The original documents are located in Box 43, folder "Walker, Charles E. - Washington Economic Report (2)" of the John Marsh Files at the Gerald R. Ford Presidential Library.

CHARLS E. WALKER'S
WASHINGTON ECONOMIC REPORT

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

Vol. 4, Number 6 - March 24, 1976

Dear Subscriber:

In this issue, we briefly examine the results of the North Carolina primary; raise the question as to whether potential misuse of the slippery concept of "tax expenditures" threatens the new Congressional budget process; and suggest that significant financial legislation is dead for this Congress.

CAMPAIGN 76: THE NORTH CAROLINA PRIMARY

Only two conclusions seem safe with respect to Tuesday's North Carolina primary: (1) surveys and seers notwithstanding, the American voter remains his unpredictable self; and (2) Jimmy Carter is for real.

Democrats. Jimmy Carter did not just beat George Wallace; he took him to the woodshed and laid it on with a razor strap. The Carter victory, stacked on top of his successes in Iowa, New Hampshire, Florida and Illinois, may well mean that once again as Wisconsin goes (on April 6), so goes the Democratic Convention in July. Carter has demonstrated an amazing ability to appeal to a broad spectrum of Democratic voters. If he can effectively extend that support into the liberal wing in Wisconsin -- not capturing all of Mo Udall's turf but demonstrating some significant vote-gathering ability in that sector -- then the ballgame could be over.

But, remember our first conclusion: The unpredictability of the American voter -- an unpredictability that is most evident in primaries. A relatively poor showing by Carter in Wisconsin could provide fodder for a "stop-Carter" coalition and some strengthening of "favorite son" prospects. If so, the July convention could be more than an occasion to approve a platform and rubber stamp a Carter-picked running mate.

Republicans. Sea change or simply prolonging of the agony? After four losses, "the Gipper" (Ronald Reagan) finally won one for himself. Nor was there any room to quibble about the significance of the margin; after the big win in Illinois by Gerald R. Ford, the 6-point spread was impressive.

The odds still favor Ford as the Republican nominee, but only if he campaigns hard and -- in contrast to the word from his advisers Tuesday night -- re-examines at least one aspect of his campaign. On Feb. 10, WER wrote:

> We expect foreign policy to loom as a major issue in the [Republican] nomination battle...This is because detente is increasingly unpopular in Middle America, especially with the people who are likely to play a key role in the Republican nominating process....
>
> Whether Ford recognizes his exposure to a finely honed Reagan attack on detente and SALT remains to be seen.

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Reagan finally got it all together and mounted that "finely honed attack" -- an attack that is likely to be pressed with considerable vigor in his speech on national television next week. Ford's banning of the word, "detente," from his own lexicon clearly was not sufficient; a significant portion of Republican voters want more. To many of them, that move may be viewed as rhetoric so long as the man they percieve as the architect of detente, Secretary of State Henry Kissinger, remains at stage center with respect to U.S. foreign policy.

Conclusion. Campaign 76's series of primaries has provided more extended suspense for the American people than almost anything since "The Perils of Pauline." The difference is that when a youngster saw Pauline facing certain death on one Saturday afternoon, he knew she would be back the next Saturday and ultimately victorious.

No such certainty is possible with respect to Campaign 76.

"TAX EXPENDITURES" AND THE CONGRESSIONAL BUDGET PROCESS

This second session of the 94th Congress is the crucial testing period for the new Congressional budget process. The procedure established in the Congressional Budget and Impoundment Control Act of 1974 was subjected to a successful "dry run" in the first session. Now, real bullets have been substituted for blanks and, by adjournment, the people will know whether this monumental effort to bring a rational process to Congressional budget-making will endure, or whether (as with a similar attempt in 1946) the procedures will be honored in the breach.

The procedures are now relatively well understood by business and financial leaders. By May 15, Congress must agree on a preliminary concurrent resolution setting tentative targets and ceilings with respect to spending and revenues for Fiscal Year 1977 (beginning October 1, 1976). The spending category is divided into 16 functional categories. Then, before the beginning of the fiscal year, a second resolution is to be adopted -- this one containing the final and binding totals for the coming year.

Our purpose today is not to review the procedure, although we shall follow it closely and report to you as the process unfolds. Instead, in this WER we want to call attention to recent developments which could destroy this vital reform. These developments relate to a relatively new concept, "tax expenditures." The implicit danger of too much reliance on the concept is perhaps best illustrated by testimony that Senator Edward M. Kennedy (D-Mass.) presented to the Senate Budget Committee last week. In this respect, it is only fair to note that the concept is included in the new budget legislation, which in turn "forces" (and we use the word advisedly) the Administration to publish a detailed breakdown of these so-called expenditures in each annual Budget Message.

Deficiencies in the Concept. According to Senator Kennedy, the concept of tax expenditures is "an imaginative and useful way of dealing with the impact of the tax laws on the overall budget process." Credits, deductions, preferential rates, deferrals and other "benefits" and "subsidies" in the tax laws are, in the Senator's view, " a form of federal spending." He concludes that, in many respects, including budget impact, "these tax expenditures are equivalent to direct spending through appropriations."

We disagree. In our view, this would be correct only if all income earned by individuals and businesses in this country is deemed, in the first instance, to accrue to the Federal government. If not, how can some portion of a taxpayer's income that he is "permitted" by the Government to keep and spend, save or invest as he sees fit be viewed as "equivalent to direct [Government] spending through appropriations?" That this may result from a tax preference, presumably devised by Congress

to serve public policy, makes no fundamental difference.

In a series of questions that Senator Kennedy argues should be applied in evaluating tax expenditures, one key aspect is "whether federal financial aid" is needed? Will the typical taxpayer agree with the Senator -- and others who push the tax expenditure concept -- that Government actions to permit him to keep more of the income that he himself earns are a form of "federal financial aid"? To the contrary, the whole idea would make his blood boil.

Look at the matter in another way, this time in the corporate sector. Corporate tax payments for FY 1977 are estimated at a shade under $50 billion. Suppose that the effective corporate tax rate were increased 10 percent. Ignoring disincentive effects of the higher rate on revenues, Uncle Sam's take would rise to $55 billion. But suppose the additional $5 billion is allotted to tax preferences to serve social goals (e.g., investment in unproductive anti-pollution equipment). Would it be logical to add that $5 billion to "tax expenditures"? If so, the assumption is that the corporate tax rate was approximately 10 percent "too low" to begin with.

Which brings us to the fundamental point on deficiencies in the concept. For tax expenditures to carry all the implications that Kennedy and others state that they should, one has to assume that the basic schedule of tax rates on individuals and corporations is, in some sense of the term, the "correct one." And on that issue get 20 people together and you'll get 20 different opinions.

Not that the concept is useless. Quite the contrary, carefully handled, it can be very useful to public officials and fiscal experts in analyzing certain aspects of the impact of the tax system. But this use requires great care and a full understanding of deficiencies in the data and assumptions used in assembling the figures. Few experts who have studied the matter in depth would agree with Kennedy's view that "tax expenditures" are closely akin to direct spending through appropriations.

(Despite continued warnings by experts that the 16 major categories (and 77 individual items) included in tax expenditures are not additive, Senator Kennedy and most reporters continue to sum them up, coming up for FY 1977 with a total of $101 billion. And Kennedy further compounds the error by constructing a set of charts built around the totals obtained from non-additive components.)

The Threat to the Budget Process. The misunderstanding of a very slippery concept and its potential misuse are cause for concern. But the gravity is magnified many times over if excessive reliance on the concept results in disruption of the new and promising budget process. Kennedy himself refers to the 1974 budget legislation as "probably the most significant fiscal reform ever enacted by Congress." We agree -- if it works. And it would be ironical indeed if its coffin were sealed with some nails driven home by the Senator himself.

This could happen in the months ahead if, as suggested by Senator Kennedy, the Senate Budget Committee successfully recommended to the full Senate that the Senate Finance Committee be "required" to reduce tax expenditures for FY 1977 by $2 billion. News reports indicate that Kennedy is determined to lead a fight to tighten the House-passed "Tax Reform Act" in the Senate, and he views a resolution out of the Budget Committee calling for the reduction in tax expenditures as an important weapon in that battle. If the Budget Committee so responds, and the full Senate agrees, the Finance Committee would find itself sorely pressed not to comply. If it didn't, it could well be overruled on the Senate floor.

The danger that this developing state of affairs poses for the Congressional budget process is one foreseen from the start by many Congressional veterans, some of whom are still confidently forecasting the failure of the new procedure. It is one thing for a Budget Committee to propose a resolution laying out broad spending limits in each of the functional sectors and the amount of revenues that Congress should attempt to raise on the basis of legislation approved by the tax-writing committees. But when and if a Budget Committee starts treading on the treasured specific turf of substantive committees -- then the fur is likely to fly.

For example, the Senate Budget Committee resolution should appropriately lay out the total for national defense -- but should it make recommendations as to the portion of that total to be allocated to ship-building versus bombers, MIRV's versus cruise missiles, and so on? This is the territory of the Armed Services and Appropriations Committees. As to revenues, should the Budget Committee confine its recommendations on the total that seems desirable in the light of the spending target, the state of the economy, and the desired level of deficit? Or should it specifically call on the Finance Committee for changes in the "tax mix" -- corporate versus individual, cutbacks in specific tax preferences, etc.

If the answer is the latter, then what is the role of the Finance Committee, which has responsibility for suggesting specific tax legislation?

The substantive committees, already restive under the overall power exercised by the Budget Committees, are likely to resist strongly any attempts to go beyond the general limits on spending (by category) and the desired level of revenues in total. The new budget process, already threatened from other directions, may therefore be in considerable jeopardy.

FINANCIAL LEGISLATION: DEAD FOR 1976?

Earlier, following easy passage of the Financial Institutions Act by the Senate, we rated the odds for final Congressional action on changes in the powers of banks and S&L's at 60-40. In addition, a big hubbub in the press and some criticism in Congress of bank regulation had led some pundits (not WER) to predict imminent sweeping changes in the bank regulatory structure. Now, neither action seems likely this year.

Structural Reform. As to the type of legislation represented by the FIA (e.g., broader lending and depository powers for S&L's and savings banks, payment of interest on demand deposits, etc.), the forces delaying action are easy to identify. The relevant Congressional committees (at the moment, the House Banking Committee in particular) are caught up in a crunch from the affected industries -- commercial banking, savings banking, savings and loan associations, and credit unions. The American Bankers Association and many individual banks are lobbying forcefully against the Senate-passed bill and draft legislation under consideration in the House, both of which they view as slanted strongly in favor of the thrift institutions. As to the latter, the National Association of Mutual Savings Banks and the Credit Union National Association are strongly in favor of immediate action, but the publicly announced support for some combination of reforms by S&L trade associations is only skin-deep. In fact, any legislation that would be even half-way acceptable to commercial bankers would be rejected out-of-hand by a vast majority of the S&Ls.

So there you have it. No Congressman likes to be caught in a fight among important constituents; it's a no-win proposition. And that goes double in spades for an election year. Therefore, not a few Banking Committee members simply wish the problem would go away.

Regulatory Reform. As to changes in the bank regulatory structure, the votes for major changes now are simply not there. Veteran members of the banking committees have not been swayed by the shallow sensationalism of the press (particularly the Washington Post) in handling the issue. These members know that the record of regulation is, in the light of the severity of the recession, one to be proud of, not

criticized. They also know that the regulatory agencies are working hard to improve regulatory practice and define its nature and scope in a changing economy. Furthermore, with Government regulation under attack, there is deep reluctance to centralize the Federal role in banking.

In addition, the two major sponsors of regulatory change -- Senate Banking Committee Chairman William Proxmire (D-Wis.) and his House counterpart, Rep. Henry Reuss (also from Wisconsin) -- have made at least two tactical mistakes in shaping their proposals. These are (1) abolition of the Office of the Comptroller of the Currency, and (2) stripping the Federal Reserve of its bank regulatory powers.

Although the incumbent Comptroller of the Currency has come under personal attack, the almost 5,000 national banks which he regulates generally give him very high marks with respect to fairness, a willingness to listen to the complaints and suggestions of the regulated institutions (and, if convinced, follow up on them), and stimulating innovation and progress in bank regulation and practice.

Moreover, the Comptroller of the Currency is an officer in the Treasury Department -- an institution that commands considerable respect on Capitol Hill. As a result, the strong and well-stated case against regulatory changes at this time made by new Deputy Treasury Secretary George Dixon (himself a former banker) in recent House testimony was especially effective.

Proxmire's proposal would create a new Federal Banking Commission with all of the powers now distributed among the Comptroller, the Fed, and the Federal Deposit Insurance Corporation, while Reuss would leave FDIC as is but establish a new Commission to assume the regulatory functions of the Comptroller and the Fed. In either instance, the Fed would be cut out of the action and, despite statements by some Board members in recent years that the Fed should give up regulation and concentrate solely on monetary policy, the current board is strongly opposed to such action. That applies especially to the FRB's redoubtable chairman, Dr. Arthur Burns, whose prestige in Congress in general and the banking committees in particular is awesome.

Conclusion. Although structural reform of the depository financial institutions is long overdue, the fact is that the functions of banks and S&L's are shifting anyway, responding to the inexorable pressures of technological and economic events. As an example, note the spread of NOW Accounts (the next thing to interest-bearing checking accounts) from only two states to all of New England, plus the possibility of legislative action in New York. Therefore the real pity of the delay is that the ultimate day when the thrifts will be better able to stave off outflows of deposits when interest rates are high ("disintermediation") is pushed further into the future. As in the past, it is the home buyer and the housing industry that will pay the biggest price.

As to regulatory reform, some changes may be desirable, but certainly not through crash legislation stimulated largely by irresponsible journalism. The system is working, and working well. Absent some highly disruptive banking shake-out in the near future, the 94th Congress is not likely to embark on a crusade of change for the sake of change.

HIGH INTEREST NOTES

Inflation Battle Far From Won. One of the biggest pitfalls in both politics and economics is the simplistic notion that short-run developments indicate long-run trends. The rollercoaster public attitude about occupants of the Oval Office -- with GRF the most recent example -- is an important case in point. In economics, recent trends in both consumer and wholesale prices may well be highly misleading. The inflation rate is indeed declining, thanks largely to sensible fiscal and monetary policies over the past year and the absence of uncontrollable jolts from the food and fuel sectors. But the underlying rate is as yet nowhere near the annual rate of just over 1 percent indicated by last month's CPI, not to mention the ½ of 1 percent decline in the WPI (an annual rate of 6 percent). Inflation can be whipped, but premature assumptions of success, especially if used as rationalizations for pouring on the coal to reduce unemployment overnight, can blow the whole ball game.

Musical Chairs on the Hill. Record changes in key positions seem likely to occur in Congress next January. Senate leaders of both parties are retiring, and the rumor mill keeps churning out reports that Speaker of the House Carl Albert may not seek to retain his House seat. These changes have been widely reported, but what has not been recognized is the probability of very high turnover among committee and subcommittee chairmen. Retirements are one reason. But the precedent established last year through which the House Democratic Caucus ratifies the reappointment of the existing chairmen will doubtless continue, and the strong probability is that one or more will be unseated by the Caucus (as happened to three in January 1975). Then, of course, the voters will play an important role through their decisions in Congressional races in November. For more reasons than one, therefore, the 95th Congress is going to be very, very different from the 94th.

Sincerely yours,

Charls E. Walker

APR 8 1976

CHARLS E. WALKER'S
WASHINGTON ECONOMIC REPORT

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Vol. 4, No. 7 - April 7, 1976

Dear Subscriber:

This week we review Campaign 76 in the light of yesterday's primaries; analyze the new "Humphrey-Hawkins" full employment bill from both a political and economic standpoint; and reproduce an open letter on "problem banks" to The Washington Post.

CAMPAIGN 76: LOOKING TOWARDS NOVEMBER

We believe the odds to be rising -- perhaps now close to even -- that former Georgia Governor Jimmy Carter will square off against Gerald R. Ford in the Presidential election next November 2. If so, some early thoughts about running mates and overall prospects may be useful.

A good case can be made that Carter would be the strongest candidate the Democrats could offer -- an amazing situation in the light of the fact that he was little known outside of Georgia only two months ago, when campaigning in New Hampshire got under way. But in recent years the Democratic party has always had its surprises (e.g., McCarthy in 1968, McGovern in 1972), and has not disappointed observers this time. In contrast to McGovern, Carter is no product of a narrow wing of the party; he has demonstrated amazingly broad appeal -- Wisconsin is not nearly so liberal as generally thought, but the victory over Morris Udall in that state, however narrow, is a signal accomplishment.

Carter has proved to be an adroit and indefatigable campaigner. His broad appeal would give promise of a united Democratic party in November. And as a Southerner, he would stand a good chance of winning a majority of the Southern states in the general election (where the Democratic candidate has been weakest in the last few elections).

As to the choice of a running mate, the Democrats are likely to look for a vice presidential candidate from a northern industrial state or to someone from the west coast to broaden their base of support. This being the case the early list of possibilities would have to include the following: Sen. Adlai Stevenson of Illinois, Sen. Edwin Muskie of Maine, Gov. Hugh Carey of New York, Sen. Henry Jackson of Washington, and Gov. Jerry Brown of California. If Carter doesn't have the nomination sewed up before the Convention, it appears he will be very close. The margin of victory then shifts to the uncommitted delegates, labor influence and, of course, the leading contender (which at this stage appears to be Jackson, not Humphrey). If there is to be a brokered convention this is where it will be brokered, with Humphrey playing the role of elder statesman. It is still too close to call. (Important Note: Carter and Jackson, in contrast to most other Democratic hopefuls, have refused to endorse the Humphrey-Hawkins bill, discussed below.)

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Turning to Ford and the Republicans, we do not mean to imply that he has the nomination all locked up. Texas on May 1 may yet go to Ronald Reagan, as well as some other Southern states. But more and more political experts are beginning to write off Reagan. While this may be premature, one reason is the resounding victories Ford won on defense spending in both House and Senate Budget Committees last week. Detente and Henry Kissinger are still liabilities (the latter increasingly so)with conservatives, but no one can convincingly argue that Ford himself will for a minute sit back and let the U.S. become Number Two militarily to the Soviet Union. And it is this aspect of the foreign policy-national defense debate that has the most basic political appeal.

Assuming Ford is the nominee, his choice of running mate might well be crucial in the battle for Southern electoral votes. To many, the choice is obvious: Former Texas Governor (and also Secretary of Navy and Treasury) John B. Connally. However, the atrocious but all-too-evident trait of many Americans to equate indictment with guilt, even when evidence is flimsy and acquittal swift and overwhelming, has cut down Connally's chances for elective office in 1976.

Still, look for a strong push for the VP nomination by Connally's friends at the Republican Convention in August. To be sure, Connally is a relatively new member of what has been an all too clubby party, and some of the "pro's" around GRF argue that JBC on the ticket would "revive" Watergate, since he served in Richard Nixon's cabinet and was indicted during the Watergate period (although the indictment had nothing to do with Watergate as such). But these people forget that Democrats already have sufficient tie-ins to Watergate as an issue, including Nixon's appointment of Ford as Vice President, and the latter's pardon of the former President. Moreover, supporters of the charismatic Connally ardently believe that out in the hustings and on the tube, he could dispel any distrust resulting from the trial.

As to Connally flipping toward either Ford or Reagan before May 1, with an obvious impact on the Texas primary, we have no reason to doubt his public statement that he intends to remain neutral. His reason: By remaining neutral, he will be more effective in supporting the Republican candidate in November. This is especially true if, as we believe, Ford turns out to be the candidate. Not only would Carter, as we have noted, run very strong in the South (Connally's home stomping grounds); it is also the area where the wounds from the Ford-Reagan battle would be most in need of healing.

Other leading contenders for the Republican VP nomination obviously include personable and able Tennessee Senators Howard Baker and Bill Brock.

In short, if it is Ford and Carter, each has difficult choices to make with respect to a running mate. But that decision seems to us to be much more critical for GRF than the latter. The election itself could hinge on the decision.

FULL EMPLOYMENT BY FIAT: THE HUMPHREY-HAWKINS BILL

A funny thing happened to last year's proposal by a group of distinguished citizens for "national economic planning." What originated as a serious (if highly debatable) suggestion for reducing economic disorder in the U.S. was converted into a proposed legislative mandate for achieving "full employment" at flank speed. And, not surprising in a year divisible by four, this current version of national planning may well become a major plank in the 1976 Democratic Platform and perhaps also a springboard to the Presidential nomination for "non-candidate" Hubert Humphrey.

Reference is to the newest version of "full employment" legislation sponsored

jointly by Senator Humphrey and California Democrat Rep. Augustus Hawkins. With the rhetoric stripped away, the proposed "Full Employment and Balanced Growth Act of 1976," in effect, puts the onus on the man in the Oval Office to orchestrate Federal policies aimed at reducing unemployment to a rate "not in excess of 3 percentum of the adult Americans in the civilian labor force." This goal is to be attained "as promptly as possible," but within not more than four years.

The legislation is intriguing from both a political and economic standpoint.

The Original Proposal. Before noting these political and economic aspects of the new legislation, a few words about the original concept of national economic planning are in order. Adapting suggestions by a group of leaders from business, academia and labor, (the "Initiative Committee for National Economic Planning"), Senators Humphrey and Jacob Javits (R-N.Y.) introduced S. 1795 to amend the Employment Act of 1946 by adding a new title: "Balanced Growth and Economic Planning." The bill refers to "basic structural deficiencies" revealed by simultaneous inflation and recession and also states that a lack of long-term economic planning has created "fundamental imbalances" in the economy.

Their remedy? Basically, create a three-member Economic Planning Board to compile data and develop an overall economic plan. All sorts of paraphenalia are proposed in the legislation to assist in this effort, but it is the basic goals of S. 1795 that are significant in the present context. Such goals constitute a real mouthful, for they include full employment, price stability, balanced economic growth, equitable distribution of income, efficient utilization of both public and private resources, balanced regional and urban development, stable international relations, and meeting essential needs in transportation, energy, agriculture, raw materials, housing, education, public services, and research and development. How about that?

Not surprisingly, defenders of the market system jumped on this proposal with all fours. Citicorp chairman Walter Wriston likened the approach to FDR's discredited National Recovery Administration, noting especially a quotation from Woodrow Wilson that "the history of liberty is a history of limitations of government power, not the increase of it." General Motors chief executive Thomas Murphy argued that the real problem has not been a lack of central planning; instead, it is the "erratic management of fiscal, monetary and other public policies that has kept our economic system off balance." Professor Murray Weidenbaum marked the difference between (sometimes) highly successful business planning and government decisionmaking; the former is based "on the traditional assumption that the ultimate decisions on the allocation of resources in society are to be made by individual consumers" through the price and profit systems.

Federal Reserve Board Governor Henry Wallich maintained that the success of national economic planning in Japan, largely a "consensus society," is not relevant to the U.S., where decisions are reached primarily through "competition and confrontation." And economic iconoclast John Kenneth Galbraith gave the back of his hand to the whole idea: "The notion of a three-man board of detached advisers, in touch with ultimate wisdom, ultimate science, ultimate truth, is something we are now rather too sophisticated to take seriously."

And so it went. The advocates of national economic planning of course responded to the critics. Another good, old-fashioned typically American donnybrook seemed under way, perhaps leading, if not to legislation, at least to a better understanding of the strengths and weaknesses of the U.S. economy and what to do about them. (Your editor agrees with GM's Murphy. Prevail upon the powers-that-be to give us sensible fiscal and monetary policies and watch many, if not almost all, of the other problems disappear.)

But now this worthwhile debate has evidently been brought to an end. The demise of the discussion stems directly from the recent introduction of the Humphrey-Hawkins bill (which might be referred to as "Son of Humphrey-Javits"), and the hoopla that accompanied its unveiling, ingeniously hitched to the "celebration" of the 30th anniversary of the Employment Act of 1946. And last Saturday, upwards of 1,500 demonstrators "marched" on the Capitol in support of the bill.

The Economics and Politics of Humphrey-Hawkins. Some time in the future athletes may well run a 3-minute mile -- but it is doubtful that such monumental progress can be achieved in this century. The basic economic fallacy of the Humphrey-Hawkins bill is that its stated goal of 3 percent unemployment within four years -- barring early massive and successful structural improvements in labor markets -- is achievable only at the cost of re-igniting the roaring fires of demand inflation. As a result, the 3-percent target, if achieved at all, would be attained only through policies whose other effects would inevitably cause another recession and result in a rise in the percentage -- perhaps to a level even higher than the 8.9 percent peak in the spring of 1975. A 3-minute mile is a highly undesirable goal if it means the athlete drops dead a few feet beyond the finish line.

Some supporters of Humphrey-Hawkins point out that the 3-percent target refers only to "adult Americans." As a result, they say, the 3 percent would not be all that difficult to achieve and maintain. But what is an adult? To be sure, the current unemployment rate for men 20 years and over is below 6 percent, but the rate for women in the same age group is almost two points higher. Moreover, Senator Humphrey reportedly views 18 as the break point age. If so, these supporters might ponder the fact that unemployment in the 16-19 age group has fluctuated in the 19 to 20 percent range for the past year and the recent best performance was an average 14.5 percent in highly prosperous 1973.

Moving to political implications, the shift of emphasis in the new bill from about a dozen economic goals to one -- full employment, although the others are given some degree of lip service -- indicates that Campaign 76 may have been very much on the minds of the architects of the proposal. Suppose for example, that Congress passes the bill -- not too bad a bet, given its sponsorship by a growing number of Democrats and their heavy majority in the Congress. Suppose, also, that GRF, as he should, vetoes it, and Congress fails to override. Then the Democrats have moved ahead on what they believe to be their best issue -- unemployment.

If, on the other hand, something akin to the proposal were enacted into law, and if Republicans continued to control the White House, the four-year period for bringing adult unemployment down to 3 percent would ("coincidentally") expire in the middle of Campaign 80.

Our prediction is that the legislation stands a fair chance of Congressional passage but only a small chance of final approval over a Ford veto.

"PROBLEM BANKS": AN OPEN LETTER TO THE WASHINGTON POST

Editor
The Washington Post
Washington, D.C. 20071

Dear Sir:

On Sunday, January 11, the Post ran an 8-column, banner headline to the effect that two of the nation's three largest banks were on an "official list" of "problem banks." Notwithstanding the fact that a so-called "problem bank" is not necessarily in a shaky condition, along with the fact that the data was "stale," reflecting examinations made many months ago, the reverberations were severe.

Other papers, such as The New York Times, published similar stories, public confidence in what in essence is an exceedingly strong banking system was impaired, and in the fall-out an able and dedicated Federal bank regulator (the incumbent Comptroller of the Currency) faced the threat of Congressional action to abolish his office. In this last respect, it should be noted that students of banking view the Comptroller's policies in recent years as progressive and pro-competitive.

So be it. The press has the hammer and, when it goofs (as in this case), the public interest suffers. But at the least, fair play would seem to require an updating of the record when additional evidence becomes available.

Not so at the Post. On Friday, April 3, in its leading financial article, The New York Times reported: "INCREASE SLOWS AT PROBLEM BANKS . . . F.D.I.C. Data Indicate Total May be Peaking as U.S. Economy Recovers . . . DROP IS EXPECTED SOON." The Washington Star, which subscribes to the Times'news service, carried an abbreviated version of the same article in its Saturday morning edition on April 4.

I have searched the Post carefully for any mention of the FDIC pronouncement and have found none. The Times carried the piece on page 33, in contrast to earlier articles that made the front page -- but at least it carried it, and the same can be said for the Star.

It may be too late now for the Post to update the record. However, I am sending a copy of this letter to your "ombudsman," Mr. Charles Seib, who I hope will take note of the "balance" in the Post's coverage of one of the most sensitive areas in the economy.

Sincerely yours,

/s/ Charls E. Walker

HIGH INTEREST NOTES

Economic Worries in The White House. Even with unemployment at a historically high 7 1/2 percent, White House economic types with political savvy are bound to be wishing that (assuming GRF is the nominee) the election were just over the horizon, rather than seven months away. (The reason is the disturbing tendency for Murphy's Law to operate in the 1970's ("if anything can go wrong, it will"). Danger #1 on the economic front -- a prolonged teamsters' strike -- has apparently been averted. But disruptive events (including strong protectionist pressures) could erupt from abroad; New York City is by no means out of the woods; the American people still haven't faced up to the energy crisis; and (although very unlikely to occur before the election) bottlenecks, with resultant shortages, could occur in some key industries. Couple this with the fact that the recent spate of economic news has, from GRF's standpoint, been almost too good to be true, and the reason White House types wish the election were sooner rather than later is apparent.

Confrontation on Tax Reform. Last week's decision by the House and Senate Budget Committees to recommend $2 billion in new revenue for FY 1977 through tax reform almost assures the floor confrontations discussed in our last issue. Thursday's Senate Budget Committee action was followed by a public colloquy Friday among members of the Finance Committee. The latter believe that it is no more appropriate for the Budget Committee to recommend specific methods of raising revenues (e.g., income tax increases vs. "reforms," etc.) than it would be for Budget to specify the types of weapons systems to be authorized by the Armed Services Committee. If the Budget Committees win the battle as to "shaping" the tax system -- a painful process which involves long hearings and very hard work by the members and superb staffs of the tax-writing committees, the highly promising but as yet unproved Congressional budget process may well be in grave jeopardy.

Financial Legislation. Action of House Banking Committee Democrats breaking controversial financial legislation into three parts (reorganization of the Fed, structural reform, and regulation of foreign banking) is unlikely to enhance significantly the chance for any major legislation this year. The structural reform section -- by far the most important of the three -- is still hotly opposed by commercial bankers. Support by the S&L's is weak and homebuilders dislike the housing provisions. Moreover, lobbies for savings banks and credit unions are not strong enough to move the measure on their own. Sooner or later revision of law relating to foreign bank operations in the U. S. is coming, but the odds seem less than even that it will occur in a session compressed in time because of the election. The best news from the Committee was that the proposal to re-structure the Federal bank regulatory agencies was dropped.

International Liquidity and Inflation. Treasury Under Secretary for Monetary Affairs Edwin H. Yeo III hit the nail on the head recently in noting that those who blame excessive international liquidity for recent worldwide inflation are barking up the wrong tree. Said Yeo: "International liquidity developments do influence nations' economic welfare." But, he went on, the recent inflation "had its roots in unwise national fiscal and monetary policies." He concluded: ". . . monetary stability cannot be imposed on a heterogenous world by imposing a rigid monetary system -- that monetary stability can be achieved only be developing underlying conditions of stability in the major economies." Well said, Mr. Secretary; very well said indeed.

Sincerely yours,

Charls E. Walker

(Ed. Note: WER is published 24 times a year. The next issue will be published in late April or early May, after Congress returns from its Easter recess.)

CHARLS E. WALKER'S
WASHINGTON ECONOMIC REPORT

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

Vol. 4, No. 8 - May 5, 1976

Dear Subscriber:

In this issue we alert you to early efforts in Congress to raise taxes on upper-income individuals, update Campaign 76, and touch briefly on the threat of divestiture legislation for major oil companies.

WILL CONGRESS RAISE YOUR FEDERAL INCOME TAXES THIS YEAR?

With extension of an $18 billion temporary Federal income tax cut for small businesses and individuals all but certain, it is ironical that thousands of upper-income Americans may be faced with just the reverse -- at least that's the case if Senator Edward M. Kennedy and other Congressional "tax reformers" have their way. The technique? Return the 50-percent maximum marginal rate on "earned income" (salaries, bonuses, professional fees, etc.) to the 70 percent that prevailed for many years and still applies to so-called "unearned income" (mainly interest, dividends, and rent).

Background. Because of the widely held view that no one should profit unduly from World War II, the top marginal Federal income tax rate was raised to 94 percent in 1942. By 1969, it had been reduced to 70 percent. In that year, Congress voted a two-year phase-in of the 50-percent earned income maximum.

Now Senator Kennedy wants to restore the 70-percent maximum across-the-board, on all types of income, in order to assure that "high-income individuals pay their fair share of taxes." It is claimed that the move would also generate some $660 million in badly needed revenues. Moreover, he argues, one of the principal purposes of the 1969 cut in the earned income rate -- to induce corporate officials and highly paid professional people not to seek out "tax shelters" or try to convert their income into capital gains -- has not been met. To the contrary, the Senator states, "current tax shelter offerings indicate that the maximum tax is actually causing a greater Federal revenue loss from tax shelters than was the case before its enactment."

Let's take a hard look at these arguments.

Their "Fair Share" of Taxes. "Fairness" is in the image of the beholder -- a relative term interpreted differently by different people. Human nature being what it is, one might suppose that the typical low- or middle-income taxpayer (one who does not earn enough to hit the 50 percent maximum) would jump at the chance of raising taxes on people who earn more, particularly if the revenues gained could be used to cut his own taxes significantly.

But recent discussions with a wide range of working people, students and others around the country convince us that a sizable majority believes that even the highly paid doctor, lawyer or corporate chief should be able to keep at least half of every dollar he earns. We believe that those who propose to cut that amount to 30 cents have mis-read public attitudes -- that most Americans consider the 50-percent cutoff

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to be high enough, if not too high.

As to using the alleged $660 million in revenue gained to cut taxes on people in the lower brackets -- even if realized you could put the average benefit in your eye. A tax cut of $660 million for those taxpayers who fall short of the 50-percent maximum would, if spread equally, reduce individual taxes by a meager $8 annually and withholding by 15 cents a week.

A Revenue Gain of $660 Million? But even though the increase in the maximum tax on earned income would do practically nothing for other taxpayers, $660 million in additional revenue is not to be sneezed at -- not when Federal deficits are running in the $50 to $75 billion range. But just how good is the revenue estimate? We're not suggesting any "rinky-dinking" of the figures; for the first year or so after raising the rate to 70 percent, the estimated revenue gain might well be realized.

But it is highly doubtful that such gains would continue for long. People are not stupid. They will adjust their behavior to the new rules of the game. Some who now tend to let up in their efforts to earn additional income in the latter part of the year -- when they become tired of Uncle Sam claiming half of every additional dollar earned -- would reach that point earlier and find the impulse much stronger under a maximum rate that is some 40 percent higher than now prevails. If so -- and human nature supports this judgment -- the relative amount of taxable income generated with a maximum rate of 70 percent would be less than with a 50-percent limit. It would therefore raise less and less in tax revenues as the years went by.

But that's not all. Even the most ardent advocates of tax reform admit that certain preferences will remain in the tax law. For example, the exemption for interest on State and local bonds is politically unassailable. For a person in a 50-percent bracket, a tax-free yield of 7 percent is equivalent to a taxable yield of 14 percent. But if in a 70-percent bracket, the taxable equivalent jumps to over 23 percent. Undoubtedly, therefore, some of the high-income individuals who have deserted the municipal securities market in recent years would return if the 70-percent maximum were restored. This would be good news for State and local governments -- but it would offset some of the projected revenue gain from the amendment.

Moreover, to the extent other so-called "tax shelters" remain available -- and they will -- they would be sought out more eagerly by high-income taxpayers who could keep only 30 cents of their "marginal" dollars as contrasted with 50 cents today. A claim by Senator Kennedy that "the maximum tax is actually causing greater Federal revenue loss from tax shelters than was the case before its enactment" makes no allowance for the inflation that has driven up nominal incomes since 1969. Here the figures on growth of tax shelter activities (particularly syndicates) can be highly misleading. Common sense must be used, and it tells us that the higher the marginal rate, the more aggressive high-income taxpayers will be in seeking out "shelters."

Tax All Income the Same? One tax expert who supports Kennedy's proposal told WER he does so because all personal income should be taxed at the same rate. As to ordinary income (i.e., excluding capital gains) we fully agree -- and this was the goal of leading Congressional tax-writers in 1969. One reason is that the adjective, "unearned," is inaccurate. Dividends, interest and rent, so classified and therefore subject to the 70-percent maximum, come from investment of savings -- much of which is saved out of "earned income." Anybody can tell you that saving money is hard work. The shorthand distinction is therefore false and should be stricken from the statute. Almost all income, except gifts, is originally earned.

But fairness can as easily be served -- and each taxpayer allowed to keep at least half of every dollar of income -- by reducing the maximum rate on "unearned income" to 50 percent. This would further reduce the drive for "tax shelters" on the part of some high-income taxpayers. Precisely this approach was approved by the Ways and Means Committee in 1974, but was not finally enacted.

Conclusion. The proposal to raise the maximum rate on "earned income" from 50 to 70 percent appears to have little support in the Senate Finance Committee, which is now "marking up" the tax bill. Chairman Russell Long (D-La.) is adamantly opposed to it. Therefore, the real battle will erupt when the bill reaches the floor, probably in June. Senator Kennedy and other "reformers" are expected to try to substitute all or part of their own long list of "tax reform" measures for the Committee proposal.

It's too early to forecast the outcome of that battle -- but upper-income taxpayers have a great deal at stake.

CAMPAIGN 76: TEXAS, INDIANA AND THE DEEP SOUTH

When the quadrennial Presidential primary season begins, as well as at various key stages, political pundits give lip service to the traditional boilerplate -- "no one can possibly foresee the outcome," and "the only thing we can be sure of is plenty of surprises" -- then usually proceed to lay out what they believe to be strong probabilities if not certainties. Thus, before New Hampshire, a fellow named Jimmy Carter was widely expected to fall aside in the early contests and the conventional wisdom had the Democratic candidate being selected in New York in July by a so-called brokered convention.

And, after successive victories in New Hampshire and Florida, incumbent Gerald R. Ford was chalked up as a sure-fire winner at the Republican convention in Kansas City in August. Moreover, given the favorable trend in the economy, Ford's chances for victory in November seemed to be relatively good.

Now look at the picture. Carter may well have a lock on the Democratic nomination that even a ton of TNT couldn't break. And Gerald Ford is behind Ronald Reagan in official delegate strength -- fighting for his political life -- obviously in need of a transfusion for his suddenly faltering campaign.

Democrats. Jimmy Carter is in the very position that many were forecasting for GRF after the latter's first two victories. Carter can pay much less attention to the quest for the nomination, ponder the selection of a running mate, and start now to campaign against the ultimate Republican nominee. He possesses something that is truly a luxury in a Presidential campaign -- time. Time to get a little rest. Time to sharpen up his positions on the issues (his economic brain trust covers a wide spectrum, but includes some real luminaries from the profession). Time to help shape the developing Democratic platform. Time to avoid political or other blunders in sifting through the backgrounds of potential running mates. Time to plan his strategy against the Republicans. And time to make points (already started) against the Republicans. Since Carter seems to be the "only game in town" on the Democratic side, he can claim an amount of media exposure in the pre-convention period that only an incumbent could get under other circumstances.

Moreover, Carter's demonstrated appeal and his solid Southern base indicate that he is the strongest candidate the Democrats can offer in November, particularly if they balance the ticket.

Republicans. Now behind in the official count of committed delegates, GRF has got to realize that he's been doing something wrong. Losses in the South are not surprising, although the Texas wipe-out was a shocker to all observers. The real clincher with respect to Ford's problems is Ronald Reagan's narrow but definitive victory in midwest Republican heartland, Indiana, where GRF would be expected to run strongly.

"Wednesday-morning" advice as to the "transfusion" needed in the Ford campaign is flowing fast and thick. What is crystal-clear, however, is that GRF has not been able to capitalize fully on the trend in the economy, a real plus for him, and has allowed Reagan to gain the offensive on what might be referred to as the issue of "American prestige and power." This is broader than the argument of U.S. military power vis-a-vis the Russians -- it includes all facets of the deeply held belief, particularly among Republicans and the conservative Democrats who have been "crossing over" to vote for RR, that Uncle Sam has been "kicked around" long enough and it's time somebody stood up for what they deem to be the best country in the world. This is not simply national chauvinism; it is a firm conviction that leaders in Washington have been selling America short.

Conclusion. Still, the battle is far from over. Ford may make the necessary transfusion and RR's momentum may be slowed. But regardless of the ultimate winner, the significant point for November is that for once the party out of power has time to stop, ponder and plan, instead of engaging in divisive in-fighting for the nomination. And for the incumbents -- this time the Republicans -- the situation is precisely the reverse.

Politics. 'Tis a strange world indeed.

WILL CONGRESS BREAK UP THE OIL COMPANIES?

Leaders of the nation's major oil companies are frustrated over the Congressional drive to break them up, and they have legitmate cause for concern. The great majority of economists will tell you that divestiture would inevitably raise prices for the consumer. But the consumer himself doesn't believe this, partly because of the miserable job the media performed in reporting and analyzing the energy crisis of 1973-74 and partly because some politicians are attempting to run against the oil companies in this election year. Newspapers, and especially TV, convinced viewers that multinational oil companies, not the international oil cartel, were the culprits. Until this attitude is reversed -- by bringing the reasoned views of respected economists to public and Congressional attention -- divestiture will remain a continuing and frightening threat.

We do not expect such legislation to be enacted this year. A divestiture bill has been approved by the Anti-Trust Subcommittee of the Senate Judiciary Committee and it could be passed by the full Committee and even conceivably by the Senate. However, even if such legislation passed both houses it would be a prime candidate for a Presidential veto.

But in spite of the cautiously optimistic legislative outlook for this year, oil industry leaders are concerned that public emotions will continue to be used against them. If not stopped, this trend could ultimately spell trouble, not only for the oil industry but, for other industries which might follow oil into the spotlight.

Sincerely yours,

Charls E. Walker

Charls E. Walker's JUN 7 1976

WASHINGTON ECONOMIC REPORT

Analysis of Economics and Politics On the Potomac

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

Dear Subscriber:

With Super-Primary Day next Tuesday, we reserve comment on Campaign 76 in this issue -- except to say that the logic of a Humphrey-Kennedy ticket, as advanced by some members of the "Anybody But Carter" coalition, makes little sense to us. The ticket would lack ideological balance, since both are politicians of the "New Deal-Fair Deal-New Frontier-Great Society" stripe. Chappaquidick might well come out of the closet, especially in the light of peaking public concern about peccadillos among politicians. And Southerners would, with "favorite son" Jimmy Carter rebuffed, turn in large numbers to the Republican side of the ticket in November. Therefore, the prospects for a Democratic victory might be significantly reduced.

With our comments on Campaign 76 thus suspended, in this issue we discuss the coming Senate battle on tax reform and question whether the Federal Reserve can "control" interest rates.

TAX BATTLE LOOMS IN SENATE

At least two timely questions can be asked about the House-passed "Tax Reform Act" (H.R. 10612), as all but finally approved in revised form by the Senate Finance Committee last week. First, how significant are the changes effected by Chairman Russell Long and his fellow Committee members, usually by lopsided margins? Second, what will happen on the Senate floor, where "tax reformers" are geared to wage a strong fight to "toughen" the measure?

The Revised Bill. The Finance Committee revisions include more pluses than minuses. This is especially notable since revision of Federal income taxes in an election year is a risky undertaking. As Senator Long so aptly put it, to the typical voter tax reform usually means: "Don't tax you; don't tax me; tax that fellow behind that tree!" Which is another way of saying what WER has consistently maintained: "Tax reform," in the image of the typical taxpaying voter, is, practically speaking, unattainable. This is because he views "meaningful reform" as synonomous with a big cut in his own Federal tax bill -- a cut offset by increases on corporations and Fat Cats. But business is already overtaxed, which impedes badly needed capital formation. And there's simply not much fiscal blood in the Fat Cat turnip. "Loophole-closing" to provide funds for big tax cuts for middle- and low-income taxpayers is therefore an impossible dream. Still, most taxpayers do not realize this, and not a few people running for Congress make little effort in an election year to educate them. Quite the contrary. Consequently, both the Senate Finance and House Ways and Means Committees are to be commended for their generally realistic approaches to a misunderstood and politically dangerous public policy issue.

Pluses and Minuses. The provisions of the Committee-revised H.R. 10612 have received wide publicity. They include extension of some $20 billion in individual and small business tax cuts, originally enacted in 1975 as an anti-recessionary measure and now scheduled to expire June 30. On the structural side, the measure includes a vast smorgasbord of both "tighteners" and "looseners," which, taken together, would raise about $1 billion in revenue for fiscal year 1977 (which begins October 1, 1976).

Among the structural changes, the major pluses stem from a combination of what did and did not happen. In moving to promote capital formation, the Committee voted permanent extension of the 10-percent Investment Tax Credit, now scheduled to drop back to 7 percent at the end of this year. It also recommended a first step toward making the ITC "refundable," that is, available to businesses whose taxable income is insufficient to permit full use of their earned credits, if at all. We say "first step," because refundability would be delayed until the end of the existing seven-year carryforward period. Given prospective interest rates, this almost halves the value of the refunds.

A major plus resulting from what did not happen was the Committee's refusal to go beyond the House-passed provisions relating to foreign-source income of U.S. businesses. On the minus side, exporting companies were disappointed by Committee acceptance (with some modifications) of the House-approved cutbacks on Domestic International Sales Corporations, a step that will harm the nation's already deteriorating trade position. And a minus of possibly great significance was Committee acceptance of a proposal by Senator Abraham Ribicoff (D-Conn.), as amended by Senator Bill Brock (R-Tenn.) which could sharply increase taxes on income earned by U.S. firms in countries engaging in economic boycotts of the goods of other countries, as in the case of the Arabian boycott of Israeli products. The significance of the amendment can be assessed only when the precise language becomes available.

With respect to individuals, a strong plus was the refusal of the Committee to raise the maximum rate on "earned income" (the "MaxiTax") from 50 to 70 percent, as recommended by Senator Edward M. Kennedy. In fact, the Committee moved significantly and properly in the opposite direction by extending the 50-percent MaxiTax to so-called "unearned income" no greater in amount than the taxpayer's earned income, up to a maximum of $100,000 per year. A distinct minus was the failure to fashion an "alternative" minimum income tax as a substitute for the existing "add-on" arrangement. Moreover, the continued subjection of capital gains to the minimum tax works against capital formation.

On to the Senate Floor. On balance, we believe that Chairman Long and his Committee associates improved on the House-passed bill. But unlike in the House, where floor amendments to tax bills are traditionally limited, on the Senate floor anything goes, absent "unanimous consent" or other procedures which are highly unlikely in this instance. That a "shoot-out" is highly likely is indicated by the fact that Senator Kennedy is reported to have drafted a comprehensive substitute measure, based on his testimony before the Committee. As we've noted earlier, Kennedy's proposal would hit business hard by repealing the Asset Depreciation Range (adopted in 1971 to spur capital formation) in favor of a complicated liberalization of the Investment Tax Credit, by eliminating DISC's, and by forcing immediate taxation of unrepatriated earnings of foreign subsidiaries of U.S. businesses. And Kennedy would not stop there; he would as noted, sharply increase taxes on many professional people and corporate officials by eliminating the MaxiTax.

The outcome? We've run into far too many businessmen and individuals with high earned incomes who believe that the lopsided rejection of the Kennedy proposals in the Finance Committee portends a similar fate on the Senate floor. But the fact is that the Committee is much more conservative than the Senate as a whole -- so much so that the liberals on the Committee made only half-hearted attempts to inject more of their "reform" ideas into the legislation, evidently preferring to wait for the more favorable atmosphere on the Senate floor. In addition, the Congressionally approved revenue target for the coming year includes $2 billion to be raised by reducing "tax expenditures" (a euphemism for "tax reform"). Senate "tax reformers" are likely to argue strongly that the revised bill falls far short in this respect, and therefore is inconsistent with the new Congressional budget process.

It should also be recalled that last year, as part of the anti-recessionary Tax Reduction Act, the Senate voted overwhelmingly to go even further than the Kennedy proposal in raising taxes on foreign-source income, even though no hearings had been held on the subject in Committee (the action was sharply cut back at the insistence of House conferees). History could repeat itself, especially in an election year. And the imminence of the election might also broaden support for repeal of the MaxiTax.

Conclusion. The tax battle on the Senate floor will be the biggest show in town in a week or so. With the economy still below par and capital formation badly needed, it seems strange indeed that strong efforts will be made to raise taxes on many business and professional people and on the business sector in general. But efforts will be made -- and at this moment, we're not about to predict that those efforts will be turned back.

CAN THE FED "CONTROL" INTEREST RATES?

Federal Reserve Chairman Arthur Burns and his companions who help mold monetary policy are between a rock and a hard place. Too tight a policy could stint the recovery. Too easy a policy might be attacked (as in 1972) as being politically motivated, not to mention the probability that it could push the economy back toward double-digit inflation. While it's easy enough to quote Harry Truman ("If you can't stand the heat, stay out of the kitchen"), the fact is that money won't manage itself; somebody has to make the decisions that ultimately determine the rate of monetary growth. Given the current dilemma, a pretty good case can be made for the contention that, at this moment, the Fed should be pitied rather than censured.

But censure is what Fed officials are receiving from those who believe that 1) trends in interest rates are all important in determining the course of the economy; and 2) the Fed can easily control rates by varying the amount of new reserves ("high-powered" money) it injects into the banking system. Such reserves are "high-powered" because they provide the base for expanding bank loans and investments, which in turn generate additional deposits, the basic component of the money supply. Since no one has repealed the law of supply and demand, why shouldn't the Fed help assure continued strong recovery by pumping in plenty of bank reserves? Won't this result in more money and, since interest is the price for "renting" money, a decline in interest rates?

This line of argument is simple, logical -- and wrong. For the fact is that during a strong business recovery superimposed on the most inflationary period since the Civil War, strong steps by the Fed to augment bank reserves will probably make interest rates rise, not fall.

The reason is that, in addition to adding to the supply of money available for lending, increases in bank reserves also swell the amount of money available for spending -- after all, that's what people who borrow money want to do. If the money available for spending rises faster than the capacity of the economy to turn out new goods and services, we end up with "too much money chasing too few goods." Inflation accelerates. And in recent years we have "re-learned" a basic economic truth: Galloping inflation means sky-high interest rates. Borrowers rush in to get money to spend today in order to beat tomorrow's price increases. Lenders are reluctant to part with dollars that will deteriorate in real value before repayment. So, lenders demand higher interest and borrowers, in their eagerness to spend, comply. The fact that the inflation caused by a rising money supply is likely to occur some months later is irrelevant. As has been demonstrated repeatedly in recent years, credit markets have come to discount almost immediately the ultimate impact of inflationary actions.

To repeat the original question: Can the Fed "control" interest rates? If by "control" is meant "fine-tuning" on both a short- and long-run basis, the answer is clearly "No." But this is not to say that Fed actions have no influence on interest rates; quite the contrary. Today's paradox is that, given the backdrop of inflationary experience and expectations, excessive injections of funds into credit markets will cause interest rates to rise rather than fall. And to further confound those who urge the Fed to keep interest rates from rising, or actually bring them down, the only sure-fire way of doing so is to starve the economy for money and induce recession, thereby causing a contraction in the demand for credit. No one wants that.

The better part of wisdom is for the Fed to concentrate on maintaining a stable and reasonable rate of monetary growth, accept the increases in short-term interest rates that are inevitable in a strong business recovery, and through these actions advance the day when inflation -- and therefore high interest rates -- are no longer a threat to our economic well-being.

HIGH INTEREST NOTES

Energy. With the OPEC embargo moving toward its third anniversay, the U.S. is scarcely closer to a long-run solution to its energy problems than at the outset. Those who critically jest that current policy seems to be based on the hope that we shall continue to experience mild winters are not far from the mark. Whom to blame? In part, the Administration, for proposing a much too complicated plan, one with too many moving parts, in January 1975. In larger part, the Congress is responsible for refusing to reorganize its fractionated jurisdiction in such manner as to evaluate alternative approaches, and for shying away from tough but inevitable decisions (e.g., freeing prices for natural gas). But in greatest measure, the media deserve the blame -- for convincing voters across the land that the original crisis resulted not from a group of energy-rich countries creating an artificial shortage, but from the "greed" of the giant oil companies. To add to the distress, energy is receiving little constructive attention in Campaign 76 -- and it won't, so long as it still appears to be plentiful, even though much more expensive. Maybe next winter won't be mild.

The "New" Federal Reserve Board. Crucial to the solution of the monetary policy problems discussed above is the question of who makes policy. In recent years, not a few observers -- including many economists -- have become increasingly concerned by domination of the Federal Reserve Board by economists (until recently, five of the seven members were members of that profession). Not that economists are less qualified than others to make the tortuous decisions facing central bankers, but the case for diversity of background for any multi-member policy group is strong. Congress has recognized this; the Federal Reserve Act states that the President, in appointing members to the Board, "shall have due regard to a fair representation of the financial, agricultural, industrial, and commercial . . . interest of the country." Presidents Kennedy and Johnson began the swing toward economist members, but now GRF has reversed the trend. Although the count is still 4 to 3 in their favor, Ford has set a new trend in the appointment of Stephen S. Gardner (a commercial banker), Philip C. Jackson, Jr. (a mortgage banker), and David M. Lilly (an industrialist). Our guess is that the next nominee will be to the "agricultural seat," vacant for several years.

Sincerely yours,

Charls E. Walker

Charls E. Walker's WASHINGTON ECONOMIC REPORT

Analysis of Economics and Politics On the Potomac

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Dear Subscriber:

In this issue we evaluate what appears to be unreasonable fear in the stock market of a return to tight money and ultra-high interest rates and discuss the problems encountered by President Gerald R. Ford in seeking the Republican nomination, with special emphasis on economic factors. High Interest Notes take another look at the "Humphrey-Hawkins" jobs bill; speculate on the significance of the California vote on nuclear energy; and present our thoughts on the $5.3 billion in funds which the Group of 10 industrial nations are providing to help support the British pound.

THE STOCK MARKET AND TIGHT MONEY: AN IRRATIONAL FEAR

Performance of the stock market has disappointed many this year. Despite rising corporate profits and a highly favorable economic outlook the market has slogged along, rising back to the 1,000 level only yesterday -- still far short of expectations. Why the weakness?

A Mark Twain anecdote may help explain much of it. He told about the cat which sat on a hot stove lid. Badly burned, the cat jumped high in the air. Twain noted that the cat, quite logically, never sat on a hot stove lid again. In fact, he wouldn't even sit on a cold stove lid.

And so it has been with many investors and speculators in the stock market. So fresh in their minds is the memory of the ultra-high interest rates of 1974 -- a major factor in the decline of stock prices to the lowest levels since 1962 -- that market participants seem almost hypnotized by a conviction that history is about to repeat itself. And as evidence for this view, they point to recent increases in interest rates and the clearly telegraphed intention of Federal Reserve authorities to cut back on what many observers believe has been an excessive rate of monetary growth.

Stock market forecasting is a very "iffy" business, but even a modicum of success requires a clear understanding of basic forces, especially in separating cause and effect, since fundamentals ultimately prevail. To be sure, high interest rates are the enemy of high stock prices, a relationship that has been recognized since the 18th century. The basic reason is that stocks and bonds are competitive instruments for many investors; high interest rates pull money out of stocks into bonds, and vice versa. In addition, high short-term interest rates increase the cost of "carrying" stocks by market professionals and investor-speculators who pay part of the purchase price by borrowing the money ("margin purchases"). This can be especially depressing when interest rates on loans for purchasing and carrying stocks rise to double-digit levels, as in 1974.

From all this, it follows logically, does it not, that rising interest rates will always put a damper on the stock market? Not by a long shot. The fundamental question is, what are the forces causing interest rates to rise? Three can be singled out, but only one is a clear-cut danger to the stock market.

First, expanding credit demands cause interest rates to rise naturally during a business recovery. But if the recovery is balanced, sustained, relatively non-inflationary, and accompanied by rising corporate profits and dividend pay-outs, fundamentals should sooner or later prevail and the negative impact of rising interest rates on stock prices is likely to be swamped by the basic economic trends.

Second, Federal Reserve policies can cause interest rates to rise. The mechanical aspects of such policies are best described through "open market operations," or purchases and sales of Government and other securities by the Fed in the "open market." Purchases result in an increase of "high-powered" money in the banking system which, given the fractional reserve system for supporting deposits, can then expand loans, investments and deposits severalfold. Sales have the opposite effect. Other things remaining equal, purchases enlarge funds available in credit markets and interest rates tend to fall. Sales tend to make interest rates rise. In the past, and often erroneously, the former action has been described as an "easy money" policy and the latter as a "tight " policy.

But will this type of interest rate increase hurt the market? In and of itself, yes. But suppose that, as is currently the case, the so-called "tightening" of money policy represents an effort to avoid future inflation by limiting growth in the money supply -- an effort, in other words, to avoid a situation of "too much money chasing too few goods." If successful, this should sooner or later be good for the stock market. Which brings us to the third reason for rising interest rates.

This third reason is a high rate of inflation, coupled with expectations that it will continue -- a recipe for driving interest rates through the roof. This phenomenon has long been recognized in Latin American and other countries where both inflation and interest rates have ranged to 10, 20, 30 percent, or even higher. Generations of Americans were naturally unfamiliar with the phenomenon -- until we too ran into double-digit inflation in the 1970's. As noted in the last WER, the basic reason is explained by demand and supply -- borrowers rush in to obtain money to spend today in order to beat tomorrow's price increases; lenders are increasingly reluctant to part with dollars which, when repaid, will have lost a big part of their purchasing power. So, borrowers are willing to pay more, and lenders insist on charging more. Interest rates, the price of borrowed money, shoot up.

Which brings us back to our original point. To the extent current and prospective increases in interest rates reflect (1) the normal forces of business recovery, and/or (2) Fed actions to prevent inflation-generating growth of the money supply, the stock market should be no worse off and in fact should benefit from the prospects for a longer and better balanced economic advance. But if the U.S. is on the verge of another round of double-digit inflation and its inevitable companion, double-digit interest rates, then the market has very good reason for concern.

Evidence supporting the probability of a return to double-digit inflation is slim. Quite the contrary, the prospect instead is for continuing waning of inflationary pressures, especially if the new Congressional budget process continues on its successful track, the Fed behaves itself, wage settlements through collective bargaining stay on the reservation, and early shortages of basic materials do not crop up.

There may be some good reasons for predicting future weakness in the stock market. Psychology can easily outweigh fundamentals -- for a time. But if there are good reasons for an anemic market, fear of an early return to the sky-high interest rates of 1974 should not be one of them.

Perhaps this week's market represented at least a partial return to fundamentals.

PRIMARIES, THE ECONOMY, AND JERRY FORD

Not a few observers -- including, according to the press, GRF staff and brain-trusters -- are puzzled by the all-too-evident unwillingness of a clear majority of Republicans to give the President what they view as his due: Credit for a strong but well-balanced and (relatively) noninflationary recovery from the recession he inherited. Ford's supporters argue, with considerable merit, that his insistence, backed up with key vetoes, on moderate Federal expansionary policies was just what the country needed. But, GRF supporters complain, if this is true, where were the voters in the primaries? Why is GRF almost neck-to-neck at this stage with challenger Ronald Reagan.

When Ford sacked Defense Secretary James Schlesinger, we said at the time that GRF may have made the big mistake that could cost him the nomination. Not that Schlesinger's successor, Donald Rumsfeld, hasn't done a first-rate job. He has. But in firing Schlesinger, Ford gave the appearance of being less concerned about the nation's defense posture than Middle America in general and the more conservative wing of the Republican Party in particular. Why it took Reagan so long to capitalize on this is a puzzle. But when he did, what started out as a rout by Ford turned into a real horse race.

Recognition should also be given to the ideological conservative strain that appears to be ingrained in the hard core of Republicans who make up a substantial portion of primary voters. Along with the national security issue (noted above), opposition to Big Government and fast-rising Federal spending are basic to the Republican faithful. RR capitalized on these fundamental instincts. GRF, whose record testifies to similar instincts, responded more or less in kind. But he was frequently on the defensive and in many instances simply didn't "come through." Still, the beautiful performance of the economy and the advantage of incumbency would have been thought by many to assure an easy Ford nomination. But the fact is that the economy may have been too good too early. And in economics as in politics, "What have you done for me lately?" is still the name of the game. One could almost feel the surge in consumer confidence that began in December, boosted Christmas sales, and helped push the stock market temporarily above the 1,000 level. Ford was President, so he got the credit, as his rise in the polls showed. But even though the recovery continues apace, since that time the stock market has backed and filled, earlier highly favorable (and misleading) trends in the consumer price index have been replaced by relatively large increases (especially for food), real take-home pay has dropped, and the rate of decline in unemployment has slowed. These events have taken some of the bloom out of springtime.

And, just as Ford received at least implicit credit for the strong performance of the economy in late 1975 and early 1976, so in turn does he get the "blame" for what is perceived to be a less favorable performance since that time. This and the basic instincts of the Republican "faithful", and Reagan's superior campaigning ability (including almost flawless use of television) have resulted in a near-even delegate count for the contenders.

We are not among those who believe the issue will hang in the balance until the August convention. In a two-candidate contest, a first ballot victory is much more likely, and the tilt of that vote should be apparent within a few weeks. The value to the incumbent of a Peace, Prosperity and Integrity campaign should give GRF the edge. But RR's rout of Ford's forces in Missouri raises doubts.

Like we said, it's a horse race.

HIGH INTEREST NOTES

"Humphrey-Hawkins": Going Nowhere? The "Full Employment and Balanced Growth Act of 1976," otherwise known as the Humphrey-Hawkins bill (discussed in detail in WER on

April 7) may be dead as a dodo. One reason is that respected Democratic economists -- notably former Budget Director Charles Schultze, of the Brookings Institution -- have sharply criticized the measure, arguing (as we did from the start) that its goal of 3 percent unemployment of the adult labor force within four years can only lead to a very high rate of inflation. At least as important, Democrats are increasingly confident of capturing the White House next year, and their standard bearer has been less than enthusiastic about the legislation, endorsing a revised version of it only reluctantly. This could in part reflect what many people believe to be a basically conservative bent in Carter. It could also stem from political pragmatism. If nominated and elected, Carter, and not a Republican, would be charged with carrying out the legislation's mandate -- with the completion date for this impossible task being 1980, the very year when Carter would be seeking a second term. If legislation does emerge, it is likely to be a watered down version of the basic proposal.

Californians Vote for Energy. The most significant vote to come out of primary Superday may well have been the resounding 2-to-1 defeat by Californians of an "initiative" that could have resulted in safety standards that would have all but prohibited construction of nuclear power plants. It would be too much to say that the tide has been turned against the national movement which, on the basis of the skimpiest of evidence, would risk jobs, growth and the nation's living standards by hamstringing the development of a clean and effective energy source. But for Californians, who have frequently "taken the lead" with respect to so-called quality of life issues, to vote as they did is perhaps indicative of a return to sound public thinking in meeting our energy problems.

New "Bundle for Britain." Those observers who interpret the $5.3 billion of bailout funds put forth for the British pound by the Group of 10 major industrial nations ($2 billion from Uncle Sam) as a return to pre-floating exchange rate rescue operations are barking up the wrong tree. The funds have been advanced on the conviction that speculators had driven the pound significantly below its true value and that the U.K. government would take effective steps to bring its budget under control -- indispensable medicine if Britain is to recover even a meager part of the economic strength it has lost in recent decades. Some optimism may be engendered by the fact that the advance is for only six months, after which, failing convincing steps, the British will have to subject themselves to the none-too-tender mercies of the International Monetary Fund for additional credits. As to fundamental actions, we agree with the Wall Street Journal that a pledge to reduce monetary growth in Britain from the double-digit range to no more than 5 percent annually would force the budget discipline which the Group of 10 hopes to see and Britain cannot do without.

Sincerely,

Charls E. Walker

Charls E. Walker's
WASHINGTON ECONOMIC REPORT
Analysis of Economics and Politics On the Potomac

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JUL 6 1976

Vol. 4, No. 12 - July 1, 1976

Dear Subscriber:

In this issue we provide an interim report on the Senate debate and voting on the Tax Reform Act of 1976 and discuss at least one of the factors impeding business investment in new plant and equipment, as brought out in a recent colloquy between your editor and Senator Hubert H. Humphrey.

THE TAX BATTLE IN THE SENATE: AN UPDATE

There are legislators and legislators -- and then there is Senator Russell B. Long (D-La.). Master of both substance and procedure, the chairman of the Senate Finance Committee has over the past two weeks attracted sufficient votes to beat the self-acclaimed "tax reformers" on every major issue to come up in H. R. 10612, the House-passed Tax Reform Act of 1976.

Since final Senate work and the Senate-House conference on the bill are postponed until after July 19, when Congress returns from its July 4th-Democratic Convention recess, WER will hold back predictions as to the final shape of the package. Still, several aspects of the Senate battle to date are well worth noting.

Item: Both politicians and press pundits,who proclaim that Long's victory in fighting off the Senate Budget Committee's effort to prescribe how $2 billion in revenues should be raised -- i.e., by reducing "tax expenditures" (translation: "tax reform") -- was in effect an almost lethal blow to the new and as yet unproven Congressional budget process,are talking through their hats. As WER noted earlier, the real danger to the process stemmed from the decision of the Budget Committee to tread on the turf of the Finance Committee by recommending not just the amount of revenue to be raised, which is quite appropriate, but also the manner in which it should be raised, which is not within the Budget Committee's jurisdiction.

We were reasonably sure Long would win this battle, for the simple reason that the Budget Committee was trying to prescribe legislative detail and he could therefore expect support from influential members on other substantive committees. After all, if the Budget Committee can tell Finance how to raise revenues, why can't it tell Armed Services which airplanes to purchase, Public Works or Interior which dams to build or parks to establish, Commerce which modes of transportation to subsidize -- and so on. By bringing this issue to a head, and winning big, Long struck a strong blow for the Congressional budget process, not vice versa.

Item: After a long period of relative ineffectiveness with respect to Congressional processes, the corporate community finally got off its collective duff and worked hard and effectively to prevent Senate adoption of punitive tax actions that would severely impede capital formation and competitiveness of U. S. firms in world markets. For example, as recently as March 1975, the Senate voted 3-to-1 to eliminate so-called "deferral" of taxes on the profits of foreign subsidiaries of U. S. firms. Despite tremendous pressure from organized labor -- which consistently and masochistically wants to bite the hand that feeds it, the provider of jobs and payrolls -- Long and his supporters beat the proposal to repeal deferral (offered as in the past, by Democratic Senator Vance Hartke) by a single vote. (The substantive Hartke amendment was defeated by a vote of 47-43. But the crucial vote was 45-44 passage of a motion to table a motion by Senator Edward M. Kennedy to reconsider the first vote. Follow?)

No single trade association, group of companies, or individual in the business or lobbying community can take credit for this victory -- and when contrasted with the 3-to-1 rout in 1975, even the 1-vote margin was a major break-through. But in addition to Long, Republican Senator Bob Packwood of Oregon has to be singled out for high praise. Little known in the business community, Packwood is a fiercely independent legislator (now into the second year of his second term) who makes up his own mind on the merits and then fights strongly to convince other Senators of his point of view. When your editor testified for The Business Roundtable on the tax bill, Packwood came on like gangbusters on the deferral issue, causing some observers to believe he would vote to kill it forthwith. Instead, he was trying to get at the roots of an extremely complex subject. When he did, he recognized that the arguments of the opponents of deferral were without substance, burned the midnight oil in preparation for floor debate, and then proceeded to knock down every argument the "reformers" brought up. Without a Packwood, the Hartke amendment probably would have passed.

(Note: The business community should keep its powder dry on this issue. Some observers believe the deferral repealer will be resurrected when Congress returns.)

Item: So much for the good news. The bad news is the distressingly shoddy performance of the Fourth Estate in reporting, analyzing and commenting on the tax bill in the Senate. The number and frequency of journalistic cheap shots have been such as to make the Philadelphia Flyers look like a kindergarten croquet team. Particularly flagrant was a short piece on "CBS Evening News with Walter Cronkite" Wednesday evening. Its "investigative reporter" (why does it take an "investigative reporter" to analyze something that is fully on the public record?) referred to hundreds of millions of dollars of tax breaks for corporations in the legislation. In at least one instance, his facts were wrong. More important, he -- and this goes for almost all reporters working for the written press also -- paid no attention to the merits of the particular provisions. In the press, all of the emphasis is on "loopholes" that supposedly hurt the little man. No attention is given to unfair, inequitable or unintended provisions of the tax laws that unjustly hit one or more corporations.

Moreover, the press erred greatly in reporting a big victory for the "reformers" in the fight pertaining to the tax rates on "earned" and "unearned" income. Kennedy had vowed a fight to the finish to raise the existing "MaxiTax" on earned income from 50 to the 70 percent level applying to unearned income. The Finance Committee, at Long's behest, voted instead to permit up to $100,000 of unearned income to be taxed at the lower rate. That was overwhelmingly rejected on the Senate floor -- whereupon the press trumpeted the "liberals'" victory. But the real fight from the beginning was on retention of the MaxiTax -- and on this, Kennedy's effort to kill it was tabled, 59-24.

And, finally, with respect to editorialists, Senator Long has (with the notable exception of the Wall Street Journal) been treated scandalously. They were wrong in accusing him of undermining the budget process; actually he helped it. And they're wrong in charging that he has made a mockery of tax reform. For if Russell Long (and the Packwoods) continue to prevail, then sooner or later we may get the type of tax reform the country really needs -- removal of the bias in our tax system in favor of consumption and against the productive investment that is so crucial to our economic well-being.

JUL 6 1976

STATEMENT OF CHARLS E. WALKER, PRESIDENT,
CHARLS E. WALKER ASSOCIATES, INC.
BEFORE THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

MIDYEAR ECONOMIC REVIEW

June 23, 1976

History will evaluate Lord Keynes' overall contributions to political economy, but in one respect he performed a signal disservice. This was in giving the back of his hand to the long-run equilibrium analyses of the classical school by sarcastically noting that in the long run, we're all dead.

True. But to conclude from this that only the short run counts in formulating national stabilization policy, including monetary policy, can be a prescription for disaster.

One reason is that the "long run" is a combination of "short runs." What looks good in the short run, when the time horizon is short, may be highly disruptive in the long run, when a series of short-run policies has its ultimate impact.

Not that the answer to this problem is to judge each action in terms of its impact in 5, 10 or 20 years. It is instead to remind ourselves constantly that today's actions to deal with tomorrow's problems can have significant impacts on down the road.

With these remarks as background, I should like now briefly to pinpoint what seems to me the most crucial factor in the longer-run economic outlook, after which I'll comment on monetary policy in particular.

THE ECONOMIC OUTLOOK

The short-term outlook is good. Output is rising, unemployment is declining, and inflation is waning. About the only criticism that can be levelled at recent policies is that we are not moving fast enough in achieving our multiple goals relating to output and unemployment.

The answer is that we dare not, lest our short-run eagerness to drive unemployment down create massive longer-run problems. I would remind the Committee that the longest sustained noninflationary boom in modern times was in the first half of the 1960's, in which Government policymakers -- partly because of our international financial problems -- refused to pour on the coal and move at flank speed toward full employment. Many fail to recall that the 7 percent unemployment of 1961 was not driven below 4 percent until 1966, and then partly because of war. Some also fail to recall that unit labor costs and, as a result, wholesale prices were stable during most of that period.

Let me put it another way. Some day an outstanding athlete is likely to run a 3½-minute mile. This achievement will not occur this year, in the next decade, or perhaps in this century. But this is not to be deplored. Neither the performer nor spectators would be exhilarated if the runner, in his effort to break all records, dropped dead just beyond the finish line.

And so it is with economic policy. I personally would like to see unemployment and poverty eliminated tomorrow -- check that, this afternoon. But it won't happen. And crash efforts to make it happen too soon will, in my judgment, augment the inflation that I believe to be the root cause of our major economic problems, including unemployment.

This is one dimension of the "short run/long run" problem. Another relates to the pressing need for stepping up our investment in productive plant and equipment, the very basis of economic progress.

Again, you can find many who will ask, "What's the problem?" The short-run prospect is for some slackness in capital markets. Moreover, our percentage of GNP devoted to nonresidential fixed investment has been relatively stable for a long time.

To be sure, today's relatively quiescent capital markets, rising corporate profits and liquidity, and so on, are a dickens of a lot better than the situation in the very recent past. But to suggest that the short-run situation portends a solution to our long-run capital formation problem would, in my view, be shortsighted indeed.

To be sure, productive investment relative to GNP has held up well. But more and more of this investment has had to be devoted to "standing still" -- replacing worn-out or obsolescent equipment. In addition, the simple ratio overlooks the crucial relationship of investment per worker. Few economists would dispute the view that such investment raises real wages, helps fight inflation by increasing efficiency, and provides jobs for workers in an increasingly sophisticated industrial economy.

What's been happening to investment per worker? Professor Paul McCracken has concluded that the amount of nonresidential capital formation per person added to the labor force during the 1970's has declined by 22 percent from the levels in the 1956-66 decade. Professor David Meiselman has calculated that in dollars of 1958 purchasing power, from 1961 to 1965 there was an increase of $55,000 in the gross stocks of business capital for each person entering the labor force. During the 1966-70 period, it had fallen to $46,000, and during 1971-74, to only $41,000.

I'll not belabor the point. My conclusion is that our current and prospective rate of capital formation cannot be expected to further our economic goals with respect to growth, employment, and price stability. Consequently, I would urge this Committee to continue its study of this crucial problem, with special attention to changes in the tax laws to foster capital formation, rather than inhibit it, as I now believe to be the case.

MONETARY POLICY

Turning now to monetary policy, I do not have a great deal to say because I think Federal Reserve authorities have acquitted themselves very well over the past year. To be sure, the near doubling in the rate of monetary growth in the past few months -- from an annual rate of almost 5 percent since June 1975 to close to 9 percent since mid-March -- is disturbing. However, the Fed appears to be moving to "snub up" the rate of monetary growth, and this is especially appropriate for this stage of the economic recovery, when bank loan demand can be expected to mount rather strongly. Failure to keep monetary growth in bounds would repeat the monetary policy errors of 1972, which helped fuel subsequent inflation.

There are, however, a number of observers who disagree with this view. They argue that reining in the money supply now will force interest rates up. The recovery, although too powerful to be aborted in the near future, would in their view proceed too slowly and unemployment would remain at unacceptable levels for too long a period. In fact, they argue that in some way the Fed ought to reduce interest rates.

I would answer that if a 5-percent rate of monetary growth was good enough to support a stronger-than-expected recovery, it should -- absent a sharp lurch toward fiscal surplus, which hardly seems likely -- be sufficient to support continued recovery while minimizing the danger of a return to demand-pull inflation. Moreover, I strongly disagree with the view that the Fed can "fine-tune" interest rates under current market conditions. In fact, strong steps by the Fed to bring interest rates down, presumably by pumping up bank reserves, would actually have the opposite effect -- interest rates would instead rise.

This view is in sharp contrast to what I learned in graduate school, taught in my own courses in money and banking, and believed as an official of the Federal Reserve System and economist for the Federal Open Market Committee. After all, bank reserves are "high-powered money." They provide the base for expanding loans and investments. More loans and investments mean an increase in the supply of credit, which in turn should result in a decline in interest rates, the price of borrowed money. Or should it?

The hang-up arises from the fact that the new loans and investments made possible by the increase in reserves also generate additional demand deposits in commercial banks -- the principal component of the money supply. And since people usually borrow money to spend rather than hold, an excessive rate of growth in the money supply can result in a rise in spending and the classical demand inflation most simply defined as "too much money chasing too few goods."

Inflation then accelerates. And in recent years we have re-learned an important lesson -- something that people in many Latin American and other countries have known full well for many years. That lesson is that galloping inflation inevitably begets sky-high interest rates. The reason is that the so-called "monetary illusion" is partially if not almost wholly dispelled; people begin to bargain in "real terms." In labor markets the cost-of-living escalator is the prime example. In credit markets, borrowers rush in to get money to spend "today" in order to beat "tomorrow's" price increases. Lenders are reluctant to part with dollars that will deteriorate in value before repayment. So, lenders demand more interest and borrowers, in their eagerness to spend, pay it.

Some who agree with this analysis might nevertheless point out, and quite correctly, that today's increase in the money supply will lead to inflation only after a lag of several months, and perhaps longer. But that makes little difference. As has been demonstrated repeatedly in recent years, participants in financial markets have fallen into the habit of almost immediately "discounting" the ultimate inflationary impact. In fact, their actions frequently approach the ridiculous; a drop in the money supply for the week, announced on a Thursday afternoon, can cause a sharp drop in interest rates the next morning (note: not a rise in rates, reflecting an expected shortage of money to borrow, but a drop, as inflationary fears recede). Indeed, that happened only last week. And even though the actions of market participants may be ridiculous, since it is the trend in money supply over a period of months that is important, they are none the less real and have a significant impact on financial markets.

None of this means that Fed actions have no impact on financial markets. They do. But the only sure-fire way for the Fed to bring interest rates down in the months ahead would be to starve the economy for money and induce recession, thereby causing a contraction in the demand for credit. No one wants that.

I therefore conclude that the better part of wisdom is for the Fed to concentrate on maintaining a stable and reasonable rate of monetary growth, say 5 percent in M_1, accept the increases in short-term interest rates that are inevitable in a strong business recovery, and through these actions advance the day when inflation -- and therefore high interest rates -- are no longer a threat to our economic wellbeing.

Thank you very much.

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FORCED-DRAFT EXPANSION: ENEMY OF CAPITAL FORMATION

Last week, in a colloquy with your editor, Senator Hubert Humphrey unerringly -- but perhaps unintentionally -- put his finger on at least one factor holding back investment in plant and equipment even though the business recovery seems strong and enduring. The occasion was the midyear review of the Joint Economic Committee, which Humphrey heads. Your editor, with two other invited witnesses, discussed the economic outlook and monetary policy. (Our testimony is enclosed.)

Before turning to the Senator's remarks, it is noteworthy that the only significant agreement reached by Humphrey and all three witnesses (our fellow panelists were of strong liberal persuasion) was that the rate of capital formation in the U. S. had to be stepped up. The liberal economists called for lower interest rates, engineered through a more expansive monetary policy, for this purpose. Your editor plumped for a simpler and more direct approach: amendment of the tax laws to increase the after-tax return on new investment. The latter will do the trick -- simply, quickly, effectively -- and without the inflationary dangers of an overly expansive monetary policy.

The wide agreement is a good portent for future measures to promote capital formation. In the short run, however, the very policies pushed by Humphrey and the Democratic Party (in its platform) deter new business investment. The Senator in effect said so at the hearing, in noting that the major factor in a decision by either a small or large business to sink a hunk of money in expansion or modernization is the prospect of markets for its products down the road. Your editor agreed -- and went on to point out that the very bill introduced by Humphrey and Rep. Augustus Hawkins (D-Calif.) -- the "Full Employment and Balanced Growth Act of 1976" -- had the typical businessman as nervous as the proverbial cat on a hot tin roof.

The reason is that Humphrey-Hawkins calls for the President, the Fed, and all the powers-that-be to take steps to "lower" unemployment to 3 percent of the "adult" labor force within four years. Any economist worth his salt will tell you it can't be done without severe economic overheating. That in turn would advance the day of the next recession. And then the $64 billion question: Where are the markets for the products to be turned out by this new and expensive equipment -- markets that HHH himself insists are necessary if capital formation is to be fostered.

So if Senator Humphrey really wants more capital formation -- and we're convinced he does -- WER has a suggestion. Drop the idea of a forced-draft, flank-speed return to full employment. Support instead a program of moderate pressure on the economic accelerator, and attack the unemployment problem where it most needs it -- through reducing the structural aspect by helping make unemployed men and women better able and willing to work.

Footnote on the Economic Summit. WER has noted several times that control of inflation is now of higher political priority with the American electorate than reduction of unemployment. (This assertion in no way implies approval of today's level of joblessness, but recognizes that for every person looking for work, more than nine are at work -- and those nine are deeply concerned with what their hard-earned dollars buy at the store.) Now, this political priority seems to be catching on abroad, as reflected in both the tone and communique from last week's Economic Summit in Puerto Rico. A signal victory for President Gerald R. Ford (due in part to the careful advance work on the agenda by former Treasury Secretary George Shultz), the emphasis on inflation as Public Enemy #1, not just here, but throughout the industrial democracies, bodes well for each country's efforts to contain inflation, minimize "stop-go" policymaking, and assure long and sustained economic growth. And as a result, exchange rates would tend to be less volatile, thereby enhancing the international trade that increases jobs and living standards.

HIGH INTEREST NOTES

Comptroller Resigns. Having weathered unfair broadsides from both press and politicians, Comptroller of the Currency James E. Smith has for personal reasons resigned, effective later this summer. The criticisms notwithstanding, bankers have hailed Smith for his evenhandedness and his willingness to listen -- the latter a trait that other regulatory agencies might well emulate as Government intervention into business mounts. Moreover, students of banking give Smith extremely high marks for the reforms he effected in the Comptrollers' office during a period of only three years. Perhaps Treasury Secretary William E. Simon best summed it up by hailing the retiring Comptroller's "skillful leadership" and his "major initiatives to modernize the regulatory and supervisory process." Smith's term, Simon said, "will be recalled as a turning point in the interest of modern and effective commercial banking regulation."

Jimmy Carter! Jimmy Carter! In an earlier WER, we noted that one of the most significant aspects of the ex-Georgia governor's early lock-up of the Democratic nomination was the luxury of time -- time to help heal the wounds of the primaries and therefore "unify" the party; time to put his imprint on the platform; and time to select a running mate offering maximum political mileage and minimum chance of embarrassment because of a skeleton emerging from the closet. On balance, Carter has used this valuable time effectively. For the purposes of "unity," the platform is close to a work of political art, and there are some good names on the list of potential vice presidential nominees. However, despite the development of press-abetted giddiness, we suspect that the so-called unity of the party may be only skin-deep, with unforeseen bumps in the road as the campaign proceeds. Carter's major enemy now is perhaps overconfidence -- or, as astute political reporter David Broder, harking back to 1948, pointed out, "Dewey-itis." Current polls are bound to be comforting to JC. But we suggest that a good self-interview before bedtime each night might well be: "Will they love me in November as they do in June?" Which is another way of saying that right now it's still warm-up -- the first inning won't really come up until after the Democratic Convention.

How Much More of the 94th? Although the 94th Congress officially has six more months to go, the actual legislative calendar is probably closer to 45 days. Congress recesses July 2 for the July 4th holiday and will remain out for the Democratic Convention, returning July 19. It will recess one week in August for the Republican Convention and an additional week in September to observe Labor Day. The Leadership of the House and Senate has set Oct. 2 as the target date for adjournment so that members can go home to campaign. This abbreviated calendar means that many controversial bills are likely to fall by the wayside. Opponents of such legislation have time on their side because delays can bog down passage of essential and non-controversial bills. Moreover, some Democrats, believing JC will be in the White House, would rather put off legislation until next year.

Sincerely yours,

Charls E. Walker

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Vol. 4, No. 13 - July 16, 1976

Dear Subscriber:

In this issue, we give our reasons for believing that, in contrast to indications of recent polls, the coming Presidential election fight could turn into a real horse race. In addition, the impending changes in Congressional leadership are described and evaluated.

High Interest Notes cover the additional Senate Finance Committee hearings on the tax bill; factors underlying recent trends in interest rates; and the major implication of the Carter/Mondale ticket.

POLITICS AND PENDULUMS

Those surveying the political terrain between now and November 2 might well ponder the tendency for our system to gravitate toward balance. One aspect of this -- applying especially to what almost amounted to "election" of Jimmy Carter by the press even before his nomination -- is contained in the old adage, "What goes up must come down." Well, that's not always true in politics, but it frequently is, as vividly demonstrated by the "Roller-Coaster" popularity of President Gerald R. Ford. His ups and downs in the public opinion polls have been both frequent and severe.

Another aspect pertains to races in the House of Representatives, especially with respect to the seats captured by Freshmen Democrats in 1974 in marginal or normally Republican districts. In most instances a direct result of Watergate, a scandal within a Republican Administration, the 1974 results may be reversed in part because of what the public perceives to be a scandal in a Congress dominated by Democrats by almost 2-to-1. We'll come back to the House races in a future WER.

Carter a Shoo-In? That JC is eminently "electable" to the office of the Presidency is demonstrated by the startling success of his campaign to emerge from near-obscurity and capture his party's nomination. But let's not install him in the Oval Office just yet. To be sure, polls indicate that in a race today he would wipe out either Ford or Reagan. But that's today. Think back to the monumental lead in the polls that Richard Nixon had over Hubert Humphrey as Campaign 68 got under way. Humphrey closed like gangbusters and Nixon is lucky that the campaign was not even one day longer.

Not that we're forecasting any such disaster for JC, but there will be some significant things working against him. He's unpopular with the working press, or at least those reporters who covered his primary campaign. Although reporters pride themselves on their "neutrality," the fact is that many of them lean to the liberal persuasion, a leaning that frequently shows through in their coverage. This can hurt a Democratic candidate, especially one who the press and others believe to be more conservative than either his own rhetoric or the Party platform indicates.

In addition, Ford, whom we believe will lock up the nomination before the Republican convention, has a record to run on -- a record that looks pretty good to many independent-minded voters. It is summed up in the three words, "Peace, Prosperity and Integrity." Recent U.S. diplomacy leaves much to be desired, but there are no American soldiers being shot at abroad, and that's what really counts. Unemployment is still much too high, but the more important thing is that, until recently, it has been "on the mend." And, unless most forecasters are incorrect, joblessness should resume its downward trend in the months from now to the election. As to integrity, even the highly partisan Democrat, Governor Milton Shapp of Pennsylvania, introduced GRF at Independence Hall last week (where Ford made one of the best speeches of his Presidency) as "the man who led us away from the dark days of Watergate." Incidentally, the exposure Ford got in acting as President during the Bicentennial three days was invaluable in his quest for the nomination, and may have actually marked the turning point.

Beyond the fact that Ford is a known quantity with a commendable record, Carter's views are still unclear to most voters and therefore undigested. At the same time, he's no longer "a new face." In addition, GRF is trusted and can easily counter JC's "I'll never lie to you" theme. JC says he will not, but GRF is believed to have proved himself. Still, the two most important factors bearing upon the outcome of a Ford-Carter race are the trends in the economy from now until election and Ford's selection of a running mate.

The Republican Ticket. As to the latter, we discount the prospects for a Ford-Reagan match-up as a "sop." It just doesn't make sense (which doesn't by any means imply that it won't happen; Republicans are not noted for invariably coming down on the side of "electability" in choosing national tickets). What does make sense is for Ford to select a running mate who is popular in the South -- a nominee who, while perhaps unable to counter Carter there, would at least force him to pay more attention to his home turf. Former Treasury Secretary and Texas Governor John B. Connally is most frequently mentioned as the best man for this strategy (and there are some who believe that the charismatic Connally could well put the ticket over the top in Texas, Florida, North Carolina, some Border and Plains States, and even California). Moreover, Ford believes that Connally is an outstanding politician and leader; in fact he tried to get Connally to join his Cabinet last year. But others argue that JBC is perpetually tainted because of his service in the first Nixon Administration and later indictment and trial, even though acquitted by a jury in the District of Columbia.

The Economy. On the economic side, WER noted earlier that one reason Ford peaked in the early primaries and then, beginning with North Carolina, had a real slugfest with Reagan, was that the rate of improvement in the economy -- including consumer confidence -- peaked at about the same time. As the primary season rolled on, the economy continued to expand, but at a slower rate. In addition, consumer prices, especially for food, rose rather sharply and real take-home pay declined. This, coupled with Reagan's effective campaigning on national defense and foreign policy issues, turned what could have been a rout into a horse race.

There is no one in the business who can forecast with certainty how the politically significant economic variables will behave between now and the election. But, if real take-home pay moves back up (and especially if food prices rise only moderately), and if unemployment resumes its downward movement, then Ford will have a real tail-wind for the election. And the bonus would be greatly increased if, as some Agriculture Department officials predict, crop shortages abroad will enhance farm exports (thus pleasing Middle Western voters), but with our bumper crops protecting the consumer against rising food prices. As to probabilities in this respect, however, we take all crop and price forecasts from DOA with a big pile of salt.

Conclusion. We reiterate that none of this is meant to imply that Ford will get the nomination and march straight on to victory. For one thing, if nominated, he's got to get his campaign organization into much better shape -- the performance in the primaries almost snatched defeat from the jaws of victory. (It still may.) But what we do want to emphasize is that Jimmy Carter should not yet draft his inaugural address.

CONGRESSIONAL LEADERSHIP: CHANGING THE GUARD

The changes in Congressional leadership slated to take place next January are the most sweeping in modern times. Oklahoma's Carl Albert has decided to end 30 years in Congress, the past six as Speaker of the House. Massachusetts' feisty Thomas P. ("Tip") O'Neill is uncontested for the post, and is likely to remain so. O'Neill's position as Majority Leader, the number two House slot, has engendered a three-way race for that post (with later entries a possibility) among high-ranking Rules Committee member Richard Bolling of Missouri, Democratic Caucus leader Phil Burton of California, and Majority Whip John McFall (also of California).

Meanwhile, over in the Senate, both Majority Leader Mike Mansfield of Montana and Republican Leader Hugh Scott of Pennsylvania are retiring. Thus far, candidates for Mansfield's post include the current number two Senate leader, Majority Whip Robert Byrd of West Virginia; Ernest ("Fritz") Hollings of South Carolina; the Happy Warrior himself, Minnesota's Hubert Horatio Humphrey; and Senator Edmund Muskie of Maine. Major contenders for Scott's post as Republican Leader include his deputy, Robert Griffin of Michigan, and John Tower of Texas, chairman of the Republican Policy Committee.

Add it all up, and what you come out with is a massive shake-up, affecting three of the four "leadership ladders" in the Congress. Assuming reelection of top House Republican John Rhodes of Arizona, only the House Republican leadership will stay close to its present form. What do these sweeping changes mean to the business community?

The House of Representatives. Absent a judgment as to whether the next President will be Democrat or Republican, speculation as to the basic thrust of a House leadership team under Tip O'Neill is just that -- speculation. If Carter moves into 1600 Pennsylvania Avenue, then party loyalist O'Neill and other House leaders will probably do just what Democratic Congressional leadership has, in recent years, done when a Democrat was in the White House -- support him. Even so strong a Speaker as the late Sam Rayburn leaned over backwards in 1961 to revise House procedures to accommodate the liberal legislative agenda of John Kennedy. This he did primarily by enlarging (and stacking) membership on the Rules Committee in order to reduce its domination by conservatives, who frequently blocked liberal proposals. And this occurred despite the fact that Rayburn was beside himself when his old protege, Lyndon Johnson, ignored Mr. Sam's strong protests and accepted the number two slot on JFK's ticket. Tip O'Neill is, above all, a loyal Democrat. If JC moves into the White House, look for his leadership to be devoted to strong support of the Administration. (This by no means implies smooth sailing in Congress for some of the proposals Carter says he would push as President. Experience has proved that reorganization of the Executive Branch also requires reorganization in Congress, since each is built to "fit" the other. As is well known, changes in Congressional institutions and procedures come only slowly. In addition, Carter's endorsement of "zero-based budgeting," an eminently sensible idea, is also likely to generate considerable opposition.)

And if the Republicans renew their lease on the Presidential mansion? The past eight years of divided Federal government -- stormy and contentious -- might seem like a honeymoon in comparison. In stating this view, we are not pointing a finger at either Democrats or Republicans, but simply noting the combative political nature of Tip O'Neill, along with frustrations that affect both parties. To Democrats, the frustration would result from having to live through four more years of a Republican White House, thus marking (by 1981) only eight of the past 28 years in which a Democrat was President. To Republicans, the frustration is the reverse -- during the same period, Republicans controlled Congress for only two years, 1953-54, and during a number of those years found themselves with as little as one-third of the membership of both Houses.

The Senate. The Upper House is a horse of a different color. Neither Byrd, Humphrey nor Muskie exhibits the strong partisanship of Tip O'Neill -- although, to be sure, they know how to play the political game and play it well. Hollings has not as yet had sufficient exposure to permit judgment on how he would perform as Majority Leader, but few observers give him much of a shot at the job anyway. On the Republican side, the leadership would support a Republican President and oppose a Democrat. But in the latter case, the Democratic majority is likely to be so large that its influence would be exerted primarily through the threat of Presidential vetoes -- a continuation of the 1/3 + one approach that dominated the current Congress.

Conclusion. Given the probable ideological make-up of the 95th Congress, we cannot foresee any significant let-up in the anti-business drumfire of rhetoric and legislation that has gushed out of the Nation's Capital in recent years. Nor do the prospective changes in leadership give promise of a let-up.

If we are correct, the business community should chart its course accordingly. And this calls for redoubling of recent successful efforts to increase understanding of the process of government and, through active participation, to make that process work effectively for an economically strong and secure nation.

HIGH INTEREST NOTES

Additional Senate Hearings on Tax Bill. Chairman Russell Long is reconvening the Senate Finance Committee on July 20-22 to take another look at more than 50 provisions of the bill now on the Senate floor. Most of these provisions have been attacked by some Senators and self-proclaimed "public interest representatives" as "special interest" legislation. So, said Long, let's let everybody come in and speak his piece. We predict that when the shooting is over and the smoke has cleared, most of the provisions will stay in the Committee bill and clear the Senate. The reason? They have merit.

Lower Interest Rates? Market analysts are swinging to the view that the traditional rise in short-time interest rates in a business recovery will be further delayed. There are at least three reasons: 1) the balanced, deliberate pace of economic recovery; 2) resulting in part from the first reason, the prospect for further gains in the battle against inflation; and 3) prospective monetary policies. Market experts seem convinced that the Fed has successfully curbed recent excessive monetary growth (see WER #12) and will therefore let up somewhat on the monetary reins in the weeks ahead. We agree. And if we are correct, that's very good news for the stock market.

Carter/Mondale. A funny thing happened last night at the Democratic Convention. Nominee Jimmy Carter embraced both policies and a running mate that truly promise to make Campaign 76 "a choice, not an echo." From the standpoint of the body politic, nothing could be better -- in effect, the promise of a campaign based primarily on issues, and a long-needed (and hopefully definitive) decision from the people as to whether they want to take the "liberal" or "conservative" road in the years ahead. And from the standpoint of the outcome, it reinforces our view, expressed above, that the race will be much closer than many pundits are predicting.

Sincerely yours,

Charls E. Walker

Charls E. Walker's
WASHINGTON ECONOMIC REPORT

Analysis of Economics and Politics On the Potomac

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Vol. 4, No. 14 - July 29, 1976

Dear Subscriber:

In this issue we review recent developments in Campaign 76 and discuss some fallacies about flexible exchange rates.

UPDATE ON CAMPAIGN 76

Two of the most important recent events in Campaign 76 were Jimmy Carter's first public courting of Big Business and Ronald Reagan's blockbuster announcement that ultra-liberal Pennsylvania Senator Richard Schweiker was his preferred running mate.

Carter and the Business Community. In a serious attempt to bring business into the Democratic camp for Campaign 76, Jimmy Carter spoke in New York last week to a luncheon of blue-ribbon corporate leaders. Our discussions with business leaders, coupled with perusal of press reports, lead to mixed reviews.

Not a few of the businessmen appeared to like what they heard at the luncheon. Carter's firm pledge not to "make any substantive change in our tax law, or propose any as President, until at least a full year of very careful analysis" is to be strongly applauded -- one of the most sensible statements made by a Presidential candidate in the history of the Republic. This is because the U.S. tax system is not only highly complex -- it is grossly misunderstood, due in considerable part to failure of the Fourth Estate to do even a "D-" job in explaining the system to the public. To the contrary, most Americans believe the Federal individual income tax system is regressive, while the facts are the other way around. Most Americans think that Big Business pays small amounts of Federal taxes; but the facts are the other way around. And most Americans think most high-income individuals use tax shelters to avoid paying taxes, when the fact is that 99 percent pay very high taxes indeed. It is to be hoped that Carter, if elected, will absorb these facts during his year of study -- for facts they are.

Carter's statement to the luncheon that he wanted to be "a friend of business" was well received, jibing as it does with his oft-stated preference for reliance on the private sector to create jobs -- a recognition, in other words, that it's business which proves the jobs and wherewithal for growth, reduction of poverty, national security, and all of those other things that government provides. More to the point for the assembled executives, most of whom head multinational firms, was Carter's pledge that he "would not do anything to subvert or minimize foreign investment" by U.S. corporations and his tentative endorsement of retention of the foreign tax credit. Perhaps a little disconcerting was his luncheon statement that he was "undecided" with respect to proposals to tax earnings of foreign subsidiaries of U.S. corporations before those earnings have been brought home (the "deferral" issue).

If the whole episode had then ceased, Carter probably would have been able to mark the day up as a plus. But when he told the press that he wanted to raise taxes on the well-to-do (whom he had just lunched with and who already pay heavy taxes) he generated stories that gave many of the businessmen second thoughts. But, or perhaps more important, he also told the press that his current "inclination" would be to repeal the so-called "deferral" provision relating to foreign source income. This last proposal is an "article of faith" in the "tax reform handbook" of American labor and the cadre of economists tho, through some magic, have convinced the press that they ought to be labelled "reformers," and that anyone who disagrees is against "reform."

If Carter's goal was to woo business support, and it was, then he erred. Given his sure-footedness throughout the primary campaign, we're inclined to believe that the error reflects imbalance among his advisers. If Carter is as smart as we think he is, he'll remedy that defect quickly -- by getting some brain trusters on board who do not believe that the end-all and be-all of tax revision is to soak the corporations and the rich, and that in fact tax actions to promote capital formation and create jobs is pretty darned good reform in and of itself.

The Schweiker Caper. Although Ronald Reagan obviously didn't plan it that way, his almost unbelievable pre-convention designation of Senator Richard Schweiker as his preferred running mate may have solved some big problems for President Gerald R. Ford and the Republican Party.

First, the Reagan fiasco appears to have all but locked up the 30 delegate votes from Mississippi in favor of Ford, a sharp reversal from the earlier bent of this traditionally bloc-voting group. The tip-off was yesterday's switch from Reagan to GRF by Republican Chairman Clarke Reed, one of the canniest of the Southern politicians who boasts, with good reason, that he's never yet missed boarding the right political boat on time. Aside from the fact that Reed was deeply distressed by Reagan's choice of an ultra-liberal for the ticket, he probably concluded that the gangplank might shortly be pulled up. An early switch on his part from Ford to Reagan (after quiet but careful consultation with other Mississippi delegates), could not only get Mississippi on board, but also provide the delegate votes to put Ford over the top.

In addition, Reed is known to be especially high on former Texas Governor and Treasury Secretary John B. Connally, actually preferring the latter for the top spot on the ticket. A Connally call from the White House to Reed on Wednesday, just before public announcement of JBC's endorsement of Ford, doubtless had a significant impact. Which brings us to point number two.

And that is that Reagan's blunder may well have helped solve Ford's problem in choosing a running mate. For some time political pro's have been convinced that, if Ford gained the nomination, the choice had to be either Reagan or Connally, each of whom have strength in Carter's home territory, and especially in Texas. Now, Reagan's disillusioned supporters are not likely to insist, as they might have done otherwise, that Ford accept their leader as a running mate.

Third, it's probably too much to say that Reagan's mistake will "unify" the party, but his own willingness to compromise with principle -- a definite "no-no" for conservative "true believers" -- greatly reduces the chance that his supporters will engage in internecine warfare within the Party. An army without a general is not an army. The probability of disruptive procedural clashes at Kansas City has thus been greatly decreased. And, besides, both Ford and Connally are true conservatives who all but the most right-wing of the Party can support strongly and in good conscience.

So perhaps it all comes down to the end of a long period of push-and-shove, hoot-and-holler, charge-and-countercharge -- with the distinct likelihood that the battle for votes on November 2 will be between Ford and Connally, Carter and Mondale.

FALLACIES CONCERNING FLEXIBLE EXCHANGE RATES

A stated reason for the announced end of contributions from West Germany to help cover the foreign exchange costs of U.S. troops there -- an arrangement that spanned 15 years and totalled $10 billion -- points up some erroneous thinking about the impact of flexible exchange rates on international economic relations. According to the official statement issued by President Gerald R. Ford and West German Chancellor Helmut Schmidt, "...recently introduced changes in the international monetary area, specifically flexible exchange rates," were a major factor in the decision. Although there may be good reasons for stopping the German payments -- including the strength of the dollar and Schmidt's domestic political problems -- the adoption of flexible exchange rates is not one of them.

Contrary to the views of some observers, flexible exchange rates in no way remove the long-run obligation of a given country to maintain balance in its economic and financial relations with other nations. The country that avoids that discipline will still be punished, albeit through a different mechanism from that which prevailed when exchange rates were fixed. Under fixed rate systems (variously referred to as the "international gold standard", later the "gold exchange standard," and still later the "dollar standard"), a country that tended to incur a chronic deficit in its international accounts suffered a decline in its international reserves as gold and/or foreign exchange flowed out. Dwindling reserves would bring pressure on the country to cut the official value of its currency in terms of gold -- in other words, to devalue. This act was often viewed as politically dangerous, as well as being "frowned upon" in international monetary circles.

The tie-in to the West German arrangement arises from the fact that maintaining heavy U.S. troop garrisons there resulted in a significant flow of dollars out of the U.S. and into West Germany. This tended to weaken the dollar, the world's most important reserve currency, and therefore threatened the viability of the existing system of fixed exchange rates. The German payments were therefore deemed justified, not only in terms of the security that our troops provided, but also as a means of helping maintain what then was believed to be the most suitable type of exchange rate regime.

With that regime abandoned, and flexible exchange rates now in vogue, is the flow of dollars to West Germany in connection with our garrisons there no longer of concern? The Ford-Schmidt communique implies that such is the case. But this is a fallacious view of the new adjustment mechanism.

To be sure, the dollar is now strong in world markets. But if our international transactions again fall into deficit -- if we again start to "live beyond our means" internationally -- then it will fall in value relative to other currencies. The greater the flow of dollars to West Germany for troop maintenance, the greater the fall in the value of the dollar. How far will it fall? An amount sufficient to equate supply and demand for dollars in exchange markets, which presumably should also promote a new balance in our international transactions.

But the fact that "balance" is restored -- perhaps rather swiftly -- does not mean that everything will be coming up roses for the U.S. Witness the case of the pound sterling. For one thing, inflationary forces will be fostered in the U.S. because, with the dollar down, this will be a good place to buy. Conversely, imports will become more expensive to us. And this will not only help intensify domestic inflation; it has significant implications for the long-run economic and military security of the U.S.

This is because more and more of the basic materials this nation must use have to imported. A cheaper dollar means that those materials cost more -- as the classical economists put it, the "terms of trade" would turn against us. We've already seen the impact of a significant price rise in the cost of petroleum. A falling dollar would tend not only to raise that price even further, but also prices of other basic materials.

Flexible exchange rates have much to commend them, although the failure of leading nations to agree as yet on "rules of the road" (when is central bank intervention to affect currency values appropriate?) threatens the viability of the system. However, freedom from the need to observe the fundamental disciplines taught by history is not one of their attributes.

HIGH INTEREST NOTES

Tax Bill to Sink? Soundly defeated in their efforts to re-make the so-called Tax Reform Act of 1976 in their own image, Senate liberals are now pondering a delaying game aimed at killing the measure. It is reported that Finance Committee Chairman Russell Long, although unmercifully and unjustly drubbed in the press for his unwillingness to give in to thrusts that are "tax reform" in name only, is determined to get the bill through the Senate. Right at the moment we're not prepared to forecast the outcome; those who fight a game of delay have a lot working for them in the dwindling legislative days that intrude into campaigning season. Which is simply to say that the fight on the Senate floor, having already earned a 4-star classification for Congress-watchers, may still have a long way to go.

Cost/Push Pressures Abating. Policymakers who earlier feared that high wage settlement might set off another round of cost-push inflation breathed a sigh of relief last week when the Labor Department disclosed that the "first-year" impact of collective bargaining settlements declined from 10.2 percent in the first six months of 1975 to 8.4 percent this year. In addition, the second quarter was 8.2 percent, down from 8.8 percent in the first quarter and a whopping 11 percent in the last three months of 1975. Although still much higher than the maximum possible growth in long-run productivity, and affected also by cost-of-living escalators which automatically boost wages, the trend is still very encouraging. It marks another mileage point in the slow and tortuous return to stable, noninflationary economic growth -- something that can never be achieved until increases in wages and productivity come back into approximate balance so that unit labor costs cease to rise.

Rosenthal on Shirk. If Rep. Benjamin S. Rosenthal (D-N.Y.) had his way, a reasonable degree of knowledge about the industry a Presidential nominee would regulate would be sufficient to disqualify the candidate. Or so it seems from examination of Rosenthal's letter of opposition to GRF's nomination of Stanley E. Shirk, top banking expert at Peat, Marwick, Mitchell & Company for many years, to succeed James E. Smith as Comptroller of the Currency. Rosenthal charges that Shirk would not be able to divorce himself from banking information he obtained in his 35-year career with the accounting firm. Well, we certainly hope not; a regulator that knows his industry and what he's doing is something to be cherished in this ever more interventionist government. Rosenthal goes on to charge that if Shirk were called on to move against a bank that had been a Peat, Marwick client, "it may be difficult for him to act without at least unconscious consideration for his firm's potential liability to shareholders and investors in the bank." Rosenthal's outburst notwithstanding, Stan Shirk is, on paper, one of the best qualified men ever selected for the office. And those that know him well believe that the promise implied by his record in private life would be fulfilled in public service.

Sincerely yours,

Charls E. Walker

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Dear Subscriber:

With this issue, WER is shifting from bi-weekly to monthly publication. Each issue will be longer than the bi-weekly newsletters. At the same time, subscription rates are being reduced, and yours will be automatically extended beyond its expiration date. Monthly publication, in addition to providing us with a little more leg room, will permit exploration of important issues in greater depth.

In this first monthly issue, we comment on the climax of Campaign 76, update our views on the "Pocketbook Issue," and report on the "The Tax Reform Act of 1976."

CAMPAIGN 76 CLIMAX: ROUT OR HORSERACE?

Pundits and politicians who had all but moved former Georgia Governor James E. Carter into the White House are hedging their bets -- and with good reason. Within a span of 48 hours at last week's Republican Convention, President Gerald R. Ford pulled off a series of victories and made a speech that caused many observers to switch to the cautious position WER has counseled all along.

The signs of an electoral horserace rather than a Carter rout of Ford include: 1) Nomination of Ford, who has consistently run ahead in the polls as the best Republican to face Carter on November 2; 2) GRF's selection of Senator Robert Dole as his running mate; 3) Ford's challenge in his acceptance speech for face-to-face TV debates with Carter; 4) The "new" Gerald Ford, who stunned both the convention and viewers with a beautifully constructed and forcefully delivered speech; and 5) Improving (but still uncertain) prospects for unity among Republicans during the remainder of the campaign.

Ford's Nomination. Hindsight being what it is, not a few observers are now stating that Ford had it in the bag all the time. Don't you believe it; the race went down to the wire. The mistakes made on both sides -- by challenger Ronald Reagan and his people, and also by the Ford camp -- were both obvious and multitudinous. As to the former, WER wrote on February 10 that Reagan's $90 billion budget proposal would continue to haunt him and his best bet was to zing in on Ford's foreign policy and the defense issue. That he failed to do so for two months came close to knocking him out of the campaign almost at the outset. From talking with people around the country, your editor had sensed that foreign policy would sooner or later loom large in the Republican nomination battle. (Only last week, before a group of young midwestern bankers in Wisconsin, foreign policy -- touched only briefly in formal remarks -- consumed almost all of a one-hour Q-and-A period.)

Ford's big mistakes came earlier -- in guessing wrong a year ago as to Reagan's willingness to enter and fight a hard campaign, and in his November sacking of Defense Secretary James R. Schlesinger. WER remarked at the time that this latter move could cost Ford the Presidency -- and it nearly did, simply because the dismissal tended to blur Ford's long-standing strong position for national defense at a time when the

American public (and particularly Republicans) were beginning to worry that the U.S. was fast becoming militarily inferior to the Soviet Union.

Other mistakes could be mentioned, such as Ford's abortive and counterproductive ad campaign in California, where he had no chance anyway, and Reagan's last-minute move to the left by selecting Pennsylvania Senator Richard Schweiker as his running mate (not too bad an idea in concept, but counterproductive when Schweiker's record came into full public view). However, the fact is that Ford won, partly because of the first-rate delegate hunt conducted by former Under Secretary of Commerce James Baker (who seems destined for greater things in the campaign), and, as could be expected, excellent convention strategy under the leadership of political pro William Timmons.

Robert Dole. In turning to former Republican Chairman Bob Dole as a running mate, GRF spurned the "unifying" thrust of an invitation to Reagan and the "don't-write-off-Texas-and-the-South" strategy of going with former Texas Governor and Treasury Secretary John Connally. A Reagan choice might have mollified his more ardent supporters, but the ticket would have been harmed significantly in states where GRF has a fair-to-middling chance of attracting a large number of Independents and Democrats. As to Connally, who had the nomination all but locked up as recently as three weeks ago, the screams from the Republican liberals that helped fuel a raging fire of criticism, based on the view that what was on the so-called "milk tapes" would wrap Watergate in a stranglehold around Ford's neck, evidently convinced GRF that the choice would be too high a risk. A good case can be made that Ford was right, but we'll never know.

In any event, Ford took Dole, for two reasons. First, because of the grain embargo and weak cattle prices, GRF is about as weak politically as any Republican has ever been in farm and ranch country, his running mate's home ground. In Kansas, Dole enjoyed enough inherent support in 1974 to gain his second full term in the Senate, despite his long defense of Richard Nixon, a recent divorce (still somewhat of a "no-no" out yonder), and a strong opponent.

Equally important, Dole is one of the strongest campaigners in the Republican stable -- alternating spontaneous witticisms and rapier thrusts with great rapidity. Before Bob Dole has finished, Carter and running mate Walter Mondale will know they've been through a firefight.

The Dole choice rates high marks.

The Debates. The surprising thing about the prolonged agonizing in the Ford camp -- almost up to the last minute -- before he decided to challenge Carter to TV debates was not that he decided to do so, but that the decision was apparently so controversial among his aides and so hard for Ford himself to make. We have believed all along that Ford had no choice but to debate. If so, then the dramatic and forceful flinging of the gauntlet in his acceptance speech would make all the political sense in the world. Finally, Ford so decided, and in so doing gained momentum -- momentum that he has continued to maintain this week in pushing the debate issue.

Admittedly, Ford had to weigh several pro and con arguments. Strong on the pro side is that, given his standing in the polls, he has no way to go but up. Even more important, the format most often discussed is the type of public appearance which Ford handles best. He has not (until last Thursday night) ignited much enthusiasm either with TV speeches or on the stump. Canned TV appearances have been jerky and stilted. But most observers agree that in press conferences, responding to journalists (the probable format for the debates), Ford is at his best, appearing in command of the facts, on top of the issues, and wholly credible.

Still, some advisers argued that his participation wouldn't be "Presidential." That sounds like the same person or people who told him not to worry about Ronald Reagan a year ago -- just be "Presidential." Still others argued that since polls show that incumbents normally get 10 to 15 percent of the vote anyway, why risk losing some of this support by debating an intelligent and TV-wise opponent.

The answer to this last contention is that Ford is not viewed as the typical incumbent; he is an unelected President whose past constituencies have consisted of the voters in his Michigan district and the Republican members of the House of Representatives. More important, he is (as already noted) running way behind; past incumbents who have refused to debate (LBJ against Goldwater in 1964, Nixon against McGovern in 1972) enjoyed the luxury of a commanding lead in the polls -- so why risk it. This time it's the other way 'round.

In any event, the pro-debate group won and, from the reaction of the delegates, the decision was a 10-strike. If Carter does his homework and keeps his cool, Ford may gain little, or even lose ground. And even if he breaks even, the stimulation of more voters to come to the polls on November 2 -- as was the case in 1960 -- may work against a Republican candidate. Still, for reasons already stated, it's the right -- indeed, the only -- decision. In contrast to poor handling of even good ideas by the Ford camp in the past, this time the timing and deftness of the maneuver rates at least .999 on a scale of 1 to 1000 -- especially now that GRF evidently intends to make the debates a major aspect of his campaign.

(Your editor is co-chairman of a steering committee established by the League of Women Voters, which hopes to sponsor the debates.)

The "New" Gerald Ford. Who was that fellow out on the podium at Kansas City's Kemper Arena Thursday night? Was it the guy portrayed by cartoonists as unable "to walk and chew gum at the same time?" Or the one that LBJ said "played too much football without a helmet?" Or the one accused by Hubert Humphrey as thinking topsy-turvy, because "he played center so much, and was always viewing the world upside-down, from between his legs?"

The question is not whether Ford excelled on that evening, but whether he will be able to come anywhere close to the same level of performance during the campaign. The speech was first-rate both in terms of rhetoric and delivery. More important, it set the twin themes that Ford must continuously pound on to win: 1) A claim that Peace, Prosperity and Integrity represent the big achievements of his two-years-plus in office; and 2) A charge that the incumbency to be ended -- the real problem with our government -- is the Democrats in Congress, who have exercised control for 40 of the past 44 years. And while Ford is playing this theme, Dole can be expected to zero in on Carter's so-called inconsistencies and also mend fences in the midwest. Connally can be stumping the South, the Border States, and all of the West (he is particularly popular in the cattle regions).

But that brings us to the final question: What's the outlook for Republican Party unity in general and the campaign role of Ronald Reagan in particular?

Unified Republicans? All along, we've been skeptical of the view that the Ford-Reagan fight for the nomination would disrupt the Republican Party so severely as to destroy its effectiveness in the electoral campaign. Presumably this would be manifested by the "losers" either "going fishing" on November 2 or, worse yet, mounting a third party candidate. Or, still worse, "crossing over" to vote for Carter.

We see few Reagan supporters "crossing over." Delegates who helped shape a highly conservative Republican Platform are not likely to support a candidate who has endorsed a Democratic Platform almost 180 degrees in the opposite direction. But "going fishing" and third-party problems are something to ponder.

Those who believe party unity is assured point to the "Hearts and Flowers" routine of Ford and Reagan on the podium Thursday night. That's far less significant than the comment later attributed to Reagan, that if the Republicans lost this year, a third party might well be established next year. Might this not encourage the "faithful" at least to "go fishing" this year, readying themselves for that day, now in sight, when the traditional two-party system consisting of rather wide ranges of opinion would be replaced by a "pure" arrangement of liberals vs. conservatives? Maybe so, which leads to the next point.

Does Reagan intend to campaign for the Ford-Dole ticket? If not, the prospects for unity will be greatly reduced. But if he does, then true unity may well be achieved. And Reagan's ability to charge up the faithful and get them to the polls should not be underestimated.

In evaluating the possibility of a sharp Republican split, it is important to note that the differences during the primaries were not ideological nor, by past standards, accompanied by pronounced bitterness. On domestic policies, as demonstrated by the two men's records rather than rhetoric, Ford and Reagan may not be as close as Tweedledum and Tweedledee, but the strongly conservative bent of each is obvious. On foreign policy and defense, the debate is primarily over means and personalities, not goals. Consequently, the type of ideological split that rent the Democratic Party in 1972 simply is not there.

A significant third party for conservatives seems most unlikely this year. And even if a movement is mounted, it would probably drain off less votes from Republicans than Eugene McCarthy (if he hangs in) is likely to draw from Carter. The real third-party danger is later -- and could, as noted, affect the attitude and turnout of right-wing Republicans this year.

Still another view to be considered is that the long, drawn-out, but, all-in-all, fair fight was just what the Grand Old Party needed. There hasn't really been a "fun side" to Republican battles for the candidacy since Eisenhower and Taft slugged it out in 1952. What happened then? Republicans not only took the White House but also gained control of Congress -- for the second and last time in 44 years.

Rout or Horserace? We think it can be a horserace if 1) Ford gets his act together, shaping up his campaign organization and, with Dole, zeroing in on the issues; 2) GRF also prepares and performs well in the TV debates with Carter; and 3) The politically important economic variables move favorably from now until November 2 (see below). But if the economy turns sour, Ford doesn't get his act together, things turn bad abroad, and Carter continues to avoid mistakes, then it still could be a Democratic rout on November 2.

A final point: If the Party Platforms can be believed, this time the American people, as we noted in an earlier WER, are truly confronted with a choice, not an echo. This is good. Washington needs a clear mandate from the people.

ANOTHER LOOK AT THE "POCKETBOOK ISSUE"

Veteran readers of WER will recall that we have put great emphasis on the "Pocketbook Issue" (translation: Jobs, Prices, and Consumer Confidence) in Presidential elections. Campaign 76 is no exception. The impact of economic trends was clearly demonstrated during the battle for the Republican nomination. In the final quarter of 1975 and into early 1976, when the economy was thrusting ahead and consumer confidence burgeoning, Ford did very well. But when the rate of economic advance slackened and confidence ceased to soar, the stock market fell back and a sort of economic malaise set in. To make things worse from Ford's standpoint, real take-home pay -- the single most important economic statistic from a political standpoint -- declined in March and April, after a rather steep rise in preceding months. Unemployment, which had declined rapidly in late 1975 and early 1976, slowed its descent and in fact rose in June and July.

Pocketbook Facts. We've noted that trends in "politically important economic variables" will be crucial to Ford's chances on November 2. However, we refer not to the "global figures" on GNP, unemployment, and consumer prices -- those that get a big play in the press as portending "good" or "bad" for the incumbent. Those figures are usually stale, varying from a lag of two or three weeks for unemployment, over a month for the CPI, and two months for the rough average of (frequently revised) GNP data. In other words, they indicate what has happened, and sometimes quite a while back, not what has just happened or is happening. In addition, the typical voter doesn't get the economic news that's important to him from reading the newspapers, listening to radio, or watching TV.

He or she gets it directly -- at the plant or store, the local bar or social club and home. If, at the plant or store, other workers are being laid off, that's going to worry the employed worker much, much more than high unemployment figures coming out of the Bureau of Labor Statistics. If, at the bar or social club, the talk is that things are "getting worse" for neighborhood families, the impact will swamp any "good news" in the press, such as an upsurge in the leading indicators. And most important are family discussions around the dinner table -- is the paycheck going farther than it did last month or last year? (Back to real take-home pay again.) If so, a relatively happy family, and good news for the incumbent. If not, the reverse.

The Data. In this respect, even the "real take-home pay barometer" has some big shortcomings. First, it is confined to industrial workers and therefore tells us nothing about how farmers, service workers, construction people, etc., are doing. Second, it is computed by deducting Federal taxes paid (including social security) from weekly paychecks and then "deflating" the remainder with the CPI. But the CPI itself has many shortcomings -- e.g., if the price of beef goes up relative to chicken and fish, people will eat a lot more chicken and fish, and the paycheck is stretched without too much discomfort. But the CPI will rise, because the "weights" for the various components are fixed in relation to the composite "market basket" of an earlier period.

Still another point: The CPI applies to all types of consumer spending, including, for example, interest on home mortgages. A sharp rise in interest rates can push up the whole CPI -- but that's of no concern to the family that already has a mortgage, and most home occupants do.

What all this boils down to is that the price of one item, food, is by far the most critical from a political standpoint. And it's worth noting that between July 1975 and July 1976, the price of food consumed at home rose only 2 percent, as contrasted with increases of about 15 percent in the years 1973-1975.

Farm Exports. A final point relating to "politically important economic variables" pertains to farm exports. The best of all worlds from Ford's standpoint would be bumper grain crops which would permit huge exports -- thus boosting farm income -- but without eating into the typical consumer's pocketbook through higher food prices here at home.

Which way will these variables move? We don't know, although recent data, following the slackening advances in the Spring and early Summer, indicate that things may break Ford's way in the crucial September-October period. If so, the economic equivalent of "what-have-you-done-for-me-lately?" will add to the chances of a horserace instead of a rout in the next couple of months.

THE "TAX REFORM ACT"

In early August, by a vote of 49-to-22, the Senate passed its version of the "Tax Reform Act of 1976." The delay of almost two months in completing the Senate rewrite of legislation passed by the House last year (H.R. 10612) resulted primarily from a dispute between self-styled "tax reformers" (aided and abetted by most of the press) and those members of the Senate who do not view soaking corporations and the rich as necessarily good tax policy. If the views of the former group had prevailed -- and they made charge after charge to remake the Committee bill in their own image -- the cause of capital formation would have been sorely hurt. But they were rebuffed; the opposing group, under the brilliant leadership of Finance Committee Chairman Russell Long (D-La.), emerged as the clear winner.

Not that the final massive and complex product of the Senate's labors does much for capital formation. To be sure, the provision for a permanent 10 percent investment tax credit is most worthy, but efforts to ease capital gains taxes were defeated. Estate taxation, however, is liberalized (although this provision may be dropped in Conference since the House is working on its own bill in this area). But a bad minimum income tax was made worse. Consequently, the bill as it now stands is a "victory" for supporters of productive tax reform to promote capital formation, primarily for what it does not do.

What it does not do, despite strong efforts by the "reformers," is to raise significantly taxes on foreign source income of corporations (which would hurt capital formation and jobs here by draining off funds otherwise destined for domestic investment); eliminate the 50-percent maximum tax on earned income, thereby raising the top marginal rate to 70 percent; replace the investment tax credit with a Rube Goldberg approach, while also repealing the "ADR" system of accelerated depreciation; and sharply increase the minimum tax on corporations.

All of these were goals of the liberals. All failed -- sometimes by margins of 2-to-1 or better; sometimes by a single vote.

The most distressing aspect of the debate was what can only be referred to as a "smear campaign" directed at Senator Long and his supporters. To the self-styled "reformers," anything that raises taxes on corporations or the rich, no matter how unjustified in principle, is "tax reform." Long and his supporters properly reject this view, and instead examined the provisions on their inherent merits, not in terms of "rich man-poor man," or "corporations vs. individuals." The Senate in general and Senator Long in particular are to be congratulated on the outcome.

The Conference with the House starts today. What will happen? We believe that after considerable pulling and tugging, the conferees will bring forth a creditable bill that raises something close to $1 billion in revenue for the coming fiscal year, on balance promotes capital formation, and clears the decks on the tax reform issue for a year or so.

Sincerely yours,

Charls E. Walker

Charls E. Walker's
WASHINGTON ECONOMIC REPORT
Analysis of Economics and Politics On the Potomac
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Dear Subscriber:

This expanded WER arrives a few days late because we wanted to provide a full review of final Congressional action on two legislative issues of great significance to the business community. These include the tax revision legislation (labeled as "reform") and efforts to "legislate" an end to the Arab boycott of Israel. In addition, we offer a relatively optimistic analysis of the outlook for Federal tax changes to promote capital formation and comment briefly on the performance of the 94th Congress.

THE TAX REFORM ACT OF 1976

Describing and evaluating the massive tax revision bill approved by Congress on September 16 and signed by President Gerald R. Ford on October 4 puts tax analysts in a position similar to the six blind men who, according to the parable, attempted to describe an elephant by feel. Depending on whether he examined the elephant's trunk, foot, tail, etc., each man's description was inevitably narrow and inaccurate.

As to the tax bill, individuals will doubtless judge it with respect to their own tax liabilities. Since the bill simply keeps rates where they are, while consumer prices continue to mount, individuals are not likely to view the legislation with favor. To the typical taxpayer, "reform" means a sharp increase in taxes on the rich and a big cut in his own tax bill. He does not understand that there is simply not enough revenue available through that route to lower taxes on low- and middle-income families by more than a fraction. If individual taxes are to be cut significantly, growth in Federal spending must be curtailed.

Individuals who might classify themselves as "taxpayer-investors" probably view the Act with mixed feelings. Efforts by Senator Edward M. Kennedy (D-Mass.) and other "reformers" to repeal the 50-percent "MaxiTax" on earned income were rebuffed and estate taxation was eased. But on the negative side were still further increases in taxes on capital gains (primarily through a step-up in the minimum income tax), restrictions on "tax shelters" and stock options, limitation on interest deductions, and -- perhaps in the long run one of the most important provisions of the bill -- the "carryover of basis" for inherited assets. This provision assures that capital gains on such assets will ultimately be paid -- or else the assets will be "locked in" for generations.

As to corporations, we believe that the bill is a plus -- partly, as WER noted earlier, because it does not include current taxation of unrepatriated earnings of foreign subsidiaries of U.S. business, despite two thrusts in this direction by Senate "reformers." Other pluses include extension of the 10-percent investment tax credit through 1981 (it should have been made permanent, as in the Senate version); significant help for railroads and airlines in loosening restrictions on application of the ITC over the next five years; and a two-year extension of tax reductions for smaller corporations. The increase in the minimum tax on corporations and the cutback on DISC's add up to a minus, although much less severe than the Senate "reformers" desired.

But to view tax legislation in the 94th Congress as a plus for the business community requires some reading of the fine print surrounding the so-called Arab boycott amendment pushed by Senator Abraham Ribicoff (D-Conn.), as well as some crystal-ball gazing with respect to the outlook for business taxation in the years ahead. Both of these subjects are discussed in this WER.

TAX CUTS FOR CAPITAL FORMATION: AN IDEA WHOSE TIME IS COMING?

Net plus to the business community though it may be, the tax bill fell far short of the nation's needs for tax changes to promote saving, investment and productive capital formation -- in short, it did nothing to remove the bias in our tax system in favor of consumption and against investment, and in fact probably increased it somewhat. But the outlook for the future is far from bleak. Indeed, given certain assumptions, it can be viewed as downright encouraging. There are at least three reasons.

First, reliable polls show that the American people, although woefully ignorant as to the meaning of "capital" and, therefore, "capital formation," are nevertheless convinced that a serious problem exists. According to the highly regarded Cambridge Report (1st Quarter 1976), 25 percent of the people believe that there is a "very serious" problem involved in "raising the dollars needed for business investment" in the years ahead, and 39 percent think there is a "somewhat serious" problem. Some 54 percent of the respondents therefore believe there is a problem that is at least "serious," and only 25 percent replied that the problem was not "serious." The rest "did not know."

Even more encouraging, 72 percent favor private investment over government investment, with 14 percent preferring the latter. Of that majority, 66 percent stated they would favor the private route even though it meant higher corporate profits. This last point is especially impressive when it is recognized, as the Cambridge Report points out, that almost half of the respondents believe corporate profits are too high. Fortunately, that percentage seems to be declining.

A second reason for optimism with respect to tax changes favoring capital formation is the recent strong shift of views among opinion leaders -- a growing majority agrees that the problem is serious and pressing. For example, still another highly regarded polling firm, Opinion Research Corporation, reported earlier this year on interviews of "thought leaders" in Washington. The results are as encouraging as they are surprising.

The question was framed as follows: "How serious do you think the shortage of investment capital facing U.S. industry will be over the next 10 years? Will it be very serious, somewhat serious, slightly serious, or don't you believe industry faces a capital shortage?" The "thought leaders" consisted of three groups: Legislators; officials of the Executive Branch and regulatory agencies; and a combination of unions, public interest organizations, press and media.

Here are the results:

	Very Serious	Somewhat Serious	Slightly Serious	No Shortage (or No Answer)
Legislators	57%	21%	17%	5%
Exec/Reg Agencies	57	33	5	5
Unions, etc.	20	45	10	15 N.S. 10 N.A.

Most significant, of course, is the whopping response from 95 percent of the legislators that the problem is at least "serious," with 57 percent stating that it is "very serious" and 21 percent "somewhat serious." And perhaps the most surprising set of responses came from the union-public interest- media group, with 65 percent stating that the problem is either "very" or "somewhat serious," and only 15 percent believe there is no shortage.

In addition, more and more newspapers are getting into the act. Last month, for example, the Washington Post, which is not noted for a conservative bias, carried an editorial, "Productivity: Why So Low?" Citing a study of the Congressional Budget Office (an unexpected but welcome ally in the battle to promote capital formation), the Post stated that "productivity is not rising at the accustomed rate...partly because business investment per worker is not rising at its accustomed rate." And, says the Post, "Tax incentives are probably necessary to increase investment..."

The third and final reason for optimism is that the favorable Congressional sentiment revealed by the ORC survey is even more strongly held by key tax legislators. Rep. Al Ullman (D-Ore.) plans to release early next year his task force report on the subject to the full Ways and Means Committee, which he chairs. The report is expected to recommend significant tax changes to promote capital formation, probably starting with measures to reduce double taxation of corporate dividends (in the stilted language of tax experts, to move toward "integration" of the personal and corporate tax). Rep. Barber Conable of New York, slated to be the ranking Republican member of the Committee next year, is a long-time supporter of such measures. In the Senate, Finance Committee Chairman Russell Long (D-La.) has strongly supported tax measures to foster productive investment, as has ranking Republican Carl Curtis of Nebraska. And, to add a little frosting to the cake, Joint Economic Committee Chairman Hubert Humphrey (D-Minn.) is speaking out frequently on the need for more productive investment.

Outlook. These favorable developments do not mean that in January 1977 the 95th Congress will rush in to re-make the Federal laws in the image of those who believe the tax system is tilted significantly toward consumption and against saving and investment. For one thing, Governor Jimmy Carter, although earlier believed to be a strong supporter of private sector approaches to the problems of jobs and economic growth, has recently evidenced a desire to raise taxes on corporations and earnings from investment. As a result, the business community has grown increasingly apprehensive about Carter's tax policies if he becomes President in January.

But even so, a very big part of the battle has evidently been won. Only a little over a year ago, spokesmen for organized labor and economists from the Brookings Institution were stating flatly that the nation's capital needs could be met with little difficulty. Perhaps these people still feel that way. But if they do, they are out of step with a growing segment of the voting public, Congressmen, and other "thought leaders."

Still, the task of achieving truly productive tax reform is huge. The Post editorial described the problem succinctly and accurately in observing:

> ...these [tax] incentives, in their customary form, are objectionable to most of the country as mere tax breaks for the wealthy and corporations. It will require a considerable application of political skill -- perhaps, you might even say, political genius -- to work out formulations adequate to assure voters that benefits will genuinely flow to the whole country, not just to investors.

This simply means that the business community cannot now afford to rest on its oars. Much progress has been made, but the capstone actions -- signed and sealed

Federal tax legislation -- will require even stronger and more effective efforts to educate and persuade the public and Congress that productive tax reform can contribute significantly to higher living standards and a better quality of life in the decades ahead.

ARAB BOYCOTT LEGISLATION

With the force of a brakeless freight train roaring down hill at 150 miles an hour, two legislative efforts to eliminate the Arab boycott of Israel almost overwhelmed the 94th Congress in its closing days. The first of these efforts involved the so-called Ribicoff Amendment to the Tax Reform Act. The other was a set of amendments to the extension of the Export Administration Act by Senator Adlai Stevenson (D-Ill.) and in the House by Reps. Jonathan Bingham and Benjamin Rosenthal, both Democrats of New York. The Ribicoff amendment was adopted, but the latter amendments died when Congress failed to extend the Export Administration Act.

Background and Argument. In 1946, the Arab League Council established a primary boycott intended to prevent the entry of certain products into Arab countries from territory now part of Israel. A companion (and worldwide) secondary boycott, aimed at inhibiting third-parties from boosting Israel's economic and military development, was introduced in 1951. Implementation is through a complex, recommendatory set of "principles" which are administered through national boycott laws of the Arab nations. The boycott laws are subject in practice to numerous exceptions and are administered very unevenly. In fact, some prominent Jewish leaders regard the Arab boycott as no more than a "nuisance."

But the facts of the situation became obscured by a burst of rhetoric, surging emotions, and a determined move by Jewish organizations to "legislate" an end to the boycott. These efforts were opposed by the Administration (although the White House tried to work out compromises toward the end of the battle) and significant parts of the business community.

The first point to emphasize is that there are few in the business community or elsewhere that approve of the boycott; the vast majority would like to see it end immediately. The question is not one of goals but means. Opponents of the legislation favor quiet but firm diplomatic actions, which of necessity require even-handedness in dealing with Israel and the Arab nations. The opponents also argue that legislation which directly or indirectly destroys U.S. trade relations between the U.S. and the Arab nations would be counter-productive, as has been the case with the Jackson-Vanik amendment to trade legislation. If so, the cause of peace in the Middle East would be set back -- and the conflict between Israel and the Arab nations is the fundamental cause of the boycott in the first place.

The second point to emphasize is that the business community is firmly against discrimination on the basis of race, religion or national origin. But the fact is that the proposed amendments went much further. Indeed, almost all, if not all, transactions with Arab countries, if carried out in normal ways and in compliance with Arab law in Arab countries, would have been prohibited, even though no discrimination was involved. Representatives of Jewish organizations testified that their goal was not only to prevent discrimination against Jews, but also against Israel. Some of the legislation proposed, if enacted, would have discriminated against Arab countries by effectively imposing an American boycott on those countries.

Business opponents of the legislation argued that they do not discriminate against Jews or Jewish companies, that the Arab countries do not seek to have them do so, that they would not do so, and that enactment would eliminate large amounts of U.S./Arab trade far beyond that necessary to serve the purpose of the legislation. Moreover, they argued that the Arab nations would inevitably view any statutory effort to prevent U.S. firms from furnishing documentation necessary to enforcement of the primary boycott (e.g., certifying that exports were not destined for Israel) as a violation of their sovereignty. The short-run effect could be higher oil prices or another oil embargo. The long-run effect could be to drive those nations, even Saudi Arabia, toward the Russian orbit. Neither would be in the interests of the U.S. or Israel.

The Ribicoff Amendment. This provision of the Tax Reform Act denies to any taxpayer that "participates in or cooperates with an international boycott" the benefits of the foreign tax provisions of the Tax Code, including the foreign tax credit, deferral, and DISC.

Furthermore, and here we quote the Conference report:

> A taxpayer participates in or cooperates with an international boycott if the taxpayer agrees, as a condition of doing business directly or indirectly within a country or with the government, a company, or a national of a country (1) to refrain from doing business within a country which is the object of an international boycott or with the government, companies or nationals of that country; (2) to refrain from doing business with any U.S. person engaged in trade within another country which is the object of an international boycott or with the government, companies, or nationals of that country; (3) to refrain from doing business with any company whose ownership or management is made up, all or in part, of individuals of a particular nationality, race, or religion, or to remove (or refrain from selecting) corporate directors who are individuals of a particular nationality, race, or religion; (4) to refrain from employing individuals of a particular nationality, race, or religion; or (5) to refrain from shipping or insuring products on a carrier owned, leased, or operated by a person who does not participate in or cooperate with an international boycott. While it is anticipated that in most cases a third country will be the object of an international boycott, it is possible that the United States may be the object of an international boycott. The agreement may be with respect to any type of business (including manufacturing, banking, and service businesses.)

Too tough for U.S. firms dealing with Arab countries to live with? Yes -- but, and the "but" is the fine print in the House-Senate Conference Report on the tax bill, plus colloquy on the House floor between Chairman Ullman and Rep. Conable.

Consider first this paragraph from the Conference Report:

> A taxpayer is not considered as having participated in or cooperated with an international boycott unless he has agreed to such participation or cooperation. The agreement need not be in writing; there may be an implied agreement. However, an agreement will not be inferred from the mere fact that any country is exercising its sovereign rights. Thus, a taxpayer is not considered to have agreed to participate in or cooperate with an international boycott merely by reason of the inability of the taxpayer to obtain an export or import license from a sovereign country for specific goods. Similarly, a taxpayer's inability, under the laws or administrative practices of a country, to bring certain personnel into that country, to bring certain ships into the waters of that country, to provide certain services in that country, or to import or export certain products to or from a country, is not to be considered to constitute an agreement to participate in or cooperate with an international boycott. Further, the signing (at the time of import), of a certification

as to content, which is required to obtain an import license, does not by itself constitute an agreement by the taxpayer. However, this would not permit the making of an agreement not to import certain goods into the country. In addition, a course of conduct of complying with sovereign law may, along with other factors, be evidence of the existence of an agreement. [EMPHASIS ADDED.]

Although the major portion of the above paragraph seemed to go a long way toward making the amendment "livable," the last sentence -- insisted upon by Ribicoff staffers -- alarmed tax experts. In addition, a solid agreement that the burden of proof as to participation in or cooperation with such a boycott should be, in the first instance, on the Government in general and Treasury in particular was unclear in both the legislative language and the Conference Report.

In the light of all this, the colloquy between Chairman Ullman and Rep. Conable on the House floor as the tax bill moved to final passage is very important:

MR. CONABLE. Mr. Speaker, the provisions denying foreign tax credits and certain other foreign tax benefits to U.S. taxpayers which participâte in an international boycott are to be based on a determination by the Secretary of the Treasury or by Internal Revenue agents. In determining whether the taxpayer has in fact agreed to participate, it is my understanding that the burden of proof is to be on the Government. Is that not correct?

MR. ULLMAN. Yes, the gentleman is correct. As the proposal was agreed to by the conferees, the initial determination by the Secretary of the Treasury or by an Internal Revenue agent is to be made only if the preponderance of the evidence available indicates that the taxpayer has agreed to participate in the boycott. This burden of proof is thus slightly different than that applied in ordinary tax cases. However, once it has been established that the taxpayer has agreed to participate with respect to any operations, he is to be treated to have participated with respect to all his operations in boycotting countries unless the taxpayer can clearly demonstrate that he has not in fact participated. In the making of the initial determination by the Department of Treasury, the mere failure to do business with any company or in any country for good business reasons does not imply an agreement. [EMPHASIS ADDED.]

Can the firms doing business with Arab countries live with the Ribicoff amendment? Only time will tell. But the language quoted above, coupled with the fact that administration of the provision is assigned to the Secretary of the Treasury, who is authorized to make advance determinations with respect to individual cases, has caused many tax experts to conclude that continued trade with the Arabs is indeed possible.

If the final product is in fact something that business can live with, then major credit must go to Chairmen Long and Ullman, Rep. Conable, and Dr. Laurence Woodworth, chief of staff of the Joint Committee on Internal Revenue Taxation.

The Export Administration Act. The Ribicoff amendment was a sleeper. When introduced, it was given little chance of success. And it was not until the AFL-CIO, in a letter from President George Meany, endorsed it in ringing terms (at the start of the conference on the tax bill) that its passage became inevitable. The Export Administration Act, due to expire on September 30, had been picked originally by the anti-boycott legislators as a "non-vetoable" vehicle for their amendments. The Stevenson amendment would have made it extremely risky for U.S. firms to continue to do business with Arab countries. Worse still, the Bingham-Rosenthal amendment (adopted by the House Internal Relations Committee by a vote of 27-to-1!) would have provided harsh criminal penalties, bolstered by treble damages from civil suits, for those U.S. firms which complied with Arab laws designed to enforce the boycott. Few experts disagree that Bingham-Rosenthal, if enacted, would have constituted a counter-boycott of the Arab nations.

Description of the behind-the-scenes maneuvering that led to defeat of the amendments (and temporary suspension of the Export Administration Act, which is not too great a problem) is a matter for historians interested in the legislative process. Suffice it to say that the measure, after passing the House by an overwhelming 318-to-63, was finally killed through procedural actions in the Senate, with Texas Republican John Tower playing a leading role.

Outlook. This issue will not go away. For one thing, emotions are too strong, and the failure of enactment is not likely to be taken as a defeat that is final. There could well be a repeat of the battle when the Export Administration Act is brought up again for renewal, as it will be, early in the 95th Congress.

We can report that the business community is in no way opposed to reasonable legislation to prevent discrimination against Jews. If current law does not do this, and the business community thinks it does, new laws should be enacted -- but any such laws should not go beyond those provisions which are necessary to prevent discrimination against Jews by banning most trade with the Arabs if they do not drop this boycott. Such efforts to interfere directly with the sovereignty of the Arab nations runs a high risk of destroying commercial relations with those nations, exacerbating our energy problems, and undermining U.S. diplomatic efforts to obtain lasting peace in the Middle East.

THE 94th CONGRESS: ANY CLAIM TO FAME?

One of last Sunday's newspapers carried the following headline: "94th Congress: In Like Lions And Out Like Shorn Lambs." The reporter was correct in pointing out that the 94th fell woefully short of living up to its self-announced image as the most reform-minded in history as well as being "veto-proof."

As to the former, about the only true "reform" achieved was in loosening the iron hand of seniority in control of the House, but this was primarily an internal matter of interest to members -- and the results fail to indicate that the new system is superior to the old. In any event, more impressive to the individual voters is the series of sex scandals and allegations set off by Elizabeth Ray. Although not likely to be of great historical interest, they will probably loom large in voters' minds on November 2.

WER debunked the idea of a "veto-proof" Congress as early as November 1974, just after the Democratic landslide, primarily on the grounds that vetoes of major issues have to well up from the people, and the fact that President Gerald R. Ford was more closely in tune with an increasingly conservative electorate than many in the Congress.

But the newspaper reporter went too far -- or at least the headline writer did, for the article itself was not all that damning to Congress. The Democratic freshmen who came in gung ho for "reform" in January 1975 were singing a different tune within months -- after they had found out that legislating is not all that easy, as well as becoming better attuned to the basic conservative mood of their constituents. Not a few have learned the art of "survivorship," and many more are likely to return than we earlier thought. The growing understanding on their part of the public's mood was no better illustrated than when, in the House, a large group banded together to exert strong pressure on the leadership not to bring the inflationary Humphrey-Hawkins jobs bill to the floor.

But just as we said the main claim to fame of the 93rd Congress was in passing the long overdue Budget Reform Act, so might the 94th's niche in history be earned by making the process work -- at least, the first time around. We are convinced that, absent the Congressional budget process (and Ford vetoes), Federal spending for the fiscal year that began October 1 could well be $20 to $30 billion higher than is now the case -- and that could well have set off a round of inflation that would cripple this country's prospects for restoring stable growth.

If we're correct, then mark up at least one big one for the 94th.

HIGH INTEREST NOTE

Report Card on Proxmire and Reuss. With the deep-sixing in the Senate of three financial bills last month, the 94th Congress wrote finis to banking and related legislation and in so doing added the final embarrassing rebuff to the new leaders of the House and Senate Banking Committees. As WER has noted, Rep. Henry Reuss (D-Wis.) was able to deliver only a pale shadow of what he promised when the House Democratic caucus deposed the late Wright Patman of Texas and put Reuss in his place as Banking Committee Chairman. A barrage of press releases from the new Senate Chairman, William Proxmire (also of Wisconsin), has kept his name in the newspapers, but the publicity hid the fact that his strong efforts to eliminate the Office of the Comptroller of the Currency last summer came to naught. And this last Senate defeat was especially embarrassing, since the three bills (containing some seven proposals on payment of interest on Government demand deposits, NOW Accounts for New York and New Jersey, some mild "reforms" of the Federal Reserve, etc.) were not killed on their merits, but eliminated in a rare action which even prevented floor consideration. Corridor criticism of both Proxmire and Reuss is strong.

Sincerely yours,

Charls E. Walker

Charls E. Walker's
WASHINGTON ECONOMIC REPORT
Analysis of Economics and Politics On the Potomac

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Vol. 4, No. 17 - November 5, 1976

Dear Subscriber:

Only in America... Last Tuesday, a former Southern Governor who, a year ago, was little known across the Nation, captured the Presidency of the United States. Before turning to some basic economic questions concerning the new Administration, two broad points are worth noting.

First, assertions of critics that our political system had lost its vitality were clearly contradicted. The larger than expected voter turnout was one indication. Another was the ascension to the Presidency of what might be referred to as an "outsider" -- a man new to the national scene. The often stated view that the American people were ready for some fresh faces in Washington is supported not only by the outcome of the Presidential race, but also by the fact that the Congress is also relatively "new." When the House of Representatives convenes in January, 1977, more than one-fourth of its members will have served no more than two years and one-half will have come to Congress since 1970. With 16 new members, the Senate ushers in its biggest number of new faces since 1958.

Second, the divided Government that has prevailed more often than not since World War II, with different parties controlling the White House and the Congress, has come to at least a temporary end. Barring a near-miracle in 1978, Democrats now have four years to demonstrate that they can meet and solve the Nation's problems -- problems that have grown rapidly both in number and complexity. Moreover, the Democrats have the votes in Congress to mount their programs.

In our view, whether the Nation's new leaders can deliver on their promises depends to a considerable extent on the answers to the questions discussed below.

GOVERNOR CARTER AND ECONOMIC POLICY

In the wake of Governor Jimmy Carter's narrow victory over President Gerald R. Ford, at least three important questions that bear heavily on the future performance of the economy come readily to mind.

First, will Carter and the strongly controlled Democratic Congress adopt a go-for-broke, "Humphrey-Hawkins" approach to the unemployment problem? Or, Democratic Platform notwithstanding, will Carter move closer to the "steady-as-you-go" policy of the Ford Administration? Second, will Carter attempt to bring the business community in as a "partner" -- or at least an ally -- in working out these and other problems, an approach that seemed probable in the early days of his Presidential campaign? Or will he adopt the "adversary relationship" that some Democrats push so hard? Third, is the day drawing closer when organized labor and business come to understand that on the vast majority of issues on which they oppose each other, the interests of the two groups are in fact almost identical? If so, can Carter help speed that process?

The answers to these questions would tell us much about the shape, not only of the next four years, but perhaps also of decades ahead. And, not incidental to Carter, they might well provide important clues as to his prospects for earning two full terms in the White House. As background for discussing the questions, the existing widespread agreement on the goals of stabilization policy should be emphasized; those long-accepted goals are truly national and nonpartisan. They include a high but sustainable rate of economic growth; abundant employment opportunities; and reasonable stability of the general price level. Most differences of opinion over policy involve means rather than ends.

The Kennedy Parallel. With respect to short-run stabilization policy, President-elect Carter is confronted with a problem quite similar to that facing John F. Kennedy in January 1961. When JFK entered the White House, unemployment was approaching seven percent, and if today's labor force composition had then existed, the rate probably would have been considerably higher. Also, fear of inflation was still hanging over from the 1950's, even though inflation in those years was tame indeed as compared with the past decade. Then, as now, the basic problem of stabilization policy was to get unemployment down without forcing prices up. Kennedy faced a critical choice then, as does Carter and the Democratic Congress today -- "steady-as-you-go" or "go-for-broke."

Kennedy chose "steady-as-you-go." According to some contemporary observers, the go-slow policy was approved by JFK only after rather fierce debate among his advisers, with a liberal Council of Economic Advisers pitted against a relatively conservative Treasury. That the Treasury won the argument on the grounds of this Nation's vulnerability to a raid on its gold stock is irrelevant; what is important is that the U.S., following the "steady-as-you-go" policy, enjoyed the longest period of sustained, noninflationary growth in its history.

Some important clues to the Carter approach should emerge soon. Most important will be the men and women he selects to lead Treasury, the Office of Management and Budget, and the Council of Economic Advisers. Back in the earlier days of the Presidential campaign, when Carter was assuring the business community of his support for a basically private sector approach to reducing unemployment, rumors circulated that he might well appoint a prominent Republican as Secretary of the Treasury. As WER noted at the time, the basic idea is a good one and, in fact, would emulate JFK's action in appointing C. Douglas Dillon to the top Treasury slot -- one of the smartest moves that Kennedy made in shaping his Cabinet and subsequent national policy.

An early indication that Carter intends to appoint a conservative to head Treasury (whether Democrat or Republican is not all that important) could serve three goals. It could help stem the anti-Carter sentiment that swept the business community when he endorsed higher taxes on investment and foreign source income, and this in turn should contribute to better performance of financial markets. It could also help assure that the intra-Administration debate as to short-run stabilization policy is well balanced, with the conservative view getting a full hearing. And, not least important, it could be a first step in forming a partnership or alliance with the business community to help solve this Nation's social, economic and foreign policy problems.

Carter and the Business Community. Neither Carter nor business leaders should underestimate the importance of an informal but effective partnership between the two. An advantage to Carter is that a friendly business community could be of considerable help in getting constructive economic and social programs through the Congress. The heavy Democratic majority in the Congress by no means assures rubber-stamping of Carter proposals. And even though organized labor contributed heavily to Carter's victory and also has considerable support in Congress, the business community is not without influence. Moreover, its legislative effectiveness has increased significantly in recent years.

In addition, good relations with the business community would doubtless improve the climate for job-creating investment in productive plant and equipment. One reason that business has been slow to step up capital spending in this recovery is fear about future Federal policies, both with respect to the economy as a whole and business in particular. Carter could help remove those fears, thus promoting increased capital formation. This would be good for the country, good for working people, good for business -- and good for a Carter Administration.

In this respect, both Carter and business leaders are doubtless aware of the fact that, given heavy Democratic majorities in the Congress, a Democratic president who favors increased capital formation has a much better chance of getting Congress to reduce business taxes than does a Republican president.

This informal partnership or alliance, if developed, could extend far beyond the narrower interests of business. If Carter effectively supported measures to foster capital formation, and if he could also induce Congress to move more deliberately and carefully in regulating business, the latter in turn should be an active and vigorous partner in helping solve other national problems. These include the high priority items of income maintenance (including modernization of our Social Security system), health, energy, and national defense.

If Carter wants to develop this type of relationship with the business community, he must avoid the type of mistakes that President Kennedy made early in his Administration. One of these was an unsuccessful attempt to reshape drastically the relations between the Administration and what was then known as the Business Advisory Council (now the Business Council). Shortly thereafter, JFK became exceedingly angry over an increase in steel prices, and the steps he took in an attempt to force a rollback in turn angered many in the business community. Partly as a result, the business community viewed the Kennedy-Dillon proposal for an investment tax credit with misgivings and withheld its support. It was not until late 1962, when Kennedy promised to ask Congress for a significant cut in overall corporate taxes that relations began to mend. By the time of his assassination a year later, JFK and business, if not in full partnership, had developed a reasonably good and constructive relationship.

Again, Carter's appointments to key economic posts will tell much about the path he chooses to follow with respect to business.

Business and Organized Labor: A New Ballgame? At first glance it might seem that Governor Carter, as President, could do little to advance the day when business and labor, although continuing to negotiate the allocation of gross business income at the bargaining table, will act in harmony on important matters of public policy. Both the founders of the labor movement and its current leaders know that business must earn reasonable profits, else it cannot pay high wages -- but public utterances and Congressional testimony evidence little recognition of this basic fact. Moreover, leaders of organized labor in the United States know that profits are also the most important factor in achieving an adequate level of productive investment, which in turn provides jobs, improves working conditions, and helps raise the standard of living. In short, labor leaders in the United States know that to a large extent their bread is buttered on the same side as the owners and operators of American business. Still, almost any proposal sent to Congress to improve the after-tax profit position of business is immediately damned by labor leaders as a "handout-for-business" and against the interests of the working man.

There are growing signs, however, that although the rhetorical battle between business and labor shows few signs of abating, thoughtful men on both sides increasingly recognize that there is a substantial identity of interest -- and they are doing something about it. Discussions between business and labor leaders, which showed great promise in 1974 and for a while in 1975, have continued in the past year or so even though the official Labor-Management Advisory Committee was disbanded a year-and-a-half ago. In addition, labor is playing a more active role in the activities of the Joint Council on Economic Education, with the most recent breakthrough consisting of its support, as contrasted with earlier opposition, for experimental efforts to raise the level of economic understanding among adults (heretofore the Joint Council's efforts had been confined to secondary schools and colleges).

These seem to us to be more than straws in the wind. Consequently, the new President's contribution can be critically important.

What Carter can do is to provide an institutional framework and the considerable moral force of the Presidancy to further the encouraging progress already made. If he will do this, the benefits could far exceed any lessening of tensions between labor and business on Capitol Hill, important though that may be. The benefit to the country -- and to Carter's re-election prospects in 1980 -- could also accrue from progress toward an informal "social contract" between business and labor. This "contract" which would help keep wage increases in line with productivity gains would thereby reduce the pressure of costs on prices.

Pie-in-the-sky? Perhaps. But the President-elect's promise to try to unify the nation should encompass this vital area. Indeed, if President Carter could contribute significantly to "unity" between business and labor in approaching major problems of public policy, the prospects for sound and effective Governmental actions to deal with these problems would be greatly enhanced.

Conclusion. The success or failure of the first Carter Administration could well be determined within the next 90 days. Government is run by people; good government results from good people being in charge. It's that simple. Jimmy Carter has endured a long and arduous journey on the way to the White House. Let us hope that now, at this critical time, his endurance holds and that he conducts his "transition operation" with great care. His constituency -- which now includes all the people of the United States -- deserves no less.

[Footnote on the Federal Reserve. We doubt very much that the often voiced concern about efforts of a Carter Administration to move strongly into monetary policy is justified. Such concerns have been expressed during past transitions between Administrations, and in each instance an accommodation has been worked out. In addition, there is substantial support for a semi-independent central bank in Congress and, somewhat surprisingly, among the public as a whole. The man-on-the-street may not understand what is meant by the phrase, "politicizing monetary policy," but it scares him. Finally, never under-estimate the ability of Dr. Arthur Burns, the prestigious chairman of the Federal Reserve Board, to adjust to new situations and personalities. This is not meant to imply that Burns and his fellow Fed officials will bend monetary policy to the will of a Carter White House, but rather that the fundamental goals of both groups are the same. When that is the case, achievement of a modus vivendi between intelligent people is better than an even bet.]

Sincerely yours,

Charls E. Walker

Charls E. Walker's
WASHINGTON ECONOMIC REPORT
Analysis of Economics and Politics On the Potomac

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Dear Subscriber:

In this final WER for 1976, we first discuss the outlook for relations between business and government and then venture our annual "predictions" for 1977.

BUSINESS AND GOVERNMENT: A LOOK AHEAD

After a decade of disruptive and often traumatic economic instability at home and abroad, many U.S. business leaders are both uncertain and cautious; some are downright scared.

The uncertainty stems in part from a shift in national leadership from a man whose actions affecting business usually could be foreseen, to a former Georgia Governor and small businessman new to the national scene. This uncertainty itself -- an inability to anticipate Government action and reaction -- has led to caution in business decisions involving even minimal risk, caution that is reinforced by a lack of confidence in the breadth and strength of future markets, both here and abroad. At home, ultimate victory over "stagflation," and elimination of the "stop-go" policies associated with it, is far from certain. Abroad, the problems are almost too numerous to list. They include stagflation and associated political instability in some Western industrial democracies, along with resultant uneasiness in international currency markets; trends in East-West political and trade relations; availability to the U.S., other advanced nations, and the "have-not" countries of vital commodities (e.g., energy) at reasonable prices; promotion of growth and political stability in the poorer countries; attainment of lasting peace in the Middle East; and so on.

The number of businessmen who are downright scared is much smaller than only a few weeks ago, thanks in significant degree to the skill demonstrated by President-elect Jimmy Carter thus far in building his economic team, coupled with a clearly signalled tilt toward moderation (as WER had recommended) in prospective economic policies. Still business is keenly aware of its low esteem in the public eye and, by no means unrelated, the frequent and vicious pummeling it receives from some politicians, regulatory authorities, and the press.

On the other hand, business has learned a great deal during this unique and troublesome decade. Business leaders know that it's an almost entirely new ball game. They are minding the store in Washington with increasing awareness, and they are applying ability and experience long devoted to turning a profit to developing better relations with the public and government. More and more business leaders are determined that their organizations will meet their obligations as corporate citizens, and that the business community as a whole will serve as a constructive force helping to solve all national problems, not simply those previously considered to be part of a narrow business agenda.

The Carter Administration. To put it mildly, the business and financial community was nervous as a cat on a hot tin roof on November 3, following Jimmy Carter's narrow victory over President Gerald R. Ford. As we noted then and subsequently, Carter could allay these fears, and also start building a base for his re-election in 1980, by avoiding inflationary, crash programs of a "go-for-broke" variety to push the nation back to full employment within a short time; by building bridges to the business community; and by promoting detente, if not a partnership, between business and labor on public policy issues. We were convinced Carter would move in this direction. Common sense told us it was in his own interests, both in terms of helping to moderate his leadership problems in the next four years, and starting now to assure his re-election.

Carter has done so, and in a most deliberate and effective manner. He has refused to endorse anything more than relatively mild fiscal stimulation to pump up the economy, but instead has emphasized the need to fight unemployment sector-by-sector, recognizing the special problems and particular needs of each. (Look for University of Texas economist Ray Marshall to play a leading role in this effort. An outside choice for Secretary of Labor, Marshall is granted high marks by George Meany's AFL-CIO, which tried to hire him as its top economist, as well as businessmen who have worked with him on the problems of labor relations and unemployment in specific industries. Marshall's views and expertise are made to order for the Carter approach.) Similarly, Carter and his aides have extended a welcome hand to the business community, and the President-elect has personally expressed the view that labor and business can and should cooperate more often in working on public problems.

But, actions speak louder than words. And Carter's major actions that have reassured business leaders consist primarily of three cabinet-level appointments -- Bendix CEO Michael Blumenthal as Secretary of the Treasury; Georgia banker Bert Lance as director of the Office of Management and Budget; and Brookings economist Charles Schultze as chairman of the Council of Economic Advisers. Only time will tell, but this trio, on paper, shows signs of constituting a first-rate economic team.

Blumenthal earned high marks in the Kennedy-Johnson years as a State Department official and later as a trade negotiator. More recently, he has (according to Dun's Review) made Bendix one of the country's best-managed business corporations. Perhaps the most positive aspect of the appointment is Carter's recognition of the fact that foreign economic policy will be at center stage in the years ahead and that Blumenthal, with extensive international experience both in government and business, is the best type of Treasury leader under such circumstances. This speaks well for Carter, for recognizing the problem, and also for placing responsibility where it should be, in Treasury. Blumenthal has his work cut out for him.

Carter's choice of Charles Schultze to head the Council of Economic Advisers is superlative. A staff member at CEA in the Eisenhower years and director of the Bureau of the Budget under LBJ, Schultze has in recent years conducted a series of studies for the Brookings Institution, where he is a Senior Fellow, which have been widely acclaimed and have also added to his own extensive and penetrating knowledge of Federal programs and policies. Schultze has made a tremendous impression on Carter and can be expected to play the central if not dominant role in formulating domestic economic policy, especially since top Treasury has more than a full plate on the international scene.

Least known of the Carter economic appointees, Bert Lance is at the same time the most conservative -- a trait we like in the official who has more control over the Federal purse-strings than any other. Lance is expected to play a key role in Carter's efforts to reorganize the Executive Branch, a task huge both in the doing and in potential results. If, when unveiled, the Carter-Lance reorganization plan is sound, and if, as we predict, it runs into a drumfire of opposition from Congress and various special interests, the business community as a whole would do well to offer its political and moral support.

The public interest is reason enough. But beyond that, any sensible reorganization is bound to centralize much of the focus of responsibility for regulating business, a burgeoning and proliferating Federal activity that is driving more and more businessmen up the wall. Sensible reorganization will be good for the country and business alike.

Some observers state that these appointments, on balance, are likely to give Carter economic policies a "moderately liberal" thrust. We agree -- but the word "liberal" must be carefully defined in this instance. Neither Blumenthal nor Schultze -- and certainly not Lance -- are skeptics when it comes to the market system. The knee-jerk liberal of twenty years ago (an increasingly scarce bird both in and out of government) would, if given a choice, invariably choose a government over a market solution to national problems. Not so the pragmatic liberal of the 1970's. He is convinced that an approach which works with and through the market, perhaps by judicious use of the taxing power, is almost always preferable to reliance on the heavy and usually inefficient hand of direct government intervention.

Blumenthal and Schultze fit this mold as, in fact, do many in the new generation of business leaders. As noted earlier, these leaders are dedicated to the proposition that business has responsibilities that extend beyond next quarter's earnings statement. And they also believe that solving the problems of unemployment, inflation, poverty, international trade, and so on, should not be left to government alone. They believe, in short, that corporate power, immense in its totality, can and should be harnessed for the public good.

In our post-election WER, we noted that a Democratic President has a much better chance of persuading a Democratic Congress to reduce the heavy business tax burden than does a Republican chief executive, and as an example we pointed to John F. Kennedy's successful calls for such cuts. Similarly, "liberal" economic officials such as Blumenthal and Schultze are likely to have an easier time convincing a lawyer-dominated Congress that a market approach, if feasible, is usually superior to regulation in promoting public policies. For example, to the acclaim of one of the more liberal columnists in the New York Times, Schultze, in a Harvard lecture, called for an effluent charge (presumably a tax on sulphur oxide emissions by utilities and foundries) as a substitute for direct regulation -- in other words, increasing the cost to a business of such action, thereby inducing (at the margin) decisions to use cleaner coal, install "scrubbers," or follow whatever approach the businessman believes to be best suited to the specific situation.

We wish Schultze well. He probably recalls that a Republican Treasury proposed just such a tax in 1971. The business press, failing to understand the measure, described it as "a license to pollute," and the measure was never introduced in Congress. Schultze and his associates, as pragmatic liberals, have an excellent opportunity to gain Congressional endorsement of such approaches, thereby shifting some of the burden of achieving public policy goals to the market mechanism and away from direct Government intervention.

The business and financial community is no longer exhibiting the nervousness of the early post-election period. But Carter and his men should realize that business confidence is still far below the level necessary to help fuel a solid business recovery. More important, confidence once gained can be lost and, once lost, is much, much harder to re-establish. Still, so far, more than so good.

The 95th Congress. Although Carter and Company have apparently rejected an adversary approach to the business community, the 95th Congress, with 354 Democrats and 181 Republicans, is a horse of a different color. Only time will tell, but our best advice to business vis-a-vis the Congress is to hope for the best but prepare for the worst.

Not that the 95th shows promise of continuing the radical procedural "reforms" that rocked the House of Representatives two years ago. Indeed, the gathering of House Democrats in Washington in early December to elect leadership and establish general rules could, in contrast to its predecessor, be dubbed "The Un-Raucous Caucus." Once Texan Jim Wright defeated Richard Bolling and Phil Burton in a cliffhanging race to succeed "Tip" O'Neill as Majority Leader (who was elevated without opposition to the Speakership), the caucus appeared to lose its momentum. It seems fair to predict that House Democrats in the 95th will generally follow the leadership and avoid legislative intrusions such as the forced vote on repeal of the oil depletion allowance as part of the Tax Reduction Act of 1975.

Congress can come at business from several angles; only two will be mentioned here -- business taxes and new legislation to regulate lobbying.

As to taxes, the first point to consider is the six Democrats who will be appointed to the House Ways and Means Committee to succeed departing members Mills, Landrum, Green, Karth, Vander Veen and Helstoski. In the 94th, Mills, Landrum, Karth and Helstoski rejected the view that all business tax cuts were handouts and their votes made a significant difference, especially in fending off efforts to raise taxes on foreign source income. But according to rumors, five of the six may well be replaced with Democrats holding opposite views. If so, significant anti-business tax legislation could well originate in the Ways and Means Committee, something that has not occurred for a very long time.

We do not expect this to happen with respect to a quick tax cut, if indeed Carter submits one to the Congress. In fact, any such reduction is likely to include some business tax reduction, probably a two-point increase in the investment tax credit for at least two years. Nor is either the Finance Committee nor the full Senate likely to rebel against the first Democratic President in eight years and significantly alter his proposal (although we do expect the Senate to make adjustments and additions, with the best bet for the latter being the energy tax measures jettisoned from last year's Tax Reform Act).

No, the danger period is more likely to come when the 95th Congress, gets to the tax reform program which Carter has promised by late 1977 or early 1978. Paradoxically, the chance for constructive capital formation measures in such legislation is improving, but those in the Congress who view so-called "deferral" of taxes on the earnings of foreign subsidiaries of U.S. firms as a "tax loophole" may seize upon the opportunity to curtail, if not eliminate, this wholly justifiable provision of the Tax Code. The odds for such action are increased by the fact that organized labor continues its relentless opposition to "deferral," opposition based upon the erroneous view that the growth of U.S. multinational businesses has led to an "export" of jobs from this country. Only last week, leaders of organized labor once again blasted multinationals in this respect.

In readying for this potential battle, business must also keep an eye on renewed efforts to tighten lobbying legislation. Not that new legislation is not necessary; the law badly needs up-dating. But the bill that died in the final days of the 94th Congress was stacked heavily against business and strongly in favor of labor and the self-anointed "public interest groups." This time around proponents of the anti-business approach to amending the lobbying laws will have plenty of time to work their will. If passage of unfair legislation is to be avoided, the business community will have to do a much better job on the substance of the issue than it did in the 94th Congress.

Conclusion. Business has more to fear from Congress than the Carter Administration. The latter, through word and deed, has rejected -- at least for now -- the adversary relationship that so many members of Congress seem wedded to. Business' relations with Congress have improved by leaps and bounds within only a few years. And that's fortunate indeed, for those relations are likely to be put to a severe test during the next two years.

GAZING INTO THE CRYSTAL BALL (VOLUME III)

Although WER's prediction record for 1976 failed to match our 1975 record, we are undaunted and venture once again into this dangerous area -- with tongue only partly in cheek.

(1) Congress will move quickly to enact a tax cut of at least $15 billion, perhaps sending the measure to President Carter by mid-March. The measure will include permanent cuts for individuals in all income brackets, but strongly weighted toward those with lower incomes, and a temporary cut for business. Other possibilities in the business sector include faster write-offs for mandated investment for anti-pollution purposes and deferral of taxes on reinvested dividends.

(2) The Administration will succeed in pushing economic growth to the 6 to 7-percent range only if it is at the same time successful in dampening inflationary expectations. If so, short-term interest rates will rise as the growth rate advances, but long-term rates will remain close to present levels, reflecting primarily a decrease in the "premium" resulting from inflationary expectations.

(3) Chairmanship of the Republican National Committee will not go to one of the party's leading spokesmen, but to an individual charged with re-building the party at the grass roots. In Congress, Republicans will emphasize constructive alternatives to Administration programs rather than knee-jerk opposition.

(4) Under plans developed by Secretary of Transportation Brock Adams, Congress will start to move toward a rational and balanced Federal transportation policy. Look for the highway trust fund to be the "centerpiece" of an "intermodal" trust fund covering all major types of transportation.

(5) With former Defense Secretary James Schlesinger heading up a new Department of Energy, the U.S. at long last will begin meaningful steps to deal with the energy dilemma.

(6) Look for Rep. Richard Bolling to bounce back from his defeat for Majority Leader, and work effectively to increase the effectiveness of the Joint Economic Committee, which he will chair in the 95th Congress. With a Democrat in the White House, the mimeograph machine used in the past eight years to direct shrill and frequent blasts at Administration economic policies can be locked up. Bolling may even be able to restore the nonpartisan image of the Committee, which prevailed for many years after its creation in the 1940's but evaporated as time went on. Bolling is already off to a good start by commissioning papers and holding hearings on problems of long-term economic growth. The Committee is also likely to shake off much of the Congressional fixation with "macro" problems and zero in on the specifics, as to industry and sector, with respect to unemployment, investment, inflation, international trade, etc.

(7) Moves by Senate liberals to mount a "symbolic effort" to unseat Finance Committee Chairman Russell Long will receive little support. The liberals leading the attack are basically the same group (now fewer in number) that was defeated time after time in last summer's Senate tax battle by Long and his supporters.

(8) Campaign rhetoric notwithstanding, Jimmy Carter as President will move toward a scrupulously evenhanded approach in the Middle East, thereby helping to lay the base for a strong and early U.S. effort to promote a lasting settlement between Israel and the Arab nations.

(9) Given strong House leadership and election of a low-key chairman (Washington's Tom Foley) to replace fiery Phil Burton, the House Democratic caucus can be expected to play a much less prominent role in the 95th Congress. Ventures into the legislative arena (as in the instance noted earlier, in which the 94th rebuffed the Ways and Means Committee and forced a floor vote on the oil depletion allowance) are likely to be scarce to non-existent. The caucus may well be in search of an identity during much of the session.

(10) Confronted by strong public opinion concerning U.S. readiness vis-a-vis the Soviets, coupled with the latter's huge arms build-up, Carter will find it difficult if not impossible to cut the defense budget. A further increase is a better bet.

(11) Still not fully tested, the new Congressional budget process will undergo further but successful evolution within a new context -- a Democratic Congress reacting to a Democratic White House, in contrast to the adversary relationship that has prevailed in the past. Considering the prestige and power that the Budget Committees have attracted, Carter and OMB Director Lance will do well to consult with (and that does not mean advise) budget committee leaders early and frequently.

(12) Once he's had a chance to study the facts, Carter will learn that the U.S. tax system, although not perfect, is far from the "disgrace" he referred to in the campaign. Rather than the traditional type of "tax reform," i.e., taking from Peter to give to Paul, emphasis will instead be on positive measures to promote jobs and growth, and to find substitutes (a nonregressive value added tax?) for a highly regressive payroll tax.

Sincerely yours,

Charls E. Walker

BEST WISHES FOR HAPPINESS AND JOY THIS HOLIDAY SEASON AND THE NEW YEAR!