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**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

1730 PENNSYLVANIA AVENUE, N. W. • SUITE 200 • WASHINGTON, D. C. 20006 • (202) 785-9622

Vol. 3, No. 11 - May 21, 1975

Dear Subscriber:

This week we discuss leadership in the Oval Office, Congress' apparent inability to deal effectively with the energy problem, and the case for Variable Rate Mortgages. High Interest Notes take another look at the work of the new Congressional budget committees, examine the proposal of a 1975-model RFC to help troubled electric utilities, and comment on one aspect of U. S. firms doing business abroad.

LEADERSHIP IN THE OVAL OFFICE

Thanks to sound judgment and firm action on the part of President Gerald R. Ford, coupled with the valor and skill of U. S. fighting forces, many Americans have at least temporarily abandoned the hang-dog look that has become all too noticeable in recent years. Also of considerable importance, the unfortunate event afforded GRF the opportunity to demonstrate the leadership capacities which old associates knew he possessed, but which the public doubted. WER will completely review the pluses and minuses of the Ford Administration after its first anniversary, almost three months ahead. In this issue, only a few highlights are covered.

Ford has made mistakes, no doubt about it. But he hasn't made any big mistakes. His Administration, generally of high quality in terms of people, is pretty much in place and is moving ahead in both the governing and political functions.

Although foreign policy problems are massive, restoration of U. S. leadership of Free World nations following the debacle in Southeast Asia no longer seems impossible, and Ford's forthcoming trips abroad could help undergird that leadership.

Most important, thanks in part to leadership by Ford and Defense Secretary James Schlesinger, the defense budget -- which must remain the firm underpinning of our leadership position -- looks as if it will come through Congress in pretty good shape. This is in sharp contrast to prospects in January, and can be attributed in part to shifting views on the part of the public. Also in foreign policy, clearly identifiable steps toward a viable peace in the Middle East would be icing on the cake.

In domestic matters, Ford has had the unenviable task of working with a Congress controlled by the opposition party and, in addition, one consisting of many members with little previous experience in the art of government -- and when it comes to the U. S. system, the word "art" should be spelled with a capital "A." But the big spenders have been repelled (thanks to a considerable extent to the fine work of the new Budget Committees) and Ford's out front when it comes to the crucial vetoes.

Politically, establishment of a blue-ribbon 1976 campaign planning committee headed by the highly able former Goldwater aide, Dean Burch, was a wise move. This not only should dispel the "lame-duck" atmosphere that was developing, but Burch's key role (along with the handling of the ship seizure) may allay some of the sniping from the right. (This week, Ford was given a rousing welcome on the home turf of one of the chief snipers, Republican Senator Jesse Helms of North Carolina.)

A final point of paramount importance. When WER said last summer that Jerry Ford was the right man, in the right place, at the right time, we based that statement primarily on the view that Ford could restore to the Oval Office a quality that deteriorated throughout the 1960's and fell to zilch after Watergate: Credibility. And don't let anybody tell you that this problem started with Richard Nixon.

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WER has sampled a wide variety of opinion over recent months -- from sales clerks to farmers to cab drivers to heads of major corporations. Almost without exception, each person is convinced that Gerald Ford is incapable of looking anyone in the eye, personally or on TV, and telling a lie.

Example: In a press conference last fall, Ford was asked whether the U. S. engaged in covert operations in Chile. His answer was a simple "Yes." It raised a storm of criticism as to substance (with many commentators ignoring the fact that all major nations try to protect their interests through good intelligence operations), but it rated A+ for candor.

Ford has therefore gone a long way toward restoring to the Oval Office a priceless asset, an attribute without which our system of Government is likley to be greatly impaired -- confidence in the word and integrity of the President of the United States.

To GRF and his supporters, however, a final cautionary note. Political popularity that is at its zenith one day can fall to its nadir the next. Sometimes this is because of uncontrollable events; sometimes it results from mistakes on the part of the powers-that-be; sometimes it results from the controversial but necessary decisions a President has to make from time to time. For example, Ford's decision to pardon Richard Nixon last summer (to us then and now, a courageous, humane and politically astute decision whose consequences would fade with time, as has been the case) brought to a crashing end the press-created "honeymoon" best described as the English Muffin period (GRF in PJ's cooking his own breakfast).

This time, we're predicting no such sudden popularity descent from the heights of Mount Everest to the depths of the Dead Sea. We simply warn that Election 1976 is over 17 months away. Stated differently, the current luxury of basking in the sun should not encourage Ford supporters to count their electoral votes (or even their convention delegates) before they're hatched.

## ENERGY LEGISLATION: WHAT WENT WRONG?

In a shouting match between Democrats and Republicans as to "who struck John," few are asking the really relevant question of why the legislature of the world's most powerful democracy is unable to come to grips with the energy problem. Both President Ford and Oregon Democrat Al Ullman (Chairman of the House Ways and Means Committee) are honorable men, as is GRF's chief negotiator with Congress on the issue, Federal Energy Administrator Frank Zarb. Ullman charges that the White House pulled the rug out from under him, while Administration spokesmen retort that the bill approved by Ways and Means simply won't do the job that has to be done.

We suggest, first, a lowering of voices and, second, an examination of fundamentals. And the most fundamental point of all is that the 94th Congress, as a body, does not want to face up to the energy issue in 1975. This is because the Members of Congress do not believe that their constituents are willing to pay the price for conserving energy and developing additional supplies, a price that is unavoidable if we are to reduce our steadily growing reliance on foreign oil.

The people have in turn been misled by two developments. The latest was the "disappearance" of the crisis in 1975 -- after all, there are no lines at filling stations and fuel oil was in abundant supply during the winter (one might even say that, from the standpoint of getting Congress to act, we had the "bad luck" of a mild winter). Energy shortages are now confined to specific types, such as natural gas.

But even earlier the good old media -- and especially television -- convinced many Americans that the crisis of 1973-74 was not really the result of years of neglect and the actions of those potentates in the Middle East, but the "big, rapacious, multinational oil companies." Didn't their profits so indicate? Not that media efforts were organized as a "campaign"; it was simply a poor reporting job. (Incidentally, the sharp jumps in oil company profits in 1974 were front-page news. Now you usually have to turn to the financial section to locate the fallbacks in profit rates in 1975.)

A 22 — THURSDAY, JANUARY 23, 1975

The Washington Post

AN INDEPENDENT NEWSPAPER

*Charls E. Walker*

# Backing Loans to Business

Although The Post is correct (Jan. 9) in opposing a new Reconstruction Finance Corporation, strong arguments can be made that the U.S. needs some sort of National Guarantee Authority (NGA).

Proper distinction between an NGA and a new RFC is essential. The RFC lent money—the stuff you spend at store. An NGA would only guarantee loans, in whole or in part, made by private lenders to other businesses. This approach is superior to direct government lending because it involves fewer budget dollars and is less subject to political abuse (the private lender would not be forced to make a given loan). Moreover, by federal guarantee of only a percentage of the loan in perhaps a majority of cases, the lender would bear some risk and therefore be more careful in screening applicants.

*Mr. Walker, a consultant in Washington, was Deputy Secretary of the Treasury in the first Nixon administration.*

As to its structure and size, the NGA should be run by a blue-ribbon, public-private board, with an initial guarantee authority of some $10 billion to $20 billion.

A decade ago, such a proposal would probably have had little chance. But when in 1971 Treasury officials started taking the congressional pulse on the Lockheed loan proposal, they found surprisingly widespread support, not just for the Lockheed guarantee, but for enactment of broader authority. The revival of the RFC proposal indicates that the sentiment has not changed.

Some opponents of an NGA argue that the federal government has not and should not intervene to help major businesses faced with temporary credit strains. But, despite all its shortcomings, the RFC did make some $40 billion in loans over two decades. In addition, the Overseas Private Investment Corporation and predecessor government agencies have provided political risk insurance to business (mostly big) on $7.6 billion of U.S. investments in less developed countries since 1948.

In addition, as of the end of last year the Small Business Administration had some $8 billion in loans and guarantees outstanding. Helping big business as compared with small business is a difference in degree, not kind. What's the real difference, NGA proponents ask, between the Behemoth Corporation and the Easy-Order Pizza Palace—except for size?

Another important consideration is the need to improve the "delivery system" between the nation's central bank, which can create money, and businesses which from time to time need cash because of events beyond their control. This occurred in the spring of 1970, when the U.S. economy underwent a severe "liquidity crunch." The Federal Reserve banks had plenty of money to lend and were willing to do so—that's the prime job of a central bank in a liquidity squeeze. However, the language of the Federal Reserve Act is rather strict on loans other than to commercial banks. Consequently, the effectiveness of the "delivery system" for liquidity desperately needed by nonbank businesses depends upon major commercial banks acting as a conduit.

This worked satisfactorily in 1970. The credit crisis feared as a result of the Penn Central failure was averted, but only because major commercial banks provided funds to cash-hungry corporations. I hope that we have no more such liquidity crunches, and if we do, the existing system may work satisfactorily. But the risks are obvious.

Proponents of an NGA also note that when government regulation of an industry becomes so inept (as with railroads) as to threaten the very existence of one or more regulated firms, private financing begins to disappear because of the rising risk. As in the case of some of the railroads, some type of government financing is desirable, if not inevitable.

One can also point to the extraordinarily large hunks of capital that are often necessary to develop products of advanced technology. In the past, many products, especially aircraft and satellites, were developed with government defense and space money. Moreover, there are situations in which technology may be well established, but the product is so new, the potential profitability is so uncertain, and the cost of building production facilities is so great that private financing is simply not available. If such projects are in the public interest, and they frequently are, some financing techniques must be devised.

Alternatives to an NGA for such purposes are not attractive. They include such things as nationalization of industries, creation of monopolies, or mergers to create huge banks with plenty of financing capacity, as in Canada and several other countries.

The case for an NGA is impressive. As to congressional action, it may or may not occur. But the problems are not going to disappear and sooner or later they will have to be faced—hopefully sooner rather than later.

The Washington Post

EUGENE MEYER, 1875-1959
PHILIP L. GRAHAM, 1915-1963

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It is still far from certain that significant energy legislation will emerge from the 94th Congress, and if it does, it is impossible to forecast its final content. The Ways and Means bill, scheduled for floor consideration after the Memorial Day recess, may fail wholly in the House or be radically altered. And then there's the Senate, where legislative actions of overriding importance can sometimes occur within a time span of minutes.

A gloomy report? Yes. But it's time to stop asking, "Who struck John," and initiate a public education program on the energy issue. Hopefully, this time the media -- and especially TV -- will be part of the solution rather than the problem.

(As we go to press, word is circulating that GRF will renew pressure on Congress to act by applying the second dollar increase on each barrel of imported oil, a move delayed earlier to give Congress time to write acceptable legislation.)

VARIABLE RATE MORTGAGES: AN IDEA WHOSE TIME IS YET TO COME

Although all too willing to vote billions of dollars in stop-gap aid, as well as to approach Federalization of housing credit in periods of financial stress, Congress shows a strange unwillingness to attack effectively the fundamental causes of the roller-coaster behavior of the residential construction industry. Few would argue that any single panacea exists; but the consensus of impartial experts who have studied the problem is that institutional reforms in the mortgage financing industry -- some sweeping, some not so sweeping -- are necessary if the feast-and-famine scenario of residential construction since World War II is to be replaced by more stable growth.

As to sweeping reform, Congress' unwillingness to deal with fundamentals has been evidenced by the cold shoulder granted to the eminently sensible conclusions of the President's Commission on Financial Structure and Regulation (the "Hunt Commission," after its chairman, retired industrialist Reed Hunt) and, just last week, overwhelming rejection in the House of another eminently sensible proposal, "variable rate mortgages" for thrift institutions.

The Hunt Commission, and the Administration recommendations drawn therefrom, would broaden the lending and investing powers of thrift institutions, thereby making them less susceptible to the "disintermediation" (withdrawal by depositors to invest in higher-yielding Government and other market securities) that has plagued the industry from time to time since 1959. Along with this, "Regulation Q" (which in effect limits the interest earned on savings by the little man but places no such limit on anyone with $100,000 or more to invest) would be eliminated, if not immediately, over a period of years. A Senate banking subcommittee, chaired by Senator Thomas McIntyre of New Hampshire, has acted favorably on the Administration's adaptation of the Hunt Commission proposals, but the prospect for early action in Congress as a whole is uncertain.

As to variable rate mortgages, Congress bought the arguments of labor and consumer groups that any such device would result in higher interest costs for the typical borrower. If this nation were facing a period of more or less constant increases in mortgage rates, these arguments would have some substance (although it still could be argued that the borrower's income should rise as rapidly as mortgage rates). But mortgage rates are likely to be on the "up escalator" only if we fail in bringing inflation to heel -- and most signs point in the opposite direction. Thus the borrower on a VRM could well be paying lower rates a few years down the road and, on average, over the life of the mortgage.

But the objections voiced by labor, self-anointed consumer spokesmen, and civil rights groups miss much of the point. A VRM automatically increases the power of the lender to pay higher savings rates as interest rates in general go up; this is because the interest the institution earns on its VRM's goes up at the same time. And since it can pay higher rates on savings, the lender is in a better position to fight disintermediation, or even attract additional funds to lend to worthy borrowers. Therefore, if Congress were willing to experiment, even for a few years, with VRM's, the

typical homebuyer might well gain -- and the homebuilding industry prosper -- because the tendency for abrupt cut-offs in the flow of mortgage credit would be lessened.

To be sure, the proposed regulations on VRM's issued by the Federal Home Loan Bank Board left something to be desired, but this shortcoming could easily have been corrected by Congress, either formally or informally, without throwing out the infant with the bathwater. But the opposition arguments carried the day, with the inevitable result that, because of an unwillingness to bring our mortgage and building industries into the 20th century, the typical homebuyer will suffer.

HIGH INTEREST NOTES

A Revised "Hurrah." The "two-and-one-half cheers" which WER voiced for the Budget Committees in the last issue should be now raised to a resounding three. Two reasons: First, the House-Senate Conference Committee scaled back the undoable Reuss amendment, which would have called for the closing of $3 billion in "tax loopholes" almost immediately, to $1 billion (and senior members of the conference, convinced that the resolution understates revenue projections, are not all that serious about the $1 billion). Second, Administration officials are now admitting that, because of differences in assumptions, the $69 billion deficit approved by Congress and the $60 billion stated as acceptable by GRF are not all that far apart, perhaps less than $5 billion. We reiterate that the public should be grateful to the Congress and the committees for a successful start in the new budget process, and special thanks should go to the committee chairmen, Senator Edmund Muskie (D-Me.) and Rep. Brock Adams (D-Wash.).

An RFC for Utilities? The proposal pushed by some in Congress and now being considered in high Administration councils to create a modern Reconstruction Finance Corporation to provide badly needed funds (through purchase of preferred stock, etc.) for the nation's electric utilities needs to be examined with great care. Perhaps direct Government loans are the only answer in some instances, but partial Government guarantee of loans, with private lenders taking part of the action, can do the job in many instances while minimizing the political dangers inherent in a direct loan approach. Inasmuch as this matter was discussed thoroughly in WER last January (Vol. 3, #1), we simply note the dangers involved at this time and jog your memory by enclosing a reprint of a Washington Post article on the subject.

Doing Business Abroad. The disclosure that a number of U. S. corporations doing business abroad have had to pay "fees" that can only be viewed as bribes to foreign officials underscores our long-held view that even the biggest multinational is no match for the smallest banana republic if the latter is determined to extract its pound of flesh (ranging from the recently reported bribes all the way to expropriation of assets). In this respect, we believe that the U. S. Government has for decades let its business community down -- leaving to private enterprise that which should and only can be done on a government-to-government basis.

Take South Korea as an example. Does anyone in his right mind believe that officials in a nation which depends on the U. S. for its very life would dare extort millions of dollars from a major U. S. corporation if our State Department put its foot down?

If and when the U. S. develops a comprehensive, integrated and fully up-dated foreign economic policy -- and it's been needed for a long time -- the long-neglected Government role as a protector of U. S. interests abroad deserves close attention.

Sincerely yours,

Charls E. Walker

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JUN 5 1975

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Vol. 3, No. 12 - June 4, 1975

Dear Subscriber:

This issue of WER is devoted primarily to a long and close look at proposals to change the Internal Revenue Service.

REFORM THE IRS?

Suddenly, in the post-Watergate atmosphere, there are a spate of proposals to "reform" the IRS. As the Treasury official with executive responsibility for overseeing the IRS from 1969 to 1973, your editor had the privilege of an "insider's knowledge." On the basis of that experience, WER views most of the recent proposals as poorly conceived.

One such proposal would divorce the IRS from its parent, the Treasury, making it an "independent agency." Its advocates say this would remove IRS from "politics." Still another would strip IRS of all law enforcement activity other than that stemming solely from evasion of the tax laws -- in other words, no more use of the tax laws as in the successful efforts to trap the Al Capone's since the 1930's and the drug traffickers of the 1970's, who, for one reason or another, were able to escape prosecution for more serious crimes. And one prominent TV commentator has recommended that the IRS cease completely its audits of individual tax returns -- his answer to the alleged misuse of audits for political purposes.

Clearly, with this plethora of suggestions, it is time to think through carefully the place, function, and method of operation of IRS.

Preliminary Comments. Too few realize that many problems which arise with respect to IRS are inherent in our heavy reliance on personal and corporate income taxes to raise Federal revenues (excluding social insurance taxes, about 60 percent). One problem stems from the fact that taxation of income, personal or corporate, requires a definition of what is "income," an issue on which economists disagree (are capital gains "income" in the traditional sense?). Even more significant in the day-to-day world, taxable income is a "residual," computed by deducting "expenses" or other items from gross income.

For individuals, deductions include contributions to church, charity and education; medical expenses; interest and local property taxes (here homes generate the biggest amount); and State and local income taxes. Certain "credits" against taxes owed are also allowed (in contrast to a deduction, which comes off the top line, a credit comes off the bottom line). For business, the fundamental problem is in determining a legitimate "expense" in converting gross to net income.

In many instances, decisions which one would think should be clear-cut merge into a mottled shade of gray -- and that's precisely why this country is "blessed" with an IRS staff of almost 70,000, a multitude of tax lawyers and accountants, and countless concerns that specialize in helping individuals prepare their annual returns.

Split IRS from Treasury? The desire to remove IRS from "politics" is impossible to achieve. Not that every effort should not be made -- and was, in the first Nixon Treasury -- to prevent political factors from influencing IRS decisions. But the fact is that some IRS decisions inevitably have "political" consequences -- and there's no way around it. If the computer spews out the return of a leading political figure for

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audit, and especially if he's a member of the party not currently in control of The White House, charges are likely to be made that audits are being used for partisan political purposes. But most Americans feel strongly that any citizen should always be willing, without complaint, to open his records to the IRS. Just as Justice Holmes said that "taxes are the price we pay for a civilized society," submitting to audits is the price of maintaining the best and most admired voluntary tax assessment system in the world.

Making the IRS an "independent agency" would in no way diminish the political impact of its actions. Politicians would still be audited, along with celebrities and influential citizens -- and the latter more often than others, simply because they usually make more money. (President Nixon was convinced that the IRS was run by a bunch of partisan Democrats bent on harassing Republicans, evidently because more Republicans tend to be audited than Democrats. Treasury never could get through on the point that the reason was simple: On average, Republicans make more money than Democrats; the higher your income, the greater the chance of an audit.)

But making the IRS independent of Treasury could have some exceedingly serious consequences. With the recent revelations concerning the late J. Edgar Hoover's brilliant but highly questionable techniques for assuring his own long tenure as head of the FBI, it is unlikely that an IRS Commissioner could use similar techniques for the same purpose -- although the danger would be there. More important is the crucial role played by the Secretary and Deputy Secretary of the Treasury in repelling the politically motivated thrusts that are likely to threaten the IRS as long as we rely on income taxes for so much revenue. (A shift to a Value Added Tax would remove this problem, since taxes would be on gross sales; no deductions, except for taxes paid earlier in the production process, would be allowed.)

These political winds can blow from two directions: highly partisan White House officials or a few members of Congress. The Secretary of the Treasury is the chief financial officer of the Federal government and almost invariably a person of high prestige and impeccable integrity. Therefore, unless White House or Congressional politicians develop a "back-channel approach" to IRS (and this has been known to happen), any person desirous of leaning on the IRS Commissioner for partisan reasons has to run the gauntlet of the Treasury Department -- a formidable gauntlet indeed.

Consider an important illustration. Before Assistant Attorney General Johnnie Walters was named Commissioner of IRS in 1971, there was mutual agreement that his chain of command was through top Treasury officials and any relations he had directly with the White House would be only after consultation with his Treasury bosses.

In the summer of 1972, after George Shultz had succeeded John B. Connally as Secretary, someone in the Nixon White House delivered the infamous "enemies list" directly to Walters with an order to "get hacking" on politically motivated audits. Walters took the list to Shultz, who said: "Lock it in the safe and forget about it."

The moral of this story is that it would take a very strong Commissioner, who stands in the third level of the executive pecking order, to resist such pressure on his own (although he could, of course, resign). But with a Treasury Secretary saying, "forget it," Walters was secure.

No, the IRS should not be divorced from Treasury. The strength and integrity of top Treasury officials are the only real defenses -- other than resignation -- that a Commissioner has against severe pressure to use his tremendous powers for partisan political purposes.

One other point. The IRS -- then the "Bureau of Internal Revenue" -- became mired in a major political scandal in the early 1950's. The result was that the Service was "purified" by converting all positions except the Commissioner to career status. But just as sure as God made little green apples, sooner or later IRS will again be faced (as after Watergate) with charges of partisanship; for it's in the nature of the tax collection process.

If and when that happens, the Commissioner surely would want and need the support of the nation's chief financial officer.

IRS Law Enforcement Activity. An exchange of letters between the executive secretary of the Federal Criminal Investigators Association and the Assistant IRS Commissioner for Compliance leaves it unclear as to how far current IRS leadership would de-emphasize use of the tax laws to trap organized crime figures, narcotics traffickers and corrupt politicians. The current thrust of the Service seems clear -- it wants to confine itself primarily to enforcement of the tax laws per se, with no special attention to clearly identifiable breakers of other, and more serious laws, including murder and drug pushing.

Some at the IRS argue that this is other people's business. And in a perfect world, with a perfect government, and a perfect system of law enforcement, they would be 100-percent correct. But we live in a world of many imperfections.

The record speaks for itself. Over a period of more than four decades, the Federal tax laws have been used to send to prison hundreds of underworld figures; many corrupt politicians; and, under a program started only in 1971, scores of drug traffickers.

The powers-that-be in Treasury and IRS had better think carefully before substantially removing IRS from this important function. Both the people and Congress would probably (and properly) object to such a policy.

(Reference here is not to the Federal "strike forces," special groups of law enforcement officers from several agencies, which, under Justice Department leadership, are supposed to zero in on organized crime. Treasury supplied most of the manpower for these efforts and was, despite some successes, never convinced that the results were worth the time and effort. Treasury attempts to force evaluation of the work were strongly opposed by Hoover, whose agency supplied a minority of the personnel. Attorney General John Mitchell, Hoover's titular boss, refused to buck Hoover, and Treasury's evaluation proposal was dropped.)

Eliminate Audits? A few months ago TV pundit David Brinkley came up with a startling"ultimate solution" for the problem of political audits by IRS -- namely, don't audit anybody. Is Brinkley serious or putting us on? Does he want to risk destruction of our self-assessment tax system? To be sure, the vast majority of Americans are honest and (to the best of their ability) prepare honest tax returns. But there's a certain percentage of the population that does not hesitate to cut corners, whether on expense accounts to employers or tax returns to Uncle Sam. The big deterrent in the latter case is the threat of audit. And if audits are abandoned, then sooner or later we go the route of those nations where cheating on taxes is considered not only to be a la mode, but the taxpayer downright dumb if he doesn't do it.

Abandonment of audits just doesn't make sense.

Some Suggested Reforms. Does all this discussion imply that no changes should be made at IRS? Not by a long shot. Here's a brief shopping list.

(1) Instead of allowing only one Presidential appointee to a policy position of IRS -- the Commissioner -- enlarge the number and then logically hold the President responsible for proper administration of the agency. Today, he is held responsible, but has difficulty running IRS (through Treasury and the Commissioner), because he can legally appoint only one man to an agency of some 70 thousand men and women. (The chief counsel of IRS is also appointed by the President, but he is technically part of the Treasury legal office.)

(2) Establish an "ombudsman" function in IRS, to protect the interest of the small-income taxpayer who can't afford to hire a tax attorney or accountant.

(3) Coupled with the foregoing, severely and publicly reprimand IRS personnel who can be shown to have kicked around any taxpayer, large or small. The "horror cases" that catch attention in the press are few and far between; Treasury tries to make certain that each such case is investigated. But everyone knows also that an IRS agent sometimes lets his authority go to his head. When that happens, he should be brought sharply to task.

(4) Continue the efforts of recent years to provide truly equal opportunity for entry and advancement upward in the IRS. For too many years following the "reforms"

of the 1950's (which went too far in making the agency entirely career Civil Service except for the Commissioner), the IRS operated at the top career level almost as a "closed corporation" with little opportunity for minorities and a "no help wanted sign" out for women. It was good news indeed to hear that the first woman who broke through to the supergrade level in 1972, largely as a result of pressure from Treasury, was recently advanced to the highest such rank available. Still, she remains the only female of supergrade status in the agency. As to opportunities for minority staffers and high-level entry to IRS by outside "professionals," good progress has been made.

Conclusion. Having said all this, WER may now surprise the reader by stating flatly that the IRS is still the best-managed bureaucracy in the Federal Government. Its management training program is first rate and, during its price stabilization duties in 1971-73, some hard-nosed management specialists at the Cost of Living Council became convinced of the excellence of its management and personnel.

The important point is that "reform for reform's sake at IRS should not be undertaken. The fact is that most of the proposals that have surfaced thus far are bummers. However, there are some things that can be done, constructive but not startling, to make IRS an even better agency.

HIGH INTEREST NOTES

First-Rate Appointment. President Gerald R. Ford continued to maintain his high batting average in the quality of appointments by naming Alabama mortgage banker Philip Jackson to the Federal Reserve Board. The FRB needs a member with practical experience in an industry that takes the hardest lumps from monetary instability, yet participants in the industry who can separate the forest from the trees -- who think in long-run rather than short-run terms -- are few and far between. Jackson is an exception. It's a first-rate appointment.

Economic Recovery: Not "When," but "How Fast"? In February 1974, WER predicted that "the odds are better than even that economic historians will pinpoint the fourth quarter of 1973 as the beginning of the sixth post-World War II recession." Altho the prestigious National Bureau of Economic Research has not yet "officially" dated the downturn, both real GNP and industrial production peaked out in late 1973 (to be sure, the oil embargo was an important factor). Now, WER is convinced that the odds are better than even that recession is very close to and perhaps past its trough. If so, how fast and strong will the recovery be?

We shall try to answer this question in greater detail in subsequent Reports, but unless the first signs of a turnaround in residential construction are further confirmed, and unless business attitudes concerning investment in new plant and equipment improve significantly, the recovery is likely to be on the slow side. The fact is, however, that there is plenty of mortgage money around and business attitudes may strengthen markedly as the economy comes back (reflecting mainly strength in consumer spending and inventory re-building). Then the danger might be an inflation-generating recovery and a sharp increase in short-term interest rates, with a dampening effect on housing (because of a return to "disintermediation") and the stock market. At this writing, WER takes a middle position: Probability of a reasonably strong -- but not too strong -- recovery from this nation's sixth post-World War II recession.

Sincerely yours,

Charls E. Walker

JUL 9 1975

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Dear Subscriber:

Last week, with a series of "expert panels," the House Ways and Means Committee began hearings on the "Tax Reform Act of 1975." The inclusion of "capital formation" on the Committee's agenda was a pleasant surprise, but we're not overly optimistic concerning constructive action in this area. Many myths abound with respect to the Federal tax structure so that reality is frequently crowded out. This expanded issue of WER analyzes some of these myths and, as your editor will do in testimony later, lays out the basic case revising the tax code to promote capital formation.

CAPITAL FORMATION: THE "GOOSE THAT LAYS THE GOLDEN EGGS"

Tax legislation in the 94th Congress is a "good news/bad news" story. The good news is that three powerful groups agree that our tax system should be adjusted to foster job-producing growth in productive investment. These include Administration officials, management representatives, and (a surprising newcomer) leaders of organized labor. The bad news is that the public thinks the Federal tax system is unfair (except for the payroll tax, the Federal individual income tax is adequately progressive) and the constructive views on capital formation of labor's leaders are not widely shared by union members. A generally labor-oriented Congress is therefore most reluctant to approve measures that can be labeled as "giveaways to business."

Proponents of changes in the tax structure to promote capital formation have their work cut out for them. The task is to get people to learn the truth about taxes.

Federal Taxation: Myth vs. Reality. The media and some politicans have convinced the typical taxpayer that (1) the Federal income tax system is grossly unfair because the rich and big business "get away with murder" in paying taxes; (2) corporations can be taxed without hurting "people"; and (3) there are some $40-$90 billion of "tax loopholes" just begging to be clossed--to the benefit of the "little man."

All of these views are wrong.

*Myth #1:* The idea that the rich pay no taxes got its big push in early 1969 when it was disclosed that 154 Americans with adjusted gross incomes over $200,000 paid no Federal taxes on 1966 income. Burdened with what was in his view an awesome tax loan (actually less than in most foreign countries), and suffering a decline in his standard of living as taxes and the price level rose, the taxpayer "revolted." The result was the Tax Reform Act of 1969, a massive revision of the tax laws.

(The falsely held view abounds that the 1969 Act contained no genuine "reform" and served mainly to line the pockets of tax lawyers and accountants as it greatly complicated taxpaying for the typical citizen. A leading TV network anchorman so opined a few nights ago. In fact, the 1969 Act sharply reduced the number of non-taxpaying rich Americans and greatly simplified taxpaying for the typical citizen. This it did through liberalizing the standard deduction, which meant 13 million additional taxpayers did not have to go to the trouble of itemizing, and by removing 12 million taxpayers completely from the tax rolls through the Low Income Allowance. As to lawyers and accountants, the number of people who find their taxpaying complicated by the legislation is a relative handful--and these people can afford it.

Even though the 154 rich people who paid no taxes amounted to less than one one-hundred-thousandth of one percent of all taxpayers, most Americans believe that all well-to-do citizens should bear some reasonable portion of the tax burden. And the fact is that as a result of the 1969 legislation limiting tax perferences and crea-

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ting a minimum income tax (but one that could be made fairer by amendments along the lines suggested by Treasury), the number of rich non-taxpayers had fallen from a peak of 300 in 1969 to about one-third that number by 1972, even though the number of taxpayers in the $200,000 plus category increased from 12,226 in 1966 to 23,200 in 1972.

But to view the matter this way is like looking at Pike's Peak through the wrong end of a telescope. The vast majority of rich people do pay taxes, and they pay heavily. In 1972, citizens with adjusted gross incomes of $200,000 and up paid an effective rate of 42.8 percent, and a 58.8 percent rate on taxable income.

(This argument will be attacked by those who rightly point out that tax-exempt interest on State and local bonds is never reported, and "adjusted gross income" is therefore a misleading figure. The argument is overstated. Tax-exempt interest earned by individuals, corporations, pension funds, etc., amounts to about $6.9 billion annually. Even if all that interest went to individuals it would amount to less than 1 percent of aggregate adjusted gross income. And don't forget that part of that tax-free interest comes back as a "tax subsidy" to states and localities, since borrowing costs are reduced, thus helping to build schools, roads, sewage facilities, parks and the like. However, tax experts agree that the subsidy is inefficient--both State and local governments and Treasury could benefit if the former were allowed to borrow on a fully taxable basis, with about a third of the interest cost "rebated" to the borrower directly from the Federal Government. Sooner or later, perhaps in the current legislation, Congress is likely to accept this proposal.)

Rich people do pay taxes--and they pay through the nose.

*Myth #2*, that corporations can be taxed without hurting people, is sheer nonsense. Your editor has said this many times before, perhaps beginning to sound like a broken record. But the sad fact is that even sophisticated financial reporters talk about "corporations getting a big tax break" in a certain bill, and so on.

On the dubious assumption that those politicians, labor leaders and reporters who perpetuate this myth are listening, let's run through the logic one more time. A corporation is simply a legal arrangement for providing jobs people need and the products they want, and a pretty darn good one at that. This "legal arrangement" cannot, in the final sense, be taxed; the tax is always passed backward or forward so that it hits people. Depending on a variety of factors, the tax may be "passed on" in the form of higher prices, backward in lower dividends or, if especially onerous, to workers as wages are held down and jobs wiped out. If passed forward, the tax may be progressive, regressive or neutral, depending on the income levels of the industry's customers. If backward to investors, the danger is that they'll put their savings elsewhere, and the output of goods that people want and need will be curtailed. And if the business fails and jobs are destroyed--well, that alternative speaks for itself.

There is some basis for debate on the "corporation vs. people" argument, since large stockholders are usually rich (although the "little people," through pension funds, etc., own more stock than they realize). But the real issue is who bears the burden of corporate taxation, rich people or poor people. If it is passed backwards to stockholders, what are the consequences for investment. We want rich people to bear a heavier share of the tax burden, and they do. But each tax cut or increase, preference or penalty, should be discussed not only in terms of who bears the burden, but also in light of the consequences to the economy. Take something as "far out" as eliminating the corporate income tax (and why not?)--the real issues are, who gets hit, how much, and with what consequences for the economy?

With respect to *Myth #3*--that there are billions of dollars of tax loopholes waiting to be closed--whoever brought "tax expenditures" into the lexicon of public finance ought to be given a special award by demagogues. On any slow news day, it is all too easy to pick up the Special Analyses, 1976 U. S. Government Budget and turn to pp. 108-109 and whale away at billions upon billions of dollars of "tax loopholes"--conveniently ignoring the fine print that consumes some 16 pages and warns the reader about the limitations of the concept.

The Budget contains estimates of "tax expenditures" only because Congress requires it. And the "fine print" almost literally bristles with skepticism, in contrast to the usually antiseptic prose of the Office of Management and Budget. Skepticism there should be, for the concept itself--which if carried to its extreme, almost comes down to "all of your income that Uncle Sam is generous enough to let you keep"--is, in the light of the limitations of modern-day economics, open to serious question. But we're stuck with the idea that what the laws of the land allow as a "tax preference" must be tabulated as a "tax expenditure," with dollar amounts assigned to each. And it must be admitted that if, as is seldom the case, the estimates are used carefully and with full knowledge of their limitations, they can be useful in evaluating the general thrust of "tax subsidies"--i.e., forgiveness of specific taxes in order to get people to act in socially desirable ways.

Myth #3 contains several sub-myths. One is that the lion's share of "tax expenditures" goes to corporations. Not so. Of the $91 billion estimated for FY 1976, some $70 billion go to individuals and $20 billion to corporations.

Another sub-myth: That for individuals, the special rates on capital gains are the biggest "loophole" of all. We don't think these special rates are really "loopholes," but in any event the $4.2 billion estimated for this item pales in comparison to the $11.7 billion for deductibility of taxes and interest on owner-occupied homes. Add to this $5.7 billion resulting from the exclusion of pension contributions and earnings on employer plans; $6.3 billion related to medical insurance and expenses; $3.5 billion of interest deductions on consumer credit (decidedly not the rich man's exclusive terrain); and $4.8 billion for charitable contributions, and the whole ball game looks a lot different. And since we're talking about one of the demagogue's favorite "loopholes," capital gains, just how solid is that $4.2 billion estimate of "tax expenditures?" If capital gains were taxed as ordinary income, shouldn't capital losses (unless offset against gains, limited to $1,000 per year, with certain privileges) be allowed as ordinary income deductions? If so, what would happen if stocks declined? In reality, the $4.2 billion estimate is next to worthless.

But as to capital formation, we quarrel most with a "tax expenditure" such as the investment tax credit (ITC), which carries an estimated "revenue loss" of $5.4 billion. In this respect, we note two caveats from the fine print: "Each [tax expenditure] estimate is based upon two assumptions. The first is that only the tax provision in question is deleted and all other features of the tax system...remain unchanged.... Second, taxpayer behavior and general conditions are assumed to remain unchanged in response to the hypothetical changes in the tax law." OMB states that these assumptions are "in many cases, unrealistic." That's quite an understatement.

If the ITC had been repealed on, say, Jan. 1, 1975, we venture to predict that nothing like $5.4 billion in revenues would be gained by Uncle Sam in FY 1976. Businesses would cut back on their purchase of productive equipment, output would be dampened, jobs would decrease or grow less rapidly, as would incomes and profits. And it's these last two that enter so heavily into the Federal tax base. When your editor taught economics some twenty years ago, he frequently fell back on the Latin term, ceteris paribus, or "other things remaining equal," a euphemism for stating that our models didn't apply in the real world. And so be it with "tax expenditures," especially as applied to the ITC.

But, some economists and Congressmen will say, "Wait just a minute. Isn't it true that at 'full employment' the credit's pull of resources into manufacture of productive equipment simply reduces investment somewhere else?"

Two comments: First, the 1976 Presidential budget was roundly criticized by generally the same people who would like to "do in" the ITC because the budget assumed an average unemployment rate of 8 percent for 1975 and 1976. The "full employment" argument against the ITC hardly holds for the $5.4 billion estimate of loss for FY 1976, for the simple reason that we're far from full employment.

Second, and much more important, if indeed the ITC pulls resources from other uses into productive investment when employment is relatively "full," then all the better--that's what the ITC is all about. Its purpose is to promote a higher level

of investment in productive facilities. To criticize the ITC because it does what it is supposed to do is topsy-turvy reasoning.

But enough of tax myths. To recount only a few, and there are many more, makes it very clear why the man-on-the-street is so confused and frequently downright wrong when it comes to the whys and wherefores of the Federal tax system.

Capital Formation: What It Is and Why It's Important. Here we hit only the high spots. For a more complete discussion, see the enclosed testimony by Secretary of the Treasury William E. Simon before the Senate Finance Committee in early May. It's one of the best statements ever made on the subject.

As used here, "capital formation" is the growth in productive assets, plant and equipment, that is mainly financed by saving, which is that part of income (for the family or the nation) that is not spent on consumption. To be sure, money creation can be used in lieu of savings. But if monetary expansion exceeds some reasonable relationship to real output, the process will ultimately prove self-defeating. Inflationary expectations will be stimulated, interest rates will rise, and sooner or later capital formation will suffer (as it has during recent periods of high interest rates brought on by inflationary fiscal and monetary policies).

Capital formation is of vital importance because it is one of the main sources of increases in productivity, or output per manhour. Greater output per manhour means a higher rate of economic growth and therefore a bigger economic pie which all can share; the result, in short, is a higher standard of living. (This will disappoint the "no-growth" crowd, who want to go back to bicycles and, presumably, outdoor toilets. But it will be hailed by those who view a high rate of economic growth as the best offense we can mount against poverty.)

Moreover, faster increases in productivity mean less inflation, greater international competitiveness, and more jobs. As to the last, from the time of the invention of the steam engine, workers have feared that machines would destroy jobs. Not so. Over the past twenty years, the U. S. economy has devoted over $1 trillion to investment in plant and equipment, but employment has risen from 69 million to 84 million. (Note: The current level of unemployment is caused primarily by a cyclical recession, not "automation" and other "bogie-men" that have wrongly been viewed as job-destroying, when they are actually job-creating.)

It's hard to pin down a figure, and variations are great, but each job in American manufacturing costs somewhere between $25,000 and $50,000 in investment necessary to equip the typical worker. Somebody has to put up the money and corporate profits (one source of capital formation) have declined sharply both in real terms and as related to GNP. Which brings us to the nub of the discussion.

How Do Taxes Affect Capital Formation? Growth, jobs, international competitiveness, control of inflation--seems like "capital formation" should be right up there with Home, Mother and Apple Pie as a revered American institution. Sad to state, it's not, otherwise Congressional tax-writers would be rushing in to further stimulate such activity (on top of the ITC increase earlier this year) through really "reforming" the tax structure, rather than engaging in a "Who-hit-John" argument as to corporations versus individuals, rich versus poor, and that $91 billion in "tax loopholes."

An unprovable but, nevertheless, strongly held opinion of WER: The U. S. tax system is stacked against savings, investment and capital formation in favor of consumption. Why unprovable? Because economics is a far from perfect discipline and always will be--at least, so long as people are people, and therefore unpredictable. But logic, experience and the tax systems of foreign countries should give Congress pause as it revises the Internal Revenue Code.

Take, for example, a personal income tax that is biased against the thrifty taxpayer. Suppose the income tax situations of Joe Doakes and John Smith (income, deductions, exemptions, credits, etc.) are identical. Doakes blows much of his income on wine, women and song, but Smith saves a big hunk of his, putting it into a savings account, directly in stocks or mutual funds, in bonds, or what-have-you. Does the tax system reward Smith for devotion to the Puritan Ethic? Not by a long shot, for both he and the profligate Doakes pay the same Federal income tax. And, oh yes, Smith will also pay taxes on the interest he earns. And if he gets dividends on his stock, the income will in effect be taxed twice.

Unconvinced? Then look abroad. Taxes on capital gains here are among the highest in the world; most countries don't levy them at all. As to "capital recovery costs" (what Uncle Sam let's you set aside each year, tax-free, to keep the business going by replacing worn-out or out-moded plant and equipment), the U. S. now compares favorably with West Germany, but lags far behind Japan in the early years of an asset's life and isn't even in the ballpark when compared with France, Canada and the United Kingdom (the last two have recently gotten "religion" on capital formation).

As to West Germany, which recently has the best combined growth/inflation record among Free World industrial nations, the clue is in the relative levels of taxes on investment versus consumption. According to Secretary Simon's Table 5, in 1971 West Germany raised only 4 1/2 percent of its revenues from corporate income and profits taxes. This stands in stark contrast to 10 1/2 percent in the U. S. The U. S. raised 18 percent from taxes on consumption; Germany, 28 percent. And when social security distributions are excluded, the corporate figures are 7 and 13 percent in Germany and the U. S., respectively, while the consumption portion rises to a modest 23 percent here versus a whopping 42 1/2 percent in West Germany.

The evidence is therefore strong that the U. S. under-taxes consumption and over-taxes saving, investment and capital formation. And if we keep that up much longer (we're still eating pretty "high on the hog," thanks to a relatively better performance in earlier years), then we're going to take a back seat economically to those enlightened nations that know a good thing when they see it.

This isn't a prediction; it is, as Secretary Simon describes so well, already happening. We are putting relatively less of our national income into capital formation and, as a result, we are growing more slowly, both in gross terms and output per worker. And this slow growth has had a heavy impact on the typical U. S. worker. Over the past several years, after both the "official tax collector" and the "unofficial collector" known as inflation got through with him, the worker has barely moved ahead. Real hourly earnings of nonagricultural workers rose a bare 10 percent (or an uncompounded rate of 1 percent) from 1965 to 1974, versus almost 20 percent in the preceding decade. Real take-home pay, which allows for Federal taxes did even worse.

We're not talking about theories here. We're talking about meat on the table, reduction of poverty, better homes--just a few "bread-and-butter" issues like that.

What to Do? Secretary Simon's testimony lists eight factors affecting productivity growth, and we'd be foolish to ignore any of them. But revision of the tax code is part of the "here and now"; hearings have begun and capital formation is on the agenda.

What should be done to bolster capital formation through true "tax reform' is, to us, quite clear. Since radical changes in our tax structure take more time and study (e.g., we need to look carefully at a consumption-based Value Added Tax), Congress should start long-range investigations and in the meantime forego the temptation of raising taxes on corporations and other businesses. (Remember: Thoses taxes ultimately hit people.) Preferably, such taxes should be cut, with a special eye on their investment-creating impact. As to the revenue impact and the deficit, such cuts in the past have been followed by higher, not lower, corporate tax payments, because business activity has benefitted and profits and incomes increased.

A cut in the corporate tax rate, economically sound but a political longshot, should be seriously considered. The ITC should be raised to a permanent 12 percent (now at a "temporary" 10 versus a permanent 7) and made "refundable"; that is, a businessman or corporation would get it even though taxable profits are too low or even non-existent. At least a start should be made toward "integrating" the corporate and personal income tax, which is gobbledygook for reducing the double taxation of corporate dividends; this might best be done by making dividends deductible for income tax purposes. Taxes on dividends reinvested in a business might be forgiven or at least defferred.

As to individuals, elimination of the capital gains tax is too much to expect, but rates might be lowered on longer-held assets. Estate taxes (which are not now being considered but are postponed until late this year or next) are a scandal, essentially

unrevised for decades. They approach almost confiscatory levels. And this is not simply a concern of scions of fat-cat families. There are many small businessmen and farmers who are deeply worried about the necessity of their heirs' breaking up properties in order to pay taxes on even relatively modest estates.

What Will Happen? What will Congress really do? Probably not very much, and the result might well hamper capital formation rather than help it. Take the organized attack on DISC (Domestic International Sales Corporation). Labor is bitterly opposed to this 1971 measure, stubbornly refusing to recognize that its purpose is to grant tax preferences for setting up facilities (for export purposes only) in the U. S. rather than abroad, thus reducing the so-called "export" of jobs. Unfortunately, the Administration seems ambivalent on this issue, with Treasury relatively quiet and OMB circulating a report on export promotion in general that is (to be generous) not up to OMB's usual standards (or even a first course in economics). Most puzzling is the implication that "exports don't matter," since exchange rates are more flexible than in the past. With flexible or even floating rates, weak exports mean our trade balance will suffer, the dollar will drop abroad, and all that foreign oil and other stuff we need will cost a lot more. It is what economists of your editor's generation called the "terms of trade"--"terms" which exist under fixed, flexible, or floating rates.

DISC should be retained by this Congress for at least three reasons. First, it became law only in 1972 and hasn't had a full chance to prove itself. Still, second, the figures we've seen are encouraging; DISC does appear to be helping exports, thereby keeping jobs here and our trade balance up. Third, even though DISC can and should stand on its own merits, the capital crunch confronting U. S. business today is so massive that we question the wisdom of any action that increases business taxes.

DISC should be given a fair chance to work. If it doesn't, let's junk it--but not prematurely. And especially let us not do so when it would result in an increase in the already too heavy burden of taxes on capital formation.

Conclusion. This conclusion is in effect an "open letter" to Congress.

"You have heard a lot about taxes. Perhaps you've wondered how much of what you've heard is true, how much false. We believe that myths abound.

"But you--and especially members of the tax-writing committees--have an excellent opportunity to find out for yourself. Your committees have top-notch staffs and can call tax experts from academia, business and government. All that we in the business community can ask is for you to cast aside any preconceived notion that the rich get away with murder on taxes; that corporations can be taxed without hurting people; and that a plethora of "loopholes" are there begging to be closed.

"We urge you instead to grasp a golden opportunity and begin a Great Debate--one that may well determine whether this country remains in the economic front ranks or, by the time our grandchildren reach voting age, falls into the second or third line of world economic powers.

"We urge you to marshall and master facts, sift all arguments, and then vote your conscience. We would be most comfortable with that approach. For we are convinced that once reality is contrasted with myth, and fact separated from fiction, the case for revision of the tax code to encourage capital formation is compelling.

"In short, let's not further starve the 'Goose that Lays the Golden Eggs.'"

Sincerely,

Charls E. Walker

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FOR RELEASE UPON DELIVERY

STATEMENT BY THE HONORABLE WILLIAM E. SIMON
SECRETARY OF THE TREASURY
BEFORE
THE SENATE FINANCE COMMITTEE
MAY 7, 1975

Mr. Chairman and Members of this Distinguished Committee:

I welcome this opportunity to appear before you this morning on a subject of timely and urgent concern: our capital investment needs for the future.

For several months, many economic policy makers in Washington have been preoccupied with the problems of ending the recession, slowing the rate of inflation and steering the nation back to a course of stable, durable economic growth. Today there are many signs that the economic slide is gradually decelerating, and we can be increasingly confident that we will be on the road to recovery before the end of this year.

As we emerge from the recession, it is especially important that we now begin to focus greater public attention on the longer-range problems of our country. While the process of recovery will require careful and vigilant management, we must be equally concerned whether the period of the recovery and beyond will bring sustained economic progress or a sorrowful repetition of the boom and bust cycles of the past.

Certainly there is no subject more central to our hopes for the future than our ability and our willingness to meet the capital investment needs of coming years. Those needs are impressively large, and they will demand a full-scale effort. In my testimony this morning, I want to draw upon an abundance of documentary evidence showing that the United States has not been keeping pace in its capital investments and that we must devote more of our resources to this purpose if we are to achieve our most basic economic dreams for the future. To summarize, the record shows that:

-- During the 1960s, the United States had the worst record of capital investment among the major industrialized nations of the Free World.

-- Correspondingly, our records of productivity growth and overall economic growth during this period were also among the lowest of the major industrialized nations.

-- As other nations have channeled relatively more of their resources into capital investment and have acquired more modern plants and equipment, they have eroded our competitive edge in world markets.

WS-294

-- Our record on capital investments reflects the heavy emphasis we are placing on personal consumption and government spending as opposed to savings and capital formation.

-- Our record also reflects a precipitous decline in corporate profits since the mid-1960s.

-- While the U.S. economy remains sufficiently large and dynamic to overcome our investment record of recent years, our future economic growth will be tied much more directly to the adequacy of our capital investments.

-- Estimates of future needs vary, but it is relatively clear that in coming years we will have to devote approximately three times as much money to capital investments as we have in the recent past.

-- It is an economic fact of life that increased productivity is the only way to increase our standard of living. For the sake of future economic growth -- jobs, real income and reasonable price stability -- the inescapable conclusion is that government policies must become more supportive of capital investment and that we must make a fundamental shift in our domestic policies away from continued growth in personal consumption and government spending and toward greater savings, capital formation and investment.

Some analysts have concluded that it will not be possible to meet our future capital investment needs. I disagree. I firmly believe that we are capable of achieving our basic investment goals, but I also believe that they represent one of the most formidable economic challenges of the decade ahead.

## I. CAPITAL INVESTMENT EXPERIENCE

The beginning point for our consideration of capital investment -- and one that should be of keen concern to everyone -- is the pattern of economic growth during the decade of the 1960s. The average annual rate of real economic growth during that period for the twenty nations belonging to the Organization of Economic Cooperation and Development (OECD) ranged from a high of 11.1 percent for Japan, to a median of about 5 percent for Australia, the Netherlands and Norway, to a low of 2.8 percent for the United Kingdom. The United States during this time experienced an average growth rate of 4 percent a year -- 17th among the 20 nations (Table 1).

Of the many economic, political and social factors that influence economic growth rates, none is more important than the level of capital investment. Economists generally agree

that the factors affecting growth include: (1) the accumulated base of capital goods; (2) the current pace of new capital investments; (3) the effective application of new technology; (4) the quality of the national labor force -- its education, training, discipline and commitment; (5) the infrastructure of transportation, communication, financial and service facilities; (6) access to industrial raw materials; (7) managerial skills; and (8) the organization of the economic system. The mix of these basic economic variables -- along with other specific factors not listed -- varies from country to country and changes over time. It is also possible to substitute one, or a combination, of these productivity variables for specific inadequacies. Most analysts agree, however, that a strong rate of new capital investment is required to generate sustained growth. In fact, the effectiveness of all of the other factors that determine productivity are heavily dependent upon the quantity and quality of capital goods made available by new investment.

The United States retains a position of economic leadership because it has been blessed over a long period of time with a favorable mix of all of the important economic variables, along with political stability and improving social mobility. For many years our advantageous ratio of capital to labor has been acknowledged as the basis of the remarkable rise of the U.S. economy. Even now spending for plant and equipment continues to increase and these outlays still exceed the amounts invested elsewhere because of the large size of the U.S. economy (Table 2). In 1974, gross private domestic fixed investment totaled $195.6 billion, up from $194.0 billion in 1973 and $131.7 billion in 1970. Investments in business structures and producers' durable equipment totaled $149.6 billion in 1974, up from $136.8 billion in 1973 and $100.6 billion in 1970.

Nonetheless, even though plant and equipment expenditures will continue in the future as the economy grows, it is unrealistic to assume that the historical patterns of investment and productivity will be adequate to meet the priorities of the future. And I certainly am not suggesting that we can fulfill every claim presented by society. The disappointing record of Federal deficits in fourteen of the last fifteen years ending with FY 1975 -- or forty out of the last forty-eight years -- and the unfortunate boom and bust pattern of economic performance over the past decade indicate that we have not been able to effectively identify and manage our national economic priorities. Some analysts have claimed that future economic growth will release unused resources to fulfill new claims against the national output. To the contrary, the intensity of claims for available resources will likely increase in the future.

Investment as Percent of
Real National Output 1960-73*

| | Total Fixed** | Nonresidential Fixed |
|---|---|---|
| Japan | 35.0 | 29.0 |
| West Germany | 25.8 | 20.0 |
| France | 24.5 | 18.2 |
| Canada | 21.8 | 17.4 |
| Italy | 20.5 | 14.4 |
| United Kingdom | 18.5 | 15.2 |
| U.S. | 17.5 | 13.6 |
| 11 OECD Countries | 24.7 | 19.4 |

* OECD concepts of investment and national product. The OECD concept includes nondefense government outlays for machinery and eqipment in the private investment total which required special adjustment in the U.S. national accounts for comparability. National output is defined in this study as "gross domestic product," rather than the more familiar measure of gross national product, to conform with OECD definitions.

** Including residential.

Source: U.S. Department of the Treasury.

The reduced pace of capital investment in the U.S. economy has also been emphasized by Professor Paul W. McCracken, former Chairman of the Council of Economic Advisers and now Senior Consultant to the Department of the Treasury. Using historical figures, reported in constant dollars, for the amount of nonresidential capital formation per person added to the labor force, he estimates that commitments in the United States during the 1970s are 22 percent below the level reported in the 1956 to 1965 decade. In terms of business capital investment per worker, the United States still maintains a considerably higher capital to labor ratio than in Europe and Japan. However, our advantage has declined as other nations have increased their capital investments per worker. The Department of Commerce estimates that since 1960 the existing base of plant and equipment assets has

nearly doubled in France and Germany and more than tripled in Japan. 1/ The cumulative total of such assets in the United States increased at most by about 50 percent during the same period.

Gross Nonresidential Fixed Investment
Per Person Added to Civilian Labor Force
(In 1958 dollars)

| Period | Amount |
|---|---|
| 1956 - 1960 | $49,500 |
| 1961 - 1965 | 55,300 |
| 1966 - 1970 | 46,400 |
| 1971 - 1974 | 41,000* |

*Estimate based on incomplete data for 1974

Source: Statement of Paul W. McCracken before the Committee on Ways and Means, January 29, 1975. Basic data from the Departments of Commerce and Labor.

## Factors Influencing U.S. Rate of Capital Investment

In evaluating the relatively slower rate of capital investment in the United States, several moderating factors should be considered.

First, the unusually large size of the U.S. economy and its relatively advanced stage of development, including the accumulated total of previous capital investments, creates a different investment environment. In 1974 the U.S. national output was $1.4 trillion, which is approximately equal to 90 percent of the combined total for the nine countries in the European Economic Community and Japan. Having already created such an impressive productive capacity it is to be expected that our rate of additional growth might be lower than the development rates of other nations who are striving to achieve our relatively advanced level of economic activity.

1/ An Overview of Investment: The United States and Major Foreign Economies, International Economic Policy and Research Report, U.S. Department of Commerce, Domestic and International Business Administration, October 1974, p.9

A second and even more important influence has been the historical priority placed on consumption within the U.S. economy. We are a consumption-oriented society and this pattern has been developing for several decades. The emphasis on consumption has undoubtedly caused much of the rapid development of the U.S. economy because it has created a strong demand for goods and services needed to sustain output, employment and investment. In 1974 personal consumption totaled $877.0 billion, or 63 percent of our gross national product; total government purchases of goods and services totaled $308.8 billion, or 22 percent; gross private domestic investment, which includes the change in inventories, was $208.9 billion, or 15 percent; and net exports of goods and services amounted to $2.0 billion or 0.1 percent of total national output. Personal and government consumption outlays have long dominated the GNP totals, and this pattern of economic activity is deeply ingrained in our society. As a result, despite our high per capita incomes, the accumulations of gross savings flows required for capital investment are lower in the United States than elsewhere. It is also important to note that the level of gross private savings in the United States has remained stable throughout the postwar era.

Average Annual Gross Savings Flows
As a Percent of Gross National Product
(Percent)

| | 1955-59 | 1960-64 | 1965-69 | 1970-74 |
|---|---|---|---|---|
| Gross Private Saving | 15.9 | 15.4 | 15.9 | 15.8 |
| Personal saving | 4.5 | 3.8 | 4.5 | 5.5 |
| Undistributed corporate profits | 3.4 | 2.8 | 3.1 | 2.8 |
| Inventory valuation adjustment | -0.3 | 0.0 | -0.3 | -1.2 |
| Capital consumption allowances | 8.3 | 8.8 | 8.7 | 8.7 |
| U.S. Government Surplus | -0.1 | 0.2 | -0.2 | -1.1 |
| State and Local Government Surplus | -0.3 | 0.1 | 0.0 | 0.5 |

Source: Department of Commerce, Bureau of Economic Analysis

These figures are subject to differing interpretations. Some analysts have claimed that it will not be possible to attract enough savings to meet future investment needs. This negative conclusion assumes that the capital needed to increase plant and equipment capcity will be preempted or diverted to meet the consumption preferences of the private and public sectors. I would hope that the severe output, inflation, unemployment and balance-of-payments distortions of the past decade would be a useful warning against such a result. It should be apparent from the experience of recent years that we must invest adequate funds in new plant and equipment -- as well as in education and training -- in order to increase our nation's productivity and thereby raise our standard of living. Failure to provide necessary productive capacity to meet the Nation's economic goals is certain to have undesirable effects upon our society over the long run.

Other analysts have used the same gross savings figures to claim that there will not be any particular strain in handling our future investment needs. They believe that as investors are provided with a sufficiently high return on their investments, they will increase savings to meet the higher demand for capital. This conclusion seems to be based on two questionable assumptions: (1) that the existing savings ratio of the past decade is adequate for both past and future capital investment needs; and, (2) that each sector in the economy can obtain its minimum investment needs within the total outlays financed.

I do not agree that past investment levels have been fully adequate. Experience has demonstrated that inflation and unemployment problems have been created in part by capacity shortages. Many of our current difficulties are the direct result of the energy and raw materials strains that developed in early 1974 and eventually contributed to our current recession and related unemployment. The continuous deterioration of our international trade balance during the 1960s, when the dollar was overvalued, was also at least partly the result of the loss of competitiveness for U.S. products and increased reliance on foreign sources of goods. As you will see in a moment, I think there is also clear evidence that in order to meet future needs, the Nation must increase its capital investment as a claim against national output. Unfortunately, specific investment needs have not been adequately fulfilled in many sectors of the economy, even though general outlays have increased. We must also be concerned about the capacity of our capital markets to provide adequate financing. Economists often assume that the supply of investment funds will automatically match the

demand for capital if interest rates and equity yields are attractive. Our financial markets are very efficient in collecting savings and allocating the funds. However, we should be more sensitive to the disruptive impact of high interest rates. Even though financial markets may be functioning well in allocating the available capital, specific sectors of the economy may not be able to obtain the investment funds needed, particularly at interest rates they can afford. The periodic problem of providing adequate mortgage financing at reasonable interest rates is one example of the limitations within the markets. The difficulty in obtaining equity financing is another. Whether or not industry will be able to acquire the investment funds needed will be heavily influenced by future actions of the government. National policies cannot ignore financial realitites by diverting capital into deficit financing and disrupting the goals of stable monetary policy without inhibiting the necessary process of capital formation. The costs of capital and its availability for private sector needs are heavily dependent on these public fiscal and monetary actions. While the financial markets are very resilient and responsive to changing credit and equity needs, they are not entirely immune to the disruptive impact of government policies.

A third important factor affecting the pattern of U.S. investment compared with other nations is the relatively large share of total capital outlays we commit to the services category, which includes housing, government and other services. According to a study published by the Organization for Economic Cooperation and Development (OECD), the United States allocated 70 percent of its total investment to the services category during the 1969 to 1971 time period. The U.S. figure is significantly higher than that reported by the other five major industrial nations included in the study (Table 3). Accordingly, the U.S. share of investment committed to the manufacturing sector, 19.7 percent, was considerably lower than the figures reported by France (27.8 percent), West Germany (25.2 percent), Japan (26.8 percent), and the United Kingdom (23.8 percent). Our heavy investment in the services category tends, of course, to emphasize consumption and moderate the growth in productivity. This arrangement may satisfy immediate consumer preferences, but we must weigh those preferences against long-term concerns about domestic productivity and international competitiveness.

A fourth in luence on the pattern of capital investment in the United States is the relatively large share of our investment that must be used for replacement and modernization of existing facilities. It is estimated that 62 percent of U.S. capital investment during the time period 1960 to 1971 was used for replacement needs, compared to the United Kingdom, 61 percent; Canada, 52 percent; France, 54 percent; West Germany, 53 percent; and Japan, 31 percent. 2/ The divergent pattern reflects the advanced status of economic development in some nations and the postwar experience of Europe and Japan in restoring their devastated industrial facilities following World War II. The Department of Commerce estimates that 60 to 70 percent of the U.S. stock of plant and equipment has been added since 1960, compared to approximately 75 percent of the capital goods of West Germany and France and 85 percent of Japan's industrial capacity. It should be emphasized that this heavy replacement requirement does provide a continuing opportunity to introduce new technology into the U.S. economic system. Since the annual value of U.S. capital investment is so large, it cannot be assumed that the entire U.S. industrial system is technologically obsolete, even though some specific sectors have suffered a sharp competitive deterioration. Nevertheless, the otherwise imposing outlays for replacement and modernization do not add to the total productive capacity of our economy.

A fifth and final factor influencing the national rate of capital investment is the pattern of government policies. Government can affect investment either directly through the incentives it provides or indirectly through various tax and regulatory policies and its own pattern of spending.

A review of the diversified economic incentives available in other nations indicates the very active investment role played by many foreign governments. Basic industries are frequently controlled by the government with total, or at least dominant, public ownership. Special financial and operating assistance is also frequently provided for preferred private companies to assist their development if it is considered to be in the national interest. The United States has avoided most of the capital allocation and special incentive programs used in other countries. I strongly favor this private sector approach and believe that it has been a positive factor in the development of our economy.

There are some Federal programs which provide direct financial support through the Economic Development Administration, the Small Business Administration and 169 different government credit programs, but the major influence of Federal Government

on capital investment comes through the Federal budget. Government budget decisions now represent approximately one-third of the total GNP and this figure will rise even higher if spending trends of the past twenty years are continued. The government also influences private sector activities by providing capital grants, research funding and other incentives which stimulate investment. For example, the FY 1976 budget prepared by the President calls for outlays of $4.6 billion on general science, space and technology programs, $2.2 billion on energy activities and $9.4 billion for environmental and natural resources. Part of these outlays will involve capital investment needs.

The Government is also exercising increased influence over private investment decisions through the growing number of safety, health and environmental standards. Precise estimates are difficult, but it has been estimated that during 1972, 8 percent of the textile industry's capital investments and 12 percent of the steel industry's investments were related to health and safety standards mandated by the government. While such standards may be highly desirable, we should recognize that these investments do not increase the Nation's total productive capacity.

Many State and local governments also provide special incentive programs to attract capital investment into specific geographical areas. Such incentives include capital grants, advantageous credit arrangements, relocation and manpower training grants, special site and building assistance, infrastructure investments, and preferred tax and utility arrangements. While such incentives have influenced the location of some facilities, the total amount of capital investment has probably not been increased.

The private sector continues to be the best means of increasing capital investment in the United States and our government has fortunately not attempted to control the pattern of such investments.

Negative Results of Inadequate Capital Investment

While the historical pattern of capital investment in the United States may satisfy our immediate goals, there are serious economic risks in having a slow rate of capital investment for an extended period of time. The emphasis on immediate consumption has occurred because American consumers have historically preferred to spend 91 percent of their disposable after-tax income. The government has basically supported this independence of choice although its tax and spending policies have unfortunately exercised an increasing influence on private decisions. But we must now question the future adequacy of past investment patterns if we are to adequately prepare for the economic future of our great nation.

Various studies have indicated the close relationship between capital investment and various measures of economic growth and productivity. A dynamic economy is needed to create jobs by applying new technology and expanding production capacity. A productive labor force is also necessary for producing goods and services to meet rising demands for an improved standard of living and as a means of holding down inflation. When productivity increases,the effects of rising wages are offset so that unit labor costs can be held down and prices are more stable. Inadequate capital investment also limits new job opportunities and creates unemployment. Specific examples of production capacity shortages became painfully apparent to the Cost of Living Council (COLC) as it administered the program of wage and price controls from August 1971 until June 1974. Recognizing the inflation pressures created by these numerous capacity constraints, the COLC followed a definite policy of requiring specific capital investment commitments from private industry as a basis for price decontrol decisions. The COLC also became very concerned about future inflation problems that could result from raw materials shortages and increasing capacity shortages in several basic industries as economic growth occurs. Unfortunately, productivity gains in the United States have been disappointing, particularly when compared with the experience of other leading nations.

Productivity Growth, 1960-1973

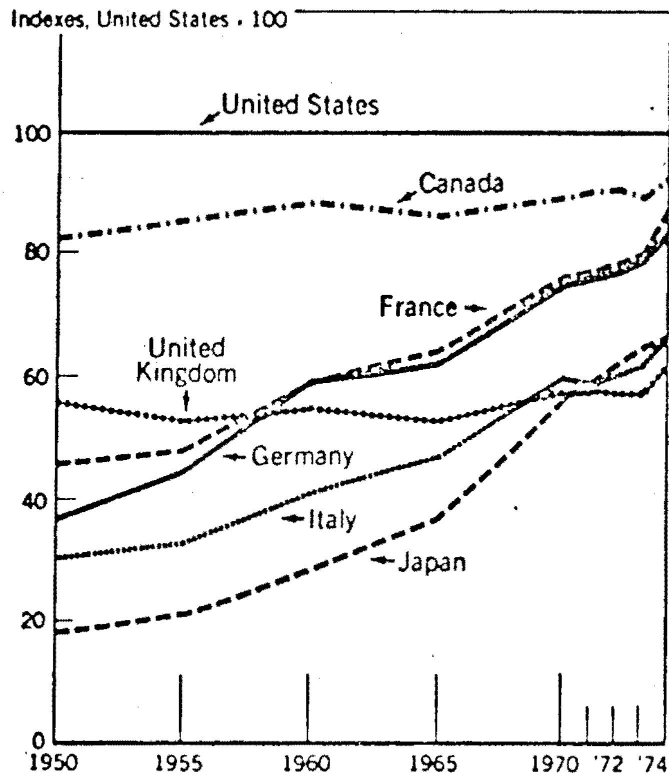
(Average Annual Rate)

| | Gross Domestic Product per employed person | Manufacturing output per manhour |
|---|---|---|
| United States | 2.1 | 3.3 |
| Japan | 9.2 | 10.5 |
| West Germany | 5.4 | 5.8 |
| France | 5.2 | 6.0 |
| Canada | 2.4 | 4.3 |
| Italy | 5.7 | 6.4 |
| United Kingdom | 2.8 | 4.0 |
| 11 OECD Nations | 5.2* | 6.1 |

* Average for 6 OECD countries listed.

Source: Department of the Treasury

The rapid growth of the U.S. economy to its present size and the relatively low level of inflation until the late 1960's has been based on the creativity and productivity of the system. Americans have grately benefitted from this growth, not only in personal economic gains but in terms of national security and international leadership. Continued prosperity, however, cannot be taken for granted; it must be earned. We must be willing to allocate more of our resources to the future and fewer to satisfying immediate demands. This is a difficult concept for some to accept because they prefer current consumption. With so many needs still unsatisfied in a land of relative plenty, this feeling is understandable. Our ability to fulfill these needs will only be restricted, however, if we now fail to prepare for the future. The simple truism that we cannot consume more than we produce should be obvious, but we sometimes ignore it in setting national priorities. And we can no longer afford to ignore the fact that as the real output of other nations has increased more rapidly than our own, our competitive advantage has gradually been eroded.




Source: Department of the Treasury.

## II. FUTURE CAPITAL INVESTMENT REQUIREMENTS

Economic projections are always difficult, but estimating future capital needs is particularly uncertain at this time because costs and priorities continue to change rapidly. It is obvious, however, that future capital requirements will be enormous -- larger than anything we have ever faced before. Clearly we will need to increase the quantity and quality of housing; develop new energy resources; improve the quality of our environment; rehabilitate the existing transportation system and develop a better urban transportation system; continue the mechanization of agriculture; construct new office buildings, communications systems, medical facilities, schools and other facilities; and meet the massive needs for new plant and equipment. In all of these sectors we must not only replace and modernize existing facilities but also add new capacity, particularly in many of our most basic industries.

The Department of Commerce estimates that capital requirements for producers' durable equipment and nonresidential structures will total $3.4 trillion during the 1974 to 1985 period. If annual outlays for residential construction, which have averaged $50 billion during the past four years, are added to this figure, the total capital needs rise to well over $4 trillion. Details of their estimate include:

Gross Private Domestic Nonresidential Fixed Investment
(billions of current dollars)

| | 1974 | 1985 | Cumulative 1974-1985 |
|---|---|---|---|
| Total producer's durable equipment | $100.0 | $276.7 | $2,188.8 |
| Nonresidential structures | 54.7 | 151.3 | 1,197.3 |
| | $154.7 | $428.0 | $3,386.0 |

A similar study performed by the General Electric Company confirms the massive size of future capital requirements. Assuming a real GNP growth rate of 4 percent and an inflation rate of 5 percent, General Electric expects gross private domestic investment, including residential housing, to total $4½ trillion over the 1974 to 1985 time period.

The General Electric and Commerce studies are consistent if housing outlays are added to the Department of Commerce totals. Both estimates are limited to private investment and exclude the large government expenditures required for roads, dams, government facilities, schools, pollution abatement outlays, and many other projects.

Assuming, then, that the cumulative investment needs between 1974 and 1985 will range from $4 to $4½ trillion, the point to remember is this: over the most recent period of the same length,

1962 through 1973, our total outlays for capital investment in the United States were $1½ trillion. Thus, our capital investment needs in coming years are approximately three times the level of the recent past. That is perhaps our best measure of our challenge ahead.

Both of the studies I have mentioned are necessarily based on many uncertain projections and arbitrary assumptions about a continuing close relationship between investment and economic growth. But even if some of these assumptions prove to be erroneous -- as they will -- and new investment requirements arise -- as always happens -- the actual results will not materially change the following conclusions:

1. Capital requirements for gross private domestic investment will be in excess of $4 trillion during the 1974 to 1985 time period.

2. The future rate of inflation will be a crucial factor in determining the amount of future investment because it will influence both the price of assets acquired and the economic incentives for future investment.

3. The achievement of national capital investment goals is possible if we are willing to increase the share of national resources committed.

## Energy Investment Requirements

One area of capital investment that is particularly critical for the future is energy. To achieve greater self sufficiency in energy, enormous capital investments will be required. We basically have two alternatives. The first one is to meet our increased energy investment requirements by reducing outlays in other sectors. While energy priorities are indeed important, it would be most unfortunate to disrupt the entire economic system in this way. A second -- and more desirable -- approach is to include these new requirements within an enlarged total investment goal. Our purpose should not be to redistribute the economic pie, but to continue enlarging it so that everyone will have a bigger share.

Recognizing that the ultimate cost of energy investment needs will be influenced by many variables, it appears that capital requirements over the next decade will total about $1 trillion stated in current dollars to include the effects of inflation. Energy investments will comprise an important share of the total capital requirements discussed above but their financing is manageable if they are given a high priority as part of a comprehensive national energy program. The specific amounts to be spent in each category will depend upon the energy policies adopted and dynamic developments within the economy. Nevertheless, the range of possible needs is indicated in four separate studies prepared by the Federal Energy Administration, National Petroleum Council,

National Academy of Engineering and Arthur D. Little, Inc. All four studies are stated in constant 1973 dollars to make them comparable. If necessary adjustments are made for potential inflation and the increased needs that have been identified since the studies were prepared the resulting capital needs expressed in current dollars, will approximate $1 trillion between now and 1985.

Comparison of Capital Requirements Estimates*: Total Dollars

Cumulative 1975 - 1985

(Billions of 1973 Dollars)

| | NPC (a) | NAE (b) | ADL (c) | FEA Accelerated Supply |
|---|---|---|---|---|
| Oil and Gas (including refining) | 133 | 149 | 122 | 98.4 |
| Coal | 8 | 18 | 6 | 11.9 |
| Synthetic Fuels | 10 | 19 | 6 | .6 |
| Nuclear | 7 | 93 | 84 | 138.5 |
| Electric Power Plants (excluding nuclear) | 137 | 53 | 43 | 60.3 |
| Electric Transmission | 42 | 125 | 90 | 116.2 |
| Transportation | 43 | - | 43 | 25.5(d) |
| Other (e) | - | - | 8 | 2.2 |
| Total | 380 | 457 | 396 | 454 |

(a) U.S. Energy Outlook, a summary report of the National Petroleum Council, Washington, D.C., December 1972 (Average of four supply cases)

(b) U.S. Energy Prospects, An Engineering Viewpoint, National Academy of Engineering, Washington, D.C., 1974

(c) Arthur D. Little estimates based upon an energy conservation scenario.

(d) Does not include investments required for tanker fleets, but does include $5.5 billion targeted for Trans-Alaska oil pipeline.

(e) Solar, Geothermal, Municipal Waste Treatment Plants, and Shale Oil.

Source: Federal Energy Administration, Project Independence Report, November 1974, p. 282.

The overall impact of energy requirements is summarized in a special report issued by the Chase Manhattan Bank in March of 1975. The Energy Economics Division of the bank is noted for the quality of its special reports. Over twenty years ago that division predicted that an energy shortage would develop in the United States if certain policy adjustments were not made. One of the major concerns of these reports over the years has been the chronic underinvestment in energy resources which became apparent in the late 1950's. The conclusion of the most recent Chase Manhattan Bank report is particularly perceptive:

"Although the relationship between investment and supply of energy is an elementary principle that applies to any and all sources of primary energy, it is nevertheless one that is not well understood. In fact, the lack of understanding was responsible for the incredibly unenlightened regulation and many other political actions about the world that had the two-pronged effect of preventing the generation of sufficient capital funds and discouraging the investment of money that actually was available. And the current energy shortage is the consequence. Yet, even today, after so much damage has been done, there is still a widespread failure to recognize the relationship between investment and supply. Instead, two distinctly different attitudes generally prevail. Many apparently continue to believe they can somehow again have enough energy without paying all the associated costs. Others, obviously, are resigned to the prospect of a permanent shortage and see conservation as the only avenue of partial relief. Neither attitude is realistic, of course. The world still does not lack basic energy resources remaining to be developed. And it is conceivable that eventually there can again be enough to serve all its needs but only if the necessary investment is made first. If it is not, a permanent shortage will indeed be the certain outcome."

Source: The Chase Manhattan Bank, Energy Economics Division, "How Much Oil -- How Much Investment," A Special Petroleum Report, March 1975.

The report goes on to emphasize -- correctly, I believe -- that a permanent shortage is intolerable because it would so constrict total economic growth that the growth in labor force -- even at the more moderate pace expected in the 1980s -- could not be absorbed. The resulting unemployment problems would cause severe economic problems in addition to threatening our political and social stability.

Future investments in energy resources will naturally be determined by total demand over time. Estimates have already changed dramatically as costs have risen and conservation efforts have increased. However, these developments are so recent that it is difficult to predict future demand until a national energy policy is agreed upon and the various energy incentives and disincentives are identified. The Chase Manhattan analysts had originally projected a continued growth in the world's demand for energy at an average annual rate of 5 percent which is the same pace as recorded from 1955 to 1970. Admitting the unusual degree of uncertainty, the bank has now lowered its projection to an annual rate of 4.2 percent with a strong warning that energy forecasts have historically erred on the conservative side. Oil consumption is expected to grow at a more rapid annual rate of 4.5 percent over the 1970 to 1985 period, resulting in a cumulative consumption of 375 billion barrels, nearly two and a half times more than in the 1955 to 1970 period. North America is expected to remain the world's largest consumer of total energy and oil, but the growth rate for this area may be lower because of a slower population growth and our potential for conservation savings.

Turning to the financial requirements for the petroleum industry, Chase Manhattan Bank estimates a world-wide need for $400 billion to find 600 billion barrels of oil between 1970 and 1985. This is more than two and a half times the actual investment for this purpose during the 1955 to 1970 period. An additional $370 billion will be needed between 1970 and 1985 for world-wide development of refineries and processing facilities, tankers, pipelines, environmental equipment and the necessary marketing facilities. The total of $770 billion is nearly three times the actual commitment in the preceding fifteen year period. Finally, another $400 billion will be required for other investments, payment of dividends, debt repayments and additions to working capital.

The total financial needs of the world's petroleum industry from 1970 to 1985 are estimated by the bank to be $1.2 trillion stated in constant 1970 dollars. Inflation will of course increase the dollar amounts required. If inflation averages 5 percent over the time period, the world petroleum industry financial needs would rise from $1.2 to $1.6 trillion. With 10 percent inflation, the figure would increase to $2.2 trillion.

With regard to financing these world-wide petroleum industry requirements, the bank estimates the following distribution of potential sources based on the $1.2 trillion constant dollar estimate: (1) Communist nations, $225 billion; (2) new capital market issues, $240 billion; (3) capital recovery allowances, $260 billion; and (4) profits, $460 billion. These figures must be adjusted upward according to whatever rate of inflation occurs.

This brief listing of sources obviously conceals many difficult financial challenges. The world's capital markets will already be absorbing large public and private financing demands. Government policies may reduce capital recovery allowances permitted for computing tax liabilities. And the assumption that oil industry profits will be large enough to cover such a large share of the total is questionable. Commenting on the public's reaction to oil industry profits in 1973 and 1974 after fifteen years of average performance, the bank report states:

> "As emphasized earlier, there cannot possibly be enough energy of any kind without adequate investment. And investment cannot be adequate without sufficient profits. But profits are labeled excessive and restraints are proposed without apparent consideration of the need for profits as a source of investment funds. As indicated earlier, the industry will need at least $845 billion of profits between 1970 and 1985 if the world experiences a 10 percent rate of inflation. But in the first four years of the period the industry generated no more than $60 billion of profits, only 7 percent of the required amount. Even in the highly unlikely event of no further inflation, the $60 billion would represent but 13 percent of the industry's total needs for the fifteen year period."

## III. GOVERNMENT POLICIES

While our economy is capable of financing its large private capital investment requirements, our success in meeting that goal is heavily dependent upon the shape of government policies. It is absolutely imperative that government policies become more supportive. A continuation of the severe fiscal and monetary distortions of the past decade would undoubtedly prevent the achievement of our basic goals. Inflation must be controlled, and the government must avoid disrupting the capital markets if the private sector is to obtain the financing required. In fact, public officials must balance the Federal budget over time and record occasional surpluses in order to free up capital resources to fulfill existing private investment claims. Instead of reducing private investment to release resources for government social programs, we should concentrate on balancing the budget over time so that the future flow of savings is not diverted away from private investment.

Unfortunately, the Federal Government has reported a deficit in fourteen out of the past fifteen years ending with FY 1975. During the single decade FY 1966 through FY 1974, the cumulative Federal deficits totaled $103 billion. Net borrowings for supporting over one hundred "off-budget" Federal programs totaled another $137 billion during that decade. As a result, the Federal Government withdrew one quarter of a trillion dollars out of the capital markets. But this record is only a prelude to our present situation when Treasury financing requirements will total about $75 billion in calendar year 1975 in order to finance the massive Federal deficits expected. While much of the current deficit results from the recession, which has caused tax revenue losses, increased unemployment compensation benefits and other outlays resulting from the "automatic stabilizers" used to fight recession, a review of the budget details indicates that traditional spending programs are also rising rapidly and new programs are proposed almost every day. As indicated in Table 4, the spending figures included in the original budget submitted by the President last February called for outlays of $313.4 billion in Federal spending in FY 1975 and $349.4 billion in FY 1976. Recent projections by the Office of Management and Budget indicate that FY 1975 outlays will be $324.2 billion, an increase of 20.8 percent over FY 1974 outlays. It should be obvious that government spending-- both for temporary stimulus and traditional programs -- is increasing at a rate that is creating serious resource allocation problems far into the future and that these pressures will not conveniently disappear as we gradually emerge from the recession later this year.

Looking beyond the recession problems of 1975, we seem to face the dilemma of having an apparently irresistible force of growing government spending meeting the immovable object of future capital investment requirements. But we should no longer consider the growth of government spending and related deficits to be an irresistible force. To do so will inevitably lead to even more serious economic problems of unemployment, reduced real gains in our national standard-of-living and even more inflation resulting from inadequate physical capacity and reduced productivity. We must recognize the basic reality that when we apply too much pressure on our capacity to produce goods and services, the inevitable result is inflation and shortages. The underlying growth trends of the U.S. economy will continue to provide for further economic progress, but we cannot realistically expect to satisfy every new claim within our economy by simply shifting resources from the private to the public sector. Adding new government commitments is not feasible if the total productive capacity of the economy is exceeded.

This guideline has been frequently violated as total demand has increased too rapidly for the economic system to absorb. When this happens the economy begins a boom and bust sequence with severe inflation and unemployment distortions. Nor can we wish away the problem by claiming that there is plenty of slack in the 1975 recession and that we can ignore problems of overheating the economy until later years. The escalation of government spending levels summarized in Table 4 has already seriously eroded our future fiscal flexibility and the lagged impact of current spending decisions will directly affect the future. In short, if we are to achieve our crucial goal of adding at least $4 trillion of private capital investment by 1985, we must first establish more moderate and sustainable fiscal and monetary policies.

## Tax Policies

Federal tax policies affect capital investment decisions by determining the after-tax earnings available for investment and by establishing incentives or disincentives for future investment. An OECD study of tax policies indicates that total government tax collections in the United States during the years 1968, 1969, and 1970 were a smaller proportion of the gross national product than in most other industrial nations. The U.S. figure of 27.9 percent for those three years was above that of Switzerland (21.5) and Japan (19.4 percent) but below the levels reported for many European nations, ranging from Italy (30.1 percent) to Sweden (43.0 percent). Since the study was completed, the United States undertook major tax policy changes in 1971 and in March of 1975, but the comparative relationships have probably not changed very much. There is, however, a major difference in the distribution of the tax burden. As indicated in Table 5, only 18.1 percent of the U.S. tax revenues in 1971 were provided by taxes on the consumption of goods and services. Other industrial nations relied much more heavily on consumption taxes: France, 34.8 percent; West Germany, 28.1 percent; United Kingom, 26.6 percent; Canada, 28.7 percent; and Japan 20.7 percent.

The definite tilt toward personal and corporate income taxes in the United States is consistent with our historical preference for immediate consumption. It is not my purpose to critize this historical priority, but the future requirements for capital investment indicate that tax policies should be reviewed. Just such a review has been underway in the Department of the Treasury in preparing for the tax law changes completed last month and in anticipation of a joint review with the Congress in the coming months of possible tax reform initiatives. I do not want to make any specific recommendations this morning because we are still working on our analysis and recommendations. We will want to review the options with Congress before specific actions are suggested. I will merely refer to some of the policy areas that need to be reviewed:

1. Corporate income tax -- These taxes directly influence the cash flow available for investment. The rate has vacillated slightly above or below the 50 percent level for many years. While a reduction in the rate of taxation would probably be the most straight-forward approach to enhancing investment incentives, any change would represent a major shift in policy and would require extensive Congressional consideration. The Tax Reduction Act of 1975 did increase the corporate surtax exemption from $25,000 to $50,000 and decrease the "normal" tax from 22 to 20 percent on the first $25,000 of earnings. These changes, however, do not affect the tax impact on the great bulk of corporate earnings subject to the corporate surtax.

As part of this on-going review of tax policies we also need to consider the influence on investment of our two-tier system of corporate taxation in which income is taxed once at the corporate level and again at the shareholder level. This approach discriminates against corporate investors generally and small equity investors particularly. An individual in the 20 percent tax bracket in effect pays 48 percent at the corporate level and then an additional 20 percent on what is left for a total tax burden of 58.4 percent, or nearly three times his individual rate. If the individual is in the 70 percent bracket, he pays 48 percent at the corporate level and then an additional 70 percent on what is left. His total tax burden is 84.4 percent. If the same business could be conducted in a noncorporate form, the investors would pay only 20 and 70 percent respectively.

Our tax system puts a great penalty on companies that must incorporate. Companies that do incorporate are those that have large capital needs that must be raised from many persons. We should keep in mind that our system of taxation bears more heavily on corporations than do the tax systems of almost every other major industrial nation. In the last few years our major trading partners have largely eliminated the classical two-tiered system of corporate taxation. Through a variety of mechanisms they have adopted systems of "integrating" the personal and individual income taxes so that the double taxation element is radically lessened.

2. <u>Investment Tax Credit (ITC)</u> - Business firms have strongly supported the ITC as a major stimulus to additional capital investment. Empirical studies do indicate that the amount of investment in machinery and equipment has increased when the ITC has been put into effect and has declined when it is suspended. Some critics believe, however, that the ITC simply influenced the timing and types of investment rather than increasing the total amount. Whichever view is correct, there was strong support for the investment tax credit provision in the Tax Reduction Act of 1975 which increased the credit to 10 percent for two years and removed the lower percentage limitation for utilities. Unfortunately, the investment tax

credit has had an uncertain status once it was initiated January 1, 1962 and businessmen are justifiably concerned about the stability of an incentive which has already been removed twice and then reinstated.

3. Depreciation guidelines - The amount of capital recovery charges permitted for tax purposes also influences the after-tax earnings available for private investment. In 1954 the Internal Revenue Tax Code was changed to permit depreciation charges to be made on an accelerated basis. The official guidelines were again liberalized in 1962, and in 1971 the Asset Depreciation Range (ADR) -- along with the investment tax credit -- was added to the regulations.

The ADR rules allow companies to select a time period for calculating depreciation within a range of 20 percent above or below the Treasury guideline which specifies useful life periods for various assets. Despite these adjustments, American businesses complain that they have a competitive disadvantage compared with some other nations. The figures summarized in Table 6 do indicate that American firms using both the ADR and the investment tax redit can recover 55 percent of the value of new investments during the first three years. By comparison, the allowances in other nations are as follows: Canada, 100 percent; France, 90.3 percent; Japan, 63.9 percent; United Kingdom, 100 percent; and West Germany, 49.6 percent. It should be added that the U.S. position becomes more comparable by the seventh year. Various business groups have proposed further liberalization, such as a wider ADR percentage, but further consideration should be part of the general tax reform analysis involving the Department of the Treasury and the Congress.

4. Special Incentives - The government is frequently asked to provide special incentives in the form of reduced or delayed taxes, accelerated depreciation schedules, capital grants or other benefits to enchance the rate of return on capital investments. While such incentives are usually requested on the basis that they will contribute to the achievement of some national priority, it is usually difficult to justify such special treatment. When special advantages are given to a specific industry or geographical region, others become relatively disadvantaged and it is very difficult for government authorities to determine which claims should be favored, particularly in a dynamic economy where priorities can change rapidly. While there may be a few specific situations where the government should intervene in the allocation of resources which is now handled efficiently by the private markets, my overwhelming preference is to avoid the economic distortions which are found to occur.

Corporate Profitability

The final area of concern that I want to address here is the future outlook for corporate profitability. Such profits are, of course, the major incentive for additional investment and an important source of funds for financing outlays, along with various external sources. In a fundamental sense profits are the driving force of our system -- the engine that pulls the economic train for the 85 percent of our work force still in the private sector -- and they are just as much a "cost" of doing business as payments to workers, supplies of materials and services, taxes, etc.

Unfortunately, corporate profits are too often thought of as an unnecessary claim required by greedy businessmen rather than the basic incentive in our economic system. Public opinion surveys in the 1930s and in more recent years are consistent in indicating that the general public thinks that profits account for approximately 28 percent of the sales dollar. The fact is, however, that profits account for approximately 5 cents out of each dollar of sales. Actual earnings of business firms are thus far below what the general public -- and some Members of Congress -- perceive them to be. In fact, corporate profits will have to improve substantially in order to provide the necessary incentives and to make the necessary contribution to futute investment outlays. My concern is that the negative attitudes about profits held by many Americans might become an unfortunate part of public policy. We must avoid legislation and regulation that is punitive of profits honestly earned. The result could only be that capital formation would be inhibited, and the real purchasing power of wage earners would rise more slowly. We must always be alert to the fact that profits translate into jobs, higher wages, and an increased standard of living for all of our people.

One important reason why there is so much misunderstanding about corporate profitability is that our accounting system has not yet been able to adapt to the disruptive effects of the double-digit rate of inflation we have suffered. Inflation hurts investment by increasing the prices of new assets and eroding the purchasing power of corporate earnings. Taxes must be paid on reported earnings even though these figures are exaggerated by inventory valuation profits and the inadequacy of capital recovery allowances, which are based on the historical costs of existing assets rather than the inflated outlays required for new assets. Inflation also disrupts investment by discouraging savings once the general public recognizes that the purchasing power of such commitments is eroded so quickly.

Fortunately, the Department of Commerce publishes figures which attempt to adjust for the distorting effects of inventory valuation, the effects of accelerated depreciation methods and the understatement of capital recovery allowances based on historical cost asset values. The results of these adjustments are summarized in Table 7. These figures clearly indicate that adjusted after-tax profits of nonfinancial corporations as a share of national income and of the value of corporate output are far lower than the public opinion polls would suggest. Furthermore, from a peak in 1965 through 1973 the relative share of corporate after-tax profits has declined by one-half according to both measures. The same discouraging pattern results when these adjusted earnings figures are compared to the replacement value of capital assets to determine the rate of return on invested capital. From a peak rate of return of 10 percent. In 1965 this measure declined to 5.4 percent in 1970 before recovering to a level of 6.1 percent in 1973. The sluggish economy of 1974 and 1975 will further reduce this figure. It is not unfair to say that the United States has been and remains today in a profits depression. Since the incentive for new investments ultimately depends upon sustaining an attractive rate of return on capital, this trend is particularly disturbing.

It should be emphasized that all of these comparisons have been stated in current dollars which conceals the negative impact of inflation on the purchasing power of retained earnings. Professor John Lintner of Harvard University recently reported that the retained earnings of U.S. nonfinancial corporations were 77 percent lower in 1973 than in 1965 if the figures are converted into constant dollars in order to remove the effects of inflation and if adjustments are made to remove the effects of inventory valuation gains and the underreporting of depreciation changes based on historical costs. Without these adjustments, reported retained earnings in 1973 were 46 percent above the 1965 figure. 3/

Because business firms cannot use "phantom" earnings to acquire capital assets, the future pace of private investment will depend upon the growth of real profits. The government can influence the economic incentives needed to stimulate investment through its tax policies, regulatory and administrative practices and various spending programs, but the private investment decision ultimately depends upon the rate of return expected and

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3/Lintner, John, "Savings and Investment for Future Growth: 1975-6 and Beyond," presented at a colloquium on "Answers to Inflation and Recession: Economic Policies for a Modern Society," conducted by The Conference Board, Washington, D.C., April 8-9, 1975, p.15.

the availability of adequate financing at a reasonable cost. Government officials and the general public must recognize the basic importance of corporate profitability and the disruptive effects of excessive government spending pressures -- pressures which create deficit financing requirements that take precedence over private investment needs in the capital markets. This problem has not received adequate attention.

## IV. SUMMARY

As we strive to end the most severe economic recession in our postwar experience, my deep and abiding concern about the future adequacy of capital investment will perhaps appear to be ill-timed to some analysists. There is extensive slack in our economy with an unemployment rate near 9 percent and reduced rates of plant capacity utilization in many specific industries. The economic slide, however, will not last much longer, and we will again be reporting real growth gains before the end of the year. As the pace of economic activity accelerates, we will likely rediscover shortages of labor and production capacity. In fact, some industries still have high plant capacity utilization ratios, and many types of skilled labor will be difficult to find even in the early stages of economic recovery. In 1971 it was widely believed that extensive slack existed but the economy was again operating at a very high rate of capacity by 1972 and shortages and explosive inflation soon occurred.

Our statistics on plant capacity have always been uncertain measures, and current economic conditions have motivated the Department of Commerce to give top priority to a comprehensive survey of production capacity as a basis for preparing more meaningful estimates of plant capacity utilization rates. It is ironic that such a fundamental factor in preparing national economic policies has been based on such uncertain economic statistics.

Dr. Pierre Rinfret, President of a well known economic consulting firm, Rinfret Boston Associates, Inc., has published an impressive study of the national production capacity which indicates that our current government statistics grossly underestimate the rate of capacity utilization in American industry and that there is virtually no reserve capacity. His study estimates that the capacity utilization rate for manufacturing industries was 86.6 percent in 1974 (Table 8) a figure well above the government's estimate for 1974, of 78.9 percent. It should also be emphasized that the concept of operating at 100 percent of physical capacity is misleading. Over the last fifteen years the government figures indicate that manufacturing capacity utilization has averaged only 83 percent despite some periods of intense output. The highest figure reported by the government during these fifteen years was 91.9 percent for 1966. Most companies need to preserve some reserve capacity to handle unexpected output requirements and to substitute for operating assets which need repairs or replacement. Therefore, the existing government figures do not accurately measure the realistic level of capacity utilization.

Looking beyond the current problems of recession and sustaining an economic recovery, the additional capital investment of at least $4 trillion from 1974 to 1985 represents a major challenge to the future growth of our economy. We must also give careful attention to the problems of specific industries in attracting needed investment for balanced growth. I am confident that these basic goals can be accomplished. But the desired results will require government policies which will moderate inflation and balance the Federal budget over time in order to avoid diverting needed capital away from investment and into the financing of chronic government deficits. A continuation of the fiscal and monetary distortions of the past decade will only frustrate our capital investment efforts and lead to still more serious economic problems in the future.

Thank you.

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TABLE 1

Average Annual Rate of Change in Real Growth for Member Nations of OECD, 1960-70

(percent)

| Country | Percent |
|---|---|
| Japan | 11.1 |
| Greece | 7.6 |
| Portugal | 6.3 |
| Yugoslavia | 6.7 |
| France | 5.8 |
| Italy | 5.6 |
| Canada | 5.2 |
| Finland | 5.2 |
| Australia | 5.1 |
| Netherlands | 5.1 |
| Norway | 5.0 |
| Belgium | 4.9 |
| Denmark | 4.9 |
| West Germany | 4.8 |
| Austria | 4.8 |
| Iceland | 4.3 |
| Ireland | 4.0 |
| U.S. | 4.0 |
| Luxembourg | 3.3 |
| United Kingdom | 2.8 |

Source: Organization for Economic Development and Cooperation.

TABLE 2

Gross Private Domestic Fixed Investment, 1950-1974 (Billions of dollars)

PART A. Nominal Dollars

| Year | Total | Nonresidential Structures and Producers' Durable Equipment | Residential Structures |
|---|---|---|---|
| 1950 | $47.3 | 27.9 | 19.4 |
| 1951 | 49.0 | 31.8 | 17.2 |
| 1952 | 48.8 | 31.6 | 17.2 |
| 1953 | 52.1 | 34.2 | 18.0 |
| 1954 | 53.3 | 33.6 | 19.7 |
| 1955 | 61.4 | 38.1 | 23.3 |
| 1956 | 65.3 | 43.7 | 21.6 |
| 1957 | 66.5 | 46.4 | 20.2 |
| 1958 | 62.4 | 41.6 | 20.8 |
| 1959 | 70.5 | 45.1 | 25.5 |
| 1960 | 71.3 | 48.4 | 22.8 |
| 1961 | 69.7 | 47.0 | 22.6 |
| 1962 | 77.0 | 51.7 | 25.3 |
| 1963 | 81.3 | 54.3 | 27.0 |
| 1964 | 88.2 | 61.1 | 27.1 |
| 1965 | 98.5 | 71.3 | 27.2 |
| 1966 | 106.6 | 81.6 | 25.0 |
| 1967 | 108.4 | 83.3 | 25.1 |
| 1968 | 118.9 | 88.8 | 30.1 |
| 1969 | 131.1 | 98.5 | 32.6 |
| 1970 | 131.7 | 100.6 | 31.2 |
| 1971 | 147.4 | 104.6 | 42.8 |
| 1972 | 170.8 | 116.8 | 54.0 |
| 1973 | 194.0 | 136.8 | 57.2 |
| 1974p | 195.6 | 149.6 | 46.0 |

PART B. Constant 1958 Dollars

| Year | Total | Nonresidential Structures and Producers' Durable Equipment | Residential Structures |
|---|---|---|---|
| 1950 | 61.0 | 37.5 | 23.5 |
| 1951 | 59.0 | 39.6 | 19.5 |
| 1952 | 57.2 | 38.3 | 18.9 |
| 1953 | 60.2 | 40.7 | 19.6 |
| 1954 | 61.4 | 39.6 | 21.7 |
| 1955 | 69.0 | 43.9 | 25.1 |
| 1956 | 69.5 | 47.3 | 22.2 |
| 1957 | 67.6 | 47.4 | 20.2 |
| 1958 | 62.4 | 41.6 | 20.8 |
| 1959 | 68.8 | 44.1 | 24.7 |
| 1960 | 68.9 | 47.1 | 21.9 |
| 1961 | 67.0 | 45.5 | 21.6 |
| 1962 | 73.4 | 49.7 | 23.8 |
| 1963 | 76.7 | 51.9 | 24.8 |
| 1964 | 81.9 | 57.8 | 24.2 |
| 1965 | 90.1 | 66.3 | 23.8 |
| 1966 | 95.4 | 74.1 | 21.3 |
| 1967 | 93.5 | 73.2 | 20.4 |
| 1968 | 98.8 | 75.6 | 23.2 |
| 1969 | 103.8 | 80.1 | 23.7 |
| 1970 | 99.5 | 77.2 | 22.2 |
| 1971 | 105.8 | 76.7 | 29.1 |
| 1972 | 118.0 | 83.7 | 34.3 |
| 1973 | 127.3 | 94.4 | 32.9 |
| 1974p | 118.1 | 94.1 | 24.0 |

Source: Department of Commerce, Bureau of Economic Analysis

TABLE 3

Output and Investment by Sector
1969-1971 Averages (Current price percents)

| | United States | France | Germany | United Kingdom | Canada | Japan |
|---|---|---|---|---|---|---|
| PARTITION A | Sector Percentage of Total Output: | | | | | |
| Agriculture | 3.0 | 5.9 | 3.2 | 2.6 | 3.9 | 7.3* |
| Mining | 1.6 | 0.8 | 2.2 | 1.4 | 3.4 | 0.9 |
| Manufacturing | 30.3 | 45.3 | 50.4 | 33.5 | 26.6 | 43.0 |
| Utilities | 2.3 | 1.8 | 2.3 | 2.8 | 2.4 | 2.0 |
| General Services | 62.8 | 46.2 | 41.9 | 59.7 | 63.7 | 46.8 |
| (Dwellings) | (5.4) | (4.5) | (3.8) | (2.3) | (3.3) | (NA) |
| (Government) | (14.7) | (8.8) | (9.4) | (10.1) | (14.0) | (3.1) |
| (Other Services) | (42.7) | (32.9) | (28.7) | (47.3) | (46.4) | (NA) |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |
| | Sector Percentage of Total Investment: | | | | | |
| Agriculture | 3.8 | 4.6 | 5.3** | 2.6 | 5.5 | 5.9 |
| Mining | 1.0 | .7 | 1.3 | 1.5 | 7.5 | .9 |
| Manufacturing | 19.7 | 27.8 | 25.2 | 23.8 | 16.6 | 26.8 |
| Utilities | 5.2 | 3.9 | 5.0 | 8.6 | 9.4 | 3.9 |
| General Services | 70.3 | 63.0 | 63.2 | 63.5 | 61.0 | 62.5 |
| (Dwellings***) | (19.9) | (26.3) | (22.2) | (15.1) | (21.5) | (17.9) |
| (Government) | (20.4) | (12.8) | (9.9) | (15.9) | (17.9) | (24.9) |
| (Other Services) | (30.0) | (23.9) | (31.1) | (32.5) | (21.6) | (19.7) |
| Total | 100 | 100 | 100 | 100 | 100 | 100 |
| PARTITION B | Sector Ratios: Investment Percentages Divided by Output Percentages | | | | | |
| Agriculture | 1.3 | 0.8 | 1.7 | 1.0 | 1.4 | 0.8 |
| Mining | 0.6 | 0.9 | 0.6 | 1.1 | 2.2 | 1.0 |
| Manufacturing | 0.7 | 0.6 | 0.5 | 0.7 | 0.6 | 0.6 |
| Utilities | 2.3 | 2.2 | 2.2 | 3.1 | 3.9 | 2.0 |
| General Services | 1.1 | 1.4 | 1.5 | 1.1 | 1.0 | 1.3 |
| (Dwellings) | (3.7) | (5.8) | (5.8) | (6.6) | (6.5) | (NA) |
| (Government) | (1.9) | (1.5) | (1.1) | (1.6) | (1.3) | (8.0) |
| (Other Services) | (0.7) | (0.7) | (1.1) | (0.7) | (0.5) | (NA) |

Source: OECD, National Accounts of OECD Countries, 1960-71.

* Output averages of Japan are for 1969-70

** Investment averages of Germany are for 1967-68.

*** Investment in owner-occupied dwellings. For Canada, France and the United Kingdom the figure is from residential investment, which differs slightly from the former category.

TABLE 4

FEDERAL BUDGETS

CHANGES IN THE UNIFIED BUDGET OUTLAYS

BY FISCAL YEAR, 1961-1976
(dollars in billions)

| Fiscal Year over Preceding Year | Federal Outlays | Dollar Increase | Percentage Increase | Surplus or Deficit |
|---|---|---|---|---|
| 1961 | $ 97.8 | $ 5.6 | 6.1 | -3.4 |
| 1962 | 106.8 | 9.0 | 9.2 | -7.1 |
| 1963 | 111.3 | 4.5 | 4.2 | -4.8 |
| 1964 | 118.6 | 7.3 | 6.1 | -5.9 |
| 1965 | 118.4 | -0.2 | -- | -1.6 |
| 1966 | 134.7 | 16.3 | 13.8 | -3.8 |
| 1967 | 158.3 | 23.6 | 17.5 | -8.7 |
| 1968 | 178.8 | 20.5 | 13.0 | -25.2 |
| 1969 | 184.5 | 5.7 | 3.2 | +3.2 |
| 1970 | 196.6 | 12.1 | 6.6 | -2.8 |
| 1971 | 211.4 | 14.8 | 7.5 | -23.0 |
| 1972 | 231.9 | 20.5 | 9.7 | -23.2 |
| 1973 | 246.5 | 14.6 | 6.3 | -14.3 |
| 1974 | 268.4 | 21.9 | 8.8 | -3.5 |
| 1975 (est.)* | 313.4 | 45.0 | 16.8 | -34.7 |
| 1975 (est.)** | 324.2 | 55.8 | 20.8 | -42.2 |

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* Last official budget estimates published February 3, 1975.

** May estimate of OMB as to expected FY 1975 outlays and most recent, May , Department of Treasury FY 1975 receipts.

Source: Economic Report of the President, February 1975, Table C-64, p.324, for years 1961 through 1974.

## TABLE 5

### Comparison of General Tax Revenue Sources, 1971

| Tax Revenue by Type | United States Value ($ millions) | United States % of Total | France Value (Francs millions) | France % of Total | Germany Value (DM millions) | Germany % of Total | United Kingdom Value (Pounds millions) | United Kingdom % of Total | Canada Value (C $ millions) | Canada % of Total | Japan Value (Yen millions) | Japan % of Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Corporate Income & Profit 1/ | 30234 | 10.4% | 18747 | 5.8% | 11655 | 4.5% | 1558 | 7.8% | 3080 | 10.2% | 2977 | 18.8% |
| Household Income & Profit 1/ | 98176 | 33.6 | 32492 | 10.1 | 70295 | 26.9 | 6668 | 33.2 | 10221 | 33.9 | 3802 | 24.0 |
| Consumption Taxes 2/ | 52698 | 18.1 | 112139 | 34.8 | 73425 | 28.1 | 5340 | 26.6 | 8660 | 28.7 | 3289 | 20.7 |
| Social Security Contributions | 60286 | 20.7 | 134802 | 41.9 | 88430 | 33.8 | 2828 | 14.1 | 2463 | 8.2 | 3174 | 20.0 |
| Other Taxes | 50301 | 17.2 | 23916 | 7.4 | 17655 | 6.7 | 3685 | 18.3 | 5710 | 19.0 | 2612 | 16.5 |
| Total | 291695 | 100.0% | 322096 | 100.0% | 261460 | 100.0% | 20079 | 100.0% | 30134 | 100.0% | 15854 | 100.0% |

### Comparison Excluding Social Security Distributions

| Tax Revenue by Type | United States Value ($ millions) | United States % of Total | France Value (Francs millions) | France % of Total | Germany Value (DM millions) | Germany % of Total | United Kingdom Value (Pounds millions) | United Kingdom % of Total | Canada Value (C $ millions) | Canada % of Total | Japan Value (Yen millions) | Japan % of Total |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Corporate Income & Profit 1/ | | 13.1% | | 10.0% | | 6.8% | | 9.0% | | 11.1% | | 23.5% |
| Household Income & Profit 1/ | | 42.4 | | 17.3 | | 40.6 | | 38.6 | | 37.0 | | 30.0 |
| Consumption Taxes 2/ | | 22.8 | | 59.9 | | 42.4 | | 31.0 | | 31.3 | | 25.9 |
| Other Taxes | | 21.7 | | 12.8 | | 10.2 | | 21.4 | | 20.6 | | 20.6 |
| Total | 231409 | 100.0% | 187294 | 100.0% | 173030 | 100.0% | 17251 | 100.0% | 27671 | 100.0% | 12680 | 100.0% |

1/ Includes capital gains.

2/ Defined as taxes levied on transactions in goods and services on the basis of such intrinsic characteristics as value, weight, strength, etc. The source document provides further elaboration concerning tax category definitions.

SOURCE: Revenue Statistics of OECD Member Countries 1965-1971, OECD.

TABLE 6

Comparative Cost Recovery Allowances for Industrial Machinery and Equipment

| Country | Representative Cost-Recovery Period (years) | First Taxable Year | First 3 Taxable Years | First 7 Taxable Years |
|---|---|---|---|---|
| Canada | 2 a/ | 50.0 | 100.0 | 100.0 |
| France | 8 b/ | 31.3 | 90.3 | 100.0 c/ |
| Japan | 11 d/ | 37.1 e/ | 63.9 | 88.1 |
| United Kingdom | 1 | 100.0 | 100.0 | 100.0 |
| Western Germany | 9 f/ | 16.7 g/ | 49.6 | 88.8 h/ |
| United States: | | | | |
| with investment credit but without ADR (Accelerated Depreciation Range) | 13 i/ | 21.7 j/ | 47.9 | 80.1 |
| without either investment credit or ADR | 13 i/ | 7.7 | 33.9 | 66.1 |
| with both investment credit and ADR | 10-1/2 i/ k/ | 23.5 j/ | 54.7 | 88.5 |

a/ Beginning May 1972 machinery and equipment acquired for manufacturing or processing of goods in Canada could be written off over two years (50 percent per year).

b/ 250 percent declining balance method multiplied by a factor of 2 to give effect to multiple shift operations.

c/ Method changed to straight line in fourth taxable year. Straight line rate applied to original cost in such year.

d/ Modified double declining balance method; 18.9 percent per Japanese Government rate table multiplied by a factor of 1.28 to give effect to multiple shift operations.

e/ Includes special first year allowance of 25 percent; allowance reduces recoverable base cost in second and succeeding taxable years.

f/ The average cost recovery period for machinery and equipment in Western Germany is 8 to 10 years to which additional allowances are permitted for multiple shift operations: 25 percent of allowance for two-shift operations and 50 percent of allowance for three-shift operations. Allowances may be further increased when plant is located in certain areas such as Berlin, areas bordering on iron curtain countries, and undeveloped areas.

(TABLE 6)

f/ continued

Cost recovery allowances based on an average cost recovery period of 9 years. The double declining balance method is used. A 25 percent additional allowance for two-shift operations is taken into account beginning with the fifth year when the method is changed to straight line. The corporate depreciation rate thus computed is slightly over the maximum 20 percent rate permitted on a declining balance method to reflect that:

(A) The straight line method produces more depreciation than does the double declining balance method for certain short-lived assets; and

(B) Items of machinery and equipment costing under U.S. $200 can be expensed.

No other incentives have been taken into account.

g/ Full year allowance in first taxable year for assets acquired in first half of such year; half year allowance for assets acquired in second half.

h/ Method changed to straight line in fifth taxable year.

i/ Double declining balance method.

j/ Includes 14 percent allowance equivalent to 7 percent investment credit at effective 50 percent income tax rate. Credit does not reduce recoverable base cost.

k/ 13-year recovery period reduced by 20 percent and rounded to nearest one-half year.

SOURCE: Statement of Arthur Anderson and Company, before the Committee on Ways and Means, U.S. House of Representatives, April 16, 1973.

TABLE 7

DOMESTIC PROFITS OF NONFINANCIAL CORPORATIONS, REPORTED AND ADJUSTED, 1950-1973
(billions of dollars)

| Year | Nonfinancial domestic profits of nonfinancial corporations | Adjustments: For inventory profits or losses | Adjustments: To standardize depreciation method 1/ | Adjustments: To standardize depreciation on replacement cost basis 2/ | Adjusted domestic profits of nonfinancial corporations | Tax liability | Adjusted after-tax profits of domestic nonfinancial corporations | National Income | Adjusted after-tax profits of domestic corporations as percent of national income | Gross product originating in nonfinancial corporations | Adjusted after-tax profits of nonfinancial corporations as percent of gross product originating in nonfinancial corporations |
|---|---|---|---|---|---|---|---|---|---|---|---|
| 1950 | 38.5 | -5.0 | -0.4 | -3.6 | 29.5 | 16.7 | 12.8 | 241.1 | 5.3 | 151.7 | 8.4 |
| 1951 | 39.1 | -1.2 | -0.2 | -4.4 | 33.4 | 21.0 | 12.3 | 278.0 | 4.4 | 174.3 | 7.1 |
| 1952 | 33.8 | 1.0 | 0.0 | -4.6 | 30.2 | 17.8 | 12.4 | 291.4 | 4.3 | 182.0 | 6.8 |
| 1953 | 34.9 | -1.0 | 0.6 | -4.3 | 30.2 | 18.5 | 11.7 | 304.7 | 3.8 | 194.7 | 6.0 |
| 1954 | 32.1 | -0.3 | 1.5 | -4.1 | 29.2 | 15.7 | 13.5 | 303.1 | 4.4 | 191.6 | 6.9 |
| 1955 | 42.0 | -1.7 | 2.7 | -4.2 | 39.0 | 19.8 | 19.2 | 331.0 | 5.7 | 216.3 | 8.8 |
| 1956 | 41.8 | -2.7 | 2.9 | -5.1 | 36.8 | 19.8 | 17.0 | 350.8 | 4.9 | 231.2 | 7.4 |
| 1957 | 39.8 | -1.5 | 3.3 | -5.7 | 35.8 | 18.9 | 16.9 | 366.1 | 4.6 | 241.9 | 7.0 |
| 1958 | 33.7 | -0.3 | 3.2 | -5.6 | 30.9 | 16.3 | 14.6 | 367.8 | 4.0 | 236.0 | 6.3 |
| 1959 | 43.2 | -0.5 | 3.5 | -5.5 | 40.7 | 20.8 | 19.9 | 400.0 | 5.0 | 263.7 | 7.6 |
| 1960 | 40.1 | 0.2 | 3.4 | -5.1 | 38.6 | 19.5 | 19.1 | 414.5 | 4.6 | 273.1 | 6.9 |
| 1961 | 40.3 | -0.1 | 3.1 | -4.5 | 38.8 | 19.8 | 19.0 | 427.3 | 4.4 | 278.4 | 6.8 |
| 1962 | 44.7 | 0.3 | 5.3 | -4.1 | 46.2 | 20.9 | 25.3 | 457.7 | 5.5 | 302.8 | 8.4 |
| 1963 | 49.1 | -0.5 | 5.2 | -3.7 | 50.1 | 22.9 | 27.2 | 481.9 | 5.6 | 320.0 | 8.5 |
| 1964 | 55.8 | -0.5 | 5.2 | -3.5 | 57.0 | 24.3 | 32.7 | 518.1 | 6.3 | 346.0 | 9.4 |
| 1965 | 65.8 | -1.7 | 5.7 | -3.8 | 66.0 | 27.6 | 38.4 | 564.3 | 6.8 | 377.6 | 10.2 |
| 1966 | 71.2 | -1.8 | 5.9 | -4.2 | 71.2 | 30.1 | 41.1 | 620.6 | 6.6 | 413.0 | 9.9 |
| 1967 | 66.2 | -1.1 | 6.0 | -4.8 | 66.3 | 28.4 | 37.9 | 653.6 | 5.8 | 430.8 | 8.8 |
| 1968 | 72.4 | -3.3 | 6.3 | -5.4 | 70.0 | 34.0 | 36.0 | 711.1 | 5.0 | 469.9 | 7.6 |
| 1969 | 68.0 | -5.1 | 7.4 | -7.8 | 62.5 | 33.7 | 28.8 | 766.0 | 3.8 | 504.3 | 5.7 |
| 1970 | 55.7 | -4.8 | 7.6 | -9.1 | 49.5 | 27.6 | 21.9 | 800.5 | 2.7 | 519.1 | 4.2 |
| 1971 | 63.2 | -4.9 | 8.2 | -10.1 | 56.4 | 29.8 | 26.6 | 857.7 | 3.1 | 555.1 | 4.8 |
| 1972 | 76.3 | -7.0 | 9.4 | -11.4 | 67.3 | 33.4 | 33.9 | 946.5 | 3.6 | 614.3 | 5.5 |
| 1973 | 95.8 | -17.6 | 10.2 | -12.5 | 75.9 | 40.7 | 35.2 | 1065.6 | 3.3 | 684.3 | 5.1 |

1/ The adjustment to standardize depreciation method is equal to the difference between tax depreciati on and depreciation calculated assuming a straight-line depreciation formula and 85% of the Internal Revenue Service's 1942 edition of Bulletin F service lives.

2/ The adjustment to put depreciation on replacement cost basis is equal to the difference between depreciation as calculated on the assumptions stated in the preceding note and as calculated using the same assumptions but on a current rather than historical cost basis. Numbers in this and following table may not add because of rounding.

Source: Department of Commerce, Bureau of Economic Analysis

TABLE 8

CAPACITY UTILIZATION: March 1975

| Industry | Utilization Rate | Is this level of operation higher, lower, or about the same as in 1974? (Percent Distribution) Higher | Lower | Same |
|---|---|---|---|---|
| All Industries* | 84.5 | 13.2 | 45.0 | 41.7 |
| | | | | |
| Manufacturing | 86.6 | 14.2 | 51.3 | 34.4 |
| Nonmanufacturing* | 78.6 | 10.5 | 28.1 | 61.4 |
| | | | | |
| Manufacturing | 86.6 | 14.2 | 51.3 | 34.4 |
| Durable Goods | 86.6 | 12.8 | 50.0 | 37.2 |
| Primary Metals | 89.7 | 8.7 | 39.1 | 52.2 |
| Iron & Steel | 90.5 | 11.8 | 23.5 | 64.7 |
| Nonferrous Metals | 88.0 | 0.0 | 83.3 | 16.7 |
| Electrical Machinery | 87.2 | 50.0 | 0.0 | 50.0 |
| Nonelectrical Machinery | 94.5 | 15.0 | 40.0 | 45.0 |
| Transportation Equipment | 75.3 | 23.5 | 58.8 | 17.6 |
| Motor Vehicles & Parts | 79.2 | 11.1 | 77.8 | 11.1 |
| Aerospace | 67.2 | 42.9 | 42.9 | 14.3 |
| Stone, Clay & Glass | 77.7 | 0.0 | 72.7 | 27.3 |
| Other Durable Goods | 85.7 | 0.0 | 72.7 | 27.3 |
| | | | | |
| Nondurable Goods | 86.7 | 16.2 | 52.9 | 30.9 |
| Food & Beverage | 89.2 | 23.5 | 17.6 | 58.8 |
| Textiles | 72.5 | 0.0 | 100.0 | 0 |
| Paper | 87.9 | 0.0 | 80.0 | 20.0 |
| Chemicals | 82.3 | 33.3 | 50.0 | 16.7 |
| Petroleum | 89.7 | 22.2 | 22.2 | 55.6 |
| Rubber | 80.4 | 0.0 | 100.0 | 0.0 |
| Other Nondurable Goods | 82.1 | 14.3 | 57.1 | 28.6 |
| | | | | |
| Nonmanufacturing* | 78.6 | 10.5 | 28.1 | 61.4 |
| Mining | 94.8 | 0.0 | 0.0 | 100.0 |
| Railroad | 87.1 | 0.0 | 75.0 | 25.0 |
| Air Transportation | 81.0 | 0.0 | 66.7 | 33.3 |
| Other Transportation | 89.4 | 0.0 | 50.0 | 50.0 |
| Public Utilities | 76.6 | 12.5 | 22.5 | 65.0 |
| Electric | 74.3 | 12.5 | 18.8 | 68.8 |
| Gas & Other | 86.0 | 12.5 | 37.5 | 50.0 |
| Commercial & Other | 78.0 | 16.7 | 16.7 | 66.7 |

* *Excludes Communication.*

Source: 1975 Capital Investment Surveys; Rinfret Boston Associates, Inc. March 1975, Perspective--5

AUG 4 1975

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

1730 PENNSYLVANIA AVENUE, N. W. • SUITE 200 • WASHINGTON, D. C. 20006 • (202) 785-9622

Vol. 3, No. 16 - July 30, 1975

Dear Subscriber:

In this issue we explore the relationship among Federalism, control of the price of "old" oil, and the financial plight of New York City; some of the problems involved in "legislative government"; and criticism of Secretary of the Treasury William E. Simon. A High Interest Note speculates on the probable outcome of the clash between Congress and President Gerald R. Ford on energy legislation.

"OLD" OIL AND NEW YORK CITY: WHAT'S THE CONNECTION?

At first glance, "old" oil and New York City seem to have little in common. But there is a relationship, one that should be pondered by voter and politician alike. The similarity is that both the plight of those who produce "old" oil and certain aspects of the financial crisis of New York City are closely related to the shift of our government, over two centuries, from Federalism to a strong central government.

"Old" Oil. Simply defined, "old" oil is the equivalent output of existing wells in 1972. "New" oil is the post-1972 increase in domestic output, either from new or old wells. Under Federal law and regulation, old oil can sell for no more than $5.25 per barrel. New oil, as well as oil imported from abroad, can sell for whatever price it brings on the market.

With new and foreign oil selling for about $13/bbl, U.S. citizens who produce old oil must sell their product at a price some 60 percent lower than if they lived in Saudi Arabia, Iran, Canada, or Venezuela.

Query: Why should the good hard-working citizens of Albany, Texas--most of whom drive pick-up trucks to the supermarket, not Cadillacs--watch their "treasure" flow out at below-market prices while the Shah of Iran not only gets a price much higher, but red carpet treatment when he and his entourage come to this country? Sounds cock-eyed, doesn't it--at least, to the people of Albany, Texas.

To be sure, there is a great deal of talk about "windfalls," as if this phenomenon had not been part and parcel of our profit and loss incentive system from "day one." If, through ingenuity or luck, someone builds a better mousetrap, he reaps the benefits. And if a person is lucky or far-sighted enough to produce or husband a commodity that falls into short supply (e.g., a land speculator who buys up property on the outskirts of a growing city), he reaps the rewards, and usually without question.

The fact that in this instance the "windfall" results from actions of an international oil cartel strongly affects the politics of the situation in the U.S. Consumers of petroleum products feel that the cartel is "robbing" them by establishing a monopoly price. But the fact is, that, in dealing with the internal economics of the problem (i.e., curtailing the demand for and stimulating the supply of energy of all types), the situation is no different from one in which the world price was truly competitive as opposed to a cartel price. And the same can be said of the "equity" problem--the unfairness (at least in the view of the producer) of both foreigners and domestic producers of "new" oil getting a price far above what is allowed on old oil.

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This sort of subsidization is not new; it's been going on since 1954 with respect to natural gas. With intrastate gas (uncontrolled by Uncle Sam) selling for $1 to $2 per thousand cubic feet, the users of natural gas in the North and East who still get this clean fuel for a fraction of that amount have got a real good thing going. So good, in fact, that some of their representatives in Congress want to extend control to intrastate uses, realizing, correctly, that the higher pull for the latter use will ultimately dry up the cross-country flow.

So it should be no surprise that people in oil-producing areas believe that the ball game is rigged against them. And one can even understand--although not approve of--the ubiquitous bumper stickers in those states which read: "Drive Faster--Freeze a Yankee to Death!" Those people feel that if they pay full value for the exports of manufactured products from, say the Northeast, then people up there ought to pay the market price for oil and natural gas.

How is all this related to the present state of Federalism? If the 50 states were "sovereign," or even semi-independent units in a Federal system, this situation could not have occurred. The "exports" of manufactured goods from an Eastern state would sell at competitive prices, but its people would also have to pay market prices for imports of energy.

There are many advantages to a strong central government. But when one of its functions involves taking away from Peter to help Paul, and without reasons that satisfy Peter, then it may be going too far--at least, Peter is likely to think so.

New York City. As related to Federalism, the situation with respect to the nation's largest city is somewhat the reverse of the old oil matter. In this instance, a city racked by financial crisis has turned to Washington for help only to be spurned --and appropriately, too.

The important point is that, in a true Federal system, the thought that the Federal government would be expected to "bail out" a locality that had for years lived beyond its means would be most unlikely. Since cities are in effect creatures of their states, help from state capitals is another matter--and, in fact, over the years such help has frequently been forthcoming, as was the case in the creation of a state-run financing authority ("Big Mac") to help New York City.

But Big Mac is having its troubles--those "parochial" investors West of the Hudson and North and East of the Bronx view its bond issues with a jaundiced eye. "Financial Federalism" *still* exists--there is no legal way to make investors in Boston, Chicago or Dallas buy Big Mac's securities if they don't want to. This is a hard truth which leadership in New York State has now come to understand, and leadership in New York City must also comprehend before the sun will come out from behind the clouds over Fun City. The city must demonstrate that, financially, it can stand on its own feet.

Conclusion. The economics of the semi-demise of Federalism in setting the price of petroleum products are pretty obvious: In the short run, producers are hurt and consumers benefit, but in the long run all are hurt because supply is curtailed and waste is encouraged. The economics of the New York City situation are also clear: City payrolls must be cut and, unless productivity can be enhanced substantially, "services" curtailed.

The politics of the situation are not all that clear, at least in the petroleum area. For New York City, the Federal government has said, "Work it out yourself--if we help you, every city in this country with financial troubles will be camping on the Secretary of the Treasury's doorstep." But in petroleum, some solutions being discussed in Congress are worse than no solution at all.

We refer to the extension of the control logic that caused the natural gas problem in the first place. The mistake was to control the price of natural gas at the wellhead to begin with (even *The Washington Post* agrees with this view). But faulty logic can eventually become part of the conventional wisdom. The result now is that some in Congress would "correct" the problem of diversion of new gas into intrastate uses by extending Federal control within state boundaries.

Not too many years ago that solution would probably have been struck down as unconstitutional. But if Congress so acts today, we doubt it.

## "WAYS AND MEANS" AND THE HOUSE DEMOCRATIC CAUCUS

Three times since December the House Democratic Caucus has done damage to the process for writing tax legislation in general and, in particular, to the House Ways and Means Committee, which is supposed to originate all tax legislation.

First, last December, the pre-94th Congress organizational session enlarged the Committee from 25 to 37 and shifted the traditional 3 to 2 ratio of majority to minority members to about 2 to 1. Sooner or later the 19 new members will familiarize themselves with what may be the most complicated section of Federal law, the Internal Revenue Code. But it has caused trouble this year.

Second, the Committee worked strenuously and effectively to bring out the Tax Reduction Act, deciding by a vote of 22 to 14 that the thorny issue of oil depletion would be postponed until the energy legislation was considered. But the Democratic Caucus would have none of that. Instead it voted to force a "rule" on the bill which would allow oil depletion amendments on the floor of the House. The result? With the nation in the middle of a monumental energy crisis, we raised taxes on the petroleum industry by some $1.7 billion (including Senate-initiated changes in the foreign tax credit as applied to oil companies); a figure which will rise to $2.2 billion next year. This is one factor--although certainly not the only one--that has led to the recent increase in gasoline prices which the constituents of those Congressmen who clobbered depletion are now complaining about.

Third, in May the Ways and Means Committee reported an energy bill which the Caucus "accepted" in the sense that it asked for no special considerations in the "rule"--more than 60 amendments were permitted to be made and were considered. But as best we can determine, the Caucus did little or nothing to "whip" its members into line behind the bill. Although far from perfect, the bill was the product of much hard work by what is by and large a dedicated group of legislators. Looking ahead to the 1976 elections and an electorate at least temporarily apathetic about the energy crisis, the majority of the House (including most of the new members) voted the Ways and Means Committee's carefully considered conservation proposal, including an increase in the gasoline tax, down the drain.

Where was the Caucus? If it is fitting to "whip" members into line to vote for a politically "tasteful" thing such as cutting back depletion, then why is it not fitting to bring out the "whip" for the distasteful but all too necessary actions to deal with the energy crisis?

To voters and taxpayers, the fundamental question is whether the Caucus, which performed a most worthwhile task in loosening the iron hand of seniority in the House, has since served the cause of good government. We need make no judgment now. The voters will do so in November 1976.

## MEANWHILE, OVER IN THE SENATE

Disenfranchised in the Senate by half of their representation, the citizens of New Hampshire are exhibiting increasing ire over the inability of the world's "most powerful deliberative body" to resolve the question of who will occupy that State's disputed Senate seat. Countless hours of debate have been spent on the matter and a plethora of votes on the issue have come to naught. Finally, Majority Leader Mike Mansfield (D-Mont.) said that the Senate would have to reduce the time allotted to the New Hampshire dispute and move on with regular business.

The Majority Leader is undoubtedly correct in concluding that the electorate is overly tired of the Senate's inability to resolve the problem. But the Senate's inability to act is disturbing to many observers, especially the disenfranchised voters of New Hampshire.

Again, we draw no conclusion concerning morals or motivations. We simply note that the people are getting a rather interesting view, in both Houses, of "legislative government" at work.

(Today's Senate decision to permit a new election in New Hampshire does not at all change our fundamental point. The fact is that the Senate's inability to act will have partially disenfranchised a state for almost 9 months.)

TO BILL SIMON: HANG IN THERE

Not a few people in the press, the financial community, Congress and the Administration have come up with lots of egg on their collective faces as a result of their debate earlier this year with Treasury Secretary William E. Simon on (1) the acceptable deficit for this fiscal year; and (2) U. S. exchange rate policy.

Not that we agree with everything Simon says. But this year he's batted close to 1.000. His "finger-in-the-dike" stance helped hold down the Congressionally endorsed 1976 budget deficit. Through his efforts and those of others, State Secretary Henry Kissinger's early moves that would have underwritten a world-wide price for oil and promoted cartelization in other nations producing raw materials, have been slowed, if not check-mated. He won the contest with *The Wall Street Journal* and others on flexible versus fixed exchange rates (Simon is for the former.)

But to some observers, Simon makes decisions too quickly and, according to reports, is difficult to work for, a factor that accounts (in the view of his critics) for a relatively large turnover of top Treasury officials during his tenure.

We disagree, and strongly. A hip-shooter at times, both by instinct and training (to be a successful Government bond dealer, as Simon was par excellence, you've got to make decisions within seconds), Simon's accuracy on balance rates very high marks.

And as to turnover, most of the resignations have been in the mill for a long time. Both financial pinches and long periods of overwork (something not confined to Treasury in Washington) were significant factors. Much more important, the departing officials have almost invariably been succeeded by highly qualifed people--e.g., Pittsburgh banker-economist Ed Yeo for Jack Bennett as Under Secretary for Monetary Affairs; Sidney Jones for Edgar Fiedler, Assistant Secretary for Economic Affairs; and Charles Walker (no relation, but a man who doesn't know how to spell his first name correctly) for Fred Hickman, Assistant Secretary for Tax Policy.

A message to those in the Administration, press, and elsewhere who think otherwise: Treasury is doing just fine.

HIGH INTEREST NOTE

The Energy Mess. At this writing, no one can foresee the outcome of the energy mess in Washington--and the word, "mess," is probably an understatement. Congressmen from oil-producing states are willing to accept the President's gradual phase-out of price controls on "old" oil, as well as some reasonable "cap" on the price of new oil, but they have grave misgivings over any sort of "windfall profits" tax. With some logic, they argue that the very purpose of gradual phase-out of the "old" oil control is to reduce the immediate "windfall" and spread it over time. However, they might be willing to accept a tax that permits a tax exemption for all or most of the profits that are "plowed back"--that is, reinvested in producing more energy. As eminently reasonable as that sounds, since we are in the middle of an energy crisis, many in Congress won't accept it. In other words, the strongly emotional reaction against the oil industry--aided and abetted by the media--is dimming the prospect for legislation that will increase the availability of domestic energy and reduce our dangerous reliance on imports from the Middle East.

What will happen? We may be wrong, but we doubt that a compromise can be worked out with the Administration this week, before Congress recesses for the month of August. The alternatives are short-term extension, with things to be worked out after the recess, or complete expiration of the controls authority at the end of August. This would mean at least a temporary period in September when prices might shoot up rapidly. Then the wails from the grass roots might finally galvanize Congress into action.

Sincerely,

Charls E. Walker

*(Ed. Note: WER is published 24 times a year. The next issue will be mailed in September, following the Congressional recess.)*

OCT 27 1975

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

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Vol. 3, No. 20 - October 23, 1975

Dear Subscriber:

Herewith we comment further on President Gerald R. Ford's fiscal proposal; review Congressional efforts toward financial reform and speculate on the shape of the finance structure a decade hence. A High Interest Note comments on the outlook for the Congressional budget process. Included as a special insert is an excellent article on capital formation from the New York Times.

## MORE ON THE FORD FISCAL PLAN

The view we advanced in the last WER--that GRF's proposal for a $28 billion tax reduction and cutback in the rate of increase in Federal spending rated extremely high marks both politically and economically--has been reinforced by interim developments. Opponents have denounced the program as "blatantly political," a complaint that usually indicates a bull's-eye proposal by one's opponent. And, of course, that complaint ignores the overriding need to bring Federal spending, which has risen by more than 50 percent in three years, under control--else ruinous inflation is inevitable. (With respect to liberal economists who decry Ford's tax proposals as timed to assure his nomination and election in 1976, many of the same were saying earlier that the Administration was derelict in not proposing fiscal stimulus for a recovery which, in their view, was bound to weaken in early 1976.)

But the most significant disclosure of the past two weeks is that the President has been studying the 1977 budget intensively since last summer; selected some $30 billion in cuts, set out by sector, for that budget; and returned his proposals to the individual departments and agencies for comments and response. Therefore, the Congressional complaints that no ceiling could be placed on the FY1977 budget in the absence of specific Ford proposals (a contention perplexing to the individual voter) may have played directly into the President's hands. We wouldn't be at all surprised if, as Congress labors on the tax bill, including cuts for individuals and corporations, the basic outline of the President's 1977 budget found its way to Congress a couple of months early. If so, the back-home pressures on Congress to go along with the Ford program could be strong. The typical taxpayer is not likely to look on a budget of $395 billion (almost 4/10 of a trillion dollars) as an austerity diet.

As to the tax bill itself, its future is obscured by the thickest of fogs. All that is certain is that Congress will enact significant cuts for individuals--and hopefully some to promote capital formation through lower burdens on corporations and investors--within the next couple of months. But even if the so-called "reform measures" clear the House (and they've been weakened somewhat in the Ways and Means Committee), they are not likely to clear the Senate before January 1.

It's a new ball game.

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## DISINTERMEDIATION, THE HUNT COMMISSION, AND THE "FIA"

Senator Russell Long (D-La.), chairman of the Senate Finance Committee said recently: "Democracy is like a raft: it won't sink but you will always have your feet wet." And so has it been with the urgent need to "reform" the nation's depository financial institutions.

The need for such reform was crystal-clear to financial experts by the late 1960's. A jerry-built structure which had served public policy reasonably well over the years had fallen into deep trouble. We refer to the woes of the so-called "thrift institutions"--the nearly 6,000 savings and loan associations and mutual savings banks which in recent years have provided the bulk of home mortgage financing. With short-term interest rates on a seemingly endless roller-coaster, with each crest higher than the last, these institutions have, with increasing frequency, been confronted with the frightening experience (to management) of "disintermediation"--a jawbreaking economist's term which describes a process much like a "run on the bank."

These "runs" have occurred as depositors in the thrifts, and to a lesser extent in commercial banks, have withdrawn money in periods of high short-term interest rates to purchase Government and other securities carrying interest rates much higher than those legally payable under "Regulation Q," an anti-consumer Federal price control administered by the Federal Reserve Board and Federal Deposit Insurance Company for banks, and by the Federal Home Loan Bank Board for savings and loan associations. And it's not just management of the thrift institutions who have been discomfited; homebuyers have been faced with an "on-again-off-again" scenario in the mortgage market.

The thrifts are sitting ducks for disintermediation, not just because of Regulation Q, but also because they can't afford to pay interest rates to savers high enough to compete with market instruments. And this inability is not generally a reflection of poor management, but results primarily from the structure of Federal and state laws which force the thrifts to hold large portions of their earning assets in long-term real estate mortgages. This results in a fundamental imbalance: a significant portion of the deposits of the thrifts is "hot money," moving quickly to whatever safe asset pays the highest interest rates, but their ability to raise rates in order to counter such withdrawals is severely limited because the thrift's major assets, mortgages, turn over slowly. This means that the average rate of return on total assets rises only gradually, in contrast to the rates on the securities which compete with savings deposits. These rates can shoot sky-high almost overnight.

(Commercial banks are also hit by disintermediation when short-term rates rise, but not nearly as severely as the thrifts. This is primarily because of the faster turnover of the average commercial bank portfolio, coupled with a greater degree of flexibility in "bidding" for time deposits through sale of "certificates of deposit." However, flexibility of the thrifts in this latter respect has increased significantly in recent years under new regulations of the Federal Home Loan Bank Board and state authorities.)

The Hunt Commission and the "FIA." Which is all by way of leading up to the fact that, at long last, Congress shows signs of facing up to fundamental financial reforms that are both inevitable and desirable. The handwriting on the wall was the unanimous approval by the Senate Banking Committee earlier this month of the Administration-sponsored "Financial Institutions Act" (advanced by Nixon and endorsed by Ford). As reported by the Committee, this legislation provides for radical changes (over time) in the powers and regulation of banks and thrifts, but the changes--including payment of interest on demand deposits, elimination of Regulation Q, what amounts to "checking account" powers for the thrifts, and significant broadening of their lending authority--literally breezed through the Committee. Because of the nature of fundamental financial forces, such legislation is, as noted, inevitable. But the ease with which it passed Senate Banking was indeed surprising.

Never mind that the legislation is several years late. The perception of its need came in the late 1960's; the President's Commission on Financial Structure and Regulation (The "Hunt Commission") was organized in 1970 and reported in late 1971;

# Capital, Employment and Corporate Taxes

*THE NEW YORK TIMES, SUNDAY, OCTOBER 12, 1975*

**By DON R. CONLAN**

Much of the discussion of the so-called capital shortage issue may be beside the point. Too often the argument begins with a laundry list of necessary or socially desirable investments, takes a look at probable levels of savings and then strikes an ominous mind-boggling dollar total representing the looming "shortages" of investment funds in the economy.

Any economist worth his salt knows that there is no such thing as a shortage—of anything. The capital shortage between now and 1985 is not so many trillion dollars, it is zero. In the national economic sense, the source of investment money by definition is always equal to the use to which it's put. There is no way around it: saving equals investment, period.

This concept is well understood at the level of a single organization. There are always more investment projects than investment funds. But each organization has an explicit or implicit hurdle rate of return that screens out those for which it doesn't have money. As capital becomes more scarce or its cost rises, or both, so does the hurdle rate. Thus, in 1985, as in 1975, exactly as much will be invested as is made available by the process of economic growth and saving. And what is made available will be conditioned partly by available rates of return around the savings-investment circle.

Many economists stop right there and dismiss the capital shortage idea out of hand. But that also misses the point.

The central issue in the capital shortage argument is similar to the central purpose of a functioning democracy. To survive, a democracy must make every effort to provide high levels of living, growth of real incomes and the gainful employment of as many of its citizens as possible.

In other words high employment is the key, and the rest follows.

According to the best available demographic projections, between now and 1985 about 15 million new people will be moving into the labor force. Altogether, if we expect to get down to 4 per cent unemployment somewhere between 18 million and 20 million jobs must be created or revived.

That's nearly 40 per cent larger than the employment gains of the past decade when you figure in the massive job destruction produced by the 1973-75 recession. Politicians understand better than anyone else how far under water we are in the pursuit of our national employment goals and how long these goals can be ignored before they create major political discomfort.

What happens when we take these high employment goals as a given and run them through an economic and financial model to determine what they imply for other items? This was the approach used by a special volunteer group of economists in a recent report to Secretary of Labor John T. Dunlop on the capital formation question. The highlights of what they found are quite interesting:

¶The economy in real terms must grow at a 6½ per cent annual rate for the next five years followed by a 3½ per cent growth for the succeeding five years in order to reach 4 per cent unemployment by 1985. (The near-term estimates were very similar to those embraced by the Administration even though there is no postwar precedent for a sustained five-year growth rate in excess of 6 per cent.)

¶Real per capita income, a measure of living standards, would grow at about the same pace as they did during the period from 1965 to 1973.

¶Growth in fixed investment between now and 1985 would be 50 per cent greater than the pace during the 1965-73 period and, if comparison is made to the full 1965-75 decade including the recession, the prospective growth rate would be more than three times as fast.

¶This investment for new workers entering the labor force between now and 1985 would amount to more than $80,000 apiece in real terms—an amount 75 per cent larger than the average during the past two decades.

¶Pretax corporate profits would increase at an annual rate of more than 12 per cent, triple the growth rate of 1965-73.

¶The Federal budget would be in approximate balance by 1985, reflecting much slower growth in Federal spending.

¶The various measures of the credit-worthiness of the corporate sector show no significant deterioration from present levels.

¶The rate of inflation was assumed to average about 5 per cent a year.

In short, everything falls neatly into place for all concerned. The accounts balance and the sources versus the uses of savings in the economy equate without a gap of any kind, whether it be a G.N.P. gap, an employment gap or an investment gap. The only gap that might remain is a credibility gap. How could all of this happen so neatly?

Paradise was not achieved without a considerable assist from Government policy. To begin with, it was necessary to cut personal income taxes several times during the projection period in order to counter the upward drift in the effective personal income-tax rate. Without adjustment, inflation would have pushed the average person's income to higher and higher tax brackets, producing an extra drag on purchasing power and personal savings.

Now that kind of policy action probably would meet very little political resistance. From here on, however, it gets very sticky.

It is quite likely that the growing difficulty of businesses and banks in selling new securities is a reflection of increased concern for the underlying stability of these enterprises. If so, then it is probably not reasonable to expect that the public will just go on investing in the securities of these institutions unless their apparent financial deterioration is checked.

With that assumption, the first major detour in the road to an idyllic 1985 comes into view. This, in fact, is the heart of the capital formation issue.

Without a change in the way businesses are financed the prospects of actually putting into place all the investment required to reach high employment by 1985 are dim. It is not the amount of shortfall in investment financing that is in question; rather it is the form of that financing, which may prevent the economy from fulfilling its employment promises.

The problem in a word is equity capital—the financial underpinning of American businesses and banks. Even with the Dunlop group's highly optimistic outlook for profits in the longer run, the financial yardsticks — such as debt-equity ratios and interest coverages—continue to slip unless the Government adopted offsetting policies.

What is required to stop the deterioration no doubt will chill the ardor of even the most sympathetic politician. Nevertheless, within the frame of the model they used, there was no way to avoid some combination of the following politically unpopular actions:

¶A drop in the corporate income tax rate to 45 per cent from 48 per cent.

¶A permanent 10 per cent tax credit for investment.

¶An increase of 5 per cent in corporate depreciation allowances.

These projections strongly suggest that a direct connection presently exists between the high employment objectives of a democratic society and the financial health of its business and financial institutions.

With the issue of tax reform once again before Congress, it would seem appropriate at least to recognize the possibility that our best intentions in behalf of new members of the labor force may be thwarted because we could not deal with the political stickiness of business tax reform.

To say it's now or never is an exaggeration. Nevertheless corporate profits soon will move up very sharply for cyclical reasons and the case for reform will appear moot. In the meantime we will have slipped a cog in the job-creation process. High employment is the key, all right, but it may not happen without a show of political courage.

*Don R. Conlan is executive vice president of Capital Strategic Services, Inc., a financial consulting firm. He was formerly associate director and chief economist of the Cost of Living Council.*

and the Administration's distillation of the Hunt recommendations went to the Hill in the summer of 1973. In a democracy, a decade from perception of a problem to finally dealing with it is, in fact, not all that long. As Senator Long stated, the "raft of democracy" has not sunk; but our "financial feet" are pretty wet.

Where Will it Lead? Based on the assumption that the 94th Congress will pass something akin to the FIA (and we believe the odds to be about 50-50), where will it all end up? What will the nation's depository financial system look like a decade hence?

One important point must be understood. Congress, if and when it passes FIA, will not be "leading the way" toward financial reform; instead, it will be playing catch-up. For the fact is that competitive and technological developments have combined to leave Federal laws and regulations "at the post" with respect to the operations of banks and the thrifts. Indeed, State actions or inactions permitting thrifts to offer variations of interest-bearing "checking accounts" (first in Massachusetts and New Hampshire) are examples of the basic thrust. Congress is therefore moving to catch up, not break new ground.

Not that Congress per se is fundamentally to blame. Instead, the myopia of some mortgage and housing interests is the real culprit. Battered time and again by the disintermediation that could be permanently diminished by such things as variable rate mortgages and the Hunt Commission recommendations, the industry not only failed to provide strong, unified support for these constructive measures, but actually was a major force in delaying them for so long. As a result, disintermediation worsened and home-building suffered. We won't say: "We told you so." But as our better half said recently, "Saying you 'won't say I told you so' is just as bad as saying 'I told you so!'"

1985. George Orwell's chilling "predictions" for political conditions in the next decade (as set forth in his classic novel, 1984) may or may not come to pass. But, based upon forces already at work, an outline of the depository financial structure a decade hence is not all that difficult to conjure up. Our view is that by that time the existing potpourri of commercial banks, mutual savings banks, savings and loan associations, and credit unions will have been assimilated into three basic types of institutions. Moreover, through branching arrangements (more often than not handled electronically rather than through people moving paper), the number of such institutions (but not offices) will be greatly reduced. The reasons: Competition, consumer preferences, and technological developments.

Except in small communities served by one bank, where branches of larger institutions will sooner or later intrude, our depository financial system is highly competitive. This means that the consumer of financial services calls the tune. Therefore, one likely trend is in the development of "one-stop family financial centers," depository institutions which provide "cradle-to-grave" financial services. Such services would include interest-bearing "checking accounts" (which will be immediately transferable to others through "point-of-sale" or home telephone credit card terminals); any type of loan that a family is likely to need (home, car, appliance, education, hospital, funeral, etc.); personal trust services, including administration of estates; and investment services, both advisory and of the mutual fund type. Implicit in all of this is an important family bookkeeping service: one monthly statement summarizing activity and status.

Way out? It's already happening and the trend is likely to accelerate, not diminish. This is because the consumer of financial services will be the winner. That consumer will have more alternatives in buying financial services. Consequently, he will enjoy lower borrowing costs, higher interest rates on savings, and the great convenience of handling all family financial affairs in one spot--or perhaps by telephone.

People who hear this financial forecast for 1985 frequently conclude that this type of service can and will be offered only by savings and loan associations. We doubt it. The suburban commercial bank, along with branches of downtown institutions, will offer services pretty much like that of the S&L's. In fact, the suburban commercial bank may be barely distinguishable from the S&L across the street. Perhaps its only major difference will be in continuing to finance local business clients--small business-

men, professional people, etc.--usually in the same shopping area served by the bank. And if an S&L wants business lending powers, it probably will be able to convert to a commercial bank (as has already occurred in a few instances).

At the other end of the spectrum will be the big "wholesale" commercial bank (Morgan Guaranty Trust Company is perhaps the best current example) which pretty much eschews retail consumer business and instead concentrates on financing large enterprises and managing large trust funds, mainly for corporations.

Then, in between, will be those downtown institutions, with large branch networks, which handle both the "wholesale" business and, through their branch networks, family financial services and small business needs.

Conclusion. Pie in the sky? We repeat: It's already happening. In fact, a decade may be too long a time span to be discussing; it all could happen much more quickly. And such trends are likely regardless of the outcome of depository financial reform legislation in the U.S. Congress. For that's the direction fundamental forces are moving.

HIGH INTEREST NOTE

Congressional Budget Process. Our optimism concerning the ultimate effectiveness of the newly established Congressional budget process--the only way to bring mushrooming Federal spending under long-run control--has been dampened in recent weeks. One reason is a great deal of wrangling between the Budget Committees and the Department of Defense as to the proper "numbers" to be used in interpreting changes in the latter's budget. Another is the heavy legislative burden on non-budget matters borne by members of the Committees, which by definition limits the time they can devote to budget matters. Finally, public statements of some members of the staff of the Joint Congressional Budget Office, which is supposed to be strictly nonpartisan, have been interpreted by some observers as at least semi-partisan in nature. If that impression continues, and especially if it grows stronger, the effectiveness of both the Joint Staff and the Congressional budget process can be greatly impaired. In this city, partisan statements are strictly reserved for principals, not staff.

Sincerely yours,

Charls E. Walker

Late Flash: As we went to press, the House Ways and Means Committee rejected GRF's fiscal package and approved instead what is in effect an extension of individual tax cuts. Inasmuch as the tax bill still has a long way to go, and since Ford has promised to veto any cut unaccompanied by a spending ceiling, the analysis in our lead article still stands. The "new ball game" will go on--probably through the 1976 Presidential campaign.

NOV 21 1975

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

1730 PENNSYLVANIA AVENUE, N. W. • SUITE 200 • WASHINGTON, D.C. 20006 • (202) 785-9622

Vol. 3, No. 22 - November 20, 1975

Dear Subscriber:

In this expanded issue, we speculate on some of the fundamental factors that led to President Gerald R. Ford's firing of Defense Secretary James R. Schlesinger, concluding that economic policy had much more impact on the decision than heretofore recognized. Comments are also directed at a new proposal calling for creation of a Federal super-agency to regulate all Federally chartered depository institutions. In addition, recent trends in monetary policy and short-term interest rates are reviewed.

## FORD AND SCHLESINGER: THE ECONOMIC CONNECTION

Last week, WER noted that the most puzzling thing about GRF's shake-up of his top national security team was the abrupt dismissal of highly regarded Secretary of Defense James R. Schlesinger. Among the reasons we ventured was the probable opposition of Schlesinger to defense budget cuts for FY1977 (beginning next October 1), cuts which Ford deems necessary to support his bold bid for a combined tax cut and spending rate reduction totalling $28 billion each. If this be true, then the shake-up has an important economic dimension -- one that we only hinted at last week.

We now have reason to believe that the "economic connection" was a major factor in the Schlesinger sacking. For the fact is that, although Schlesinger's difficulties with Congress and the FY1976 budget have been greatly overplayed by the press, the prospective cutback for FY1977 had become so large as to put Schlesinger in an untenable position in the months ahead. Dedicated as he is to a U.S. defense establishment second-to-none if Free World security is to be assured, the FY1977 budget allocation which Gerald R. Ford has been insisting upon for economic reasons would inevitably result in Schlesinger's resignation. Once the decision is made, a Cabinet officer cannot repudiate the budget request of his President.

But, informed observers know full well that Gerald Ford and James Schlesinger are in fundamental agreement on national defense matters -- indeed, GRF went out of his way in his first speech after the Cabinet shake-up to re-state that support. Why, then, was Schlesinger fired?

Press speculation has centered on personality conflicts and behind-the-scenes "maneuvering" of other Administration officials. But Schlesinger's dismissal may have resulted primarily from a combination of priorities and political realities. One of the political realities is that the American people have always been reluctant to devote adequate resources to national defense except in the face of clear and present danger (witness the dismantling of our defense establishment after World War II, only to be shocked back into reality in 1950 by the invasion of South Korea). The other political reality is the make-up of the 94th Congress -- two-thirds Democratic, and that group consisting of a large number elected on platforms which, to say the least, were hardly compatible with halting the steady decline in our real defense budget.

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Therefore, GRF might have concluded that the 94th Congress would be no happy hunting ground for reversing our downhill slide in national defense.

But, given disenchantment of the typical worker-voter-taxpayer with Big Government, that same Congress might well be a good hunting ground for something else -- action clearly in the public interest that would at the same time help assure Ford's election in his own right a year from now. We refer to the crucial need to bring Federal spending under control. As we've said time and again, if we fail to do so, this nation is surely and perhaps not so slowly headed for Hell in a handbasket.

Look at the record: Budget deficits in 15 out of the past 16 years; estimated cumulative deficits exceeding $100 billion this year and next; and, most important, rates of increase in Federal spending of 9 percent in FY1974, 17 percent in '75, and an estimated 17 percent this year, for a shocking 3-year advance of almost 50 percent!

That rate of increase is not -- repeat, not -- sustainable. And that's the reason, pure and simple, for the bold Ford move to couple the carrot of a tax cut (in an already overtaxed economy) with the bitter pill (when it comes to the particulars) of cutting back the rate of spending increase. (When will the press report GRF's proposal for a 1977 budget ceiling of $395 billion clearly and accurately? It is not a cutback from the current level, but in the rate of increase, from an expected 13 percent to a still-high 7 percent.)

To those economists who state that monetary policy is the central, if not overriding force, in affecting prices, output and employment, we respond that Federal overspending begets an overly expansive monetary policy. In short, the Federal Reserve is the lender of last resort for both the private economy and the Federal Government. And in this latter role, the political pressure to hold interest rates down by creating money used indirectly to finance huge deficits in periods of high-level economic activity, even though self-defeating, is always very strong. Monetary policy makers must share some of the blame for our current economic problems. But, at root, fiscal profligacy is the major culprit.

Some observers profess to be concerned by the lack of relation of Ford's tax cut/spending ceiling proposal to the state of the economy or the newly revised mechanics of Congressional budgeting. As to the former, we made a strong case for the "economics" of the plan in an earlier WER. And as to the Congressional budget process, let's not confuse means and ends. Your editor had something to do with the genesis of that process, and we were convinced then (in 1972) that its ultimate establishment (in 1976) would, at best, arrive at one minute to midnight.

We were wrong. With Federal spending skyrocketing during the period from genesis to implementation, the procedure was at best established much closer to dawn than the witching hour. And even though the process has been working reasonably well, and shows signs of long-run effectiveness, there are plenty of reasons for GRF to call for a variation in the process, for Congress to vote a firm $395 billion FY1977 ceiling now, almost a year in advance of the procedural deadline, and then tailor spending to fit that cloth.

For Congress to do otherwise would be tantamount to a football coach sticking doggedly to his original game plan when at halftime he finds his team trailing by four touchdowns. A prominent Senator once told your editor that "Congress can vote the time of day," if it wants to. "Budget mechanics" notwithstanding, Congress can place an effective ceiling on FY1977 now -- if it wants to.

Which leads to a description of the unhappy choice confronting Gerald Ford. Which was to have higher priority? Attempting to drag much higher defense spending out of a highly reluctant Congress? Or pressing strongly forward with determined efforts to bring Federal spending under control and thus reduce the major force supporting endemic inflation? GRF evidently decided to confront the spending/inflation issue first and, despite his own unstinting support for strong national defense, fight vigorously for an adequate defense budget after being elected in his own right. In fact, that fight should not be delayed until 1977, but instead be a central issue in the 1976 primaries and campaign.

His Defense Secretary, on the other hand, evidently felt compelled to make it clear that such a course would result in his resignation. The President moved first.

Who is right and who is wrong? Subscribers know that we are deeply disturbed over the constant increase in the real Soviet defense budget and the decline in ours. But subscribers also know that we have consistently viewed inflation as Public Enemy #1. Also of crucial importance is the fact that adequate national security rests upon the foundation of a solid national economy. Moreover, political realities are political realities.

It's a tough call, but that's what Presidents are for. And we are not at this time prepared to second guess Gerald R. Ford on his priorities.

It is simply a pity that in establishing these priorities a public servant of the highest dedication and ability had to be dismissed. But we venture to say that this nation and its government have not seen the last of James Rodney Schlesinger, Sr., who, after all, is only 46 years of age.

## BANK REGULATION: SHOULD THE FED'S TAKE OVER?

In the early 1960's, as executive vice president of the American Bankers Association, your editor became enamored of various proposals to centralize Federal regulation of commercial banks in one agency. The idea was not new, but its resurrection by Federal Reserve Board Governor Louis Robertson (now retired) gave the idea fresh life. On first glance, we liked it.

But, as the old song goes, "We did but we don't anymore." In our view, the case for a single Federal bank regulatory agency -- recently revived by proposals put before the House and Senate Banking Committees -- is built upon a series of non-sequiturs that constitute one of the flimsiest Houses of Cards ever constructed. (Although the House proposal relates to all depository institutions, our comments pertain only to commercial banks.)

Not that a management efficiency expert would give high marks to the existing system; his sense of order would be sorely disturbed. A schematic chart of commercial bank regulation, depicting the responsible agencies and their lines of authority, resembles the wiring system for an IBM 360 computer -- something the Mad Hatter might come up with after a 5-martini lunch. There are fifty state regulatory authorities, with "primary" authority to charter and regulate state banks. Several Federal agencies are involved in bank regulation but three have most of the action -- the Office of the Comptroller of the Currency, the Federal Reserve Board, and the Federal Deposit Insurance Corporation.

Taking these in reverse, the FDIC (whose three-man governing board includes the Comptroller of the Currency) has some degree of authority over the 14,000 banks, state and national, that carry Federal Deposit Insurance. The Federal Reserve Board exercises some regulatory authority (its monetary policy actions hit all banks) over 4,700 national banks, which must be Fed members, and the 1,100 State banks that elected to join the System. And the Comptroller of the Currency charters and directly regulates all national banks.

Proponents of House Banking proposals to establish a single Federal regulatory agency point to this system as jerry-built, and they are right. But so were a lot of other things. How something was built is irrelevant; the real question is, does it work and, if so, with reasonable efficiency? And remember, we're not talking about the corporation that the typical management consultant deals with. We're talking about GOVERNMENT -- which is something else again.

We make no case for the archaic policies in a number of states that have

kept the U.S. banking system from supplementing "independent banking" with competitive branching and holding company arrangements. That has not been a matter of regulation; it's the law. But to assume that centralization of Federal bank regulation would solve that sort of problem is simplicity unlimited. Centralization has to be justified on other grounds.

Advocates of centralized bank regulation also argue that "efficiency" of regulation would be increased. Perhaps so, but we strongly doubt it, and in rebuttal we point to the record of the Interstate Commerce Commission and other more or less monolithic Federal regulatory agencies. Moreover, the fundamental question is not efficiency of the regulatory authority, but in the regulated industry itself. Despite continued excessive reliance on unit banking in too many states, the U.S. banking system is, on balance, among the most efficient in the world.

In addition, the apparent overlapping in regulation, especially with respect to examining banks, is more apparent than real. Examiners from the Federal Reserve and the FDIC don't trudge into national banks before, after or with representatives of the Comptroller's office or the Federal Reserve. For decades a system has existed in which national banks are the domain of the Comptroller of the Currency, with examination reports passed on to the Fed and FDIC. Similarly, the Fed exercises examination authority over state member banks and the FDIC over insured nonmember banks -- in both instances, in cooperation with State agencies, which have primary authority. The system is not perfect. But it works far better than the schematic diagram might imply.

With bank failures multiplying in recent years, some observers have argued that centralization of Federal regulation would reduce their number and impact. We fail to see why. Full information is exchanged among the three Federal agencies. And, in point of fact, the recent failures -- including large ones in Southern California and New York -- could have occurred just as easily under a centralized regulatory system. Moreover, the decentralized regulatory system did not prevent efficient handling of the failures (no depositors were hurt).

To be sure, a single Federal agency would avoid the inconsistency of philosophy and regulation that sometimes occurs under the existing system. Federal and state regulators seldom see eye-to-eye. And for a while during the first half of the 1960's, the Comptroller of the Currency, in an effort to reduce the heavy burden of bank regulation and spur competition and innovation in the industry, was the "Peck's bad boy" of the Federal regulatory scene, almost constantly at odds with the Fed and FDIC.

But this "inconsistency" has had some very good results in recent years. It shook up an industry that had become stodgy. And it helped reduce what had become a stifling and anti-competitive system of Federal bank regulation -- precisely the type of situation one might expect a single agency to engender. Stated differently, with all of its faults, a system with some 53 prime regulators has a tremendous capacity for promoting innovation, and to do so cautiously and experimentally, in one or more states, without undermining the public confidence that is essential to sound banking. History proves that many of the significant breakthroughs in providing banking services have indeed come from one or more states. Given the temper of the times, regulators in a given state may well be less rigid with respect to innovation than a Federal agency.

We also question the view that creation of a single Federal agency would in no way impair the ability of state authorities to do their own thing. Centralization means just that, in theory as well as practice. Sooner or later -- and probably sooner -- the state officials would find their authority undermined or overridden, and the "dual system of banking" that has prevailed throughout most of our history would die.

"So what", ask some observers? The "so what" relates to one of the greatest strengths of our decentralized regulatory system, namely, the safeguards it provides against political favoritism and abuse in chartering banks. Given limited entry into the banking industry, the possibility of political favoritism by those who control such entry is immense. To be sure, there is no "failsafe" system for preventing political abuse, but the privilege of seeking a charter from either Federal or state officials tilts significantly in that direction.

Moreover, the privilege of shifting a bank charter from state to Federal, or vice versa -- moves that have taken place with relative frequency over the years -- helps guard against the type of overregulation that impedes innovation and competition. (Established by a former Secretary of the Treasury, Chase Manhattan Bank started out as a national bank, shifted to a state charter in the 1950's, and back to a national charter in the 1960's.) Critics like to refer to this arrangement as "competition in laxity" among the regulatory authorities. We view it differently -- a workable system which deals effectively with an inevitable problem: how to inject a reasonable degree of flexibility and competition into a heavily regulated industry.

Some observers relate the current move to centralize banking regulation to the work of the President's Commission on Financial Structure and Regulation (the Hunt Commission). Not so. The Hunt Commission was set up primarily to examine the structure of the nation's depository financial institutions, and its first-rate report was devoted primarily to that subject. On bank regulation, the Commission did not recommend centralization, although it would reduce the number of Federal regulatory agencies from three to two.

(Retiring FDIC Chairman Frank Wille has proposed a reshuffling of Federal bank regulatory authority, but without the centralization of the Congressional proposals. His plan has merit and clearly deserves consideration.)

Currently, the centralization proposals are just that -- proposals. We urge the responsible Congressional committees to move with caution in this area. Like many institutions in our democracy, the existing system is far from perfect. But we could do much worse.

## MONETARY POLICY AND INTEREST RATES: A TOPSY-TURVY WORLD

On Thursday, November 13, release of weekly Federal Reserve figures on growth of the money supply indicated a much greater surge than expected -- according to some reports, the largest growth for any week since 1959. Almost any graduate student of a generation ago, confronted with such an event as basis for an examination question, would immediately answer that the impact on short-term money market rates would be downward -- and he would be given an "A" by his professor.

But ponder these words from Friday's Wall Street Journal: "Specialists... said the sharp rise could cause short-term interest rates to press upward...," and they did. One of the most sensitive, the yield on Treasury bills rose from 5.34 to 5.44 percent on the 13-week issue and from 5.63 to 5.80 percent on the 26-week issue -- sharp rises for prime securities of short maturity.

There is a logical answer to this seeming paradox, but it underlines the fascination of the discipline (it is not a science) of economics. What is today's "truth" may be tomorrow's "fiction." Such developments give credence to a story your editor sometimes uses on the lecture circuit. It pertains to the economics professor who, tired of devising new examination questions year after year, finally gave up and began to repeat the same questions. Given the voluminous files of old quizzes in dorms and frat houses, didn't that give the students a real leg up?

"Not at all, " responded the Prof. "The questions are the same every year, but I change the answers!"

And so it goes. In the early years after World War II, the economic establishment's misinterpretation of Keynesian doctrine led to emphasis on fiscal

actions as the end-all and be-all of government stabilization policy; monetary policy was viewed as a "junior partner" in the effort. Experience, reinforced by the research and logic of Milton Friedman and his followers, has changed all this. Many economists today believe that fiscal policy is the junior partner.

Or take exchange rates. Given the experience of the 1930's, economists in general supported the fixed exchange rate regime which received the imprimatur of all Free World governments at Bretton Woods toward the end of World War II. But, today, rigidity of exchange rates is generally rejected by both economists and governments (except for the French). "Flexibility" (if not the freely floating rates that Friedman espouses) carries the day.

Back to last week's money market. With money supply surging, why did short-term rates rise sharply, rather than fall? Because "specialists" have gained a considerable degree of "sophistication" with respect to the interrelationship among money supply, inflation, and interest rates. A rapidly expanding money supply does mean more money available in credit markets, therefore resulting in downward pressure on interest rates. But rapidly expanding money also means rising danger of "too much money chasing too few goods," with accelerated inflation the result. And the fact is that credit market "specialists" are convinced that in the months ahead the rate of price inflation is and will continue to be the dominant influence on interest rates.

But the story doesn't stop there. Some experts doubtless reasoned that the sharp upsurge in the money supply would probably cause the Federal Reserve to move sharply to tighten money this week, in order to "correct" the aberration. And here's where some, but not enough, "sophistication" can be a dangerous thing.

The sharp upsurge in money supply was, to be sure, far in excess of the 5 to 7½ percent guidelines set by the Fed. But as Fed officials have made clear time after time, those guidelines must be applied over, say, a 3-month period, not just a week. Therefore, those "specialists" who look for a sharp lurch toward restriction in the rate of monetary growth are probably barking up the wrong tree. Fed officials appear to be on the right track, and we think they'll stay on it.

But our original point remains. Those answers do change -- and the economist, business leader or Government official who fails to recognize this truth is going to be caught playing catch-up rather than King of the Hill.

Sincerely yours,

Charls E. Walker

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

JAN 29 1976

1730 PENNSYLVANIA AVENUE, N. W. • SUITE 200 • WASHINGTON, D.C. 20006 • (202) 785-9622

Vol. 4, No. 2 - January 28, 1976

Dear Subscriber:

In this issue we look at the politics of President Gerald R. Ford's budget for fiscal year 1977, submitted to the Congress last week, and address the question: "Will the Fed crimp the recovery?"

## THE POLITICS OF THE FORD BUDGET

For the first time in our memory, the domestic issues in a Presidential election may well be fought out in terms of one document--President Gerald R. Ford's fiscal year 1977 budget. It does seem startling that the centerpiece of the campaign may be a fiscal plan whose final outcome will not be known until almost a year after the election. But strong arguments support the view that GRF's austere $394 billion spending plan for next fiscal year, coupled with tax and other proposals, will indeed be the focus of attention in the campaign.

(NOTE: Budget-watchers must learn some new dates. As a result of the Congressional Budget Act of 1974, fiscal year 1977 begins not on July 1, 1976, but three months later, on Oct. 1, with the hiatus known as a "Transition Quarter." The two most significant dates before the beginning of the fiscal year are May 15 and Sep. 15, when preliminary and final budget targets, respectively, must be approved by Congress. As WER has noted earlier, with the first action coming only a few weeks before the expiration of the temporary income tax cut on June 30 and the Democratic Convention in July, and the second a little more than a month before the general election, the dates assume great political importance.)

Ford's domestic budget can be discussed in terms of the proverbial 3-legged stool, with the first leg involving an additional tax cut; the second, spending restraint; and the third, a shift of significant authority over some programs to the states.

The Tax Cut. Ford is likely to score a strong political gain with the first leg, which calls for an additional $10 billion cut in taxes on individuals and businesses on July 1. With the $18 billion in temporary reductions voted last month expiring at that time, the total would add up to the $28 billion Ford called for in October (with the stipulation that it be accompanied by a similar cutback in the growth of spending.)

In and of itself, the proposed tax cut will be difficult to attack in the campaign. Most taxpaying Americans today believe their Federal levies are ridiculously high. Moreover, the charge that it would be irresponsible to cut taxes further at a time of economic recovery and continuing inflation is countered by Ford's proposal to match the tax cut with an equal dose of spending restraint. Rather than attack his suggested tax cut (except to advocate less for business and more for individuals), the Democrats are likely to try either to meet it or beat it, by enlarging the amount.

This implies that, regardless of the state of the economy, at least an extension of the temporary cuts on July 1 is almost a political sure thing. And, with the campaign heating up and the Democratic Convention just around the corner, the odds favor

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an enlargement. After all, the old "what-have-you-done-for-me-lately?" attitude will be fully as strong next summer as in the past. A simple extension that would leave withholding rates unchanged is not likely to strike the typical voter as generous.

Spending Restraint. The second leg of Ford's fiscal stool is his proposed spending limit of $394 billion. This would represent a dollar increase of about 5 1/2 percent (no increase, and probably a small cutback, in real terms), a stark contrast to spending surges which have doubled Federal outlays in the six fiscal years since 1969.

As noted, the spending leg of the stool helps make the tax cut leg fiscally responsible. Politically, to separate the two, opponents will have to convince voters that the spending cut either cannot or should not be effected. This may be a tall order.

As WER has noted for some time, and as supported by a recent Harris poll, the electorate has shifted strongly in a conservative direction. This is not to say that the typical voter is ready to embrace the views of the far right; it is to say that the old-fashioned Yankee skepticism, after more than a decade of disappointing efforts to use Federal dollars to solve all our social problems has re-surfaced. There is nothing reactionary in calling for a slower, thoughtful, more carefully planned approach to social problems. Why, asks the taxpaying voter, throw more good money after mountains of bad?

At its extreme, the unhappiness that has begat this trend toward neo-conservatism is most apparent at the low- and middle-income levels of taxpayers. Correct or not, many are convinced that the hundreds or thousands of dollars they send to Washington each year are wasted. They think their dollars are either squandered on a swollen bureaucracy or handed out to cheaters on welfare, food stamps, and the like. Never mind what the truth of the matter is; in politics, it's the perception that counts. And those in Washington and elsewhere on the Eastern or Western seaboards who doubt this ought to get around and talk to a few people in Middle America.

Then, of course, there is the fundamental issue of "Big Government." In the past, this was (except on April 15) largely confined to the businessman who had to work his way through a maze of Federal regulations and piles of paperwork. But now the negative impact of a big, paternalistic Federal establishment is beginning to hit the individual. One person sees his job threatened as a result of edicts of the Environmental Protection Agency. Others finally come to realize that the Federally mandated safety and environmental features (e.g., the catalytic converter) hit them, the buyers, squarely in the pocketbook. And then you have classic cases such as with the seatbelt interlock, where the entire Federal establishment back-pedaled so quickly as to boggle the mind.

Add it all up, and the trend toward conservatism in the electorate is easy to understand. Which makes it all the more difficult for opponents of Ford's spending restraint to make their case in the hustings. Moreover, the argument that Congress simply doesn't have time to pass the necessary legislation is not likely to impress the home folk. In their view, what was enacted can be unenacted, and why should it takes years to do so?

Nor is the argument that Ford's budget proposal will impale the unemployment rate at a perpetually high and unacceptable level likely to carry the day. Again, the concern about Big Government, the inflation it engenders and the freedom it impinges upon, may well override the genuine and understandable concern about unemployment, especially if the economy continues to rise and unemployment fall.

Grant Consolidation. Ford's third leg of his fiscal stool--the proposal to replace 59 grant programs with broad block grants for States and localities--has important implications for his nomination fight against Ronald Reagan as well as in the electoral battle, if indeed he wins the nomination. Reagan's $90 billion transfer proposal is taking a drubbing in the press, perhaps unfairly. And only time will tell whether the voters agree with what seems to be growing skepticism in the Fourth



## HIGH INTEREST NOTES

"Fishbowl Banking"? As the war of words rages in the press and Congress concerning public dissemination of supposedly confidential bank examination reports, two important points are being missed by the advocates of full disclosure.

First, much of the data being fed to the public is stale. Only last Sunday, the New York Times based a long article on an internal Federal Reserve memorandum dated January 15, 1975. Much has happened since that time. Most important, with business recovering, bank conditions are doubtless improving.

Second, the argument of "fishbowl banking" advocates that the first specific disclosures, relating to New York's First National City and Chase Manhattan banks, led to no adverse market repercussions completely overlooks the fact that these are two very strong institutions. Suppose that, in contrast, the disclosures had pertained to two very weak banks. The immediate result could well have been a "run" on the part of depositors not covered by Federal insurance, a sharp increase in the rates the banks would have to pay on certificates of deposits, and a precipitate drop in the value of their stock.

All of these events would severely complicate the task of the bank regulators, whose practice it is to work out mergers of such institutions, sometimes assuming liability for weak assets, so as to protect all depositors and minimize the loss to stockholders.

"Fishbowl banking" can only complicate these efforts to maintain a strong financial system and protect bank customers.

Tax Legislation. Look for a stripped-down version of the House-passed Tax Revision Act of 1975 to clear Congress with the extension (or enlargement) of the tax cuts expiring at mid-year. The powerful and astute chairman of the Senate Finance Committee, Russell Long (D-La.), plans mid-March hearings on that portion of the House-passed bill (H.R. 19612) which he held back in December. Long is also expected to include some of the provisions of H.R. 6860, the Energy Conservation and Conversion Act, which passed the House last summer but, after some pre-August actions, has since that time rested untouched in the Senate Finance Committee.

Northeast Railroads. As we predicted in December when GRF threatened to veto the Congressionally approved Rail Revitalization Act of 1975--a measure which would also reorganize the bankrupt carriers in the Northeast, representatives from the Administration and Congress have, after much hard work, hammered out a compromise. Congress is expected to pass the measure this week and Ford to sign it shortly. A future WER will discuss in detail the legislation and what it presages both in the Northeast and elsewhere.

Treasury and the Security Council. We're still at a loss to explain GRF's opposition to legislation making the Secretary of the Treasury a statutory member of the National Security Council. Given the crucial impact of economic strength in the international pecking order, in no other country in the world would the Finance Minister attend such meetings "by invitation only." But Ford both opposed the legislation and then vetoed it after Congressional approval. The Senate has overridden the veto. Hopefully, the House will do the same.

Estate. But, Ford's proposal appears eminently doable, if Congress will only go along. And there is likely to be plenty of pressure from State and local officials for Congress to do so.

Conclusion. To conclude that Ford's budget proposals have put him on the offensive is by no means to assert that he's taken the ballgame, either for nomination or election. It is rather to emphasize that the budget for the first time encompasses the basic campaign strategy of an incumbent President who wants to stay in office.

The strategy appears to be well conceived and much of the rhetoric and substance of the campaigns of other candidates is likely to be a response to the issues that make up Ford's "3-legged stool."

How well the strategy will be executed--and this is the big danger to Ford--remains to be seen. The fact that GRF is the first President since Harry Truman to brief the press personally on the budget at least underscores his recognition of the budget as his basic platform.

## WILL THE FED CRIMP RECOVERY?

For a couple of decades--from the Great Depression until the 1950's--the impact of monetary policy on economic activity was not a matter of major national concern. This was not because it was in fact unimportant, but primarily because the events of the 1930's, coupled with the writings and influence of John Maynard Keynes, had elevated fiscal policy to super-status in economic stabilization policy. Monetary policy, which had held the key spot for many years following the establishment of a central bank in 1913, was erroneously viewed as being almost totally ineffective in promoting recovery from the Depression. If mentioned at all by most economists, it was viewed as a junior partner to fiscal policy with a minimal role to play.

Not so, today. Monetary policy was "re-born" in the 1950's and, due largely to the arguments and analysis of Milton Friedman and other monetarists, now occupies a place of at least equal importance to fiscal policy. In fact, some monetarists would argue that it's the whole ball game. Not surprisingly, the rising prominence of monetary policy has had political ramifications. One group of "Fed-watchers" is keeping eagle eyes on the policies of Fed Chairman Arthur Burns and his associates--and this is a powerful group indeed. We refer to the Congress in general and, in particular, its potent Joint Economic, Banking and Budget Committees.

Not that the JEC and the Banking Committees haven't put Fed officials through their paces frequently in recent years. This was especially true of long-time Fed critic and former House Banking Committee Chairman Wright Patman (D-Tex.), who plans to retire from Congress this year. But, as often as not, the criticisms from Capitol Hill lost a good deal in transmission for a simple reason: Congress itself could not deliver on its own end of the stabilization policy tandem, namely, in conceiving and executing a sensible fiscal policy.

Now, however, warnings from Capitol Hill should take on more force. Congress shows signs of mounting an effective budget policy of its own, thanks to the Congressional Budget Act of 1974 and the highly successful "dress rehearsal" for Congressional budget policy in 1975. The reasons for this success include the soundness of the basic legislation, which was drafted with great care; the temper of the times (i.e., the more conservative bent of the electorate); and the statesmanship exhibited by senior members of the Budget Committees and the leadership in the two Houses. The list is long, but it surely includes Budget Chairman Edmund Muskie and Ranking Member Henry Bellmon in the Senate and, in the House, Chairman Brock Adams. Prominent members of the House Committee who deserve considerable credit are Democrat Thomas L. Ashley and Republicans Elford A. Cederberg and Barber Conable.

In short, the progress and promise of Congressional budgeting has increased the credibility of Hill criticism of the Fed. We therefore urge Fed officials to heed the concerns and ponder carefully the advice coming from Congress, especially members

of the Budget Committees. Recent conversations with some of these Members have revealed a deep concern: If they beat off the "budget busters" in this election year (emulating similar success last year), will the Fed provide sufficient money to fuel recovery, or will it impede or perhaps even stall the recovery far short of reasonable employment goals?

When queried recently on this point by a Congressional budget leader, we could not in all honesty say, in effect, "not to worry." The Fed has blown it before and can blow it again. But the odds favor an accommodative--and hopefully not over-accommodative--monetary policy in 1976. There are at least two reasons for this conclusion.

First is the fact that Fed officials are mindful of both their power and responsibilities, not to mention the consequences of bad policy. They know that anemic monetary growth can stall recovery, that they are being watched closely by Congress and others for signs of niggardliness, and that if the recovery indeed falters, a verdict of "guilty" may well result in harsh legislation affecting the Fed's structure and powers.

Second, week-before-last the Fed flashed an unmistakable sign of its desire to be accommodative. This sign--a relatively large reduction in the discount rate, from 6 to 5 1/2 percent--indicates official concern with a recent rate of monetary growth even lower than the Fed's own publicly professed target of 5 to 7 1/2 percent, coupled with a desire to meet those targets in 1976.

How best to "monitor" the Fed in the weeks and months ahead? Interest rates are a faulty indicator; so many other factors affect their behavior that at times they can be downright misleading (i.e., rising when the Fed is increasing the rate of monetary growth, and vice versa). Bank loans tell only a part of the story, especially when, as now, corporate liquidity is high and loan demand slack. Of all the indicators, probably the best is the "monetary base."

The monetary base is the foundation of the "money stock," or "money supply." It consists primarily of "Federal Reserve credit" (mainly, holdings of Government securities) and the nation's gold stock. The ratio of the narrowly defined money supply (demand deposits plus currency) to the monetary base is about 4 to 1, but, for several reasons, tends to vary somewhat over time. Nevertheless, the ratio is sufficiently stable to warrant selection of the monetary base as the most dependable indicator of what the Fed's up to. Stated differently, a relatively stable growth in the monetary base is the key to long-run stability in monetary growth. Experience suggests that this rate should be about equal to the desired rate of growth of money supply, (i.e., 5 to 7 1/2 percent).

One advantage of emphasizing this indicator--and we urge Congressional and other "Fed-watchers" to give it high priority--is that it is one variable that the Fed can control. For a variety of reasons, money supply and other indicators are subject to considerable slippage with respect to the impact of policy actions. The monetary base is not subject to significant slippage, but is fundamentally under Federal Reserve control.

Moreover, the data are easy to follow. Simply write the Federal Reserve Bank of St. Louis, P. O. Box 442, St. Louis, Missouri 63166 and ask to receive (without charge) its weekly booklet, "U.S. Financial Data," and its monthly "Monetary Trends." (Another useful publication from the bank is its quarterly "Federal Budget Trends," also available without charge).

All interested and informed parties agree that the Federal Reserve has a crucial role to play in providing enough, but not too much, monetary growth in 1976 and beyond. Close monitoring of its efforts to do so, with attention directed at the appropriate indicators, is bound to serve the public interest.

Sincerely yours,

Charls E. Walker

FEB 12 1976

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

1730 PENNSYLVANIA AVENUE, N. W. • SUITE 200 • WASHINGTON, D.C. 20006 • (202) 785-9622

Vol. 4, No. 3 - February 10, 1976

Dear Subscriber:

President Gerald R. Ford has completed his series of domestic messages to the Congress and their political and economic "massaging" is well under way. Democratic politicians and economists charge that the fiscal plan is too austere and will stop the recovery far short of high prosperity and full employment. They plump for more spending than Ford recommends and place special emphasis on creation of public service jobs.

As we emphasize below, however, Ford continues to pursue his "game plan" of maximum reliance on the private sector to continue recovery and build jobs -- all within the context of lessening inflation. In this issue, we take a hard look at the "Pocketbook Issue" in Campaign 76 and stress again the emergence of inflation as a major voter worry and therefore of signal importance in the election.

In addition, we set forth some questions on bank regulation that are not being given adequate attention as criticism mounts on Capitol Hill.

## CAMPAIGN 76 AND THE POCKETBOOK ISSUE

The 1976 Economic Report of the President, submitted to Congress two weeks ago, underscores our earlier assertion that GRF is basing his bid for nomination and election on the major thrusts of his budget message -- spending restraint, tax cuts, and grant consolidation for State and local governments. These are the positive aspects of the Ford campaign. Equally important, and furnishing the material for considerable rhetoric and debate this year, is the Administration's conscious decision to forego a crash approach to reducing unemployment. Ford and his economic aides are forthright and candid about their policy, arguing that forced draft measures to reduce unemployment quickly will backfire as inflationary pressures mount and the seeds of another recession are sown.

Is Ford right? This is the gut question confronting the business man who needs to take into account the economic philosophy of the occupant of the White House in 1977. If Ford is correct, and can gain the nomination (still another question), he stands a reasonably good chance of continuing to receive his mail at 1600 Pennsylvania Avenue, Washington, D.C., rather than in Grand Rapids, Michigan. But if he's wrong, or if he and his campaigners fail to execute the strategy, then the occupant of the White House in 1977 is likely to be a horse of a different economic color.

Dr. Gallup Speaks. Polls must be interpreted with care, but when the margins are large, they can be useful indicators of views. In a recent survey, Dr. George Gallup posed the following question: "What do you think is the most important problem in the country today?" To this shorthand method of digging out the issues in Campaign 76, a whopping 47 percent responded: "The high cost of living." In the light of experience with inflation and its impact on take-home pay in recent years, that answer is not so surprising.

But what is most interesting, and carries with it considerable food for thought for politicians, is the fact that only 23 percent of the respondents picked unemployment as the nation's major problem. Next on the list was "crime and lawlessness" at 8 percent and international problems at 5 percent.

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Two conclusions are apparent from this early public ranking of issues for Campaign 76. First, the political "Phillips Curve," which we wrote about recently, has indeed shifted significantly. Unemployment is still an important issue, one the Democrats are pushing hard, but inflation also possesses a pretty big political bang for the buck. Many of the 89+ percent of people working are more concerned about the still rising cost of living than they are about the 7+ percent who are out of work. This may be a selfish view, but it's not surprising. Fortunately, unemployment compensation, food stamps, etc., have greatly reduced the human costs of unemployment.

Second, of the two traditional issues, "Peace" and "The Pocketbook," the latter now looms as the focal point of the campaign (but, for reasons we shall note shortly, not with respect to the Ford-Reagan battle for the Republican nomination).

Good News/Bad News. The Gallup survey is both encouraging and discouraging. It is encouraging because it may portend a long-needed shift away from the bias of national economic policy toward expansion -- policies which, since World War II, have helped ground in inflation as a fact of life. Conviction on the part of the largest block of voters that inflation is Public Enemy #1 may mean that at long last we shall be able to deal with the problem effectively. If so, we'll also have a better chance of achieving high and lasting employment, since chronic inflation sooner of later destroys jobs.

Also encouraging is the fact (not shown in the poll, but apparent nevertheless) that a growing number of politicians in both parties view explosive Federal spending as the root of the inflationary problem. This is a major reason the new Congressional budget process shows signs of working properly. And if spending is brought into line, Federal Reserve authorities will find it much easier to pursue a stabilizing monetary policy, since the pressure to finance never ending deficits through money creation will be reduced.

But the Bad News of the Gallup poll is that only 5 percent of the interviewees point to the international area as involving the most important problems confronting the country. This, too, is natural, in the wake of Viet Nam and given the isolationism that has always been close to the surface in the U.S. But a great debate on this nation's role as a world leader should stand in at least equal importance to domestic economic issues in Campaign 76. However, unless the lid blows off somewhere around the world within the next few months, no such debate seems likely -- except perhaps, as noted below, in the battle for the Republican nomination.

To repeat, the general election shows every sign of being fought out on the Pocketbook issue.

The Spending Bills. Both the Gallup survey and the judgments we've expressed in earlier Reports concerning the conservative shift of the electorate appear to be contradicted by two actions in Congress last month, actions which when combined add up to over $50 billion in Federal spending. These include Congressional overriding, by a relatively large margin, of a $45 billion HEW appropriation for various social programs, and overwhelming approval of a $6.2 billion measure to create public service jobs.

The apparent paradox can be at least partly explained by the nature of our political system. When it comes to issues, those of local or regional importance tend to dominate in Congressional races. But in voting for a President, the combined view of the electorate in 50 states and 435 Congressional districts can add up to something considerably different from the apparent sum of the parts. This is one reason we have in recent years often had a President from one party confronted by a Congress controlled by the other.

Take the jobs bill. To be sure, as Gallup states, twice as many people rank inflation as a bigger problem than unemployment. But the unemployment rate is the highest since the 1930's, compensation benefits are running out for a couple of million unemployed workers, the concept of public service jobs was accepted last year, and $6 billion out of a budget approaching $400 billion doesn't seem all that much to pay for what proponents claim will be an effective "quick fix" for part of the unemployment problem. For understandable reasons, the arguments of Ford and his aides that public service jobs are highly inefficient as a cure for unemployment, involving



more of a "musical chairs" operation than a net increase in jobs, do not carry much political weight. Moreover, it is difficult to argue that this bill alone would do much to fuel the fires of inflation.

As to the HEW appropriations measure, again, projects highly popular in individual Congressional districts were involved; the dollars involved had already been allowed for in last year's Congressional budget "rehearsal"; and, despite the huge price tag on the bill as a whole, its impact on the budget deficit cannot be demonstrated as being very large. Nevertheless, Ford has an issue. Given the disenchantment with Big Government in the electorate as a whole, it can earn points in Campaign 76.

We therefore do not interpret the Congressional actions of last month as changing the basic tone of the campaign. But, with respect to that campaign, who will carry the Republican banner?

Ford vs. Reagan. Our answer to that question is short and sweet: We don't know, and neither does anybody else. As of now, it looks like a real horse race with only two entries. About all that can be said is that those who were counting Ford out in November and December are now singing a different tune. Moreover, Reagan is likely to continue to have trouble with the specifics of his $90 billion budget proposal.

Partly for this reason, and partly because of the fundamental views of the Republican majority for which Ford and Reagan are vying, we expect foreign policy to loom as a major issue in the nomination battle, though the Pocketbook will still occupy front pew in the campaign. This is because detente is increasingly unpopular in Middle America, especially with the people who are likely to play the key role in the Republican nominating process.

How Ford and his campaign strategists will react to a full force Reagan attack on detente is unclear. Our best guess is that in both rhetoric and actions the Administration will begin to take a much tougher line both with the Soviets and their Western Hemisphere ally, Cuba. The Angolan situation, up to now badly mishandled by the Administration, might possibly be turned into a political plus -- if not in the battle for nomination, at least during the election (assuming that the Democrat nominee is someone other than Senator Henry Jackson, whose hard-nosed attitude toward the Russians is difficult to challenge). Moreover, unless any SALT agreement can be demonstrated beyond doubt to be balanced and enforceable, the outcome is likely to be a distinct negative for GRF against Reagan. The damage from Pat Moynihan's resignation as U.N. Ambassador, reportedly because of differences with Henry Kissinger, may diminish, especially if he throws his hat into the Democratic race for the Senate in New York.

Whether Ford recognizes his exposure to a finely honed Reagan attack on detente and SALT remains to be seen. But his willingness to support a larger defense budget than earlier seemed likely -- at the time, for example, of the sacking of former Defense Secretary James Schlesinger -- demonstrates his concern for our defense posture and perhaps also the damage to his chances for the nomination that any fallback in the defense area would entail.

In any event, foreign policy will get some attention in the campaign, if only with respect to the Ford-Reagan nomination battle. The pity is that the mood of the country is ambivalent -- few voters want the U.S. to be second to anyone in military strength, but when the costs of Free World leadership are toted up, old-fashioned isolationism, bolstered by a natural desire to deal first with problems at home, threatens to rear its ugly head.

Conclusion. Unemployment as an issue has by no means lost its teeth, but the pinpointing of the high cost of living as this country's number one problem by close to a majority sampled in a nationwide poll, with unemployment gaining only half as many votes, clearly raises inflation and its control to the highest order of political issues. For the first time in our memory, inflation shows signs of being the single most important domestic issue in a national campaign.

This seems to be the way Gerald Ford and his strategists read the cards. If they're right, Campaign 76 may mark a significant turning point in national elections. At the least, it may well be a campaign based on issues rather than personalities. And that's as it should be.

PERSPECTIVE ON BANK REGULATION

Some of the critics of Federal bank regulation in general and Comptroller of the Currency James E. Smith in particular are having a hard time seeing the forest for the trees. Disclosure of what a host of banking and financial experts have known for years -- that certain loans are "classified", by examiners, that lists of so-called "problem banks" exist, and that poor management practices can creep into even our larger institutions -- has given journalists with no Watergate to chew on something to write about, and politicians with few issues to pursue something to investigate. Moreover, the latter are trying to bend the disclosures to support pet legislative proposals that have been sitting on the back shelves for years.

We urge two things: That the situation be viewed in perspective and, at the least, that the right questions concerning the disclosures and bank regulation be asked. Thus far, we are not encouraged.

As to perspective, let's not forget that until very recently, in historical terms, a tendency toward massive bank failures plagued the U.S. economy. The worst period was from 1921 to 1934, when the number of banks, largely because of failures, fell from over 30,000 to less than 15,000. Millions of people, directly, or indirectly, suffered the severe economic consequences of that avoidable catastrophe -- overnight loss of individual fortunes and irreparable damage to the economies of the areas served by the defunct banks. And the 1921-34 failures, although huge in number, were not unique; they occurred frequently throughout our economic history.

Then, in the 1930's, steps were taken to make anything but scattered bank failures a thing of the past. Two actions were important. First was the adoption of Federal Deposit Insurance (now at $40,000 per account), which guards against runs on the part of small (but not large) depositors. Second was a deliberate Federal regulatory policy to guard against failures or, if they threatened, to arrange a "marriage" (often "shotgun" in nature) with a strong, solvent institution. In many instances, the Federal Deposit Insurance Corporation would have to take over or underwrite the weak assets of the failing bank.

The approach worked. And the fact that in recent years there have been only three major bank failures is the proof of the pudding. To have come through the worst recession since the 1930's with so fine a record should be a cause for rejoicing and compliments, not recrimination and finger-pointing.

Not that appropriate Congressional committees shouldn't look into bank regulation. They should, and in fact they've been doing so from time immemorial. But they should ask the right questions. In our basically free enterprise, market economy, how far should bank regulation go in substituting for bank management? What is the cost-benefit impact of forcing, through law or regulation, banks and other depository financial institutions to stay away from the risky type loans that might become "classified"? After all, many of these are loans that Congressmen would place high on the list (e.g., to small and minority businesses, low-income consumers, etc.) from a public policy standpoint.

On the issue of public disclosure, does the interest of bank depositors and borrowers take precedence over (1) the public's "right to know" and (2) stockholder's "right" to have certain information? (How many remember that, until the 1930's owners' responsibilities in trying to promote sound banking and avert failures involved double liability on the part of bank directors for the stock they owned?) In pursuing "disclosure," should the names of borrowers, delinquent or otherwise, be published? Similarly, should major depositors be identified?

On the power of the bank regulator, should he, without due process, be authorized to remove any bank officer who is not "doing a good job"? To what extent should he use his authority, both absolute and moral, to induce the institutions he regulates to serve social goals -- perhaps by allocating funds in clearly risky ventures which harm the interests of the banks' owners?

How can it be assumed, as it has been by some, that radical changes in the Federal regulatory structure -- probably leading to further concentration of power in Washington -- will lead to better banking? Does our experience with such



agencies as the Interstate Commerce Commission and a host of other powerful Federal agencies support this conclusion? Or is it more likely that what, on balance, has been a highly innovative banking system would find itself stifled by the heavy hands of unimaginative Federal bureaucrats?

If the Federal regulatory powers are shifted, should more be granted to the Federal Reserve Board? Will this reduce the Board's ability to perform its prime and vital task of adjusting monetary variables for stabilization purposes? Has the Fed demonstrated awareness and deliberate speed in handling its existing regulatory duties, or has it instead, as critics charge, been stuffy, against innovation, and excrutiatingly slow?

This list of questions is far from exhaustive, but we believe it is illustrative of some good questions to be asked about bank regulation. Unfortunately, the powers on Capitol Hill don't yet seem to be asking them.

HIGH INTEREST NOTES

On the Need for Tax Reform. WER's often expressed view that the Federal individual income tax system is basically fair recently received indirect support from a surprising but welcome source. In a new Brookings publication, tax reformers George Break and Joseph Pechman state: "While the U.S. tax system has many deficiencies, it is well to begin...on a mild note of optimism. Compared to those of most other countries, the Federal part of the U.S. tax system is probably one of the best. It relies heavily on progressive taxes and is administered with competence and even-handedness." The authors go on to state that "there is nonetheless ample room for improvement" -- a statement with which few would disagree. But their opening comments lend support to the view that demogoguery rather than facts has been the major factor in creating public unhappiness with the tax system and enduring life for "tax reform as a political issue.

Unemployment Data. When the Nixon Administration discontinued briefings on unemployment statistics by professional staff, reportedly because the experts' candor during a time of rising unemployment was politically damaging, Senator William Proxmire of the Joint Economic Committee insisted that such briefings take place monthly on Capitol Hill. Politically, Proxmire's inspiration paid off while unemployment rose, but now the reverse may be true. Last week, The Commissioner of Labor Statistics, Julius Shiskin -- a professional of unquestioned integrity and ability -- told Proxmire and his colleagues that the January gains in employment were widespread and implied that, as in past recoveries, the rate might now drop rapidly. If so, a major thrust of the Democratic strategy for Campaign 76 could come acropper.

The Politics of Monetary Policy. Federal Reserve Chairman Arthur Burns, whom former Treasury Secretary John Connally once described as "wiser than a tree full of owls," has positioned the central bank beautifully to avoid repetition of the charge that Burns intentionally over-expanded money to help assure Richard Nixon's re-election in 1972. The reason is that economists of both liberal and conservative persuasion, joined by politicians in both parties, are loudly calling for more monetary growth, lest the recovery be aborted. Therefore, if the Fed steps up the rate of monetary growth, as we predict, and hindsight later proves that the expansion is too great and leads to higher inflation, Burns can point to the bipartisan record as a basis for his actions.

Second Thoughts? Last Spring, Commissioner Don Alexander suggested that the Internal Revenue Service be shifted from the Treasury Department to the status of

an independent agency. WER strongly challenged this recommendation, pointing out (among other things) that at times only the prestige of the Secretary of the Treasury, as the IRS Commissioner's boss, could protect the latter from politically motivated attacks. Alexander is under fire from several quarters, and until now has had the unwavering support of Treasury Secretary William Simon. Last week, as the heat on Alexander grew, Simon condemned the rumor campaign directed against Alexander, for whom a spokesman said: "...the Commissioner can't help but be pleased by Simon's words of support." We hope that the investigations under way completely clear Alexander. We also hope that he's had second thoughts about divorcing IRS from Treasury.

Congressional "Drop-Outs." WER has maintained for some time that the 95th Congress, due to assemble in January 1977, will be much different from the 94th. This view had been based mainly on the prospect of a big turnover in the 94th's huge Freshman class. Now another factor has come to the fore -- one that provides deep cause for concern. With increasing frequency, sometimes approaching several announcements a week, veteran members are dropping out of the 1976 race. Reasons include the ardor of campaigning (especially the effort needed to refute the view that Congressmen are lazy and out-of-touch with their constituents), overwork, frustration at the inability to shape and move constructive legislation, and the complaint that "it's just not any fun anymore." One glance at the growing list of retirees is enough to indicate that the 95th will not only be "different," but it will also suffer from the absence of many wise and experienced leaders who have contributed significantly to helping make our complicated system of government work effectively.

Sincerely yours,

Charls E. Walker

MAR 12 1976

**CHARLS E. WALKER'S**
**WASHINGTON ECONOMIC REPORT**

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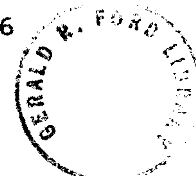

Dear Subscriber:

In this issue we call your attention to a recent speech by Senator Edward M. Kennedy (D-Mass.) on regulatory reform, comment further on progress toward tax legislation for capital formation, and look into the political/economic "crystal ball" for the remainder of 1976. A Special Insert offers our views on Campaign 76.

ARE INDEPENDENT AGENCIES TOO INDEPENDENT?

Last month Senator Edward M. Kennedy made a speech in Boston that was remarkable for two reasons. First, the speech was all but ignored by the press. Second, Kennedy set forth two ideas on Federal regulatory reform with which many people who differ politically with the Senator can readily agree. The first, discussed herein, relates to the structure of regulatory agencies. The second applies to the use of the Federal tax system as a substitute for direct regulation. This will be discussed in a future WER.

Agency Reform. Kennedy zeroes in on one of the most important shortcomings of the regulatory system which was spawned late in the 19th century, sprouted to full bloom under FDR's New Deal, and has been nurtured further in the decades since. This system is based on the concept of the "independent agency" -- a concept which, in Kennedy's view, has outlived its usefulness. "We no longer," he says, "accept on faith the view that an agency insulated from effective control by the President will automatically operate in the [public interest]."

Kennedy debunks the view that independence means more "scientific" regulation -- "management by experts whose discretion would be controlled by the basic precepts of what might be called the 'science of the regulatory art.'" Rather than being experts, commissions have, in the Senator's view, turned out to be "a haven for the failed political candidate, the rich campaign contributor, the occasional aging bureaucrat, and the crony of those in power."

These charges are perhaps too strong, if not in general, certainly with respect to some able and dedicated commissioners over the years. But Kennedy's conclusion is, to us, unassailable: "Too often, it is the agency's independence that insulates the agency from the only means we have for achieving continuing public accountability." As a practical matter, he says, "independence...has come to mean independence from the public interest."

Although Kennedy fails to note that zeal and (sometimes) bias of the staffs of independent agencies are a central part of the problem -- policy appointees come and go, but the staffs go on and on -- we fully agree with his first step in dealing with the problem: Adopt the recommendations of two Presidential commissions -- one appointed by President John F. Kennedy and the other by President Richard M. Nixon -- to "turn over the powers of at least the worst multi-headed Federal agencies to a single head, and make that head directly responsible to the President."

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To those who would object to the power centered in one person, the answer is both pragmatic and political. Practically speaking, year-in and year-out 1-man agencies have done a better job than those consisting of three or more members. An example: Recent comments by press and politicians notwithstanding, the Office of the Comptroller of the Currency, which regulates national banks, has probably the best record in recent years for spurring competition and innovation, a sharp contrast to the dead hand of some of the multi-headed agencies.

But it is the political aspect of Kennedy's endorsement of earlier commission proposals that is the more important: The "faceless bureaucrat" is, to a great extent, "faceless," precisely because he has almost no responsibility to the electorate. Responsible to Congress (not the President), many agencies spend much time and effort cozying up to their "parent" Congressional committees (authorization and appropriation, with the latter the more important).

If each Federal agency (with the exception of the Federal Reserve Board, which should remain independent within government) consisted of one man responsible to the President, then all would know where the buck stops -- a buck which now disappears in a tangle of red tape and overlapping jurisdictions.

To those who charge that the 1-man agency approach would center too much power in the Executive, the answer is that, when it comes to these highly important matters of public policy, the President now has far too little power, yet he is ultimately held responsible by the electorate for all agency actions. If the responsibility is to be his at the polls, then he should have the authority to make a record on which he, or his party, can be judged on election day.

Moreover, in this era of "sunshine laws," "freedom-of-information," hard-driving oversight committees in the Congress, and thorough and dispassionate investigations by the General Accounting Office (Congress' auditing arm), the possibility of any incumbent President directing his appointee to engage in politically motivated actions is remote.

We salute Senator Kennedy's analysis and recommendations with respect to this aspect of the regulatory problem. Query: Why did the press give it so little attention?

## CAPITAL FORMATION: AN IMPROVING OUTLOOK

Yes, Virginia, there is a "capital shortage."

At long last, the debate on whether the U.S. will lower taxes on savings and investment to help meet its needs for capital formation in the decades ahead has turned a significant corner. A growing number of think tanks, individual scholars, Government officials, and politicians are now convinced that the capital formation problem is real, that it won't go away, and that tax actions are necessary. Moreover, the mood seems to be shifting toward "the sooner the better" -- although far-reaching Congressional tax actions to foster capital formation in this Congress are unlikely.

This improved outlook has occurred in a relatively short time. As recently as last summer, in a series of hearings on tax reform before the House Ways and Means Committee, not a few witnesses argued that (1) there never has been, is not now, nor ever will be a "capital shortage" in this country; or (2) if indeed one does exist, an early return to "full employment" will solve the problem.

These contentions have been refuted. Witnesses who argued that the problem either did not exist or was grossly overstated relied heavily on data showing a steady relationship between gross nonresidential fixed investment and GNP over recent



## THE CAMPAIGN AFTER FLORIDA

Yesterday's Florida primary provided an important installment to Campaign 76. On the Republican side, barring an act of God or some unforeseen political disaster, it should be all over but the shouting. As to the Democrats, even though a current forecast as to the ultimate winner is still out of the question, the thinning of the ranks continues.

The Republicans. Although Ronald Reagan's reported statements on welfare and social security hurt him in New Hampshire, Massachusetts and Florida, we attribute the imminent demise of his campaign (barring a near miracle in Illinois next week) to a development both subtle and powerful. Some time within the past six weeks -- we don't know precisely when -- Gerald R. Ford began to come through to voters as President of the United States. And Republican voters, after making that identification, began to look around, saw that things were not all that bad, and concluded that the outlook for the future was, indeed, rather promising. (To those who argue that Ford's leadership had little to do with the favorable trend -- an unrealistic and unsophisticated assessment at best -- the answer is that the man in the Oval Office gets the credit or blame anyway.) In addition, Republican voters -- even Reagan supporters -- see GRF as a winner in November; not so with Reagan.

Ford's strongest tailwind is, of course, the economy; favorable statistics are popping up all over the place. But there is more. In the 19 months since his sudden ascension to the Presidency, GRF has avoided any really big mistakes, although to be sure, both the Nixon pardon and the Schlesinger sacking were controversial. The press -- especially political cartoonists -- went too far in depicting the nation's Chief Executive as a physical and mental stumbler, thereby evoking a backlash of sympathetic reaction. More and more voters began to see Ford as an honest, hardworking man increasingly on top of his job. People still recall that GRF used his power of veto to prevent a "budget-busting" Congress (as viewed by the typical voter) from further feeding the fires of inflation. And Ford's family, particularly the First Lady, has been a plus on the campaign trail.

As to what his critics refer to as "blatant" use of his incumbency to garner support (a Government contract here, a high-level appointment there), we think this aspect of Ford's drive has been overrated. In fact, the highlighting of the matter by Reagan and the press may have further strengthened the image that Ford is much smarter than his critics care to admit. To the typical voter, GRF is acting more like a President -- it's something the American people expect and do not criticize.

The Democrats. In Florida, the thinning of the ranks continued, this time with "Mr. Spoiler" himself perhaps coming a cropper. Terry Sanford and Lloyd Bentsen dropped out before the primaries. For all practical

purposes, Massachusetts marked the end for Birch Bayh (who "suspended" campaigning), Fred Harris, Milton Shapp, and Sargent Shriver.

"Mr. Spoiler" is, of course, George Wallace, who saw one of his strongest states in 1972 (when he carried every county) turn out a plurality of Democratic votes for the surprising Jimmy Carter. Wallace can still go to the Democratic Convention in July with a sizable number of delegates, but he expected to win in Florida and the threat of a third-party candidacy has been greatly reduced, if not eliminated. Earlier speculation that Wallace would take at least half of the delegates from the South has now been lowered to about a third. Unless he can make up considerable ground elsewhere, which is highly doubtful, Wallace's influence on the platform and selection of the vice presidential nominee should be reduced.

We refuse at this stage to use the "front-runner" tag for any Democrat, even though Carter has the most delegates (but still only about 5 percent of the number needed for nomination). Instead, the voter attitudes and tallies growing out of the three major primaries point to three major contenders -- Carter, Henry Jackson, and waiting more or less patiently in the wings, the Happy Warrior himself, Hubert Horatio Humphrey. The primaries have convinced us that the New Left Politics has, at least for this election, lost its steam. Without the Vietnam War, the left wing of the Democratic Party simply does not have a broad enough political base or average liberal voter support to mount a respectable challenge. A "centrist" Democrat clearly has the best chance of Party acceptance. These factors are working against front-running liberal Morris Udall.

Conclusion. If Reagan is all but finished and the Democrats still face one of their traditional donnybrooks in selecting a candidate, the Republicans have gained another plus (on top of the improving economy) in Campaign 76. This plus stems in part from the fact that warfare within the Republican camp is likely to cease and some degree of unity achieved. Republicans will have ample time to gear up for the electoral campaign itself.

Such gearing up should include careful contingency planning. If Jackson is the Democratic nominee, foreign policy as well as basic pocketbook issues will receive considerable attention. Carter would continue to emphasize the "fresh face" in Washington and the case for a "Citizen President." He would probably also emphasize "honesty in the Presidency," but this would be a tough issue to best Ford on. If the nominee is Humphrey -- well, given his record on both the credit and debt sides of the ledger, perhaps his only choice would be to play the jobs issue for all it's worth.

In addition, with Ford as the all-but-certain nominee, the "bully pulpit" of the Presidency could be used for maximum political mileage. This is especially true if economists, now remarkably united, prove right in forecasting the months from now to November as a period of more or less steady improvement.

At this admittedly early stage of the game, Republicans in general and Gerald R. Ford in particular are clearly in the stronger position.

decades. But these advocates failed to note that in an advanced and affluent economy, such as our own, a growing percentage of annual investment has to go to replacement and modernization of existing facilities (this is in contrast with most of our major competitors abroad). Moreover, the steadiness of the ratio is misleading. Growth of the labor force in the past decade was almost twice that of the preceding 10 years; the result is that new capital invested per worker, in real terms, declined sharply. This last point is especially important, since it is the ratio of capital to worker that is crucial in enhancing productivity and contributing to higher real wages.

Moreover, the "full employment," scenario for fostering adequate capital formation has run into at least two important snags. First, there are few experts who believe that "full employment," if defined as 4 percent, can be reached without igniting the fires of a violent demand inflation -- a development which would blow the whole ball game. And, because of the fact that inflation tends to reduce the real burden of such debt, a business community already saddled with a heavy load of long-term debt would be tempted to go further in that dangerous direction. Second, financial markets, strongly disturbed by the last round of double-digit inflation, would be even more severely disrupted by the return of inflation.

Some of the proponents of the "full employment" scenario constructed econometric models for the years ahead which included another highly debatable assumption: That the U.S. Government could consistently, in those good years, run a surplus in its budget. We hope these people are right, but past experience is most discouraging, and it would be foolish to base future policies on so questionable an assumption.

It is perhaps this last assumption -- that all that is necessary to assure adequate capital formation is for the Federal Government to run surpluses in good years -- that has caused raised eyebrows on the part of politicians. The long-run promise of the new budget process notwithstanding -- and this is its crucial year of testing -- most politicians are fully aware that with deficits bound to occur this year and next, the United States will have operated in the red in 18 out of the past 20 fiscal years. Moreover, total surpluses in the two years when in the black, 1960 and 1969, totalled only $3.5 billion; the deficits over the period as a whole come to a whopping $306 billion (not to mention billions upon billions in "off-budget" financing).

This has meant that the Federal Government, whose financial needs will always come first, has been a major consumer of the very savings that are necessary to support capital formation. There is therefore every reason to bring Federal spending under control, reduce the deficit and eliminate it over the full period of the business cycle (i.e. surpluses in good years to offset deficits in bad years). This would reduce the credit market pressures and "crowding out" that inevitably result from so huge and domineering a presence. (The term "crowding out" has been misunderstood. It need not apply to outright failure of non-Federal borrowers to obtain funds, but also to their ability to do so only at higher interest rates and in scaled-down amounts.)

As to tax actions to promote capital formation, fundamental changes will probably have to wait. The time and extent of the actions depend to a considerable extent on the occupant of the White House in 1977, the make-up of the 95th and 96th Congresses and the conclusions of a special task force from the House Ways and Means Committee now studying the problem.

However, given the gratifying progress to date in selling the case, tax actions to promote capital formation are, in our view, on the way. But it's somewhat like the typical commuter's view of the Long Island Railroad: Sooner or later his train will arrive at the station -- he just doesn't know when.

A GLANCE AT THE CRYSTAL BALL

In early 1975 your editor peered into the crystal ball and produced some 21 predictions for the year. Last week, with some trepidation, we re-checked that list and were pleasantly surprised -- 15 of the predictions turned out to be winners. All of which encourages us to review the outlook and once again play "fools rush in," this time for the remainder of 1976.

On the economic side in early 1975, we predicted recovery to begin by midyear, unemployment above 8½ percent for one or more months, interest rates generally to continue their decline, and housing starts to bottom out in the Spring. All of these were pretty much on the mark. The stock market advance which we predicted for last year was delayed until 1976, partly because (in contrast to WER), so many economists were predicting "gloom and doom."

On the political side, we correctly predicted that the Federal tax cut would include reductions for business; that the Democratic Caucus would fail to develop the cohesiveness necessary to "run" the House; that Congress would "speak loudly and carry a small stick," with rhetoric far exceeding the output of business-clobbering legislation that many were predicting; that wage-price controls would not be adopted in 1975; and that Rep. Morris Udall of Arizona would emerge as a major liberal contender for the Democratic Presidential nomination.

We erred in predicting higher energy taxes, a step decisively turned back in the House of Representatives last summer. But as to depletion, we correctly predicted the exemption for so-called independent producers.

Enough on 1975. What's in our crystal ball for the rest of 1976?

(1) The economy will continue to advance steadily, with rising employment and declining unemployment. The rate of economic advance might well pick up if the surge in consumer confidence spills over to the business sector, thereby stimulating higher spending for inventories and capital equipment.

(2) The inflation rate will continue to slacken, but the degree depends to a considerable extent on the frequently unpredictable food and fuel sectors.

(3) Short-term interest rates will rise further. Long-term rates are likely to stay within a relatively narrow band, with diminishing inflationary expectations offsetting the upward forces emanating from economic recovery.

(4) After some continued backing and filling, the stock market will break through 1,000 and hold there for some time.

(5) Congress will complete most of its legislative work by mid-year, thus freeing much of the summer and early autumn for campaigning.

(6) Another significant debate on tax reform will occur, this time in the Senate, which is to take up the so-called "reform provisions" of the House-passed bill after the April recess. The House-passed measure is likely to be toned down in the Senate.

(7) Individual tax cuts will be extended and Senate Finance Committee Chairman Russell Long (D-La.) stands a fair to middling chance of substituting an "alternative" minimum income tax for the existing "add-on" tax and sweeping some of the specific "anti-shelter" items in the House bill into the new minimum tax.

(8) Although not an idea whose time has fully come, tax changes to promote badly needed capital formation constitute an idea whose time is coming (as noted in the preceding article).

(9) As to Campaign 76 -- see Special Insert.

Sincerely yours,

Charls E. Walker