the State workers are another kind of group, the labor unions. UAW, for example, has a contract which right after the 90-day period brings them a 3-percent increase, that is another kind of category. Can you think of any of those where the Government might possibly go ahead and provide an exemption?

Mr. TAYLOR. Yes; I could in automobiles, for example.

Chairman PROXMIRE. UAW.

Mr. TAYLOR. If the Board would say, "Now we understand that inequities have been created by virtue of this date between the basic automobile manufacturers and the suppliers, there is an inequity which has to be brought into account in the final wage which is going to be paid," and I would set up an agency by which the nature of that inequity would be worked out and presumably a decision made after 90 days. If you wish, because these wages are going to go up in the last analysis, and I think the labor market is going to see to it that this happens. You can freeze for a while and then you unfreeze.

Chairman PROXMIRE. Well, I think that almost everybody agrees that after a 90-day period you have to have kind of an adjustment to recognize at least the productivity increases in our society where compensation can increase consistent with stable wage costs, consistent with stable prices.

Mr. TAYLOR. Yes.

Chairman PROXMIRE. The big issue is whether or not you can hold down that wage increase close to the productivity increase so that you can break the back of inflation, at least the very high inflation rate we are suffering.

Mr. TAYLOR. I have great doubts whether you can break the back of it by the freeze without the procedures I have talked of.

Chairman PROXMIRE. All right.

Mr. TAYLOR. Because resentment can gather and final settlements may be more costly than they otherwise would be, because do not forget, when a union signs an agreement it has to be ratified by its membership. The moods of the membership can be extremely important to both management and labor, as to whether to sign an agreement. In other words, I would do some things looking now to how you are going to get out of the freeze.

Chairman PROXMIRE. Well, I certainly agree with that but it would seem to me that rather than pick out the auto workers or any other group, strong as their case may be, for exception, it would be best to develop some kind of principles——

Mr. TAYLOR. I agree.

Chairman PROXMIRE (continuing). And try to stick with that which would permit a wage increase. After all, we had wage increases in the period 1962 to 1966 when we had stable wage costs, that is perfectly possible and consistent.

Mr. TAYLOR. Yes.

Chairman PROXMIRE. Wage increases, but those wage increases should be based on some principle which we could apply across the board.

Mr. TAYLOR. It could very well be, you know, that a hearing on some of these cases could be a show-cause hearing, which would at least channel conflict, which is really what we are talking about how we channel conflict, and maybe show-cause hearings would be the thing to do.

Chairman PROXMIRE. Thank you very much, Mr. Taylor. I want to ask you gentlemen some questions.

Mr. TAYLOR. May I say one other thing, Mr. Chairman? There is one aspect of the more recent experience with guidelines that is important. I happened to have been on the President's Advisory Committee on Labor-Management Policy at the time the guidelines of the two previous administrations were in effect. There is talk about those guidelines being resurrected or something like them. You know, however, those guidelines started out to be wage and price guidelines, and there were, if you read them, you will find there were conditions under which prices should be——

Chairman PROXMIRE. You are talking about the guidelines in the Kennedy and Johnson administrations?

Mr. TAYLOR. Yes, I am. There were conditions under which prices, spelled out under which prices, were to be decreased. Well, by some means, I do not know just how this happened, it all simmered down to a 3.2 control of wages, and——

Chairman PROXMIRE. That is about all you got out of it.

Mr. TAYLOR. Excuse me?

Chairman PROXMIRE. That is what you got out of it.

Mr. TAYLOR. That is what got the emphasis, and while there was jawboning and this sort of thing, it was always you do not raise prices as much as you otherwise would have or you do not raise prices. I do not know of a single case where any issue was made of the price decrease which was——

Chairman PROXMIRE. I think maybe in the appliance industry you got some price decreases, there were a few exceptions.

Mr. TAYLOR. I do not know about any governmental action with respect to effectuating that part of the guidelines and, of course, it turned out to be a 3.2 percent wage guideline. For reasons I will not bother you with, I think was a very faulty guideline. The 3.2 percent was based on factors which do get talked about around the bargaining table. I never—one exception which I will not go into, I never—heard management and labor say, "Well, what is the increase in national productivity?" This is not mentioned when people start talking about wages. They talk about cost of living.

Chairman PROXMIRE. There was a new concept, maybe it was right, maybe it was wrong, but it was based on the notion that we could theoretically, at least, pay 3.2 percent more because that was the overall growth of productivity in the economy across the board and then in those industries which were more productive than 3.2 they could have price increases, 3.2 they would have price stability, less productive they could have some modest price decreases.

Mr. TAYLOR. But then, of course, this price aspect to which you just referred was never effectuated as respects the cuts that were supposed to take place. It is fair to say that when labor was being asked to hold to the 3.2, this was predicated upon a stability of prices.

Chairman PROXMIRE. I think this is very helpful because you are focusing now on what I think is the problem with our present situation, that is why labor feels they were burned in the 1962–66 period.

Mr. TAYLOR. Indeed.

Chairman PROXMIRE. You had profits increased 60 percent, you had wages increased for organized labor about 16 percent, about one-fourth as much. They feel they made the sacrifice.

Mr. TAYLOR. Sure.

Chairman PROXMIRE. And they got—management and stockholders got the benefits.

Mr. TAYLOR. And they did moderate their wage demands during part of this period.

Chairman PROXMIRE. The big unions did.

Mr. TAYLOR. The big ones did, and they were being asked to stabilize their wages on the ground that prices were stable, where prices were not stable at all. So it was an entirely incongruous situation for them. Well, I have taken too much time.

Chairman PROXMIRE. No, you have been fine.

Mr. DiSalle.

STATEMENT OF MICHAEL V. DiSALLE, ATTORNEY AT LAW, WASHINGTON, D.C.

Mr. DiSalle. Mr. Chairman, after listening to Paul Porter and Mr. Taylor, I am terribly concerned about the condition we are in.

Chairman Proxmire. Will you pull the microphone closer?

Mr. DiSalle. I said, I am terribly concerned about the condition we are in. But actually, I agree with most of the statements made by both.

But I want to point out a few things about some of the differences that exist today with the situation that existed both in World War II and Korea.

We talk about the need for a large bureaucracy. In World War II we had rationing, which is not a need today, and was not a need during Korea. We had plenty of goods and we have plenty of goods today.

When we entered into Korea in June of 1950 there was a great deal of talk about price and wage control and nothing was done for a long, long time but debate on the subject helped feed the inflationary fires between June and January. The inflation of those days was not caused by lack of goods but by the wage-price spiral that was accelerating at the annual rate of 13 percent, between June 1950 and January 26 of 1951, when the freeze was imposed.

During 11 months following the freeze 1951 prices were held to a 4-percent increase, and in the following year, 1952, they were held to less than 1 percent. So it demonstrates that price controls, price-wage controls, were effective during that period, they can be effective today providing they are administered effectively.

Under the present system, the 300 people in OEP won't be able to answer the phone calls that are generating throughout the country today. I know congressional offices that are being swamped by inquiries and that are having trouble getting through to the various offices to try to get information for their constituents. This is bound to cause trouble.

In 1951 we very seldom heard about conglomerates. Today they are a large part of our economy. In 1951, between 1951 and today there have been great changes in productivity, improvement in productivity as a result of improved technology so this is a new factor that has to be considered.

We talk about whether or not people are going to be satisfied. Of course they are not going to be satisfied. Consumers are not going to be satisfied because prices are never low enough for the consumer. The businessmen are not going to be satisfied because prices are never high enough for the businessmen. If we look back today at the price levels of 1951 we find there has been a substantial change and the consumer was still complaining in 1951 about the size of the prices.

I think the principal cause of inflation today is the lack of competition in certain areas. Large labor unions are much more powerful than they were and certainly business itself is much more powerful and the lack of competition certainly does not make it necessary for them to put on a big fight about a wage increase which can automatically be passed on to the consumer.

Now we are not going to be able to have effective price controls in this period unless we do something about everything along the line. You can't hold beef prices and permit the price of livestock to go up; you can't hold the price of a cotton shirt and permit the price of raw cotton to move up without some sort of controls. I cannot agree more with Mr. Taylor for the need of some type of machinery where people can go and get answers. This is part of the effective administration of the program. Without it you might as well give it up right now.

We talked about November 12 as the final date. November 12 can be the biggest price holiday in the history of this Nation, if we just let November 12 come along and say "this is the day that all controls are off and people can fix their own prices." There would be a catchup period, they will be catching up for the 90 days that they were held in restraint, so it is necessary right now to start building the kind of an organization that will phase out the freeze, phase it out in those areas where there is no substantial impact on the economy. Phase it out——

Chairman PROXMIRE. Such as?

Mr. DISALLE. What?

Chairman PROXMIRE. Such as?

Mr. DISALLE. Well, let's say canned rattlesnake, and chocolate covered ants. There are millions of items.

Chairman PROXMIRE. Are you saying you phase it out where you have small firms that manufacture goods that are in competition?

Mr. DISALLE. Those where the impact on the economy is not substantial and this you can do and you can then devote your organization that you had to those areas where there are inflationary fires still burning.

Chairman PROXMIRE. Now you say you can phase it out with respect to certain prices in competition. How about phasing it out with respect to certain particular wages.

Mr. DISALLE. I think that can be done.

Chairman PROXMIRE. For example.

Mr. DISALLE. For example, let me give you one instance:

We had a glass manufacturer come in and ask for an increase on the basis of having a hardship. We reviewed the case and decided there was a hardship.

We granted a price increase. For fully a year after that they were never able to place this increase into effect because the competition was so strong, and would not move their prices up, they kept their prices level. So the number four manufacturer had to hold his in order to stay in business, even though he was having great difficulty. In many areas, we have automatic price controls and always have them.

Chairman PROXMIRE. You see, Mr. DiSalle, what bothers me about this is that once you begin to exempt any significant group, once you begin to make any substantial exception, I would be afraid the whole thing would crumble inasmuch as this is pretty much a voluntary operation anyway. You can say we can apply that $5,000 penalty which we have in the law in some areas and not others but even the President indicated, and I think he is right, this is going to take a great deal of voluntary cooperation. We don't have a popular war going on. You say we will have to exempt a substantial number of people, and you can't do that during the 90-day period. If you do that, isn't it a formula for torpedoing it on the ground? It is not consistent, not fair.

They can point to a neighbor getting an increase; they can point to another businessman getting a price increase, and he is not. Don't you have a pretty difficult situation unless you make it universal?

Mr. DiSalle. Mr. Chairman, OPA was the result of a failure of the voluntary approach, OPS was the result of failure of voluntary approaches, the present freeze is the result of the failure of the voluntary approach. You can't have them. But you can do this, you can hold prices and you can hold wages but in those areas where prices and wage controls are not necessary you can decontrol and get rid of an administrative burden and use your organization where it is necessary.

In late 1953 when OPS was finally wound down, we had achieved stability in most price areas, and price stability can be achieved, but there is no need in wasting your time on those areas which are not important to the economy.

Chairman Proxmire. You say the areas that are not important to the economy you can permit to pay wage increases and permit——

Mr. DiSalle. I don't think——

Chairman Proxmire. And provide price increases if they wish to do so.

Mr. DiSalle. They are ordinarily not in position to produce wage increases or price increases or to achieve them. Many luxury items——

Chairman Proxmire. What you say is not inconsistent with what the economic experts told us, Heller, Eckstein, Schultze, and Saulnier and the others. They seem to feel you should end up when the 90-day period is over concentrating on the big companies, say the hundred biggest companies, in the country, maybe 500, and you should concentrate on the big labor unions. I am not sure I agree with that description because how can you get the big labor unions to agree on that? I must say if I were the head of a big labor union I would be pretty reluctant, or if I were the head of a big company, that I am going to have my price frozen but the others are not. I wonder what you tell the other people? There are going to be exceptions to the rule? It is one thing to say everybody has to stay in line here; it is another thing to say we are going to single out some and say you are going to have to be limited but we are going to have to exempt the majority.

Mr. DiSalle. For example, if in some area where you have people come back with what you think is an unfair price increase which breaches the line, you can still bring it back under control and roll prices back. With that threat alone only people who are very necessarily in need of an increase would risk increasing their prices.

Chairman Proxmire. I would like to ask you gentlemen a number of questions here. There are so many I am not sure exactly where to start, but let me start with this. First, the price wage freeze represents a number of enforcement problems and you gentlemen represent the voices of experience in enforcement, you all had very big and significant responsibilities, you all did extraordinarily well, in my judgment, so I would like to get your comments on the following. To what extent is monitoring in compliance with a freeze necessary? How can this monitoring be accomplished?

Mr. Porter, in other words how do you tell whether or not it is being complied with?

Mr. Porter. Well, you have your traditional and standard measurements of the BLS index but there is always a lag. I think spot checks are one way, consumer complaints——

Chairman PROXMIRE. Do we have the capability now? The OEP does not have the personnel to make spot checks.

Mr. PORTER. I say they are mobilizing everybody from the Internal Revenue Bureau——

Chairman PROXMIRE. Mobilizing what?

Mr. PORTER. The Internal Revenue Bureau is answering questions.

Chairman PROXMIRE. They are answering questions but are they making spot checks?

Mr. PORTER. That I doubt except as reflected——

Chairman PROXMIRE. At any rate you say we should have an agency to make spot checks to make sure that the wage and price freeze is being complied with.

Mr. PORTER. I think so. Consumer complaints are another one, and this is the age, as the chairman well knows, where there is a vocal, conscious consumer, and I think you will hear a great deal from the consumers. Certainly my own experience on the rent control program, I think the basic key to the success of that program was, along with the strong protests of the real estate protests, we required the registration of every defense rental unit in this country, millions of them, and this was in triplicate. One copy went to the Defense rental office, one went to the landlord, and another went to the tenant. You can be sure if there were any inaccuracies in the tenants' copy the area rental office promptly heard it and that was one of our built-in enforcement techniques.

Now in addition to that——

Chairman PROXMIRE. How many people did you have administering this?

Mr. PORTER. The rent program?

Chairman PROXMIRE. Yes.

Mr. PORTER. For rent alone there were over 7,000.

Chairman PROXMIRE. How many were administering the OPA altogether?

Mr. PORTER. 75,000.

Chairman PROXMIRE. 75,000?

Mr. PORTER. And 250,000 volunteer price and rationing boards.

Chairman PROXMIRE. How many were involved strictly in wage and price monitoring, and so forth, and not in rationing?

Mr. PORTER. Not in wages.

Chairman PROXMIRE. Because one of you gentlemen made the point, I don't know which one of you did, we don't have the problem of shortages now, or rationing.

Mr. PORTER. That is right. There would be no problems in black markets.

Chairman PROXMIRE. How big a group in your judgment should there be in that agency if it is going to work during this freeze period?

Mr. PORTER. Well, I wouldn't venture a guess on that, Mr. Chairman. I think it depends largely on what the price movements are.

Chairman PROXMIRE. Let me ask it the other way: Can the OEP with the help of the Internal Revenue Service do the job, in your view?

Mr. PORTER. I would have reservations about it, grave reservations.

Chairman PROXMIRE. What other agencies should be brought in?

Mr. PORTER. Well, I don't know whether the Department of Commerce, other established agencies, should get into this area or not. We all want to avoid, and I am sure the President does, based on his brief experience as an OPA rationing attorney, the development of a large establishment for the purpose of administration. I think a few selective enforcement cases may have during this brief period a very salutary effect, to show that you mean business. I don't believe evangelism or exhortation alone will suffice. If that was so, Billy Graham should take over the job. But if there is egregious violation of what is essentially a voluntary kind of program, the Congress has given authority through the injunctive process in the Federal courts or through the civil penalties of a fine not to exceed $5,000. I don't see any real economic pressure except this cost push that I have referred to. I am inclined to agree with Mr. DiSalle that the task of the next 90 days is to see what procedure can be developed for a selective program in your big items, the large industrial units, the large powerful labor units, who say that might result in discrimination.

I am thinking if George Taylor were administering the program an accommodation could be worked out which would be not too much of a hardship.

The hardship cases are the obvious ones that must be dealt with. and I have reservations as to whether existing personnel or methods are adequate for that purpose.

Mr. DiSalle. Mr. Chairman.

Chairman Proxmire. Mr. Porter says about 7,000 people including the rationing program.

Mr. Porter. Excluding rationing.

Mr. DiSalle. But that includes the enforcement people and collecting information.

Mr. Porter. Which I liquidated.

Mr. DiSalle. In OPS we had about 12,000 in which 3,000 were enforcement.

Chairman Proxmire. You had 12,000 in the Korean war.

Mr. DiSalle. I think that would be more than adequate in this type of program, more than adequate.

Chairman Proxmire. You think there should be an agency consisting of 5,000 or 10,000 people perhaps to enforce this and provide information?

Mr. DiSalle. I think that is the only way the program can be successful.

Chairman Proxmire. It needs that to be successful.

Mr. DiSalle. It needs that, every bit of that.

Chairman Proxmire. Would you agree with that, Mr. Taylor?

Mr. Taylor. May I make a comment?

Chairman Proxmire. Yes.

Mr. Taylor. We did not have a large staff on the Labor Board in World War II largely because of the cooperation of the union representatives. The staff was somewhat larger in the Korean period but I don't think it went over 3,000. There is one aspect relating to the administrative problem mentioned by Mr. DiSalle. We looked very clearly at these administrative problems during World War II and concluded we could attain our stabilization objectives even if employers with less than eight employees were excluded. This cut down the administrative problems greatly. After further checks and added experience it seemed possible to exclude employers with 12 or less employees without interfering with the total program.

Chairman PROXMIRE. I see.

Mr. TAYLOR. But I doubt the worthwhileness of building up a bureaucratic staff in order to deal with all employers—employers with eight or 12 employees for example.

Chairman PROXMIRE. I think we would all agree on that. Then we move to the question of excluding everybody and limiting it only to the 100 firms.

Mr. TAYLOR. Look, life is inequitable and there are going to be inequities here, we all have inequities but from an administrative standpoint we felt we could not complete our objectives unless we excluded——

Chairman PROXMIRE. Under present circumstances, Mr. Taylor, how large an agency is required and is OEP the agency?

Mr. TAYLOR. I wouldn't know about OPA.

Chairman PROXMIRE. OEP.

Mr. TAYLOR. The price administration was on my mind and I am not in a position to comment on that. I do not think a large agency would not be required in the wage area if the cooperation of the labor leaders is achieved. Organized labor is a power in the country that can't be ignored and, I might say, some labor leaders, before this recent upsurge, were quite willing to start talking about voluntary arbitration over the terms of new agreements. The rank and file just wouldn't go along with it. Some of the top labor leaders are aware of the desirability of trying to develop substitutes for the strike.

Chairman PROXMIRE. In light of that would you agree with the assertion made by one member of the administration, I am not sure who it was, that Mr. Meany, President George Meany, is sadly out of touch with his members in opposing the President's freeze? Do you agree with that?

Mr. TAYLOR. No, I wish he was but I think that he reflects his membership and what they seek.

Look may I——

Chairman PROXMIRE. Yes, go ahead.

Mr. TAYLOR. After all, war and inflation are fellow travelers because of the deficit financing that is involved. Right or wrong we have raised the expectation of people that we were going to fight this Vietnam war at the same time the standard of living was going to keep on rising. I think—from my own point of view, I think—that we might be facing a time where the standard of living from the private sector will decrease if we are going to provide the social services which are necessary to keep us on an even keel. I believe we are going to have to buy more social services. It does not give me any joy when I see the GNP go up and realize it could be all bubble gum and confetti. We have been conditioned, I think, to expect the steadily rising increase in consumer goods despite vast increases in social services. Perhaps the productivity factor is over emphasized. Are we going to have enough productivity to meet (*a*) whatever defense needs there are, even after the war is over; (*b*) these great increases in social service needs, in which we are not going to get great productivity increases; and (*c*) everybody's desire for three and four automobiles. I think we could have a run on the productivity bank. Somehow or other folks have to realize that perhaps having a third television set in the house could interfere with the development of a good school system.

But in any event, I think this has become something of a cliche, all you have to do is have enough productivity to do all of these things with a stable price level. I have great doubts about whether we can achieve that kind of productivity.

I might say, too, that the immediate increases in productivity are very frequently accompanied by loss of jobs in the short run at least and not by an increase of jobs. New machinery and so forth is going to be labor saving.

Chairman PROXMIRE. These are very interesting and fundamental points, let me get back to them.

Mr. TAYLOR. I am sorry.

Chairman PROXMIRE. No, that is fine. I understand that OEP has an executive reserve program by which industry executives would be called into Government service to administer wage and price controls. Should that program be activated? Mr. Porter, do you know about that?

Mr. PORTER. I think, Mr. Chairman, any resources of manpower that are available to get broad public participation in this program are helpful. But I might add that I believe that sellers generally, responsible sellers, retail level, to the basic production level, will be inclined to voluntarily comply with this program.

Now, I remember my distinguished predecessor, Mr. Bowles, used to say 95 percent of the business community are honest and patriotic and 5 percent we have to go after. One of my staff put it another way by saying a hundred percent of the business community is 95-percent honest and you have to regulate them all.

But I don't believe in the absence of shortages, scarcity, that we need necessarily to build this kind of apparatus that Mr. DiSalle mentioned.

Chairman PROXMIRE. So you would not trigger that emergency program at present?

Mr. PORTER. Yes, I would trigger the executive pool that is there.

Chairman PROXMIRE. You would.

Mr. PORTER. To explain, report, and to try to win public acceptance because I agree with Mr. Taylor that there must be some place for an aggrieved citizen or producer or consumer to be heard.

Chairman PROXMIRE. Then I take it that both you and Mr. Taylor agree, and I am not sure about Mr. DiSalle, you should beef up the present organization administering this program at least to the points of having an office to which the aggrieved parties, labor unions, businesses, and so forth, can come with their grievances and their inequities and expect to get some redress or at least get some attention with recommendations for redress perhaps right after the freeze is over; is that correct?

Mr. PORTER. I think that is part of our system.

Chairman PROXMIRE. How do you feel on that, Mr. DiSalle?

Mr. DISALLE. I feel strongly about it. I think it is a great necessity. One of the troubles we had in OPA in recruiting was to get businessmen into the program and if they have a reserve they ought to get to them right away.

Chairman PROXMIRE. One of the difficulties here is whether the program presently conceived and enunciated by the President and Secretary Connally requires union cooperation. We have had a chance to study the AFL-CIO statement, the staff did, over the weekend and I understand they take a very strong position they want some kind of profit control, they want some kind of interest control, they want some limitation on the return on capital. They say the return to the working man is limited why shouldn't the return on capital be limited. If we do that it is going to require considerably more enforcement machinery I would think. It is quite complex on the basis of the testimony of the economists I think. How do you gentlemen feel about the possibility of controlling interest rates and profits or the wisdom of doing so and whether or not this is a price that has to be paid in order to win labor cooperation which you gentlemen say is essential.

Mr. Taylor, will you lead off on that?

Mr. TAYLOR. I think we can say this, profits have been relatively stable for quite a period of time now; that is, the percentage return on sales, percentage on investment, et cetera. Perhaps this is a matter on which organized labor might be ready to explore through some study. In other words, there could be agreement on a procedure for examining this question, rather than dealing directly with the substantive issue.

In labor relations you often do this; that is, if you can't solve the question directly you set up a study commission.

Chairman PROXMIRE. Well, you are an eminent economist with a lot of experience, so I would rely very heavily on your advice. Do you feel it is practical—you say a study, do you feel it is practical—to develop a system of controlling profits and interest? What does our experience in World War II and the Korean war tell us about it?

Mr. TAYLOR. We had a surplus profits tax in World War II and the Korean war.

Chairman PROXMIRE. That is right, how about that?

Mr. TAYLOR. I would not comment on whether it is advisable or not. I would like it studied as to whether or not——

Chairman PROXMIRE. If you won't comment on it now how about commenting on whether or not it worked well in World War II and in the Korean war, the excess profits taxes we had then?

Mr. TAYLOR. Yes. I think it worked.

Chairman PROXMIRE. Was it desirable and necessary?

Mr. TAYLOR. I think it is not necessary now.

Chairman PROXMIRE. What you are saying is that in World War II and the Korean war they had a limitation on profits, now you don't. You are limiting wages now.

Mr. TAYLOR. I think the problem was quite different then than it is now.

Chairman PROXMIRE. All right, how?

Mr. TAYLOR. Because we had sudden increases in demands for certain products in short supply and could not expect an inflow of capital to meet the demands. I thought the necessity was much greater there than at this time when we have much unused capacity.

Chairman PROXMIRE. Do you think that the labor unions would be satisfied if the Nixon admnistration, if Secretary Connally, with their background, their reputation, their demonstrated attitudes, would say "well, we are going to study profit controls, we are going to keep in effect wage controls but we are going to study profit controls" do you think that would satisfy labor?

Mr. TAYLOR. No, I happen to see great values in my field, in the tripartite approach. I have seen it work too well in too many ways. For example, I thought the advisory committee in which I had the honor to serve did well in terms of certain recommendations it made on the tax cuts a few years ago to get the economy moving again. I believe it would be less likely that the tax cut would have been feasible unless it had labor and management support as it did at that time.

I understand, of course, that much of the tripartite discussion undertaken to gain agreement on income policies in Western Europe has not had such very good success. Nevertheless, I think it is our way out.

Chairman PROXMIRE. Rather than a limitation on return on capital you would suggest that you administer the program with labor cooperation and labor representation and labor having a voice in the kind——

Mr. TAYLOR. We were talking about how it could be studied, this whole question.

Chairman PROXMIRE. How it would be studied, I misunderstood you.

Mr. TAYLOR. Yes.

Chairman PROXMIRE. I see.

Mr. TAYLOR. I would certainly give labor a voice in this study that should take place. I don't think we should say "let's jump at a ready-made policy."

Chairman PROXMIRE. No, we are not jumping, we are asking for your recommendations.

Mr. TAYLOR. I understand and I give you my recommendations.

Chairman PROXMIRE. All right, we will study it.

Mr. DISALLE. Mr. Chairman.

Chairman PROXMIRE. Mr. DiSalle.

Mr. DISALLE. During the Korean war effective control of prices also resulted in an effective control of profits.

Chairman PROXMIRE. You had an excess profits tax.

Mr. DISALLE. That was on from World War II which had never been removed but pricing took that into consideration.

Mr. PORTER. I was going to make the same point, Mr. Chairman. This freeze freezes profit margins as well as wages.

Chairman PROXMIRE. Well, does it? After all, you have several elements, No. 1, if you have a stabilization of your wages, you don't stabilize productivity and you can't get away from productivity, no matter how you feel about it.

Mr. PORTER. For the short term.

Chairman PROXMIRE. It is increasing at a 3-percent rate so during this 90-day freeze productivity is going to continue to increase, I presume it has over the long pull of American history. If it does continue to increase then the beneficiary is going to be the stockholder and the corporation. Profits are going to go up as your productivity increases your wage costs are going down.

Mr. PORTER. As to increased profits, your corporate tax will claim a substantial portion of those profits and I would hate to see direct control of profits during the current 90-day moratorium.

Chairman PROXMIRE. This is where you really have a problem with labor because part of this package is what Mr. Heller called a $9 billion tax break for big business or for business with the rewriting of the depreciation guidelines, with the investment credit.

Mr. PORTER. I read the newspaper reports of Mr. Heller's testimony.

Chairman PROXMIRE. Yes.

Mr. PORTER. And I thought he failed to emphasize that the objective and purpose of that was to create jobs and which I understand is the objective, not as a largess or a gift or a subsidy to the industry.

Chairman PROXMIRE. At any rate you gentlemen feel, I take it, that Mr. Taylor has told us that he would like to see a study of this, and I take it both Mr. Porter and Mr. DiSalle would argue that effective price control would take care of the profit?

Mr. PORTER. For the short term; yes.

Chairman PROXMIRE. How about interest rates?

Mr. PORTER. Well, that gets into a theology with which I am not entirely familiar, and I assume——

Chairman PROXMIRE. What did you do about that?

Mr. PORTER. Well, one of the things that was done in World War II, as you recall, was the Federal Reserve Board then was following a policy of very, very easy money and throughout World War II we had the fantastic situation of an enormous demand for capital, I guess, but interest rates were very low, so low they were almost negative on short-term bills.

The Federal Reserve Board administered regulation W and that was control of credit, both consumer credit and credit for the capital market and thus indirectly. I think there are other ways of controlling interests.

Chairman PROXMIRE. Well that is not called for now because the purpose of that was to limit demands and we don't need that now.

Mr. PORTER. Precisely.

Chairman PROXMIRE. But we do have to be concerned about what happens to people with capital because interest represents their return and their compensation just as wages represent the compensation of working people. You would argue that in the present circumstances we should not limit that?

Mr. PORTER. I think the central bank, the Federal Reserve, has methods and means of controlling that without having to go through that freeze.

Chairman PROXMIRE. All right. How about the raw food problem? You gentlemen have had the best experience of anyone in limiting prices and so forth. I understood you to tell us that during a large part of the period in World War II that food was not controlled and you said prices went right through the ceiling on part of it.

Mr. PORTER. Fantastic.

Chairman PROXMIRE. Do you think we should have some kind of limitation on prices on food, raw food?

Mr. PORTER. The levels of farm income being what they are, I hesitate to enforce such a proposal. But I can show you the scars I have from the packers.

Chairman PROXMIRE. The what?

Mr. PORTER. The scars that I bear from the packers and the wounds from the livestock industry, and that was the thing that caused the early debacle of OPA. It was as simple as that, withholding of livestock, shortages of meat supplies, you can remember the black markets in meat, the great hue and cry of withholding of cattle from the feedlots, and the threat of legislative decontrol.

Chairman PROXMIRE. Of course, that was such an entirely different kind of situation.

Mr. PORTER. Yes.

Chairman PROXMIRE. Because you did have a tremendous demand throughout the world because of the war, you were feeding and providing food for Europe and our troops abroad with 16 million people in the Armed Forces, it was quite different then.

Mr. PORTER. The most perfect of all systems would be to bring all agricultural commodities into the orbit of the control system. Whether it is politically or congressionally feasible or not, Mr. Chairman, I would not know.

Mr. DISALLE. Mr. Chairman, we used parity during Korea. If the price stayed below parity we did not bother with it. If it rose to parity we had to move, and if it rose above parity then we would try to control it. I remember hog prices never did reach parity during the Korean war and a very important member of the House Agriculture Committee used to call us every day about whether we were thinking about placing basic ceilings on hogs. We did not fortunately have to face that problem. We did place ceilings on cattle and cotton.

Chairman PROXMIRE. I am taking from your various statements, Mr. DiSalle, you would feel you should not extend this to raw foods; is that right?

You are indicating the parts we should exempt right now of what we are controlling.

Mr. DISALLE. That is right, if the price has not reached parity.

Chairman PROXMIRE. So I take it your attitude right now so far as raw food is concerned we should not extend it?

Mr. DISALLE. Well, many areas where we should but if you are trying to control beef prices you had better try to find out what livestock is doing, and that should be controlled if it is causing upward pressure on beef.

Chairman PROXMIRE. All right. Then you would feel that we should include foods, raw food?

Mr. DISALLE. Well, actually as I understand I guess chickens are still under control, under the freeze.

Chairman PROXMIRE. Not live animals. If you are going to buy a chicken it is not; if you are going to buy one processed it is. If it is dead and frozen and packaged and what not it is considered processed.

Mr. DISALLE. I think raw food prices should be looked at, and controls maintained if they are causing upward pressures.

Chairman PROXMIRE. Mr. Porter and Mr. DiSalle, a question has been raised about the legality of the President's wage-price freeze. As outstanding attorneys with a great deal of experience in this field, do you have any opinion about the legality?

Mr. PORTER. Well, I don't know whether the United States is going to secede from Texas or not but I think under the Economic Stabilization Act, I believe it is called, of 1970, and the President having declared, as I understand it, a national emergency, he does have the constitutional authority to do it.

Chairman PROXMIRE. Of course, during World War II and the Korean war we had a military emergency, no question about it of great significance. Under the present circumstances do you think we have that now?

Mr. DISALLE. I think so. I think the President can declare an emergency without a shooting war even though he does have one if he wants to rely on it.

Chairman PROXMIRE. Of course, the basis now is the condition of the dollar in international markets.

Mr. DISALLE. Well, as a result of some other actions we have taken.

Chairman PROXMIRE. At any rate you feel there is a sufficient emergency to warrant the President's action?

Mr. DISALLE. Yes, I think it is something that a court will not inquire into as to whether or not the President really has an emergency. An emergency is what the President thinks it is.

Chairman PROXMIRE. All right. Now following up on that, how can we enforce this? I noticed in the paper yesterday that Mr. Morgan, who I believe was one of Mr. DiSalle's associates when he was in wage and price controls, expressed doubt that fines alone would be enough, and he also expressed doubts about voluntary cooperation.

Mr. DISALLE. I certainly don't think a $5,000 limit is enough. I remember one incident of a million dollar fine to attempt to recoup some of the ill-gotten profits.

Chairman PROXMIRE. Shall we change the law?

Mr. DISALLE. It has to be changed, we have to have stronger mechanisms than we have now.

Chairman PROXMIRE. Well, how serious should it be, jail sentences as well as fines?

Mr. DISALLE. Yes, and I don't think there ought to be any limit on the fines because the fine ought to be pretty well judged by the gravity of the offense. We didn't do too much so far as jail was concerned but fines we did levy in varying amounts.

Chairman PROXMIRE. Let me add to the question you gentlemen have dealt with, and dealt with it very well in some respect, but I would like to hit the question directly and to have you give us your views as expressly and definitely as possible. I am talking about what happens next, what happens after November 12, what happens after the 90-day period? Will you each give me once again as concisely as you can just exactly what we should be aiming for? Should it be a wage-price review board, with the authority to take action against those who would increase prices or wages and should there be a continuation of the freeze administered by this Board? Should we have instead a guideline system with some specific figure for a wage increase and some limitation on the price increase? Should we abandon the efforts at controlling and limiting inflation and feeling that the freeze itself has accomplished its purpose and provided a psychological period during which things have cooled off and do nothing more?

Mr. PORTER. I certainly think phase two, as I indicated in my opening remarks, Mr. Chairman, is the important thing, and Ken Galbraith has advocated for some time a series of selective controls. I have debated that question with him privately and in correspondence and I am now persuaded that perhaps some formula, some legislative authority, should be considered that would give the Government the power to deal with this problem. You refer to the top 500 corporations, to the basic producers, large industry and big steel, large labor unions. Any controls should include provisions for hardship, and such equity, fairness as we can develop.

Chairman PROXMIRE. All right. One way of dealing with them, one approach, has been suggested and perhaps by previous witnesses, is before a major wage or price increase be put into effect that an announcement be required 30 days in advance, and that the President be given—of course, he has the authority, to do what he can by voluntary means to try to dissuade the business or the union from their demand during that 30-day period. This would be voluntary but except for the requirement that you make the announcement in advance, that the enforcement of any limitation on that announcement would be voluntary.

Mr. PORTER. I think it probably should go much further, than that, Mr. Chairman.

Chairman PROXMIRE. All right, fine. How much further and what would you provide?

Mr. PORTER. Well, I think once a determination is made by a tripartite board, as Mr. Taylor has suggested, it is in the national interest to maintain prices, wages at a fair and reasonable level, that that should be somehow enforceable. Now what sanctions——

Chairman PROXMIRE. Let's back up a little bit. You say by a tripartite board, you favor the Taylor proposal as I understand; the Taylor proposal for labor, business, and a public member board; is that correct?

Mr. PORTER. That is correct.

Chairman PROXMIRE. Would it have to be a unanimous decision?

Mr. PORTER. Well, I doubt if a unanimous decision in all circumstances would be possible. It should be a decision.

Chairman PROXMIRE. A majority decision?

Mr. PORTER. A majority, perhaps a majority decision and once made there should be appropriate sanctions to enforce it.

Chairman PROXMIRE. And would be made on the basis of what principles? Would you require——

Mr. PORTER. I think you can use the principles of the cost of living so far as wages are concerned, comparable wages.

Chairman PROXMIRE. Productivity.

Mr. PORTER. Productivity would be an element. I think such a board could consider all of those factors and then reach a decision.

Chairman PROXMIRE. But you would not provide specific limited guidelines of the kind we had from 1962 to 1966; is that right?

Mr. PORTER. I think the variation and the vagaries of the different entities and different relationships are much too complex to have a single formula.

Chairman PROXMIRE. All right, Mr. Taylor.

Mr. TAYLOR. I would go one step beyond. I would have such a board to which people could repair. I would have a guideline only in this sense, that, for example, if wages went up faster than the cost of living or the bargaining broke up there would be a show cause hearing as to why it was compatible with the national interest—for a wage increase beyond such a figure.

I would prefer that to productivity myself as a guide because it is increased cost of living which creates the big drive on wages. I think I would have a similar show cause hearing if profits rose above a certain figure, perhaps, but in a sense, there might be some deterrent in which people would be held accountable, maybe a board of accountability sort of thing. It could be asked whether the enhancement of private interest carries an excessive impairment of the overriding national interest that is involved.

Chairman PROXMIRE. What sanctions would you put into effect to enforce it? Say you have a union, a big union, dealing with a big industry that has announced a very large wage increase on the pattern we have had in the past.

Mr. TAYLOR. I almost hesitate to refer to the penalty which was made available during World War II. The War Labor Board had the power to eliminate from the income tax of the employer any wages not approved by the Board. Well, we didn't use it very often and only to a limited extent in any case.

Chairman PROXMIRE. Would you recommend that we do that again?

Mr. TAYLOR. I do not. I think it is unduly punitive because success of the stabilization endeavor did not require its imposition. It's supposed to say to a company in violation of one of the regulations: "Well, as a result of this first offense we will disallow 5 percent of the wage increase." I don't think we ever went above 10 percent. There were some abuses. Various people would find out about our penalty policy and go to these folks who were on the carpet and say "for a fee I can get this settled for you for 5 percent." This sort of breakdown revealed the avarice of some people among us. But I think it was, we felt even in war time this was, too harsh a penalty to employ; to disallow all wage increases. We never used it.

Chairman PROXMIRE. Mr. DiSalle, let me back up a little bit.

Mr. TAYLOR. Excuse me.

Chairman PROXMIRE. I would like to ask Mr. DiSalle to back up on this, I moved ahead too fast on this tripartite board: we had good testimony from Charles Schultze, I think he is a brilliant economist.

Mr. DISALLE. He was one of our economists.

Chairman PROXMIRE. And he argued it was a mistake to put labor on this board. Politically they just could not serve on this kind of a board and vote against any kind of limitation on a wage increase. It would be easier for them to accept it if they were not on the board.

Mr. TAYLOR. If they do accept it. But let's go back a step. If you are going to modify the power of labor to strike you have to have a substitute for the strike. The question is, What kind of a substitute? Labor did not participate in the formulation or administration of the guidelines from 1962 to 1968. I do not think those guidelines were successful. Labor did participate both in the Korean war and in World War II, and I think the stabilization results were more successful. In other words, they have got to accept something as an alternative to the strike, unless we want to eliminate the strike. I hope we don't do this because this then marks a complete change in the kind of society we have been trying to build. This is my feeling.

The tripartite board, when it is operated well, and some have I think, includes a public representation. That representative has one point of view but he should be subject to checks and balances. In my experience labor and industry colleagues on a tripartite board provide necessary checks and balances.

Chairman PROXMIRE. But didn't you have a big check and balance? During these periods you had a war on you had a great public support and you could appeal to labor and they were very responsive to this, they wanted us to win World War II and they were for us in the Korean war all the way. Today we don't have that, we have a war which we hope and pray is being wound down, it is very unpopular anyway, and you can't expect labor under these circumstances to give you the same kind of cooperation as you had then, is that right?

Mr. TAYLOR. Well, I think we can try. The labor unions should not be locked in combat with the Government. It is very important to bring them back into cooperation with the Government.

Chairman PROXMIRE. You think the best way to bring them back is to have them on the board that would make the determination but would you agree with Mr. Porter it should be by majority vote?

Mr. TAYLOR. Yes, I would. But it is more than that. You also have to get a majority but also a consent to lose and this is where the mediator has a job to do. The development of a consent to lose is sometimes very difficult on either management or labor side.

Chairman PROXMIRE. You have to go back to John Calhoun's, what was it, concurrent——

Mr. TAYLOR. But, at times, democracies are a fragile kind of arrangement too, and I have not given up hope on our capacity to make ours work.

Chairman PROXMIRE. Mr. DiSalle.

Mr. DISALLE. Mr. Chairman, I think it is a mistake to talk about labor as somebody that is not a part of this United States and set them aside.

Chairman PROXMIRE. I couldn't agree with you more. I think the labor people have been extraordinarily cooperative in the past. What I have been trying to emphasize is they look at the past experience and most recent experience we had with the guidelines and they were the guidelines you would think so——

Mr. DISALLE. But union members are hurt by inflation as much as anybody else. This is where the pressure comes for wage increases trying to catch up with price increases. I think a three-party board would work now. In Toledo, Ohio, for example, 25 years ago after the war we organized one, it still operates and is still successful, the three-party committee has not only acted in prevention of strikes but in bringing a strike to a conclusion.

Now there they used—they don't use the labor member who is immediately a part of the dispute as a part of the panel. There is another labor member and it works out well, and I think it can work. I remember this committee from its origin, and was there for the 25th anniversary just recently and they have a long, long history of doing well.

Chairman PROXMIRE. So you think that it would be practical to expect even with the expressed attitude recently we heard from organized labor on the freeze and what comes after the freeze, you think it would be practical and reasonable to feel they would serve on that kind of board giving some meaningful effect on the wage push inflation?

Mr. DISALLE. I think so.

Chairman PROXMIRE. All right.

Let me, oh, yes, yes, gentlemen, what do we do about the great series of big wage increases to which Mr. Porter referred so ably and so aptly, which have been agreed on by a whole series of big unions involving millions of workers. I presume, and a whole number of industries and now which have been written into the law? We have the teamsters, the communication workers, we have the steelworkers, we have autoworkers, we have many others who have written contracts now, we are going to give them big wage increases this coming year.

There are some coming right after the freeze, then in 1972 and then in 1973. It would seem to me if we accept these and build our stabilization policy around them that we are going to have a cost push, wage push inflation that will be irresistible.

But, as a matter of policy, would it be practical, in your view, to moderate those in any way, to limit those or reduce them, Mr. Porter?

Mr. PORTER. I would yield to Mr. Taylor on that question.

Mr. TAYLOR. Well, to change a labor agreement a union leader would have to put the modification up to his rank and file. This is his responsibility. There are a few exceptions and we don't like those fellows to run a union in a dictatorial——

Chairman PROXMIRE. When you say put it up, is this in your view a matter of law?

Mr. TAYLOR. These contracts, these labor contracts, have been ratified——

Chairman PROXMIRE. Right.

Mr. TAYLOR (continuing). In practically all cases by the people involved. A union leader could not agree to modify that contract without——

Chairman PROXMIRE. That was not quite my question. Is it possible by action by the Federal Government to abrogate this contract in any way and would it be wise to do so if it is?

Mr. TAYLOR. Well, it is a contract and you suddenly then move into the whole area of whether contracts are valid or not.

Chairman PROXMIRE. Well, you have an emergency situation, you gentlemen have agreed.

Mr. PORTER. Mr. Chairman, there have been rollbacks in prices on many, many occasions.

Chairman PROXMIRE. You think there could be a rollback here?

Mr. PORTER. I don't know.

Chairman PROXMIRE. I think the whole policy could flounder on that one because if you don't——

Mr. PORTER. It is a vulnerable aspect.

Chairman PROXMIRE (continuing). Have some modifications of it, do you gentlemen think you can have an effective stabilization program without doing something about moderating the big increases that have been in the law now for all these workers?

Mr. TAYLOR. I think in the absence of modification it may require 3 years to bring the present round of wage increases to an end.

Chairman PROXMIRE. That is right.

Mr. TAYLOR. These are the alternatives. In World War II we moved in on a cost of living clause in a labor agreement, but it was one of the very few. Even though it wasn't a big issue at that moment, it really caused quite a furor and almost broke up the board. The cost of living increases that concern me the most in some of these current agreements are the guaranteed cost of living increases, that is that you get 15 cents or 10 cents next year as a cost of living increase even though the cost of living doesn't go up. These are particularly crucial to the stabilization objective.

Chairman PROXMIRE. Well, let's get back to the wage increases for steel and for auto and for communication workers and teamsters; is it conceivable or possible that business could absorb a great deal of this wage increase without price increases or with very moderate price increases; is it possible?

Mr. TAYLOR. The steel industry is in a bad way technologically and they need funds to modernize. That does not necessarily mean more jobs immediately, I might add, but they sure do need price increases if they are going to get capital to refurbish their equipment or have profits to retain to refurbish their equipment, I would guess.

Chairman PROXMIRE. Well, the automobile industry is perhaps in a position where they could absorb some of it in view of the breaks they are getting in so many ways here.

Mr. TAYLOR. I would think so.

Mr. PORTER. I would think, Mr. Chairman, you would have to take this on a case-by-case basis, analyze each particular case.

Chairman PROXMIRE. I see.

Mr. TAYLOR. You have very unique situations in different industries.

Mr. PORTER. Some can absorb perhaps and some cannot. I don't know. I don't have the facts. Industry by industry, I would assume that this is what the cost of living council and what their staff and economists are now hopefully busily engaged in making that kind of analysis to see what wage increases can be absorbed and that is what I hope they come out with in phase 2. I recognize, as you have said, the difficulties in trying to abrogate contracts that have been negotiated and presumably but for the freeze would have become effective, and that may lead to a very interesting legal test of these powers, but whether——

Chairman PROXMIRE. Do you have any comparable experience in World War II or in the Korean war with this kind of situation where you have wage increases that had been negotiated for multiple years and you thwarted that?

Mr. PORTER. I think, as I said earlier, Mr. Taylor was patrolling the wage front, I was on the price front.

Mr. DISALLE. On the price front you had the experience of having an application for price increases as a result of wage increases so that we treated it as any other cost increase and tried to determine whether or not the industry could absorb it without an increase in price.

Mr. PORTER. Also, Mike, we added to that, as I am sure you did too, as I recall serving on your policy committee, that the ground rules were that the Price Administrator would not give an advance ruling under any circumstances.

Mr. DISALLE. No; that is right.

Mr. PORTER. And the bargaining process then we would take a look at it once the agreement was reached which in itself was a contribution to moderation.

Mr. TAYLOR. The long-term contract really didn't come in until the 1948 General Motors agreement. Over the years they have increased in number.

Mr. DISALLE. Mostly cost of living.

Mr. TAYLOR. That is right.

Chairman PROXMIRE. Let me ask one other question, the Washington Sunday Star yesterday described the present wage-price freeze as absolute with respect to wages but porous with respect to prices. Do you consider this an apt description of the President's wage-price program?

Mr. PORTER. Not as I read the order.

Chairman PROXMIRE. Mr. Taylor.

Mr. TAYLOR. I think they are both very difficult to effectuate.

Chairman PROXMIRE. Well, isn't it——

Mr. TAYLOR. Even the wage freeze can be porous.

Chairman PROXMIRE. But as a practical fact what the union people argue is that the Government has a good strong ally on the part of management to enforce the wage limitation. You can always say "you are not going to get me violating the law, I am not going to pay a $5,000 fine what can I do I hold down your wages," and it is in the interests of the employer.

Mr. TAYLOR. Of course, you can get reclassifications and suddenly everybody——

Chairman PROXMIRE. You can get it if the employer wants to cooperate.

I remember when I used to run a printing company, I owned a printing company, I wanted to keep those wages down, it was the only way I could make any money and make a living, and most companies feel the same way. They are not interested in increasing wages if they don't have to.

Mr. TAYLOR. If they don't want slowdowns or bad morale they may have to I. recall one of the industries we never could bring under control was the needle trade, women's dresses. There the styles change and they would have a piece rate of 16 cents to sew on a collar. So they would make a new style and the company would agree that this style was much more difficult than the other style, and so this was entitled to 20 cents.

Well, you would have to send out timestudy engineers, and they wouldn't agree, to determine whether or not that new collar was really more difficult to make. There are ways and means that you can get porous on the wage front too, you know.

Chairman PROXMIRE. Wouldn't you concede that you do have the fact that employers are anxious in holding down their costs? One way to do it is holding down wages and they are working on it all the time, constantly, they are on top of it and there are literally millions of employers and employers' supervisors and so forth who have this function, so there is much more weight in cooperation in the private sector to hold down the wage increase than there is on the price increase.

Mr. TAYLOR. If you hold down the price increase this is true. But if the prices are porous, management is not going to have trouble with his people. He doesn't simply want to avoid a strike, but other difficulties such as excessive absenteeism and slowdowns in the plants. This is a very fluid kind of thing. If he can pass it along in prices he will satisfy his work force. He might even figure this gives him lower labor costs. So there is porosity in the wage area.

In World War II we didn't know how one shipyard was inducing a lot of shipyard workers to move from one district to another despite identical wage-rate structures. But, of the approximately 40,000 employees in the yard there were only eight common laborers. Nor did the yard have any second- or third-class mechanics, they were all first-class mechanics. So this was porosity.

Chairman PROXMIRE. Of course, in World War II you had a situation where labor had a lot going for it. You had a shortage of labor, you had very low unemployment, you had people fighting to get employees, you had all kinds of situations with employers fighting to promote them. You don't have that now.

Mr. TAYLOR. You sure do.

Mr. DISALLE. You sure do. I had a large company call the other day——

Chairman PROXMIRE. We don't have it to the same degree. We have 5 million people out of work.

Mr. TAYLOR. That is right.

Mr. DISALLE. In certain classes of employment you have. A company had an employee who asked for an increase and they had it under consideration at the time and turned it down but a competitor gave him much more and he went over to the competitor, and you can't do anything in that situation unless employers have some discretion or some way of giving increases in these instances.

Chairman PROXMIRE. Gentlemen, as I understand it then, to try to wrap up what you gentlemen have told us, No. 1 you agree this is legal on the part of the President, he has a right to do as he did.

No. 2 you agree that the President's action during this 90-day period is vital if we are going to get an effective antiinflation program he should prepare for phase 2. You feel that phase 2 can be selective, and be effective in being selective, in other words you only have to limit some employers, presumably the biggest ones, so far as the prices are concerned, and you think you can concentrate on the big unions, by and large, and that this can be an effective program.

You feel that productivity should be one element involved here. Is that a fair summary?

Mr. PORTER. I would subscribe to that, Mr. Chairman.

Mr. DISALLE. Yes.

Chairman PROXMIRE. All right, gentlemen, thank you very much. You have been most helpful. I can't thank you enough and it is so good to have gentlemen of your experience and intelligence come before us and make this record.

Thank you.

(Whereupon, at 12:05 p.m., the committee was adjourned. subject to the call of the Chair.)

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