



# CONGRESSMAN'S REPORT

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## *Preparing for Peace--IV*

### **The Case of the Vanishing Dollar**

Three years ago in [one of these newsletters](#) I made the preposterous suggestion that we should increase taxes in an election year. A member of my staff thought that report ought to be titled: "Election Year Memo from a Political Lunatic." And, as a matter of fact, many of my constituents viewed my proposal in just that light. One angry former friend wrote: "Udall, are you out of your cotton-picking mind?"

Well, thirty-nine months have passed since then. History will record that former President Johnson didn't take my advice. He may have recognized the need for a temporary tax increase, or surtax, to take the steam out of the economy, but it was an election year, and he may have calculated that Congress wouldn't do it -- so why take a defeat? Also, a debate over taxes, made necessary by the Vietnam War, might have forced a war-policy debate he was not anxious to have. At any rate, we didn't enact the 5% surtax I proposed and which most of the country's leading economists were advocating. We simply closed our eyes and plunged headlong into ever-heavier war expenditures which would upset our economy and trigger the worst inflation since the late 1940s.

By the time we got around to passing a surtax last summer, inflation fever was so high that the medicine wasn't very effective -- at least not immediately. And, as every taxpayer knows, the tax we finally had to apply was twice as big as the one we were talking about back in 1966.

#### **WE HAD A GOOD THING GOING**

When you have a good thing going, you often don't fully appreciate it at the time. Looking back at the five years of 1960-65 we can now see that we had achieved something quite spectacular, precious and elusive:

**\*\* Between 1960 and 1965 the average rate of inflation in the United States was 1.3%, the best record of any industrially-developed nation in the world.**

\*\* Even better, we were able to achieve this price stability alongside steady economic growth and declining unemployment.

\*\* Because of our price stability U.S. products were unusually competitive in world trade, and we were enjoying a \$5 billion trade surplus.

What happened to change this? There is no doubt that the real cause was our decision to escalate the Vietnam War, which in 1965 started its spiral toward an annual cost of \$30 billion. How ironic it is to recall that the Federal budget submitted in January, 1966, made the assumption that the war would be over by June 30, 1967, and that the war cost for that fiscal year was underestimated by \$10 billion!

As I wrote that newsletter in March, 1966, I saw disturbing signs on the horizon. The Consumer Price Index had crept up to an annual rise of 1.7%. The Wholesale Price Index, almost static since 1959, had started moving up at a rate of 1/2% a month. Our utilization of industrial capacity had climbed to 91%, close to the point at which efficiency drops off. And an inflation psychology appeared to be developing; manufacturing firms were building up inventories of supplies, anticipating an increase in the price of raw materials. It was clearly a time, it seemed to me, when the country needed a dose of fiscal medicine -- a small, temporary increase in taxes to slow down the economy, just as we had cut taxes to speed it up.

#### WHAT THE 'UDALL SURTAX' WOULD HAVE COST

Let's see what a 5% surtax in 1966 would have cost the taxpayers of this country. And, recognizing that it might have been extended up to the present moment, let's see what it would have cost for the three-year period. Here is a breakdown for three levels of income (assuming in each case a married couple with two children taking the standard 10% deduction):

	Annual Income	Regular Tax	5% Surtax	Total Cost to Date
(A)	\$ 5,000	\$ 290	\$ 14.50	\$ 43.50
(B)	\$10,000	\$1,114	\$ 55.70	\$167.10
(C)	\$25,000	\$4,412	\$216.60	\$649.80

In other words, the "fiscal medicine" proposed for the *threat* of inflation in 1966 ranged from \$14.50 for a couple making \$5,000 to \$216.60 for a couple making

\$25,000. If left in force to the present, this 5% surtax would have cost those same couples \$43.50 and \$649.80 respectively as their share of the fight against inflation.

#### WHAT WE ACTUALLY HAD TO PAY

Now let's see what our country's failure to face up to the threat of inflation actually cost those same taxpayers. Instead of an average rise of 1.3% during the years 1960-65, the Consumer Price Index has risen an average of 4% for the past three years. This has meant that the real incomes of all Americans have been cut more than 12% since the spring of 1966. Every pension, every insurance policy and every bond is that much less valuable today as a result.

Let's look specifically at the extra 2.7% of annual inflation that was *added* after 1966 and the 10% surtax which went into effect last year. Here is what our three taxpayers have actually had to pay for this round of inflation:

	Annual Income	2.7% Added Inflation for 3 Years	10% Surtax 1968-69	Total Cost to Date
(A)	\$ 5,000	\$ 405	\$ 50.75	\$ 455.75
(B)	\$10,000	\$ 810	\$194.95	\$1,004.95
(C)	\$25,000	\$2,025	\$771.10	\$2,796.10

As you can see, the couple making \$5,000 actually lost \$455.75 instead of \$43.50, and the couple making \$25,000 actually lost \$2,796.10 instead of \$649.80. And, of course, they're likely to pay another year of surtax, while the loss from the increment of inflation will go on forever -- reducing the value of all their future income by that percentage.

We might also note that, as a result of three years of 4% inflation, the real income (in 1966 dollars) of Taxpayer A has been cut to \$4,400, Taxpayer B to \$8,800, and Taxpayer C to \$22,000.

Obviously, no one can absolutely prove that the 5% surtax of 1966 would have prevented *any* increase in this country's rate of inflation. But I don't think it takes any great sophistication in economics to recognize that fiscal measures taken early, before the onset of real trouble, need not be as severe as those required at the height of an inflationary spiral. And their chances of success must obviously be much greater.

#### EFFECTS OF INFLATION

The tragedy of inflation is that it hits hardest those who are in the most meager circumstances -- old people who are retired on fixed incomes, and unorganized, low-wage workers who lack the bargaining strength to demand higher pay. Such people find the cost of rent and of groceries going up while their incomes remain the same.

But even people in the work force whose incomes ultimately adjust at a higher level will find inflation exacting a high price. Take, for example, the cost of housing. Inflation has forced successive increases in interest rates, with devastating results.

Suppose you set out in December, 1965 to finance a \$20,000 home. Let's say you paid 10% down and signed a 25-year, FHA-insured mortgage for the remaining \$18,000. You could have obtained such a mortgage then at 5 1/2% interest. Your payments on principal and interest would have been \$110.54 a month, or a total of \$33,162 over the life of the mortgage.

Now it's April, 1969, and the purchasing value of the dollar has declined 12.8%. You're setting out to buy an identical house. You find it doesn't cost \$20,000 anymore; the price has gone up to \$22,560. And the interest rate has jumped from 5 1/2% to 8%. After a down payment of \$2,250 you end up making monthly payments of \$156.68, or a total of \$47,004 over the life of the mortgage.

In just a little over three years the cost of financing that house will have jumped over \$550 a year or \$13,842 over the life of the mortgage.

There are other ways that inflation hurts. Recently the Southern California Edison Co. announced it was withdrawing from the combine of power agencies planning a plant at Page, Arizona, to produce pumping power for the Central Arizona Project. The reason they gave: rising interest rates. Bonds that used to sell for 3.9% interest are going now for 7.25%; this cost of doing business hurts all businessmen, large and small.

Or look at the Federal budget. In one sense, the income tax is self-adjusting; when money declines in value, more taxes are collected. But this doesn't mean there are no problems. Between 1965 and 1970 the Federal debt will have grown by 14%, but because of rising interest rates the cost of *servicing* that debt will have jumped *at least* 40%. This has the effect of robbing programs that provide some service to the people.

And if that's a problem, think about all the state and local governments that depend on real estate taxes for an important part of their income. When the value of the dollar declines, tax rates or tax valuations have to go up. Adjustments of this kind aren't easy, and they don't win friends or votes. This is why it's becoming increasingly

difficult to pass local bond issues for anything, as the people of Tucson, Yuma and Green Valley learned recently.

#### **WHO STARTS THE SPIRAL?**

An age-old argument is: who starts the inflationary spiral? Is it labor demanding higher wages, business demanding higher profits, or *both*?

Some months ago the *Wall Street Journal* devoted a column to this question and came down on the side of profits. Looking at the record of inflation since World War II, the *Journal* quoted Peter L. Bernstein, president of a New York investment counseling service: "The pattern is clear enough. Instead of labor costs pushing prices up, what we see instead is a sort of profit-push. Profits are already well on their way up before prices begin to rise, and prices are well on their way up before wages begin to rise faster than output."

In truth, inflation is something like the Hongkong flu. It's hard to trace and hard to stop. Government, ignoring the state of the economy, orders more planes and tanks and ships than the country can produce without running up excessive demand for labor and raw materials. Manufacturers, faced with the opportunity for higher profits, up their prices. Labor, faced with rising prices, demands higher wages. Using another metaphor, we might say that inflation is like a tailspin in an airplane; the longer it goes on, the tighter the spin becomes. Wages drive up prices; prices drive up wages. People speed up their buying to beat higher prices later; their buying decisions help to assure that prices will go higher. Meanwhile, the United States finds its products less and less competitive in world trade, and our balance of payments problem, a perennial headache, gets worse.

There are obviously many forces contributing to inflation. That's why, once it's started, inflation is so hard to stop. But I think it's important to realize that the decisions of government play a unique role requiring the greatest of attention. In an economy approaching \$900 billion the Federal budget of \$190 billion obviously plays a crucial part. As a customer of this country's goods and services the Federal government, clearly, can be very helpful, or very damaging, in the spending decisions it makes. I think, in the last three years, it hasn't helped very much.

#### **DID THE 'NEW ECONOMICS' FAIL?**

In the summer of 1965 I wrote a series of newsletters entitled, "The Silent Revolution in Economics." It was a review of the lessons this country had learned through 30 years of depression, war, inflation, recession and stagnation -- interspersed, of course, with occasional prosperity, relative price stability and growth. Comparing money to

water in a river -- water which can be used and re-used as it flows downstream -- I tried to show how the "new economics" works. The point was that the Federal government, through its decisions to spend more or less than it takes in during a given year, can stimulate or retard the economy as needed.

Did the "new economics" fail? Some people seem to think so. But significantly, this is not the view of President Nixon or his economic advisers. In fact, this is worth noting: the "new economics" has survived the transition in administrations. Like Medicare and federal bank deposit insurance, I think it's here to stay. Different approaches will surely be taken; more or less emphasis will be placed on fiscal policy (taxes and spending) as opposed to monetary policy (regulation of credit and interest rates). But the critical role of government fiscal decisions in influencing the economy -- for good or for ill -- is now an accepted fact. No longer will monetary policy be expected to carry the load alone.

A corollary is also worth noting: balance or imbalance of the budget must still be watched, but no one is talking any more about balancing the budget *every year* as a first priority. There is great concern about the current situation, and we certainly must balance the budget *this year*. But you won't find any Nixon Administration economists arguing that *all* budgets must be balanced *as a matter of principle*. Like their predecessors, they recognize that what they do with the budget -- for example, running a surplus in a period of impending recession -- can have dire consequences for the nation's economy.

I think most economists, of various persuasions, agree that it wasn't the "new economics" that failed; it was the tardiness with which it was administered. Where they will disagree is in the possibility of its ever becoming a tool available for timely use.

#### **CAN WE AVOID ALL INFLATION?**

Perhaps we ought to put this discussion in some perspective. Inflation is bad and must be held in check to the greatest extent possible. But we should not be deluded: this country has always had some inflation. A dollar in Abraham Lincoln's pocket bought less than one in George Washington's. Inflation is a by-product of industrial development -- not just in this country but everywhere. The day will probably never come when the value of the dollar will remain constant year after year.

How many times have you heard it said that New Deal spending started the erosion of the dollar? There is probably no more firmly-held opinion in the American body politic. Yet it's not true. The 1890 dollar had shriveled to 61 cents by 1929; at the end

of the New Deal period and the start of World War II it was actually worth 65 cents! With the war and postwar period we resumed our old-established pattern of steady, occasionally rapid, inflation.

Similarly, I think it's important that we recognize that along with inflation we have had tremendous growth in personal income, the product of improving technology and increasing productivity. Thus, while it would be better if we had had no inflation, we should not lose sight of the gains we have made *in spite of inflation*. A Cleveland machine tool company ran an ad recently pointing to some of these gains. Here are a few:

\*\* In 1914 an average American worker had to work 6 hours and 44 minutes to earn enough to buy a shirt. Today he earns a better shirt in 1 hour and 49 minutes.

\*\* In 1914 he worked 1 hour 37 minutes for a pound of butter; today, 19 minutes.

\*\* In 1914 he had to work 1 hour 14 minutes for a pound of bacon; today it's 22 minutes.

For better or worse, we have learned to live with *some* inflation. I don't think we can ever expect perfect price stability. But I do believe that the kind of inflation we have endured the last three years can be prevented if we are willing to keep abreast of our economy, to analyze the economic facts available to us, and to make the tough decisions necessary to deal with them.

#### AN OLD PROPOSAL REVIVED

Anyone can tell after serious inflation has developed. All you have to do is open a newspaper and look at the grocery ads. The trick is to detect the early signs of inflation before it becomes evident in the price of sugar and lard. And this is what the President's Council of Economic Advisers is for. Studying monthly reports on business activity, building contracts, housing starts, inventory accumulation, prices and all the rest, these men have the job of assessing what is happening and advising the President what steps ought to be taken to avoid recession, reduce unemployment, prevent further inflation or prolong growth and prosperity. The trouble is that *prompt* action may be required, and Federal fiscal decisions are *never* prompt.

You may recall that President Johnson finally asked Congress to enact a Vietnam surtax in August, 1967. However, it wasn't passed by Congress until late June, 1968, by which time the value of the dollar had dropped another 4%.

I am reminded of Great Britain's initial experience with the nationalization of industry in the early days after World War II, when the Labor government attempted to make

policy decisions concerning coal production, electricity and even airline operation in the halls of Parliament. It didn't work, of course, and ultimately these "socialized" industries were accorded autonomy similar to that enjoyed by the managers of private industry. The lesson here is that legislative bodies are ill-suited to play management roles; when they try, they're likely to fail. (The Post Office Department is another example.)

The parallel isn't perfect, but I think this same kind of problem faces us in attempting to apply fiscal policy through the slow and tedious decision-making procedures of the Congress. In 1964, when we made a big cut in Federal income taxes, we got results; it was a successful move. But I wonder how timely, or effective, would have been a move to *increase* taxes a like amount. In reducing taxes we have politics on our side; in raising them we don't. Thus the lag from early 1966 to mid-1968 before enactment of some kind of surtax to check inflation.

What's the answer? Back in 1962 President Kennedy proposed legislation giving the President standby authority to raise or lower taxes within a limited range -- say 5% to 10% -- subject to congressional veto. Thus when the economy appeared to be heading for trouble, he could act quickly to prevent a recession or check the onset of inflation. The proposal got nowhere, mainly because Congress is very reluctant to give up any of its taxing authority, even if it be subject to limitations of time, size and veto.

However, I think this kind of idea needs another look in the light of our experience of 1966-69. We now face these hard realities:

1. Congress is a deliberative body, not an operational agency. Given a sound reason for doing so, every congressman will vote to *lower* taxes with enthusiasm and dispatch. But he will tend to drag his feet on *raising* them, since inaction will rarely hurt him *politically*.
2. When inflationary pressures build, *prompt* action is absolutely essential.
3. Congress is unlikely to give up any of its power to *cut* taxes.
4. Inaction by a President on the threat of inflation can hurt *him* politically, yet he is powerless to adjust taxes, potentially his most powerful anti-inflation weapon.

Recognizing these realities, it seems to me we ought to have the talent and the brains to devise machinery which would accept these realities and yet put some flexibility into our system, machinery which would let us use the effective tools we have learned about in recent years. I think there is one possible answer which would work like this:

\*\* Congress would keep its full and unfettered right to *lower* taxes.

\*\* But to prepare for the future possible threat of inflation Congress would pass legislation encompassing a series of prospective tax increases to deal with various possible emergencies. In other words, Congress would prepackage to *its* specifications and put *on the shelf* for the President's use as needed a series of prescriptions for economic overindulgence. One might be a 5% surtax expiring at the end of

one year. Another might be a 10% surtax expiring after six months.

\*\* With this standby authority the President would be given the power to deal promptly with the threat of inflation. Perhaps it might be written to take effect 30 days after an executive order signed by the President, subject to veto by either branch of Congress within that period.

Another device with much the same effect would be a change in congressional rules permitting the President to send up a proposed income tax adjustment (either raising or cutting tax rates) with a declaration that it be given priority consideration. When such a message was received, the rules of the House and Senate would require a floor vote -- up or down -- within, say, 60 days.

If President Nixon had either of these approaches available to him today, I think we could anticipate an extension of the 10% surtax for another six months or a year -- long enough, in any case, to slow down our inflation. But, since he doesn't have that authority, we can't be sure what's going to happen.

#### OTHER POSSIBLE WEAPONS

Taxes and interest rates are two very powerful weapons which can be used to fight inflation. There are others which could be used along with them; unfortunately, they are much less acceptable to one element or another in our economy. I'm speaking of the various, devices, either tried or proposed, to restrain the excessive rise of wages and profits in our industrial system.

On the one hand, it is proposed that all major, nationwide *labor disputes* be subjected to compulsory arbitration -- both sides being required to abide by the decisions of the arbitrators. I find few labor leaders or corporation executives who favor this approach.

On the other hand, there are those who favor outright *wage and price controls*. The last time this approach was tried was during World War II. However, there are so many problems with this -- enforcement, equity, the encouragement of

needed investment, to name a few -- that I doubt we will ever choose this route again short of an all-out war.

Finally, there is the approach which was actually used by the last two administrations -- an attempt to restrain these contending forces through mere power of persuasion. The key word for this approach was "*guideposts*." Through this device management and labor were given a rather precise indication of what price and wage increases would be consistent with the rise in productivity in the entire economy; anything beyond that was considered inflationary. Though lacking the force of law, these "guideposts" succeeded to a considerable degree until economic pressures became too great to restrain any longer. The Nixon Administration has now abandoned them.

This persuasion approach, or what some critics have labeled the "jawbone technique," probably isn't a very good idea on a permanent basis. For one thing, labor leaders tend to search for a White House scolding to show their members how much they're getting away with. For another, it isn't really fair to single out one steel producer or electrical manufacturer for allegedly unjustified price increases when other companies or other industries remain untouched by official criticism.

The British have tried an idea which has had some success. Prices aren't controlled, and wages aren't controlled, but excessive increases are restrained nonetheless through a requirement that they be reviewed by an impartial high-level public panel. The moral force exerted has made a considerable contribution to price stability.

Last year in the United States lumber prices were increased as much as 100%. Ordinary home-buyers and other citizens didn't know this was going on until a whole new pattern of really unjustified lumber prices had been established. Rolling them back at that point was almost impossible.

It occurs to me that something like the British system might work here. If we had a Price Stability Board composed of leading economists and top labor and business executives, it might be able to restrain through *moral force* the kind of excessive increases in key industries which trigger whole rounds of inflation. This would be especially true, I think, in the case of the large oligopolies which have acquired very considerable control over their own price structures.

There may be other approaches which would be better. But at least this formal, structured system of price and wage review would get away from the suspicion

of personal vendetta which was always a possibility in the days of White House arm-twisting. And it just might work.

#### **WILL WE KEEP THE SURTAX?**

No one in his right mind would try to put out a fire by pouring gasoline on it, and yet something of this kind could happen if Congress fails to extend the 10% surtax before June 30. The President has made an urgent appeal. The Budget Bureau says it's absolutely essential. The Council of Economic Advisers agrees. But there are a lot of reasons why that might not happen.

For one thing, many Members of Congress feel tax reform must take precedence over surtax extension. Others see the surtax as financing the Vietnam War, and they're against the war; cutting off the surtax, they reason, might force the Administration to end the war. Still others are simply opposed to the surtax, and they don't want to have to answer to their constituents for continuing it. And, of course, time is running out.

In the end, I expect we will extend it. It's strong medicine, and it was administered late, but giving it up now could make matters even worse. As before, if the choice is between 4 - 6% annual inflation or a 5 - 10% surtax (applied, not to your whole income but only to your regular tax), there can't be any doubt which is better.

In preparing for the period of peace we all hope lies ahead, I think we ought to give real attention to this problem of inflation. It need not be a by-product of war; surely we know now we can't have both "guns and butter." And it need not be a by-product of peace. It is my hope that out of this costly experience will come a determination to improve our fiscal and other machinery to deal with the problem of inflation. If we will do that, we may never again go through such an unstable period or see so many of our hard-earned dollars disappear.

I had intended this report to deal with one of the great debates taking shape in Congress -- the need for tax reform. Because of developments in the Ways and Means Committee, where our tax laws are written, I decided to reverse my original order. Tax reform will be [next](#).

As always, I'll appreciate your comments.

Monday 12th