The original documents are located in Box 4, folder "Economic Policy Review (1)" of the Richard B. Cheney Files at the Gerald R. Ford Presidential Library.

Copyright Notice

The copyright law of the United States (Title 17, United States Code) governs the making of photocopies or other reproductions of copyrighted material. Gerald Ford donated to the United States of America his copyrights in all of his unpublished writings in National Archives collections. Works prepared by U.S. Government employees as part of their official duties are in the public domain. The copyrights to materials written by other individuals or organizations are presumed to remain with them. If you think any of the information displayed in the PDF is subject to a valid copyright claim, please contact the Gerald R. Ford Presidential Library.

Digitized from Box 4 of the Richard B. Cheney Files at the Gerald R. Ford Presidential Library

THE WHITE HOUSE

WASHINGTON

March 13, 1975

MEMORANDUM FOR: Donald Rumsfeld

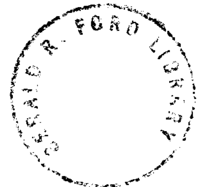
FROM: L. William Seidman LWS

SUBJECT: Economic Policy Review Sessions

A copy of the Economic Review Briefing Book is enclosed along with a schedule indicating when the sessions will be held and the topics to be discussed.

We would be pleased to have you or any of your staff attend any or all of these meetings.

Enclosures


GERALD R. FORD LIBRARY

ECONOMIC POLICY BOARD

Economic Policy Review Meetings

Agenda

Chairman: William E. Simon

Attendees: Messrs. Seidman, Lynn, Greenspan, Dunlop, Burns, Zarb, Dunn, Dunham, Rees, Hormats, O'Neil, Porter, Kosters, Robinson

I. GENERAL ECONOMIC REVIEW

Thursday, March 13, 1975: 3:00 - 5:30 pm, EOB Room 208

Time	Discussion Item	Agency/Principal	
3:00 pm	General Economic Outlook	CEA,	A. Greenspan
4:00	Budget Outlook	OMB,	J. Lynn

II. ECONOMIC POLICY ISSUES REVIEW

Saturday, March 15, 1975: 9:00 am - 5:00 pm, EOB Room 208

Time	Discussion Item	Agency/Principal	
9:00 am	Budget Initiatives	OMB,	J. Lynn
10:30	Labor Markets, Employment	OMB, DOL	J. Lynn
11:15	Monetary Policy	FRB,	A. Burns
12:00	Lunch		
1:00 pm	Tax Policy	Treasury,	W. Simon
1:45	Electric Utilities	FEA, Treasury	F. Zarb
2:45	Housing	OMB	J. Lynn
3:30	Financial Markets	Treasury, FRB	W. Simon
4:00	Transportation/Autos	OMB,	J. Lynn
4:30	Summary and Review		

R. FORD LIBRARY

March 11, 1975

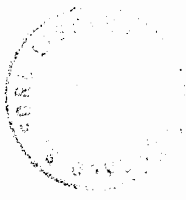
ECONOMIC POLICY REVIEW BOOK

Table of Contents

Review of General Economic Outlook	Tab 1
Review of Budget Status and Outlook	Tab 2
Federal Budget/Spending Initiatives	Tab 3
Labor Markets, Employment and Unemployment	Tab 4
Monetary Policy	Tab 5
Tax Policy	Tab 6
Electric Utilities	Tab 7
Housing	Tab 8
Financial and Banking	Tab 9
Transportation	Tab 10
Other Proposals	Tab 11
Policy Proposals and Positions	Tab 12

1. ECONOMIC OUTLOOK

Troika Review in preparation



MAR 4 REC'D

DEPARTMENT OF THE TREASURY
WASHINGTON, D.C. 20220

ASSISTANT SECRETARY

March 3, 1975

MEMORANDUM

TO: Dr. Marvin H. Kosters
Economic Policy Board
The White House

FROM: Edgar R. Fiedler

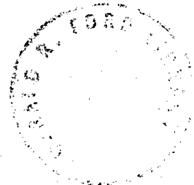
SUBJECT: Consumer Confidence and Consumer Spending

Attached is the memo we promised for possible use by the Executive Committee of the Economic Policy Board. Our conclusion is moderately optimistic, but we are as aware as everybody else of the great uncertainty that surrounds this crucial component of economic activity.

Attachment

Ed
H

cc: Rudy Penner - OMB
John Davis - CEA



The Consumer To The Rescue?

1. Most measures of consumer confidence are showing very sharp declines. Three representative statistical series are shown in Charts 1, 2, and 3. (Data are currently available for the University of Michigan and Conference Board indexes only through the end of last year.) Obviously, consumer confidence has fallen to very low levels. Direct polling of consumer attitudes (Gallup, Harris, Yankelovich and others) also testifies to a somber and cautious mood. However, the picture is not one of unrelieved gloom as it was several months ago. Sindlinger's index of consumer confidence has risen steadily this year (Chart 3) although it remains at low levels. Stock prices (Chart 4) have been rising since early December.

2. Also, there is some question as to the economic significance of the very low readings that we are getting from the various indexes of consumer sentiment. What really matters is how consumers act, not how they feel. Here, the evidence is mixed but certainly not as bearish as the interview data would suggest. For example, Chart 5 shows the quit rate in manufacturing. Despite a sharp fall in recent months, this indicator is not "off the scale" as in the case of consumer attitudes. Consumer

instalment debt (Chart 6) shows a very steep decline and is following a sharp cyclical pattern. Even here, however, there has been some responsiveness to the auto rebate program and the change in consumer instalment debt was one of the two series that rose in the first roundup of the January leading indicators.

3. While the various measures of consumer confidence are of interest to us, future consumer demand seems likely to be conditioned primarily by the future path of real income, rather than by such intangibles as "confidence". Chart 7 shows retail sales in both current and 1967 dollars and Chart 8 gives a breakdown by component. The long downslide in real purchases dates from early 1973, and has continued to date. This decline has been paralleled during much of that time by declines in real income--both personal and disposable. Perhaps no further reasons for the decline in purchases are really required. To some extent, the decline in highly-sensitive indexes of the consumer mood may exaggerate the difficulties we actually face--formidable as they are.

4. The deepening recession lowers employment and income. However, the various built-in stabilizers limit the downward push on personal income in current prices and the falling rate of inflation further reduces the downward pressure on real income. If the current contraction is to turn around by mid-year or thereabouts, the decline in real personal income--which already shows some signs of slowing--should soon begin to bottom out. If it does not, retail sales are likely to continue to fall in real terms and the period of inventory adjustment may be extended.

5. Recent and prospective wage-price developments suggest that real consumer income will turn upward soon. The rate of wage increase has been around 10 percent since the controls ended last April 30. The latest data suggest an easing in the rate of increase (which is something we'll watch closely), but we expect the wage trend to continue upward (because it does not react quickly to high unemployment rates) at something close to 10 percent. In the meantime, the price trend has decelerated and now appears to be rising at around 7-8 percent. Other things being equal, this means that real wages will be rising from here on. One development that may

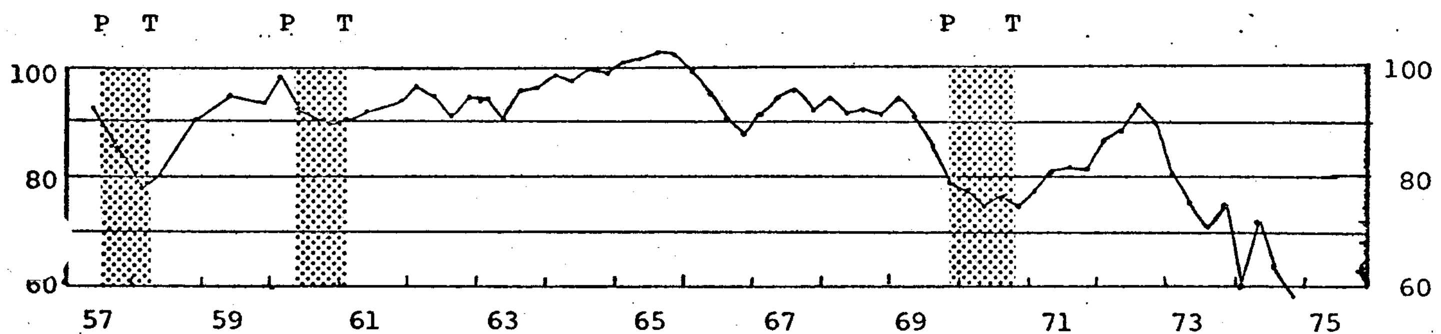
postpone this shift of trend is the decline in overtime pay, which has been going on for some months. However, the downtrend in hours is likely to stop before too long, and at that point real earnings should start upward, which in turn should spark a rebound in real consumer spending.

6. A relatively optimistic view of the likelihood that consumer spending will soon lead the economy out of recession appeared in the March 1975 Business Roundup section of Fortune. A copy is attached.

U.S. Department of the Treasury
Office of Financial Analysis
March 4, 1975

Chart 1

UNIVERSITY OF MICHIGAN SURVEY OF CONSUMER SENTIMENT



Chart

CONFERENCE BOARD: CONSUMER CONFIDENCE INDEX

P T

130 120 110 100 90 80 70 60 50 40

1967 1968 1969 1970 1971 1972 1973 1974

Chart 3

Sindlinger's Index of Consumer Confidence

80.0
75.0
70.0
65.0
60.0
55.0
50.0
0
.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
.0

1973 1974

Monthly

80.0
75.0
70.0
65.0
60.0
55.0
50.0
45.0
40.0
35.0
30.0
25.0
20.0
15.0
10.0
5.0
.0

Recession Level Below 64.0%

Depression Level 30.0%

January 1975 February

Daily

Chart 4

The Dow Jones Industrials

-NOV.- -DEC.- -JAN.- -FEB.-

22 29 6 13 20 27 3 10 17 24 31 7 14 21 28

740 720 700 680 660 640 620 600 580 560

Chart 5

QUIT RATE IN MANUFACTURING

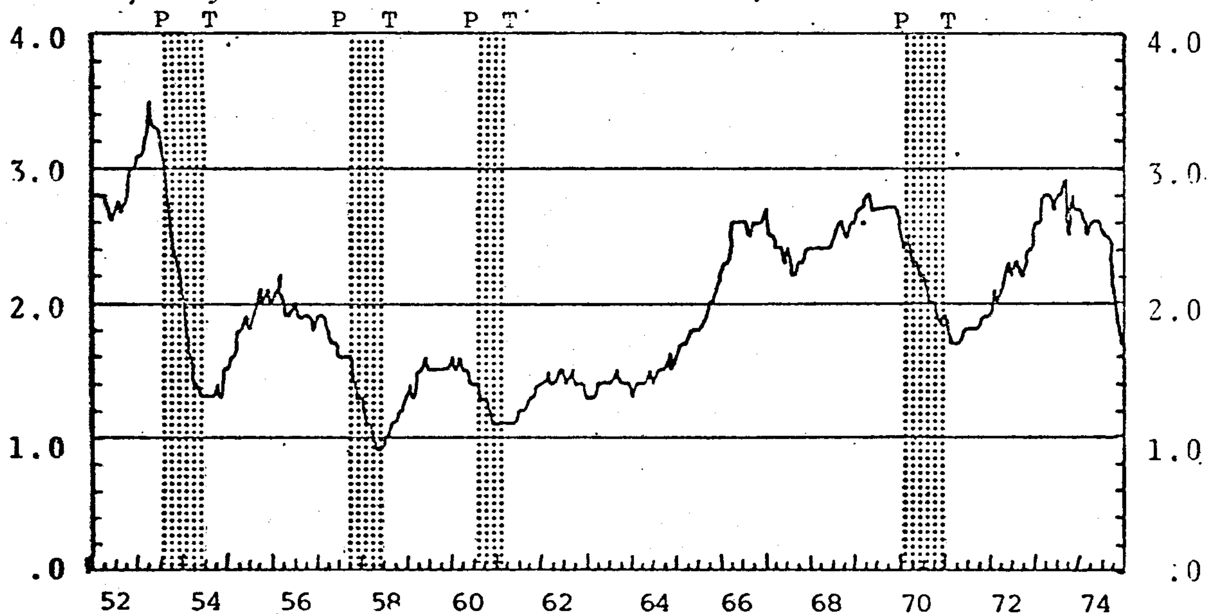
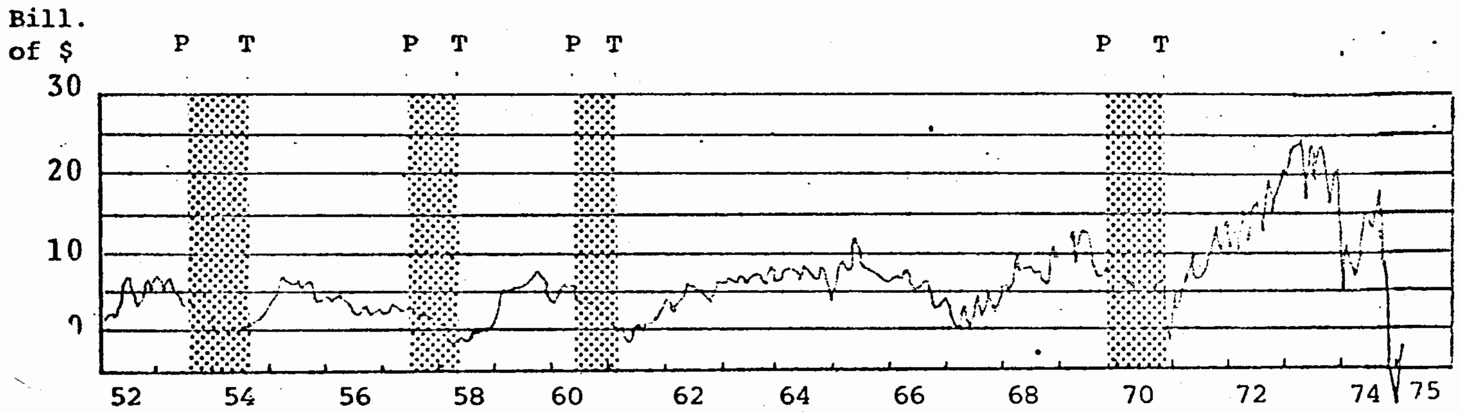
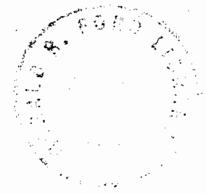


Chart 6

Change in Consumer Installment Debt

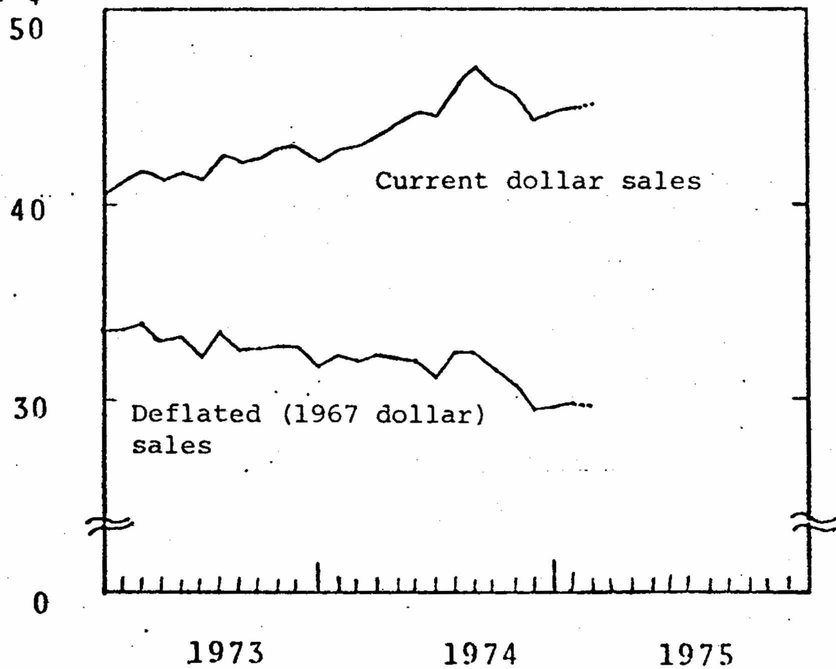




R. FORD

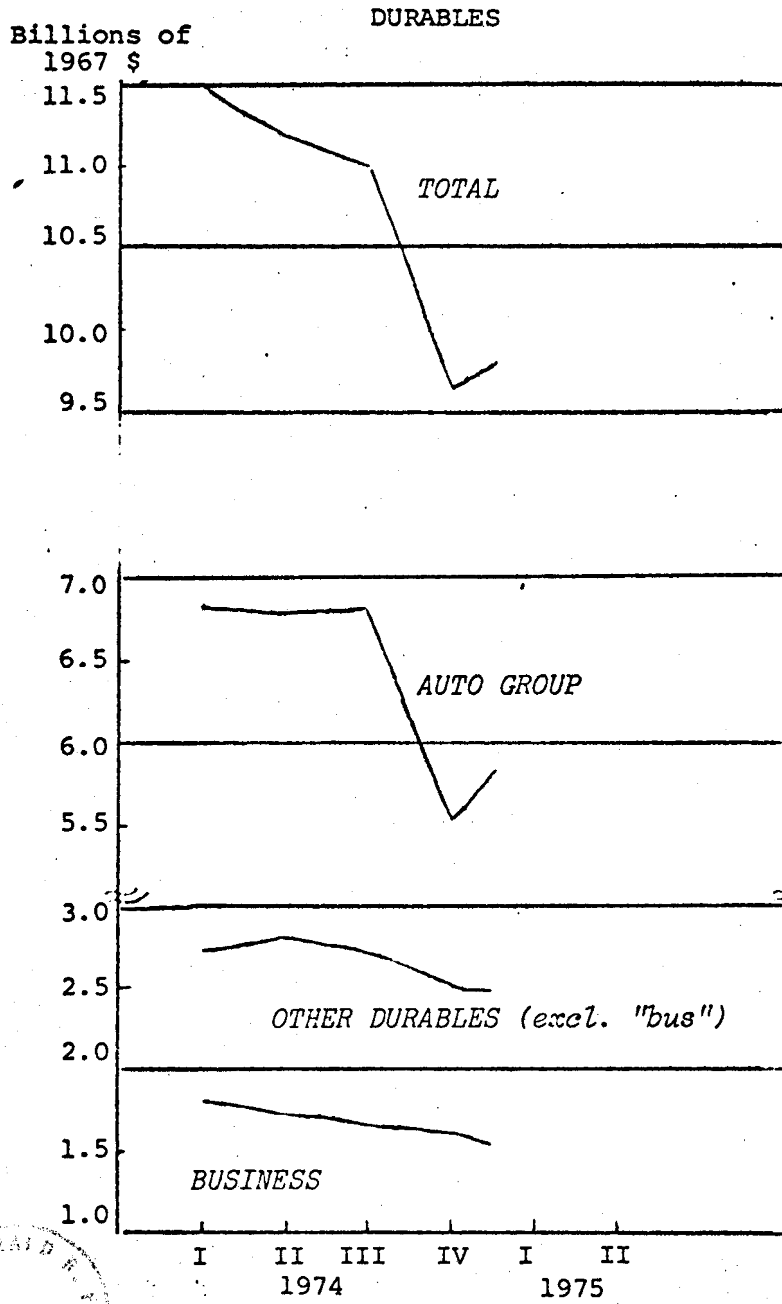
Chart 7

Retail Sales



Latest data February est.

REAL RETAIL SALES



Latest data Jan-Feb

Office of Financial Analysis

Consumers to the Rescue

Consumer spending, which traditionally has helped lead the economy out of recession, will soon be coming to the rescue again. Spending has probably hit bottom already, and the upswing that seems likely to begin in the spring should be quite a handsome one.

It will be powered by a vigorous rebound in real after-tax income, which by year-end should be 4 percent above its low this quarter. In other words, incomes should recover in the next three quarters most of the distressing amount of ground lost since late 1973.

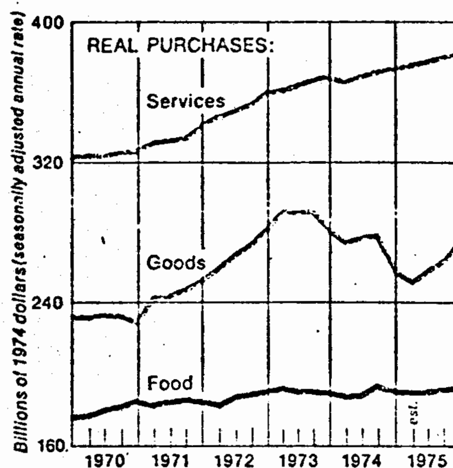
Of all the economic forces at work, the most important is a sharp cut in inflation, which from here on will be eating away less of the rise in dollar income. Personal income is holding surprisingly steady even now. Declining employment is being offset by rising pay rates and sharp increases in unemployment payments and other transfers. As employment declines more slowly, and then gradually turns up, a brisk improvement in dollar income should begin.

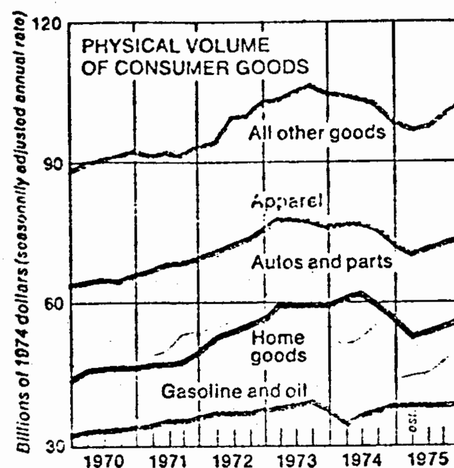
In addition, tax relief seems assured by June—probably an $8-billion rebate on 1974 taxes, plus a reduction of $8 billion in withholding on 1975 incomes. The rebate will be paid in the second quarter, but its effects will be felt all year. On this basis, the tax cut will be boosting incomes during the second half at a $25-billion rate—cutting the effective tax rate by three percentage points.

Why windfalls will be spent

Cuts in the tax rate have historically been mirrored in increases in the savings rate (see the chart at right). But this tax cut should start moving right into the spending stream, partly because so much of it will go to lower-income groups who are less able to save, and partly because the savings rate, overall, is already about as high as it is likely to get. The rate hit 8.5 percent last quarter, according to Commerce, and data from the Federal Reserve indicate that it may have reached 10 percent. Even the Commerce figure represents an increase of two percentage points—and a cut of $20 billion in the spending rate.

Last quarter's surge came because consumers were battening down for the recession by reducing their installment

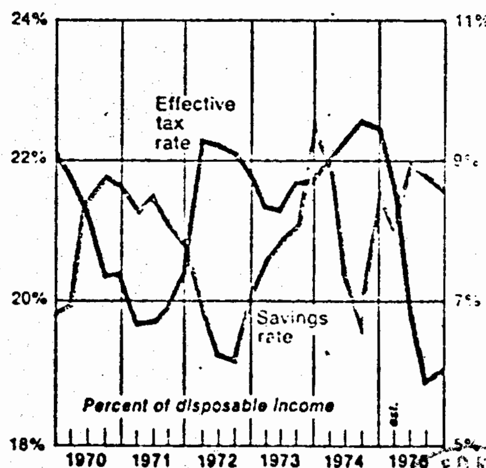




debt. Net borrowing dropped from 2.5 percent of consumer income in 1973 to something less than zero—that is, consumers paid back slightly more than they borrowed. They will start taking on debt again soon.

One traditional explanation for such savings sprees is that consumers are trying to shore up their financial positions, which have indeed been eaten away by inflation and the bear market. One measure of the damage is the ratio of real assets (other than stocks) to income—and this ratio dropped by 2 percent (to 1.53) from 1971 to year-end 1974.

Consumers are also affected by their feelings about the future. Confidence, like assets, is undermined by inflation, but at least it can be more quickly repaired. Professor Thomas Juster, a consumer economist at the University of Michigan, has found that, for forecasting the savings rate, changes in consum-



er expectations about prices have proved more reliable than changes in the real value of stocks or financial assets. On Juster's model, a delayed response by consumers to the slowing pace of inflation will tend to keep the savings rate high for a while, but as the year wears on, inflation will be exerting less and less upward pressure on savings.

The confidence index climbs

Consumer confidence about the future, as measured directly by Sindlinger & Co., has already begun improving. The Sindlinger index, which reached a 1973 high of 137 and wilted to 52 early this year, has moved up to above 75. Surprisingly, this improvement has reflected a lessening concern about layoffs—a feeling perhaps that the worst is behind us. Some further expansion may well come as taxes are cut and the news about inflation continues to improve.

So with the savings rate probably on a downtrend after midyear, much of the increase in real income should show through in increased spending. Some of it will go for services and for food, but goods purchases, which seem to be bottoming out now, should grow markedly next quarter and increase by perhaps percent before year-end.

The revival in spending should, as in the past, help start a turnaround for the economy as a whole. Total consumer buying in real terms may be reaching new peaks by the end of the year, and goods purchases, while still below the peak rate of two years ago, will be warming the hearts of the retailers. **END**

2. BUDGET OUTLOOK

Budget Summary in preparation

3. FEDERAL SPENDING

FEDERAL BUDGET/SPENDING INITIATIVES

An across-the-board assessment of major Federal programs has been prepared by OMB indicating the job creation potential associated with more funds or accelerated use of existing funds. This will provide the principal background information for discussion of possible budget/spending initiatives.

Included among proposals that have been put forward are the following:

1. Accelerate placement of Defense contracts.

2. Accelerate release or commitments of funds wherever possible.

3. Develop a major new energy initiative - the 1970's equivalent of the Manhattan project or space program. For example, cut time delays in bringing nuclear generating facilities on stream by 50 percent, or establish a program to finance and build new uranium enrichment facilities.

4. Begin early construction of oil storage facilities or some other energy initiative.

5. Develop a program of special assistance for electrical utilities in serious financial trouble.

6. Develop an emergency revenue sharing package to offset congressional initiatives to expand categorical programs.

7. Introduce indefinite extension of Unemployment Insurance benefits while unemployment is high.

8. Develop a program of private employment tax credits or incentives to increase private employment.

9. Support additional job-creation spending bills, such as EDA jobs programs.

10. Suspend matching requirements for highway and other funding.

11. Accelerate public works programs, with a minimum commitment of $2 billion to communities with high unemployment. (AFL-CIO)

12. Increase weekly benefits of Unemployment Insurance programs by using Federal funds. (AFL-CIO)

13. Increase welfare payments during the recession by providing more Federal funds. (AFL-CIO)

14. Federalize the Unemployment Insurance system. (Woodcock)

15. Introduce a countercyclical revenue sharing program; provide $6 billion in additional funds in calendar 1976, with increments falling to zero when the unemployment rate falls to 4.5 percent. (C. Schultze)

4. LABOR MARKET

March 10, 1975

LABOR MARKETS, EMPLOYMENT AND UNEMPLOYMENT

Programs to increase employment or increase assistance to the unemployed are considered primarily in the OMB review of Federal programs.

Proposals listed here include those considered by OMB and suggested by others.

Expansion of Federal Spending and Employment Programs

1. Expand Public Service Employment programs, summer youth programs, and others beyond currently programmed levels.

2. Release of impounded funds totalling $13.4 billion to create jobs ($9 billion for sewers and waste treatment plants, $4 billion for highway programs, and $.4 billion for hospital programs). (AFL-CIO)

3. Accelerate public works programs, with a minimum commitment of $2 billion to communities with high unemployment. (AFL-CIO)

4. Spend $10 billion in fiscal year 1976 for 1.25 to 1.5 million public service jobs. (Woodcock)

Stimulate Private Sector Employment

5. Increase size of overall tax reduction.

6. Introduce a program of employment incentive credits for the private sector to stimulate private employment. (DOL/OMB)

7. Develop a reemployment incentive plan to permit fractional unemployment insurance payments in connection with acceptance of part-time or low wage work. (DOL)

8. Increase demand for selected private sector outputs to induce private employment. (Rees)

   (1) Increased purchases of home mortgages by Federal agencies. This could have the additional benefit of helping to decrease mortgage interest rates, which enter into the Consumer Price Index.

   (2) Reinstatement of some rental housing construction programs by HUD.

(continued)

(3) Replacement of some federally owned cars and trucks ahead of schedule with purchases from existing inventories of automobile manufacturers and dealers. This has possible incidental benefits in fuel conservation and air pollution.

(4) Increased employment in the maintenance of railroad right of way for lines whose continued use is assured.

(5) Direct Federal assistance of some sort, such as construction loans, for public utility companies that have been forced to cancel plans for expansion of capacity in part by the high cost of long-term capital.

(6) Increased funding to local mass transit systems for earlier replacement of buses and other transit equipment.

9. Extend duration of Unemployment Compensation Benefits for an indefinite period while unemployment remains above some triggering level (such as 8 percent).

10. Extend duration of unemployment benefits available to those covered by Emergency Jobs and Unemployment Assistance Act of 1974. (AFL-CIO)

11. Speed up payments by eliminating the "waiting week" requirements in state unemployment benefits programs. (AFL-CIO)

12. Increase weekly unemployment benefits to 2/3 of former wages (with an upper limit equal to 2/3 of state-wide average weekly wage) by using Federal funds. (AFL-CIO)

13. Provide health care benefits to those losing their employer-employee health insurance coverage when they become unemployed. (AFL-CIO)

14. Make the Aid to Unemployed Fathers program mandatory in all states. (AFL-CIO)

15. Federalize unemployment compensation system. (Woodcock)

16. Provide increased welfare costs during this emergency period with Federal funds. (AFL-CIO)

17. Provide short-term assistance to homeowners having difficulty making mortgage payments because of unemployment or sharp income drop. (HDL)

18. Consider introduction of general income maintenance program at this time in view of high unemployment.

Work-Spreading Proposals

19. Create incentives applied to the employer and to employees for shortening the work-week when unemployment rises to reduce the uneven impact on workers of layoffs.

20. Develop a system for varying retirement ages, with age of eligibility for Social Security payments reduced when the unemployment rate rises, to offset the unemployment effects of cyclical changes.

21. Implement an early retirement program for Federal employees at this time to provide jobs for other workers.

Other Approaches

22. Develop programs for adjustment assistance, similar to those applied to industries harmed by imports, for other necessary adjustments such as a smaller auto production sector, effects of deregulation or energy related adjustments.

23. Suspend operation of EPA or OSHA regulations that would result in reduced employment or higher layoffs during a period of high employment.

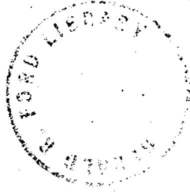
24. Impose quotas on goods that have seen recent U.S. production drops. (AFL-CIO)

25. Restrict imports of countries placing unfair burdens on U.S. commerce and workers. (AFL-CIO)

26. Control U.S. exports of raw materials in short supply in order to protect jobs of U.S. workers depending on the materials' availability. (AFL-CIO)

27. Encourage investment at home by revoking provisions for deferring tax payments on foreign-earned profits; by eliminating foreign tax credits; and by revising the Tariff Code to discourage foreign production by U.S. companies for shipment of goods back to U.S. markets. (AFL-CIO)

CWPS Suggestions



MAR 5 REC'D

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL ON WAGE AND PRICE STABILITY

726 JACKSON PLACE, N.W.

WASHINGTON, D.C. 20506

March 4, 1975

MEMORANDUM FOR: MARVIN KOSTERS

FROM: ALBERT REES *ar*

SUBJECT: POLICIES TO EXPAND EMPLOYMENT

This is in reply to your recent request for my views on alternate policies for expanding employment. The principal alternatives seem to be:

(a) Increase subsidized programs for public service employment

(b) Give tax credits or wage subsidies to stimulate private sector employment

(c) Increase demand for selected private sector outputs to induce private employment.

Among these alternatives, my strong preference is for the third.

Increased federally financed public sector employment has much less stimulating effect on the economy than it appears to have. State and local governments use the new federally funded jobs to replace attrition or layoffs from jobs they normally fund themselves. The net result is in large part to shift deficits from state and local governments to the Federal Government with relatively little net expansionary effect. The work performed by the new workers is likely to be less effective than that done by laid off workers returning to their old jobs. Moreover, state and local employment has been expanding rapidly without assistance. It has grown from 9.8 million in 1970 to 11.9 million in January, 1975 (seasonally adjusted), and is above its 1974 levels. In contrast, Federal employment is now slightly below its 1970 average, and employment in goods producing industries is also below its 1970 average, and down about 1.8 million from a year ago.

A tax credit or wage subsidy is likely to produce windfall gain for employers whose demand for output is still strong, in such industries as coal mining, steel, and food processing, but will do little to restore employment in industries such as automobiles and construction which cannot sell their output. In the long run, a wage subsidy or employment tax credit will induce some substitution of labor for capital. However, this effect will be negligible in the short run in a period in which little new capacity is being added, since short-run capital-labor ratios are largely governed by the kind of technology being used.

The goal of an employment policy should be to re-employ the experienced unemployed in their usual employment where their productivity is high. This can best be done by creating demand for the output of the most seriously depressed industries. Let me suggest a number of areas in which such policies might be explored.

(1) Increased purchases of home mortgages by Federal agencies. This could have the additional benefit of helping to decrease mortgage interest rates, which enter into the Consumer Price Index.

(2) Reinstatement of some rental housing construction programs by HUD.

(3) Replacement of some federally owned cars and trucks ahead of schedule with purchases from existing inventories of automobile manufacturers and dealers. This has possible incidental benefits in fuel conservation and air pollution.

(4) Increased employment in the maintenance of railroad right of way for lines whose continued use is assured.

(5) Direct Federal assistance of some sort, such as construction loans, for public utility companies that have been forced to cancel plans for expansion of capacity in part by the high cost of long-term capital.

(6) Increased funding to local mass transit systems for earlier replacement of buses and other transit equipment.

It is, of course, clear that any such programs add to the Federal deficit. I assume that the question being raised is "Taking for granted a larger deficit, what is the best (or least worst) way to use it?" I think that direct stimulus to depressed industries is easier to abolish once recovery is under way than alternative programs, and is less likely to create upward pressures on prices. Increased output in the private sector will have a favorable effect on productivity and unit labor cost. Increased output in the public sector is much less likely to have this effect.

5. MONETARY POLICY

MONETARY POLICY

There has been considerable recent discussion of monetary policy, both in terms of appropriate rates of monetary expansion and in terms of the relationship between the Federal Reserve and the Congress.

The Fellner memo in the first section of this Tab outlines some of the issues and recent data on monetary expansion rates is attached.

Material submitted by Congressman Ashley including a draft bill, an explanatory statement, and a companion of H.R. 212 and H.R. 3160 is included in the second section.

Proposals that have been made concerning monetary policy include:

1. Develop a vigorous voluntary approach to stepping up availability of financing in the private sector (i.e. without direct government guarantees or loans) by, for example, advertising increased availability of mortgage financing and better terms.

2. The Administration could take a stance of encouraging, or at least not discouraging, congressional initiatives to influence Federal Reserve monetary expansion policy.

3. Mandatory allocation of credit (AFL-CIO).

4. The Federal Reserve should engage in ad hoc, informal efforts to encourage allocation of credit to areas of special need. (Brimmer)

5. Establish a more regular dialogue between the Federal Reserve and Congress. For example, the Federal Reserve could report regularly in hearings on specific plans, policies, etc. (Sprinkel)

6. Use monetary policy to reduce short or long-term interest rates to specified levels. (Various sources)

7. Impose a prohibitively high progressive tax on interest income to keep interest rates down.

Monetary Policy Discussion

On Monetary-Policy Problems of Interest To Those Whose Decisions Are Complementary with Fed Policy

MEMORANDUM

by

William J. Fellner
American Enterprise Institute

Conclusions

Events of the past few months, discussed in CEA memos earlier this year, significantly loosened for a while the relation between the money supply and the nonborrowed reserves created by the Fed. This made it impossible for individuals or agencies to be near-perfect guessers on achieving any desired money-growth path. The further complication developed that, to the extent that the increase in the money supply becomes associated with lower short-term interest rates, the dollar may lose ground in foreign markets and hence what otherwise would be the desirable rate of money growth may become a rate that deviates in the inflationary direction. I believe that these difficulties will be much smaller in the coming quarters and that this will show in the money-supply statistics. There is no reason to believe that the Fed was ever aiming for the very low money growth rates of the recent past or that interest-rate targets will prove incompatible with the objective of reasonable money growth. In cooperation with the Fed these problems and the others discussed in the present memo should be made understandable to all those engaged in economic-policy work and also to the interested public at large. We should make it more generally understood also why the suggestion to commit the Fed to quantitatively specified targets is ill-conceived.

1. <u>Dilemmas the Fed is facing, as seen from the outside.</u>

Providing during the recession a given total stimulus to aggregate demand requires more monetary expansion if deficit-spending is smaller than if it is larger. Monetary expansion which is of the "right size" when the budget deficit is smaller becomes inflationary expansion for increased deficits. In spite of this, the political pressures on the Fed rapidly to increase the money supply become larger as the deficit grows larger--and for FY 1976 the deficit is apt to become very large. Those of us who have never been in their shoes can have no secure guess as to how this paradox influences the expectations and planning of monetary authorities; yet the Fed must be expecting strong pressures for the later part of the year (I too would).

Whatever the Fed's expectations are in this regard, they clearly did not lead it to aim for the exceedingly low money growth rates which we had recently (disregarding as yet the rapid growth observed in the most recent single week for which data are available).* The explanation of the low growth rates for the past 13 or even 26 weeks is presumably to be found in something else, namely, in the looseness of the relationship between the money supply and the variables under the Fed's control (see [2] below).

In fact only rarely do the critics of the Fed maintain that the small money growth rates of recent periods have resulted from deliberate policy in this crude sense.

---

*M_1 increased by $1 billion and M_2 by $2.1 billion in that single week. The total quantity of M_1 is $284 billion and that of M_2 $623 billion.

What they maintain more frequently is that the attempt not to allow short rates to decline too rapidly has gotten in the way of raising the money supply at a sufficient rate. The attempt to reduce the steepness of the decline of interest rates must have had to do partly with misgivings about the effects of a steep decline on the exchange rates of the dollar, all the more because a decline of the dollar rates abroad tends to make any given increase in the money supply more inflationary (more goods are leaving the country and there develops a price-raising effect on all "traded goods"). But misgivings about a very abrupt decline in short-term interest rates may have been motivated partly also by the anticipation of subsequent pressures on the Fed when the financing needs of the Treasury and a recovery would raise interest rates steeply from any abnormally low levels to which the rates might now fall. Yet, as we shall see, when it became apparent that the money supply was rising hardly at all, the Fed did adopt additional measures to induce the banks to create more deposits, and this was done in spite of the possible further "downward" effect of these reserve-policy measures on interest rates, particularly on short rates. At the end interest-rate objectives have not "won out" over money-supply objectives. The money-supply objectives should not remain uninfluenced by the feedback of exchange-rate movements (hence of interest-rate movements) on inflationary trends in the domestic economy but taking account of this does not suggest keeping future money growth rates at a level that would interfere with economic recovery later this year.

FORD LIBRARY

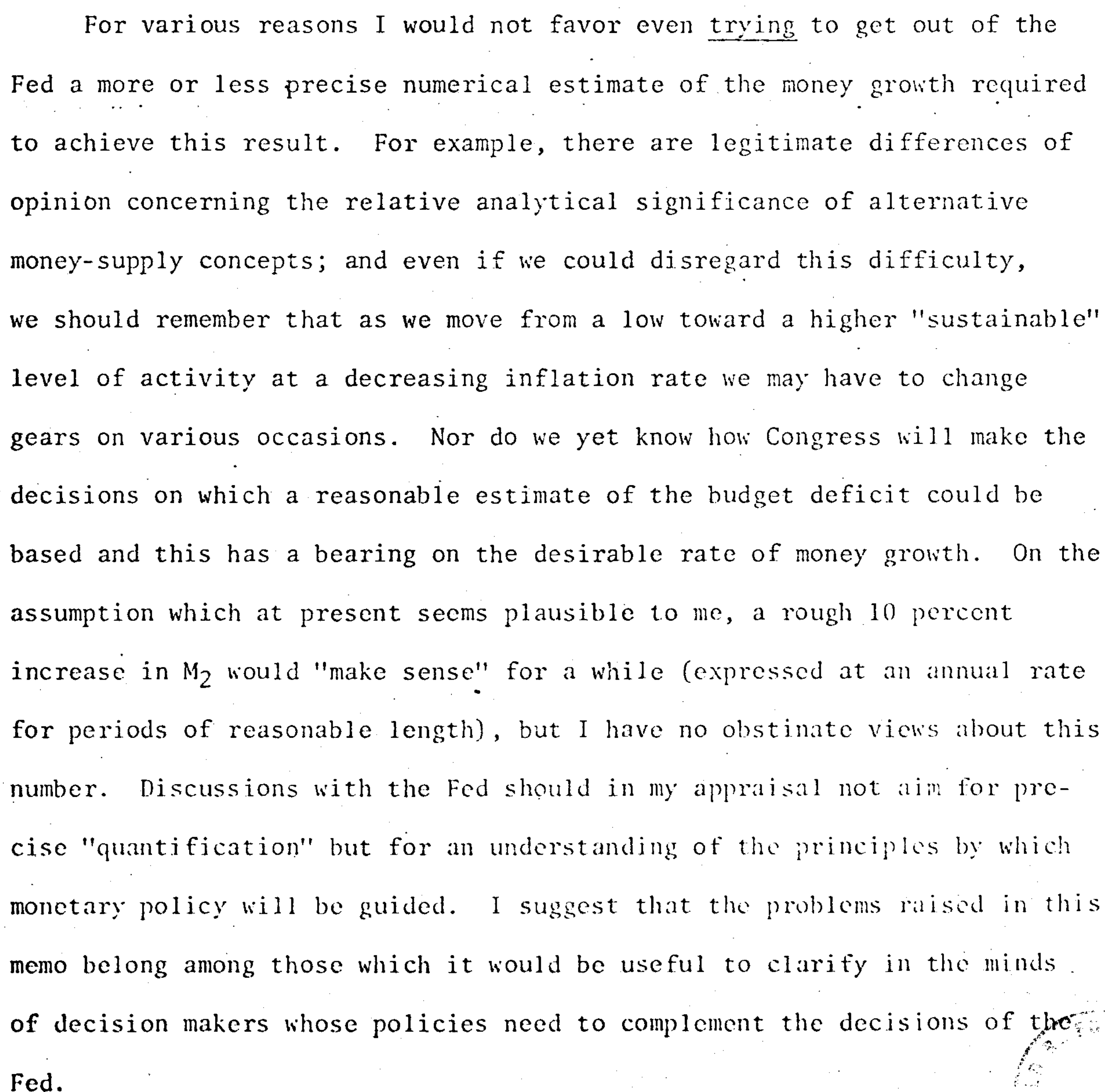
2. <u>The recent course of the money aggregates and of reserves</u>.

No one was satisfied with the practically zero M_1-growth and roughly 5 percent annualized M_2 growth observed for the past three months. Even for the past 26 weeks the annualized rates are only about 2 percent for M_1 and they are in the neighborhood of no more than 6 percent for M_2, though one gets up to roughly 8 percent if large CDs are added to the conventional M_2.

However, it is essential to note that the nonborrowed reserves provided by the Fed increased at an annual rate of no less than 19 percent during the past 26 weeks (nearly 13 percent during the past 3 months). The main reason why the money stock increased very little during this time was that the banks were repaying their formerly very significant borrowings from the Fed at a rapid rate. In such circumstances it would be quite unrealistic to expect any monetary authority to be a practically perfect guesser on the relationship between the nonborrowed reserves it supplies and the growth of the money stock. If the money stock had risen even <u>nearly</u> as rapidly as the nonborrowed reserves supplied by the Fed, the inflation outlook would be very much worse than it is now. Considering that by now the banks have repaid practically all their borrowings to the Fed, <u>and</u> that the Fed reduced the required reserve ratios on two occasions in order to induce the banks to create more money, we may now expect a considerable increase in the money supply (hopefully not an oversupply).

3. Desirable Objectives

To get a healthy upturn some time in 1975, we should have to get during the coming months and quarters growth rates of the money supply compatible with a somewhat greater than 10 percent (say up to 12 percent) increase in money GNP late in the year, hoping that by then such an increase will contain an inflation component of no more than about 5 percent.



For various reasons I would not favor even trying to get out of the Fed a more or less precise numerical estimate of the money growth required to achieve this result. For example, there are legitimate differences of opinion concerning the relative analytical significance of alternative money-supply concepts; and even if we could disregard this difficulty, we should remember that as we move from a low toward a higher "sustainable" level of activity at a decreasing inflation rate we may have to change gears on various occasions. Nor do we yet know how Congress will make the decisions on which a reasonable estimate of the budget deficit could be based and this has a bearing on the desirable rate of money growth. On the assumption which at present seems plausible to me, a rough 10 percent increase in M_2 would "make sense" for a while (expressed at an annual rate for periods of reasonable length), but I have no obstinate views about this number. Discussions with the Fed should in my appraisal not aim for precise "quantification" but for an understanding of the principles by which monetary policy will be guided. I suggest that the problems raised in this memo belong among those which it would be useful to clarify in the minds of decision makers whose policies need to complement the decisions of the Fed.

Some Details

(Optional Reading)

(1) Money Growth. The following figures give numerical content to the statements in the Summary concerning the growth of the money supply.

Percent Changes of Monetary Aggregates,
Seasonally Adjusted Annual Rates

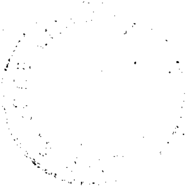
Period	M_1 (currency plus demand deposits)	M_2 (currency plus all commercial bank deposits except large CD's)	Credit (adjusted bank credit proxy)
Past 52 weeks (from average of four weeks ending Feb. 27, 1974 to average of four weeks ending Feb. 26, 1975)	3.9	6.9	9.2
Past 26 weeks (from average of four weeks ending Aug. 28, 1974 to average of four weeks ending Feb. 26, 1975)	1.9	6.1	3.4
Past 13 weeks (from average of four weeks ending Nov. 27, 1974 to average of four weeks ending Feb. 26, 1975)	0	5.3	3.8
Past 4 weeks (from average of four weeks ending Jan. 29, 1975 to average of four weeks ending Feb. 26, 1975)	7.1	10.4	0

Interest Rates
(average of daily figures)

(percent)

Period	U.S. Government 3-month bills	U.S. Government 3-5 year issues	U.S. Government long term bonds	Prime commercial paper 4-6 months	Moody's Aa bond rate
September	8.36	8.38	7.30	11.23	9.24
October	7.24	7.98	7.22	9.36	9.27
November	7.59	7.65	6.93	8.81	8.90
December	7.18	7.22	6.78	8.98	8.89
January	6.49	7.29	6.68	7.30	8.83
[illegible]ruary	5.58	6.85	6.61	6.33	8.62
Week ending:					
Feb. 7	5.67	6.91	6.59	6.45	8.68
Feb. 14	5.80	6.92	6.58	6.34	8.63
Feb. 21	5.41	6.71	6.63	6.28	8.58
Feb. 28	5.46	6.83	6.64	6.25	8.57
Mar. 7p	5.64	6.85	6.67	6.25	8.60

Monetary Policy Legislation



Material Submitted by Congressman Ashley

A BILL

To require the Board of Governors of the Federal Reserve System to make certain reports to the Congress to facilitate coordination of fiscal policy with monetary and credit policies.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

In order to facilitate planning of budget and tax policies and to assist coordination of fiscal policies with monetary and credit policies, the Board of Governors of the Federal Reserve System shall transmit to the Congress on or before the 20th of each January and July

(a) a statement of the Board's interpretation of current economic and financial conditions,

(b) a statement of the Board's expectations about business and financial conditions during the forthcoming two years,

(c) a statement of the Board's projections of long-run and intermediate-run attainable national targets for growth of national income and expenditures, rate of change in the overall price level, growth of real national product and levels of employment and unemployment,

(d) a projection by the Board of the desirable rates of growth in monetary aggregates consistent with these economic targets. The monetary aggregate projections shall include the narrowly defined money stock, demand deposits and currency; and broadly defined money stock, including some or all time and savings deposits, and direct or proxy measures of total loans and investments at commercial banks.

(e) a projection by the Board of the rates of interest consistent with the economic targets and with the specified rates of growth in monetary aggregates.

In all cases, the specification of projections and targets should be stated in terms of reasonable ranges, above and below the most likely or most appropriate single figures.

OVERSEEING MONETARY POLICY

Congress does have a duty to systematically oversee monetary policy, to bring it out in the open, debate it, criticize it, and afford opportunities for the public, including experts, to comment on it and propose alternatives.

As to fiscal policy, we require the Executive Branch to promulgate its budget and its Economic Report each year setting forth programs for the following year so that it may be subject to public and congressional scrutiny and debate.

There is no such program for disclosing monetary policy objectives. Indeed, we do not even know what current monetary licy objectives are. The policies determined by the Open Market Committee being pursued by the Fed at any given time are not disclosed until 90 days after the decision is made.

The draft bill provides that the Board shall make semiannual reports to Congress setting forth:

(a) the Fed's interpretation of current economic and financial conditions,

(b) the Fed's expectations about business and financial conditions for the coming 2 years,

(c) the Fed's Open Market Committee's long- and intermediate-run targets for growth of national income and expenditures, rate of change in the price level, growth of real national product and vels of employment and unemployment,

(d) projection of desirable rates of growth in monetary aggregates, including the various measures of money,

(e) projections of rates of interest consistent with the economic and monetary targets.

The bill does not mandate targets which the Fed must meet or pursue. It requires the Fed to make its own projections of attainable or desirable targets.

Although it does not require the Fed to stick with its targets, it might well tend to that effect, since the Fed would have to justify deviations and departures from its own objectives. And it would tend to make the Fed plan for and consider the long-term consequences of its actions.

It does not require the Fed to focus on only one narrowly-defined target of monetary growth, but includes all the variables set forth by Chairman Burns in his testimony describing what the Board must consider. (Statement, February 6)

It does not require the Fed to ignore interest rate changes, but requires their projection in relationship to economic target rates of growth of monetary aggregates.

It would assist not only the Congress, but other government entities in planning their activities which are impacted by monetary policies. The private sector, including labor, industry and investors, would be able to plan their own activities with more information as to what future economic conditions will be; while still imperfectly, certainly with more knowledge of the greatest variable - monetary policy.

Some of the mystique, and, therefore, the suspicion of the methods and purposes of Fed and Open Market operations would be removed by greater public exposure.

To the extent the Fed pursues its announced targets, openly and independently, the more likely the Congress and the Executive Branch, knowing these plans, would accept a greater degree of responsibility for fiscal policy.

If the Fed presents its targets in terms of the variables which different taxing and spending policies impinge upon its own targets for monetary policy, Congress and the Executive Branch will more likely act responsibly on taxing and spending, instead of passing the buck to the Fed to make up for its deficiences in fiscal affairs by manipulating the monetary policy.

LEGISLATING MONETARY POLICY

H. R. 212 exhorts the Fed to direct its efforts in the first half of 1975 to increase the money supply at a rate of no less than 6 percent.

H. R. 3160 abandons that approach and requires the Fed to "lower long-term interest rates."

Dr. Burns, testifying on H. R. 212, said "There is a school of thought that holds that the Federal Reserve need pay no attention to interest rates, that the only thing that matters is how this or that monetary aggregate is behaving." He went on to explain why we pay close attention to interest rates.

Suddenly, our own objective is switched from money supply to interest rates.

But Dr. Burns testified that sharply increasing the money supply to drive down short-term rates creates the real possibility that "a monetary base would be established for a new wave of inflation in the future, and that market expectations of such a development would lead rather promptly to a rise of long-term interest rates."

I don't know whether this is correct or not, but if it is, in H. R. 3160 we propose that the Fed do exactly the opposite of what H. R. 212 proposed.

What influences high, long-term interest rates? I believe most economists would say "inflationary expectations." Thus,

if the Fed is to focus on long-term interest rates and drive them down, it must act to dampen inflationary expectations and one way to do that is to restrict the money supply. Is that what we want done?

We are trying to legislate a semblance of a program for the Fed when we don't even know the Fed's own program. We are trying to legislate a single factor of monetary policy when we don't even know what the Fed will do in other factors.

It is quite possible that the Fed has been at times too erratic in its monetary policies and at other times too slow in making changes in monetary objectives in response to changed economic conditions. There is no assurance that Congress would do better, and the nature of the two institutions would indicate it would do worse. Advocates of congressional direction of monetary policy are already out-of-date in their targets, and legislation is weeks, perhaps months, from enactment.

It is quite possible that the errors of the Fed have been primarily due to its efforts to compensate for the failures of Congress and the Executive Branch to control fiscal policy, and in this it may be attempting to do too much, and by so doing contributing to economic instability.

During the past session, Congress recognized the need for an integrated approach to fiscal policy in the Congressional Budget Control Act of 1974. Under this Act we will try to

coordinate tax and spending policies. Whether it will work or not, we do not yet know. What is missing in the equation of tax and spending policy is the variable of monetary policy.

This was well stated in a recent (February 10) issue of Newsweek in a column by William Wolman:

> "No team work. What has clearly been lacking to date is the coordination of monetary and fiscal policy. The Administration and Congress continue to make plans without regard to their monetary implications. And the Fed keeps money tight--even at the risk of prolonging the recession--in fear of what Congress and the Administration might do on the fiscal front.
>
> "This is no way to run a monetary policy. The problem of policy coordination is not new or confined to the U.S. Indeed, both Germany and Switzerland, which face the identical problem of combining a stimulative policy in the short run with inflation-control in the long run, have recently made some important strides in policy coordination. In Germany, for example, Karl F. Klasen, president of the Deutsche Bundesbank, has announced that he will seek 8% monetary growth for the remainder of the year, while the government has at least agreed to face up to the interest-rate consequences of a large deficit. What is right for Germany is not, of course, necessarily exactly right for the U.S. But

some immediate moves toward policy coordination are needed if the U.S. is not to be subjected to still another fierce round of stop-go policy. If such coordination is not pushed, the odds are that policy will be too restrictive in the first half of 1975 and too expansive in the following 12 months."

6. TAX POLICY

March 10, 1975

TAX POLICY

A range of tax policy options is discussed briefly in the paper by Treasury in this Tab. The proposals discussed are mainly tax incentive approaches as contrasted with alternative fiscal policy tax changes.

Broad Tax Incentive Proposals

1. Eliminate two-tier tax through "integration" to rationalize the tax system.

2. Reduce corporate tax rates to stimulate investment.

Limited Incentive Approaches

3. Make dividends on preferred stocks tax deductible like interest expense.

4. Relieve shareholders from tax on dividends reinvested in the corporation. (could be limited only to utilities)

5. Exempt from taxation all gains from sales of new issues of stocks by corporations to stimulate financing of investment through new stock issues.

Capital Gains Treatment

6. Vary the capital gains tax by length of the holding period.

Capital Cost Recovery

7. Restructure the investment tax credit along the lines of the October, 1974 proposals.

8. Replacement cost depreciation instead of permitting depreciation only on the basis of original costs for tax purposes.

9. Variations designed to achieve similar results:

   (i) Rapid amortization cost recovery

   (ii) Partial expensing combined with depreciation

10. Indexing the tax system for inflation.

Other Selective Incentives

11. Permit rapid (5 year) amortization for selected types of property (such as e.g. health and safety or pollution abatement investment).

12. Special tax credits to encourage economic shifts to recycling, use of wastes for fuel, etc.

13. Permit cost of selected equipment outlays to be expensed.

14. Selective credits for special industries, such as in the energy area.

15. Tax incentives to encourage technology, research and development.

Selective Incentives for Housing and Savings

16. Tax exemption for interest income from thrift institutions to increase availability of home mortgage financing.

17. Temporary tax credits on mortgage interest payments designed to phase into tax deductions over time to stabilize housing.

18. Tax credit for new home purchases.

Other Tax Proposals

19. Examine Presidential discretion for setting or altering tax withholding rates within the framework of existing tax legislation.

20. Seek Presidential discretion for timely, temporary tax changes for cyclical stabilization purposes. (OMB paper in second section of this Tab)

21. Extend the tax-loss carryback provision up to 7 years.

22. Extend the carryback provisions for the Investment Tax Credit to up to 7 years, or make the tax credit refundable.

23. Tax the undistributed earnings of U.S. owned foreign manufacturing corporations that benefit from foreign tax incentives or that manufacture products for shipment into U.S. markets.

24. Postpone retroactively Social Security Tax increase (taxable earnings base) effective this year. (Commerce paper, Tab 11)

(continued)

25. Enact a small business tax exemption for first $10,000 in sales. (Commerce paper, Tab 11)

26. Reductions in selected excise taxes to stimulate production and sales and to reduce costs and prices, e.g. for tires and for trucks.

Treasury Tax Paper

Discretionary Tax Reduction Authority

7. UTILITIES

March 10, 1975

ELECTRIC UTILITIES

A great deal of information has been assembled on the electric utilities issue. Primary facts include:

-- Very substantial deferrals and cancellations of construction of new generating facilities.

-- Low earnings and cash flow resulting from regulatory lags and contributing to financing difficulties.

-- Serious current unemployment in the construction sector and possible future electrical power shortages.

FEA has prepared a major paper discussing possible Federal actions, and the FEA summary paper discussing this issue and presenting options is included in this Tab. A major background paper by FEA, a staff paper from the SEC, a list of facilities with delays or cancellations in construction from Treasury, and proposals submitted by utility companies are also available.

FEA Paper

Short-Term options presented in the FEA paper are:

Option 1: Loans to utilities under Section 13 of the Federal Reserve Act.

Option 2: Administration urge commercial banks to establish a special fund to assist utilities.

Option 3: Federal government encourages purchase of plants by governmental authorities.

Option 4: Federal government lends fuel to utilities against future payment or return of fuel.

Longer-Term options presented in the FEA paper are:

Option 1: Issue voluntary Federal guidelines for regulatory procedures, rate structures and conservation.

Option 2: Federal incentives conditional on the voluntary adoption of guidelines for regulatory procedures, rate structures, and conservation. Proposed incentives:

(a) Rebate of energy excise taxes and tariffs.
(b) Federal tax deferral on revenues from CWIP sources.

Option 3: Establish a Federal Utility Finance Corporation to purchase a special class of utility preferred stock upon joint application by the utility and its regulatory authority. ($15 bill capitalization).

Option 4: Federal government loan guarantees for utility debt provided for construction of coal and nuclear facilities, contingent on agreement by regulatory authorities on rates of return.

Option 5: Allow dividends on utility common stocks and new issues of preferred stocks to be tax free to recipients.

Option 6: Federal government contracts to purchase output from new non-petroleum generating plants.

Option 7: Federal government and utilities establish join ventures for construction of new non-petroleum fired generating plants, with the utility to repurchase on an installment basis.

Option 8: Federal government purchases and leases back to the utility of generating plants.

Option 9: Federal government gives cash rebates of unutilized Investment Tax Credits.

SEC Paper

Alternative approaches in the SEC paper are:

1. Tax relief by making dividends paid by utilities deductible for corporate income tax purposes.

2. Establish regional authorities to undertake construction and financing of major generation and transmission projects on a turnkey basis.

3. Undertake research on technological problems, construction costs, peak load demands, etc.

No recommendations are given.

Florida Power & Light Paper

Basic problem viewed as high interest costs, soaring fuel costs, and slow rate relief. Proposals include:

1. Liberalization of investment tax credit, including extension of carryback period.

2. Defer taxes on reinvested dividends, and tax at capital gains rate when equities are sold.

3. Liberalize pollution control bond issue regulations.

4. Federal financing agency should not be established.

5. Permit tax deductability of preferred stock dividends.

6. Special tax preference for new issues of stock.

Consumers Power (Michigan) Paper

Estimates of total electric utility construction schedule cutbacks totalling $20.8 billion are presented:

Total present installed generating capacity	455.5	thous. mw.
Cutbacks		
Nuclear	110.9	thous. mw.
Other	59.7	thous. mw.
Total cutbacks	170.6	thous. mw.

Recommendations are:

1. Rate increases to restore adequate earnings levels

2. Government financing program to restore construction schedules now with these features:

   - Temporary, 1975-78
   - Equity
   - Non-voting
   - Callable at par at any time
   - Going market rates, no subsidy
   - Conditional on appropriate regulatory authority commitment on rates.

Other Proposals

A list of approaches that have been suggested follows:

Tax Policy Proposals (discussed in Treasury paper in tax policy section)

1. Extend the carry-back period for the investment tax credit for 7 years, instead of 3 years as provided in the current House Bill.

2. Make dividends from preferred stocks deductible for personal income taxes.

3. Exempt reinvested dividends from personal income taxes, and tax income from sale of stocks derived from dividends reinvested at capital gains rates.

4. Exempt from personal income taxation, or apply a special capital gains rate to, first sales of stock purchased when issued by corporations in order to improve financing through stock sales.

5. Defer Federal taxes on earnings generated on the basis of inclusion of construction work in progress in the rate base until facility is placed in service. ("Sillin" proposal, Lee Sillin, Chairman of Northeast Utilities).

6. Tax exemption for dividends received on all utility common stock and new preferred issues. ("Harris" proposal, Shearon Harris, Chairman, Carolina Light & Power).

Financing Proposals

7. Use administrative discretion for a broad interpretation of pollution control investment, particularly for nuclear facilities, for purposes of financing through tax exempt industrial revenue bonds.

8. Develop a financing system, based on participation principles similar to a mutual insurance system, to begin construction of more uranium enrichment facilities.

9. Extend duration of nuclear accident insurance for nuclear power facilities.

10. Federal guarantees could be given for utility debt. (Rosenberg proposal and White Bill).

11. Provide immediate direct government loans to utilities on an "interim" basis to be repaid when funding from normal sources can be obtained.

12. Establish a Federal Utility Finance Corporation with funding provided in response to joint application by the utility and regulatory commission and conditions applied to both, such as application of rate-making guidelines and development of a sinking fund.

13. Establish regional authorities to undertake construction of major generation and transmission facilities on a turnkey basis. The authority would develop financing for construction, possibly supported by governmental guarantees of financing, or other incentives. (SEC)

14. Explore capability of the Federal Reserve for direct loans and discounting of loans in exceptional circumstances. (FEA)

15. Establish a special fund by the banking industry to supply credit for utilities in serious financial difficulty. (FEA)

Other Proposals

16. Press for rapid action on the Utilities Act of 1975 providing for:

    (a) A 5-month limitation on suspension of rate applications.

    (b) Automatic fuel cost adjustments.

    (c) Removal of prohibitions against off-peak pricing adjustments.

    (d) Inclusion of construction work in progress in the rate base.

(e) Normalization of accounting methods to permit utilities to retain benefits from the investment tax credit and accelerated depreciation provisions.

17. Work with relevant regulatory commissions to expedite handling of requests for electric utility rate increases on an urgent basis.

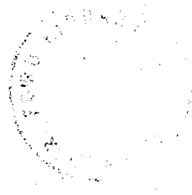
18. Develop voluntary national guidelines for electricity rate-making.

19. Focus quick attention on technological factors, such as dependability of cost and performance specifications, peak-load rate differentials, and the like. (SEC)

20. Avoid capitalization of leases as an accounting standard.

21. Power-purchase guarantee proposal. (Hosmer scheme) Under this proposal the Federal government would guarantee purchase, at profitable rates, of all electricity generated by nuclear or coal-fired plants that were delayed or cancelled due to lack of financing.

FEA Background and Options Paper



DRAFT

THE FINANCIAL PROBLEMS

OF

THE ELECTRIC UTILITY INDUSTRY

DRAFT

DRAFT

ISSUE PAPER

DRAFT

ELECTRIC UTILITIES

ISSUE

Are additional Federal actions required to solve the electric utilities' current financing crisis and to improve their long-term financial outlook?

BACKGROUND/PROBLEM

The investor-owned electric utility industry is in serious financial difficulty:

- earnings and cash flows are low;
- common stock prices are at 70 percent of book value,
- debt interest coverage ratios for many utilities are at or below legal borrowing limits.

As a result, a higher percentage of external capital is required at a time when raising such capital (debt or equity).is prohibitively expensive or unavailable. The effect of these events has been:

- Utilities: in 1974 cancelled or postponed over $20 billion of capital expenditures including more than 60 percent of planned nuclear and 30 percent of planned non-nuclear power plant expansions.
- Residential Consumers: vigorously fighting recent increases in electricity costs (primarily due to fossil fuel cost pass-throughs) and opposing any new cost increases.

- State Regulatory Commissions: caught between utilities needs and consumer opposition, indecisive action in the critical states, and generally "business-as-usual" in regard to regulatory practices.

A continuation of the current trends would:

- Seriously threaten many of the President's economic and energy goals, including:
  - reduced oil imports
  - energy self-sufficiency
  - an end to the recession
  - force the Federal Government to take future emergency actions, not necessarily in the best long-term interests of the country
  - exacerbate the political problems of the Administration.

CURRENT FEDERAL ACTIONS

To alleviate these problems the President has proposed the Utilities Act of 1975. The intent of this Act is to provide a timely increase in utility cash flow and return on investment to restore investor confidence. It would achieve those objectives by defining minimum standards for six regulatory practices governing electric utilities:*

1. A five (5) month limitation for action on rate applications.
2. Automatic fuel adjustment clauses.
3. Prohibition from banning sales of electricity off-peak at lower prices than on-peak.
4. Inclusion of construction work in progress in the rate base.

---

* A separate issue paper has been prepared to evaluate the extension of these standards to Gas Utilities. FEA, OMB and Treasury have recommended such an extension.

R. FORD

5. Inclusion of pollution control equipment in the rate base.
6. Normalization method of accounting.

If fully implemented nationwide, these minimum standards would raise the average price of electricity an estimated 13 percent. When translated into revenues and profits, the immediate crisis in cash flow and return on investment would, in the aggregate, be resolved. For an individual utility, large rate increases might be required to obtain financial viability.

The resultant average increases in utility taxable earnings would permit effective use of the higher investment tax credits, also proposed by the President.

- a uniform investment tax credit (ITC) of 7 percent (versus current 4 percent level)
- a one-year ITC of 12 percent for all industry
- an additional two years of 12 percent ITC for non-oil and non-gas fired power plants.

These actions are intended to increase utility cash flow. The President's program also requested a special class of preferred stock, with dividends deductible for income taxes by the issuing company (applies to all industry).

PROJECTED EFFECTIVENESS OF ACTIONS

1. Current Financing Crisis:

The utility industry has experienced financial crisis for more than a year. None of the proposed Federal actions can be enacted soon enough to help the current crisis. In fact, any action solely dependent on new legislation will be ineffective in the short term.

- Passage of the Utilities Act of 1975 might not be until 1976.
- If passed, the Act will be challenged in the courts.

Independent of these time factors, the intent of the Act is to increase cash flow and return on investment. This interest could be easily by-passed by a state regulatory commission which could:

- reduce rate of return on the higher rate base;
- reduce revenue requirements by decreasing allowed depreciation
- make other adjustments to the rate base.

The tax incentives also have intrinsic failings:

- Special Preferred Stock
  - the special preferred stock proposal would attract industrial and financial institutions to preferred market
  - the increased competition would drain funds from utilities.
- Investment Tax Credit (ITC)
  - the companies in worst financial condition pay little, if any taxes; hence
  - increased ITC requires increased tax liabilities to be effective, as well as normalization of tax benefits.

2. Immediate Fiscal Dislocations:

That is, in the next two-month period a utility:

- passes a dividend
- declares bankruptcy.

The Federal Government:

- should not be expected to solve this problem
- would have difficulty taking independent effective action to either:

- prevent such an event, or
- remedy the event upon its occurrence.

The Administration should:

- develop a plan to handle such occurrence in a politically acceptable fashion.
- prepare a program to minimize the national impact of such an event.

POSSIBLE SHORT-TERM FEDERAL ACTIONS

Four administrative options are available to the Executive Branch to impact on an immediate financing crisis:

Option 1: Loans to utilities under Section 13 of the Federal Reserve Act.

PROS:

- could be implemented quickly
- would not need additional legislation.

CONS:

- FRB might interpret Section 13 differently
- bad precedent to extend to non-banking operations
- some utilities can't acquire additional debt without violating indentures. If default, Government might end up operating utility.

Option 2: Administration urges commercial bank to establish special fund.

PROS:

- needs no additional legislation
- restores confidence in utilities market
- demonstrates intention to prevent utility failure.

CONS:

- may be difficult without Federal guarantee of loans
- other industries may request the same treatment
- reduces burden on regulatory authorities
- meeting with banks to secure pledges is better.

Option 3: Federal Government encourages purchase of plant by governmental authority.

PROS:

- provide immediate cash relief
- precedent in New York's purchase of Con. Ed.'s two plants
- demonstrates intent to leave responsibility to states.

CONS:

- costly to purchaser - some states may be unable
- legal constraints may take considerable time to iron out.

Option 4: Federal Government lends fuel to utilities against future payment or return of fuel.

PROS:

- relieve cash outflow of about 50 percent of average utility's monthly expenses
- could be implemented rapidly under Defense Production Act.

CONS:

- Defense Production Act expires in June, 1975
- relief is short-term and might relieve regulatory authorities of immediate responsibility.

- other industries have high fuel costs - difficult to limit to utilities
- some legal and practical problems exist.

ADDITIONAL LONGER TERM FEDERAL ACTIONS

Nine primary options are available to the Administration to mitigate or resolve the utilities' longer term financing problems:

Option 1: Issue voluntary Federal guidelines for regulatory procedures, rate structures and conservation.

The Administration would aggressively lobby for the adoption of these guidelines, particularly in those states where utilities are in difficulty.

PROS:

- requires no legislation and has minor administrative costs
- can be done immediately and supports thrust of Utilities Act of 1975 by Congress
- demonstrates Administration's urgent concern for the problem.
- does not constrain local decision-making
- would elicit broad industry and state regulatory support
- permits flexibility and avoids legal issues.

CONS:

- is not legally binding and may not be effective

<u>Option 2</u>: Federal incentives conditional on the voluntary adoption of guidelines for regulatory procedures, rate structures and conservation.

Proposed Incentives:

a. Rebate of, or exemption from, excise taxes and tariffs on oil and gas

b. Defer Federal tax due on revenues from CWIP (coal and nuclear) included in rate base until facility placed in service.

<u>PROS</u>:

- a carrot rather than a stick approach - favored by many regulatory commissioners and much of industry
- would improve financial integrity, thereby encouraging capital investment and could be limited to coal and nuclear plants
- would facilitate adoption of guidelines and construction of generating facilities complementing our energy goals
- easing of excise taxes and tariffs on segment of oil consumption where least elasticity may exist and consumer opposition the greatest - demonstrate Administration's concern for consumers' problems.

<u>CONS</u>:

- would target assistance to utilities and could lead to pressures for similar relief by other industries
- Option 2(b) would shift some electricity cost from ratepayers to taxpayers.

- rebate or exemption from excise taxes and tariffs would reduce Treasury revenues by an estimated initial $2.4 billion annually.
- Option 2(b) would reduce current annual Treasury revenue by an estimated $1.4 billion.

Option 3: Utility Finance Corporation - Establish a Federal Utility Finance Corporation to purchase a special class of utility preferred stock upon joint application by the utility and its regulatory authority.

The preferred stock would be subject to retirement by a sinking fund with a 7-10 year average life. Dividends would be paid quarterly at 110 to 120 percent of the current market rate. Eligibility for such investment would be conditioned on a commission's granting an emergency rate increase sufficient to provide a specified minimum percentage of the utility's required cash flow, and adoption of Federal voluntary guidelines. A $15 billion capitalization would be required.

PROS:

- would assure financing to most utilities and commissions
- would provide prompt financing independent of capital market uncertainty and adverse psychological impact of dividend omissions
- stringent eligibility criteria would prevent a Federal "bail out" of utilities and regulatory authorities.
- large initial capitalization but little net cost to Treasury.

CONS:

- requires bureaucracy to administer
- greater Federal intervention

- some revenue loss to Treasury
- some utilities may fail and force UFC to abandon investment or take over operation

Option 4: Federal Loan Guarantees

The Federal Government would guarantee utility debt. These loan guarantees would be provided for use in the construction of new coal and nuclear facilities. Availability would be contingent on a regulatory authority's granting stipulated rate increases or allowing a rate of return sufficient to enable a utility to sell additional equity. These guarantees would be available for a limited time; i.e., 5 years.

PROS:

- would immediately enable a utility to raise sufficient capital to finance necessary new construction and assure adequate electric power from a fuel mix in line with our national energy goals
- would enable utilities to issue bonds at slightly lower interest costs than otherwise available in the market, and thereby result in lower electricity costs to consumers

CONS:

- some utilities may default, leaving government with proprietary interest.
- does not increase the total investment funds available to the economy. Merely takes capital away from other sectors and may lead to similar requests from other industries.

- raises general level of interest rates in the economy
- to the extent utilities would be paying less Federal taxes, a higher tax burden would be placed on other taxpayers or a larger Federal budget deficit would accrue
- would relieve regulatory authorities from pressures to grant cost justified rates, resulting in further deterioration of utilities' financial positions
- would violate coverage restrictions in some existing indentures and after-acquired property clauses would prevent the Government from taking preferred creditor status as to the particular facility financed. In the last analysis, would likely result in the Federal Government providing all the money and guaranteeing outstanding bonds.

Option 5: Allow dividends on utility common stocks and new issues of preferred to be tax free to recipients.

PROS:

- would make investment in electric utilities' common more attractive to non-corporate investors because of higher after-tax yields
- the greater after-tax value of the dividend to investor would permit the utility to attract more equity investment or to reduce its cash disbursements for dividends
- if the utility reduced its dividend disbursements, the difference in pre-tax dividend costs would then be available either to improve coverage, thereby lowering new financing costs, or to permit issuance of a greater amount of new debt at existing coverage ratios.

- a variant, providing for tax-free stock dividends in lieu of cash, might be easier to implement and more effective in inducing new investment in electric utility commons. Such reinvestment might account for about $1 billion of the estimated near-term $3 billion annual equity need of the electric utilities.

CONS:

- investors would not invest in new equities of those utilities most needing help, but would invest in higher quality issues
- making preferred tax-free would have minimal impact since major buyers of preferreds are corporations which currently enjoy an an 85 percent (generally) exclusion
- cost to Treasury in 1985 probably would be less than $1.5 million for common, and about $80 million for preferred.

Option 6: Federal Government contracts to purchase output from new non-petroleum generating plants.

PROS:

- provides incentive for utilities to resume construction of nuclear and coal-fired plants by guaranteeing market
- wheeling of non-petroleum based power would be facilitated
- guaranteed future revenues might buy investors back to the market.

CONS:

- not helpful in the short term as utilities need increased earnings now to issue additional debt, plus some have coverage problems

- probably not sufficient to lure investors and boost stocks to book value
- difficult to determine purchase price
- program is fraught with practical problems in the purchasing mechanism

Option 7: Federal Government and utilities establish joint ventures for construction of new non-petroleum fired generating plants, with the utility to repurchase on an installment basis.

PROS:

- as the Government share is repurchased, it would be included in the rate base. This would result in a uniform flow in requirements for additional revenues and eliminate the one-time impact on customers when new utility plant is added.
- Government would not directly participate in plant operations - not intended to be permanent participation

CONS:

- would expand Government participation in electric power operations
- repurchase of Government share would include pre-determined interest charges - utility might see this as an adverse aspect.

Option 8: Federal Government purchases and leases back to a utility generating plants.

PROS:

- utility would exchange asset for cash, thereby improving cash flow
- utility would keep direct access to generating capacity
- new plant construction could begin without reliance on external funds

- plant would be returned to rate base in increasing increments - effect on customers would be uniform rather than a large, one-time effect.

CONS:

- state regulatory authorities might take the plant out of rate base, thereby reducing amount upon which a return is based
- rate of return would have to be increased to keep revenues available for dividends.

Option 9: Federal Government gives cash rebates of unutilized Investment Tax Credits.

PROS:

- for utilities with low levels of taxable income, could result in substantial additions to cash flow
- would help utilities in worst condition, those with low earnings, and large construction programs
- would be limited to proportion of total investment due to nuclear, coal, or pumped storage projects - incentive not to build petroleum-fired plants
- would eliminate incentive to lengthen construction periods.

CONS:

- impact depends upon Congressional actions to increase ITC
- would result in a revenue loss to the Treasury.

LEGISLATION AND BUDGET COSTS

With the exception of Option 1 (guidelines) each of the above options would require new legislation. Options 2a, 2b, 5 and 9 would be relatively straightforward tax law revisions and would have wide industry support. Option 3, the UFC, has historical precedent in the old RFC, and would likely find approval in Congress and industry. Option 4 (loan guarantees) would be opposed by industry, most state regulators, and by environmental groups, but has superficial appeal in Congress. Options 6, 7 and 8 would be opposed by most sectors of the industry.

The administrative costs of each option are small with the exception of the Utility Finance Corpoation, purchasing of power, and Federal loan guarantees which would require a Federal staff of about 100 people.

The costs to the Treasury are estimated below:

Option 2a: Guidelines coupled with rebate or exemption from excise tax and import fees:

Estimated Cost: $2.4 billion annually (near term)

Option 2b: Guidelines coupled with deferral of taxes owed on revenues from inclusion of CWIP in rate base:

Estimated Cost: $ .8 billion per year. (average for initial term)

<u>Option 3</u>: Utility Finance Corporation -- Government will have to borrow funds to meet initial capitalization of $15 billion. Cost of funds $1.05 billion annually -- but no net cost to Government due to high dividend payout on preferred stock purchased.

<u>Option 4</u>: Federal loan guarantees:

Estimated Cost: Would depend on default.

<u>Option 5</u>: Tax free treatment for dividends on utility common stocks and new preferred:

Estimated Cost: $1.5 billion

<u>Option 6</u>: Federal purchase of electricity for re-sale:

Estimated Cost: Not determined.

<u>Option 7</u>: Joint-venture construction of new generating facilities:

Estimated Cost: Open ended.

<u>Option 8</u>: Federal purchase-lease-back of generating facilities:

Estimated Cost: Open ended.

<u>Option 9</u>: Rebate on unused investment tax credit:

Estimated Cost: Not determined.

<u>Agency Positions</u>

<u>ERC Recommendation</u>