

The importance of adverse financial conditions in the current recession is amply revealed in the compositional changes in spending that occurred in 1981.

- o Among the major categories of final demands, only real consumer spending for services and nondurable goods, and government spending for defense, experienced positive real growth in all four quarters of 1981.
- o The initial weakness in sales in 1981 was largely concentrated in categories that are highly sensitive to changes in interest rates--residential investment, autos, consumer durables generally, business investment, and net exports. (The responsiveness of net exports to changes in interest rates stems in part from the effects of rising U.S. real rates of interest on the foreign exchange value of the dollar. This is discussed in greater detail below.) In time, the initial weakness in these expenditure categories spread to other categories of final sales.

#### Is the Recession Trough Imminent?

How near the economy is to a recession trough is difficult to determine. It depends in large measure on whether sufficient progress has been made in preventing excessive inventories and whether the hike in interest rates in recent weeks will serve to prevent renewed activity. Census Bureau data on inventories for manufacturers, retailers, and merchant wholesalers suggest that, as of the end of November--the date of the latest available statistics--little progress had been made in reversing the inventory buildup that resulted from weak demands. However, preliminary GNP statistics showed a much slower rate of accumulation of real business inventories in the fourth quarter of 1981 than in the third quarter. Moreover, the sharp decline in industrial production in recent months indicates that producers are trying hard to work off unwanted inventories. But if the correction is not yet complete, production adjustments may be stretched out further than most forecasters are now predicting, an outcome that could delay the date of the recession trough by a month or two at least.

The sharp, renewed increase in interest rates over the past two months further complicates the picture. It is not well understood why interest rates turned up as they did given weak private-sector credit demands and reduced inflation. Some analysts have argued that the rise in short-term rates was a consequence of the

very sharp spurt in the growth of M1 over the past 13 weeks. Given the Federal Reserve's money growth targets for 1982, short-term rates may have risen in anticipation of actions to slow the rate of money growth. The rise in long-term rates apparently reflects the rise in short-term rates and increased inflationary expectations. In view of prospective large increases in federal budget deficits, market participants may be betting that the Federal Reserve will decide to monetize those deficits--that is, permit more rapid rates of money growth in order to absorb additional amounts of federal debt--ultimately driving up the rate of inflation. In any event, whatever the source of the recent increase in interest rates, sustained high rates could be enough to delay a recovery or stop it shortly after it begins.

The CBO forecast presented in this report suggests that the recession will not last beyond the first quarter. Although the evidence is mixed, some signs point in that direction.

- o Following declines in September and October, real consumer spending firmed up in November and December. When this is combined with the sharp 1.9 percent reduction in industrial production in November, and the even larger 2.1 percent reduction in December, it suggests that progress in reversing the earlier accumulation of inventories had begun by year's end.
- o After dropping for several months, the University of Michigan's index of consumer sentiment stabilized in December.
- o Sales of new homes rose modestly in October and November.
- o Following substantial declines earlier in the year, single-family housing starts turned up in November and December. On the other hand, the bad weather prevalent in much of the country in January is likely to have brought some housing activity temporarily to a halt.
- o State and local government construction, which had fallen by almost 20 percent in real terms between January and September, stabilized in October and November.
- o At the federal government level, orders data suggest that activity in defense-related industries continues strong.

- o Although manufacturers' operating rates and profit margins are low, new orders received by capital goods manufacturers increased in November and December, partially offsetting the sharp decline in October.

The easing of credit conditions between October and December may have been partly responsible for these favorable developments. If that is the case, it represents an unusually rapid response. However, reaction times may now be much shorter than in the past in view of the apparent sizable pent-up demands for housing and other durables that were earlier restrained by adverse financial conditions. By the same reasoning, the firming up of interest rates in recent weeks ought to be the source of some doubt about the near-term outlook.

In any event, assuming that the economy is at or near the recession trough, one might reasonably expect a few more months of declining production and increasing unemployment until earlier excess inventory accumulation is reversed.

#### International Sector Developments

As is clear from Table 2, real net exports declined sharply over the course of 1981, from \$50.9 billion in the first quarter to \$36.7 billion in the fourth. This \$14.2 billion swing in real net exports was another contributing factor to the downturn in economic activity in 1981.

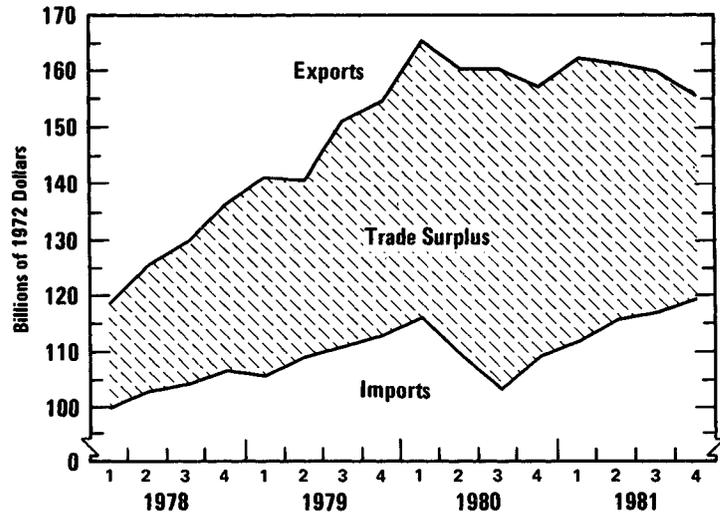
A number of factors combined to produce the deterioration of net exports, a trend that began in mid-1980 (see Figure 4). Two factors were critically important.

- o Between August 1980 and August 1981, the trade-weighted foreign exchange value of the dollar <sup>6/</sup> appreciated by more than 30 percent (see Figure 5). This increase in the foreign exchange value of the dollar caused a marked reduction in the relative competitive position of U.S. producers in world markets. Both U.S. export and U.S.

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<sup>6/</sup> The trade-weighted foreign exchange value of the dollar is an index of the weighted average exchange value of the U.S. dollar against the currencies of other G-10 countries plus Switzerland. The weights are the 1972-1976 global trade of each of the 10 countries.

Figure 4.  
Exports and Imports  
of Goods and  
Services



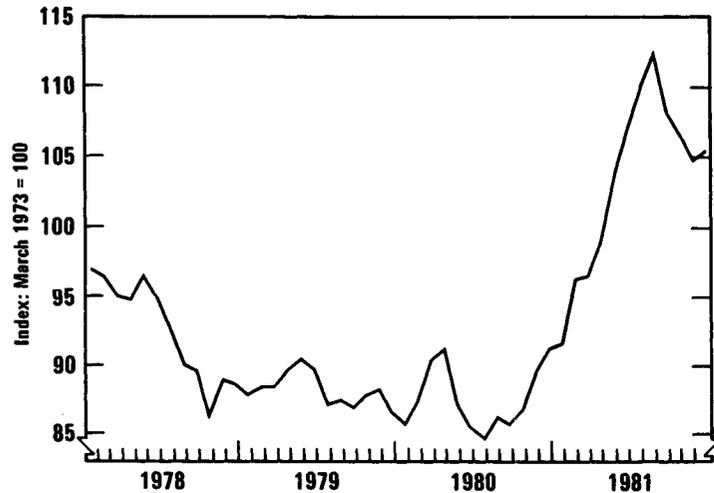
SOURCE:  
U.S. Department of Commerce,  
Bureau of Economic Analysis.

import-competing industries suffered sizable reductions in their sales volumes as a consequence.

- o The reduction in foreign (relative to U.S.) real rates of growth, a development that was particularly strong after the middle of 1980, served to slow abruptly the growth of U.S. real exports relative to real imports. The slowdown in foreign economic activity over this period was largely the result of tighter foreign monetary policies instituted to counter the effects of rising U.S. real rates of interest; specifically, to counter the attendant inflationary effects of declines in the exchange values of their currencies brought about by increased outflows of capital to U.S. financial markets.

The dramatic increase in U.S. (relative to foreign) real short-term rates of interest was perhaps the principal factor responsible for the huge appreciation of the dollar from the middle of 1980 to the middle of 1981. The narrowing of those real interest rate differentials in the fall of 1981—largely the result of lower nominal U.S. interest rates and more rapid U.S. inflation during that period—tipped the relative real interest rate advantage away from the United States in favor of foreign financial markets. As a result, the dollar moved down in foreign exchange markets. Thus, between August and December 1981, the trade-weighted foreign exchange value of the dollar fell by approximately

Figure 5.  
Trade-Weighted Value  
of the Dollar



SOURCE:  
Federal Reserve System,  
Board of Governors.

6 percent, reversing by about one-fifth the earlier dollar appreciation. Since early December, however, the dollar has moved up again; by the end of the third week in January the rise was sufficient to wipe out about half of the decline registered between August and December. Once again, the main factor responsible for the renewed appreciation of the dollar was rising relative U.S. real rates of interest, the result of both the firming up of U.S. nominal rates of interest and lower U.S. rates of inflation at year's end.

Over the course of the next year or so, the dollar is not expected to move substantially in one direction or the other--in part because no significant changes in inflation and real growth differentials are expected between the United States and its trading partners, and in part because relative U.S. real rates of interest are expected to remain at fairly high levels. For the same reasons, U.S. net exports are expected to remain fairly steady over the near term.

#### Price and Wage Inflation

The good news in 1981 was posted on the inflation scoreboard. After advancing at a rate of 12.5 percent from the fourth quarter of 1979 to the fourth quarter of 1980, the growth of the Consumer Price Index (CPI-U) slowed sharply in 1981 to a rate of increase of 9.5 percent. The Producer Price Index for Finished Goods also

decelerated rapidly in 1981, especially in the second half of the year (see Table 3).

The improvement in the overall rate of inflation in 1981 was largely the result of three developments. First, despite widespread expectations to the contrary, food prices did not accelerate in the first half of 1981 in response to the poor feed grain harvests of 1980. Indeed, during the first half of last year, food prices rose somewhat less rapidly than the prices of other goods and services. And in the second half of 1981, food prices fell sharply relative to the prices of other goods and services--the result, principally, of the bountiful harvests recorded in the summer and fall months. The sharp drop in relative food prices in the second half of 1981 accounts for most of the decline in the growth of the Producer Price Index in the last half of the year.

Second, rather than rising fairly rapidly as many forecasters expected one year ago, oil prices in international markets actually fell somewhat over the course of 1981. Finally, the foreign exchange value of the dollar rose sharply on the world's currency exchanges in 1981 (see Table 4).

The direct impact of food and fuel price changes on inflation is substantial. Food prices account directly for about 17 percent of the CPI. The prices of oil products account directly for about another 7 percent, and the cost of oil used as energy or petrochemicals to produce other goods and services accounts for approximately another 7 percent. Thus, a large portion of the CPI--nearly one-third--is accounted for by food and fuel.

Dollar appreciation tends to hold down the CPI index by lowering the dollar prices of imported goods and services. The 16 percent appreciation of the dollar over the course of 1981 can be expected to reduce the CPI eventually by about 1.6 percent, assuming it is not subsequently reversed by dollar depreciation. 7/

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7/ Not all measures of inflation are equally affected by changes in the exchange rate. In particular, the implicit GNP price deflator, which by definition excludes the prices of imported goods and services, is unaffected directly by dollar appreciations and depreciations. It is, however, subsequently affected as changes in the prices of imported goods and services are passed through to other goods and services and to labor costs.

TABLE 3. PRICE INFLATION (Percent change, seasonally adjusted annual rate)

|   | 1980:1 | 1980:2 | 1980:3 | 1980:4 | 1981:1 | 1981:2 | 1981:3 | 1981:4 |
|---|--------|--------|--------|--------|--------|--------|--------|--------|
| CPI-U <u>a/</u>                               | 16.5   | 13.1   | 7.7    | 12.9   | 10.8   | 7.5    | 12.0   | 7.7    |
| CPI-U Less Food<br>and Energy                 | 14.8   | 13.9   | 6.9    | 13.2   | 8.9    | 8.9    | 15.0   | 8.4    |
| Producer Price<br>Index For Finished<br>Goods | 16.5   | 10.5   | 14.0   | 8.9    | 10.7   | 9.4    | 4.2    | 4.5    |
| GNP Implicit Price<br>Deflator                | 9.3    | 9.8    | 9.2    | 10.7   | 9.8    | 6.4    | 9.9    | 8.4    |
| GNP Fixed-Weighted<br>Price Index             | 9.7    | 9.3    | 9.0    | 10.4   | 10.2   | 7.9    | 9.5    | 8.3    |

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Commerce, Bureau of Economic Analysis.

a/ Consumer Price Index for all urban consumers.

TABLE 4. FOOD AND FUEL PRICES, AND THE EXCHANGE RATE

|   | Percent Change from<br>Previous Year |      |      |      | Percent Change from Pre-<br>vious Quarter, Annual Rate |        |        |        |
|---|--------------------------------------|------|------|------|--|--------|--------|--------|
|   | 1978                                 | 1979 | 1980 | 1981 | 1981:1   | 1981:2 | 1981:3 | 1981:4 |
| Consumer Price<br>Index, Food<br>and Beverages<br>Component | 9.7                                  | 10.7 | 8.6  | 7.8  | 5.5  | 1.2    | 7.1    | 7.0    |
| Producer Price<br>Index, Refined<br>Petroleum               | 4.2                                  | 38.5 | 51.7 | 19.4 | 50.6   | 33.0   | -10.6  | -6.0   |
| Refiners' Acqui-<br>sition Cost,<br>Imported<br>Crude Oil   | 0.3                                  | 48.7 | 56.4 | n.a. | 47.8   | -9.6   | -20.9  | n.a.   |
| Trade-Weighted<br>Value of<br>Dollar                        | -10.6                                | -4.7 | -0.8 | 18.2 | 27.5   | 41.3   | 29.9   | -16.0  |

SOURCES: U.S. Department of Labor, Bureau of Labor Statistics; U.S. Department of Energy; Federal Reserve System, Board of Governors.

The effects on inflation of changes in the foreign exchange value of the dollar, and in food and fuel prices, are not limited to their direct effects. They also have important indirect effects on other prices, including wages. Some wage changes occur automatically as a result of cost-of-living adjustment clauses in wage contracts. Other wage changes occur that are less automatic: In an effort to catch up with past inflation, many negotiated contracts contain first-, second-, and perhaps third-year wage hikes that are larger than they would be otherwise; and workers who are not under wage contracts are frequently under implicit contracts with their employers to receive, quasi-automatically, wage increases to

make up for past inflation. These wage hikes, by raising labor costs, contribute to further increases in the general level of prices. It is important to note, however, that most of these indirect wage effects occur not immediately but with a lag.

In this regard, the deceleration in the growth of labor costs in 1981 was much less marked than the reduction in the overall rate of inflation. Indeed, outside of the encouraging sharp drop in the last quarter of the year, trends in labor costs over the course of 1981 showed only slight moderation (see Table 5). Measured in terms of percentage change from one year earlier, the Index of Average Hourly Compensation--which includes both employer contributions to social insurance and the costs of fringe benefits--rose at rates of 10 percent or more in each of the first three quarters of 1981, little changed from the rate of increase in 1980. The wage and salary component of the Employment Cost Index for the private nonfarm economy, widely regarded as one of the most reliable measures of labor costs, confirms the sustained high level of wage inflation observed in the compensation data for the first three quarters of 1981. Measured in terms of percentage change from one year earlier, the Employment Cost Index has shown little change in the past two years. In the fourth quarter, however, the growth of the Index of Average Hourly Compensation decelerated sharply, to an annual rate of increase of only 6.5 percent relative to the third quarter.

One measure of wage inflation--the Index of Average Hourly Earnings--showed a more substantial moderation in the growth of labor costs during 1981. This index is a measure of wage trends for production and nonsupervisory personnel adjusted for inter-industry employment shifts and for overtime charges in manufacturing. Annualized growth in this index slowed by 2.7 percentage points between the first quarter of 1981 and the fourth quarter.

Many analysts believe the Index of Average Hourly Earnings overstated the reduction in labor costs that occurred in 1981 because it fails to adjust wage trends for occupational employment shifts that were apparently substantial in 1981. Indirect evidence of the importance of this shift is provided by a comparison of the wage and salary component of the Employment Cost Index with the Index of Average Hourly Earnings: the main difference between these two measures is that the former makes adjustments for occupational employment shifts whereas the latter does not.

TABLE 5. LABOR COSTS (Seasonally adjusted)

|  | 1980:1 | 1980:2 | 1980:3 | 1980:4 | 1981:1 | 1981:2 | 1981:3 | 1981:4 |
|--|--------|--------|--------|--------|--------|--------|--------|--------|
| <u>Percent Change from One Year Earlier</u>                    |        |        |        |        |        |        |        |        |
| Compensation per Hour  | 9.7    | 9.9    | 10.1   | 10.1   | 10.5   | 10.0   | 10.2   | 9.3    |
| Employment Cost Index <u>a/</u> <u>b/</u>                      | 9.1    | 9.3    | 9.4    | 9.0    | 9.3    | 9.3    | 9.1    | n.a.   |
| <u>Percent Change from Previous Quarter, at an Annual Rate</u> |        |        |        |        |        |        |        |        |
| Average Hourly Earnings Index                                  | 9.2    | 10.0   | 9.0    | 10.3   | 9.7    | 8.4    | 8.4    | 7.0    |

SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.

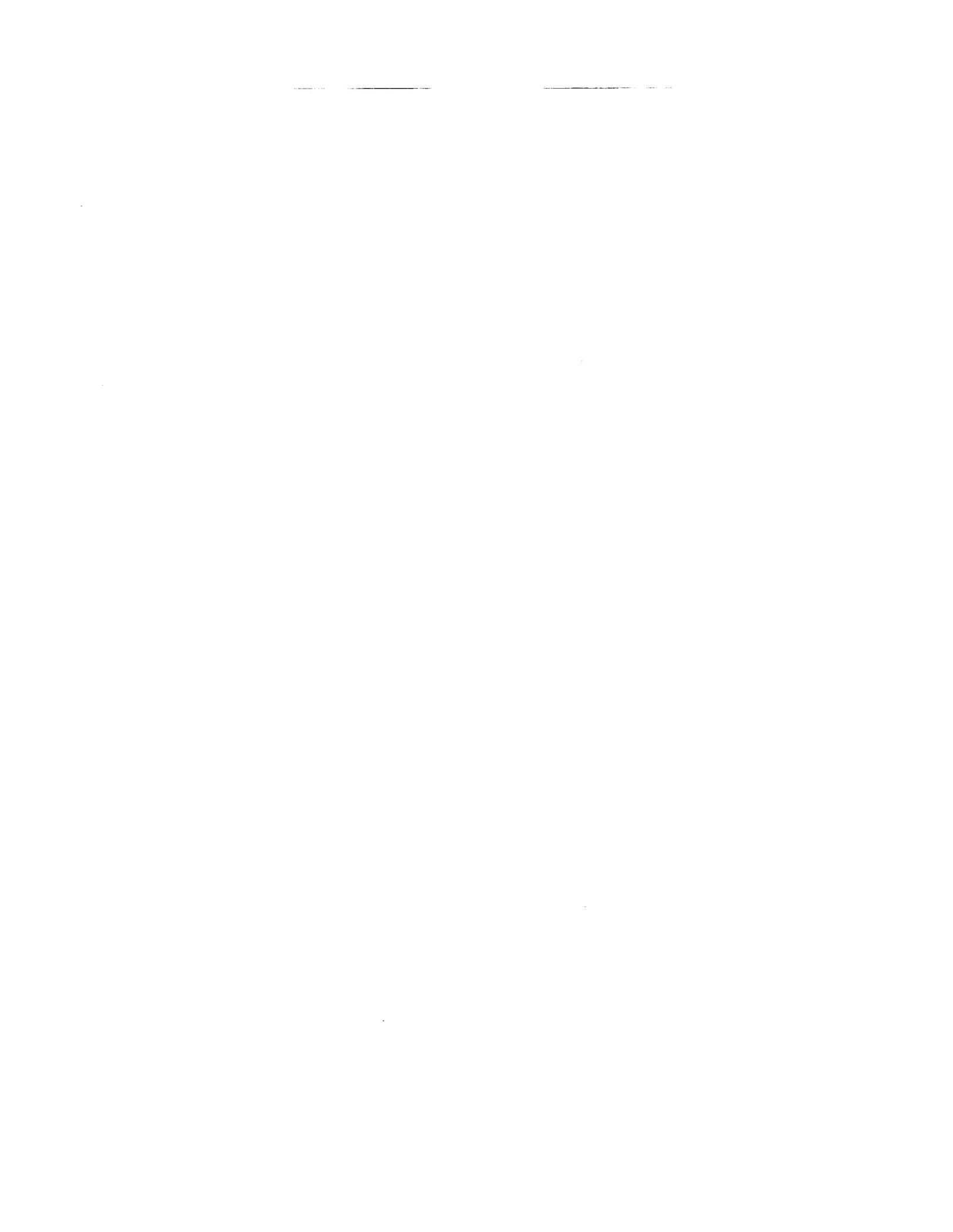
a/ Data are for the private nonfarm sector.

b/ Index for wage and salary component of compensation.

The more moderate reduction in the growth of labor costs relative to the overall pace of inflation in 1981 reflected, in part, worker efforts to catch up with past high rates of inflation. By the fourth quarter of 1981, however, there was strong evidence that underlying inflationary wage pressures were finally beginning to ease. In response to further prospective declines in inflation and to widespread weakness in labor markets, CBO expects that the growth of employee compensation will decelerate significantly further in the near term.

The CBO near-term outlook for wage inflation is likely to be bolstered by some recent, highly irregular union labor market developments. Because of rising unemployment and the increasing threat of business failures, some unions have given up wage gains, and others have actually accepted wage cuts, behavior that has been exceptional in post-World War II history. Will these changes in

negotiated wage levels significantly affect long-term wage trends? They may, but that does not appear to be the most likely outcome. Since 1975, union wages have increased by about 10 percent more than nonunion wages as measured by the Employment Cost Index. For the larger unions, the increases in relative wages have been even greater. Thus, as the economy weakened and as competition, particularly from U.S. trading partners, became more intense, wages in those sectors of the economy became more vulnerable. Accordingly, the current squeeze on key union wage rates may represent nothing more than a temporary downward adjustment of union to nonunion rates. This squeeze will exert downward pressure on wage inflation during the early part of 1982 at least, but will probably not alter substantially the general, longer-term trends in wages.



As the previous discussion has shown, financial conditions played the leading role in bringing on the current economic downturn. The high interest rates and other stringent credit conditions that prevailed until the recession began caused weakness in housing and auto sales that later spread to other sectors of the economy. High interest rates also brought about a rapid appreciation of the dollar in foreign exchange markets, which contributed to the reduction in real net exports. Fiscal policy further contributed to weak private demands because of the inflation-induced increases in effective income tax rates and the increase in Social Security taxes.

Statements from the Federal Reserve suggest that monetary policy will continue its anti-inflationary stance in the coming years. If inflation does not slow quickly, this policy will likely limit real growth in sectors of the economy most sensitive to high interest rates. By contrast, the budget measures enacted last summer will provide considerable stimulus to economic activity over the next few years. This suggests the possibility of a clash between monetary and fiscal policy unless the Congress enacts further spending cuts and tax increases to reduce federal borrowing or the Federal Reserve adopts a less restrictive monetary policy. If the clash materializes, it will be reflected in high real interest rates that crowd out private investment. The size of these effects is hard to predict. The tax cuts should provide a substantial boost to private savings and investment in the longer run, but some fear that the major objective of the tax cuts--increased business investment--could be a casualty of high real interest rates, at least during the next few years. Other analysts deny that monetary and fiscal policy are on a collision course; they anticipate a sizable boost in saving in the wake of the tax cuts, which could largely offset the upward pressure on interest rates.

The impact of current monetary and fiscal policies on the economy is uncertain for other reasons as well. Although prospective Federal Reserve money targets appear to be very restrictive, recent dramatic changes in financial markets have made it quite difficult to appraise the targets and predict their effects. Similarly, while the fiscal policy now in force is expected to

provide a boost to the economy, the sizable distributional and compositional changes made last summer in tax and spending policies are hard to assess, especially for the next few years.

## FISCAL POLICY

In 1981, the Congress and the Administration enacted sweeping changes in budget policies to sharply reduce tax burdens, raise defense spending, and slow the growth of nondefense spending. Because the tax cuts are larger than the spending reductions, these budget policies are likely to cause large and growing deficits in coming years unless further budget action is taken.

### The Structure of Budget Policy

Although the precise quantitative impacts are uncertain, the structural features of the tax and expenditure policies adopted in 1981 may have important implications for the supply and allocation of economic resources. The Economic Recovery Tax Act of 1981 provides various incentives to work, save, and invest, including: lower marginal tax rates on personal income; increased tax incentives for saving; and enhanced tax incentives for capital formation. The spending policies are intended to reduce the growth in federal outlays and to shift resources to national defense activities. These tax and spending measures are intended to slow the growth of personal consumption expenditures and to foster higher levels of private business investment.

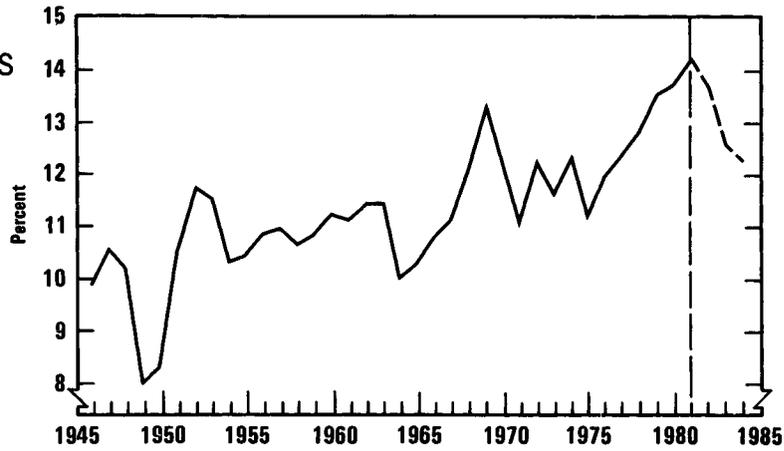
Personal Income Taxes. In recent years, personal taxes have taken an ever larger bite of personal income. Thus, despite several legislated tax reductions, the ratio of personal income taxes (NIPA basis) to taxable personal income rose steadily from 11.3 percent in 1975--the year of the antirecession tax rebates--to a record high of 14.3 percent in 1981 (see Figure 6). <sup>1/</sup> The Economic Recovery Tax Act of 1981 is expected to reverse this

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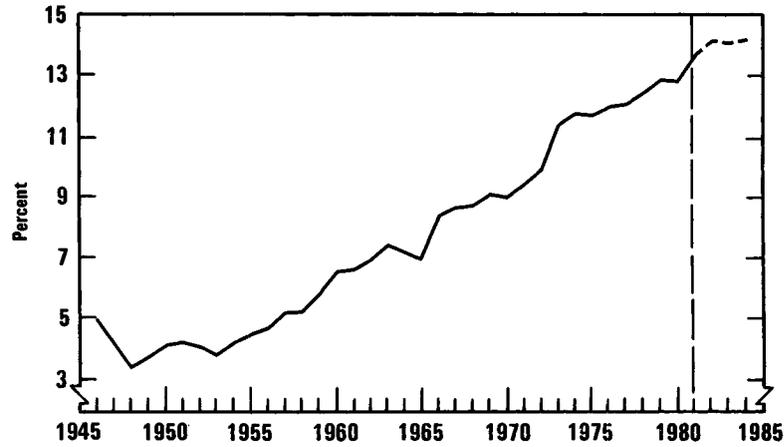
<sup>1/</sup> The 1981 reduction in marginal individual income tax rates was 1.25 percent, an adjustment insufficient to offset the effect of bracket creep.

Figure 6.  
Effective Tax Rates

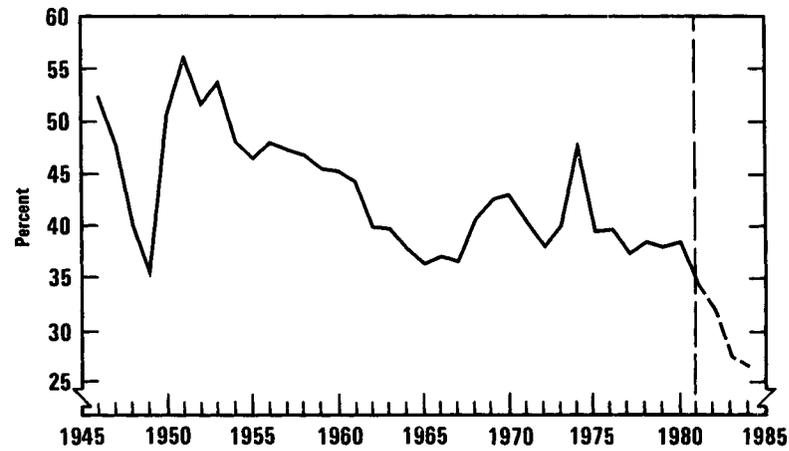
Federal Personal  
Income Taxes as  
a Percentage of  
Taxable Personal  
Income



Federal Social  
Insurance  
Contributions as  
a Percentage of  
Wages and Salaries



Federal Corporate  
Profit Tax Accruals  
as a Percentage  
of Economic Profits



NOTE: Broken line indicates projections.

SOURCES: U.S. Department of Commerce, Bureau of Economic Analysis;  
Congressional Budget Office.

trend. 2/ Through 1984, however, inflation is expected to offset a significant portion of the reduction in the effective personal income tax rate. Accordingly, the projected effective tax rate declines only to 12.4 percent in 1984--a rate that is still very high by historical standards. Thus, the average personal income tax burden is expected to remain relatively high for at least the next few years. The tax burden on high-income individuals, however, will decline significantly, largely because of the reduction in the maximum marginal tax rate on unearned income from 70 to 50 percent. 3/

While the 1981 tax act lowers the average personal tax rate, tax liabilities and marginal tax rates for many taxpayers in 1984 may be above their 1980 levels, even if their taxable incomes do not grow in real terms. For example, a married couple filing jointly with taxable income of \$29,000 in 1980 (the 32 percent marginal rate bracket) paid \$5,913 in federal income taxes (see Table 6). If their taxable income were 35 percent higher in 1984

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2/ The act includes an across-the-board rate reduction for individuals amounting to 23 percent over 33 months, and a January 1, 1982, reduction in the top marginal rate on unearned income from 70 to 50 percent--lowering the top effective rate on capital gains income from 28 percent to 20 percent. It also reduces the "marriage penalty," and provides exclusions for several forms of savings.

3/ In addition to taxes on wages and salaries, personal income taxes in the National Income and Product Accounts include taxes on unincorporated business profits, dividends, interest, and capital gains. These other sources of personal income represent a relatively small proportion of adjusted gross income (AGI), and are concentrated in the upper-income tax brackets. For example, in 1978, wages and salaries accounted for 83.6 percent of adjusted gross income of all taxable returns. However, wages and salaries represented 88.6 percent of the income of those with \$30,000 or less of AGI, 77.8 percent of income in the \$30,000 to \$100,000 AGI class, and only 48.2 percent of the AGI incomes above \$100,000. Because many high-income individuals are already in the new maximum marginal tax rate bracket, which means they are not subject to further bracket creep, the 20 percentage-point reduction in the marginal tax rate on unearned income represents a significant reduction in their real tax burdens.

TABLE 6. THE INDIVIDUAL INCOME TAX RATE STRUCTURE, 1980 AND 1984

| Taxable Income    | Marginal Tax Rate |      | Average Tax Rate |             |
|-------------------|-------------------|------|------------------|-------------|
|                   | 1980              | 1984 | 1980             | 1984        |
| 0 - 3,400         | 0                 | 0    | 0                | 0           |
| 3,400 - 5,500     | 14                | 11   | 0 - 5.3          | 0 - 4.2     |
| 5,500 - 7,600     | 16                | 12   | 5.3 - 8.3        | 4.2 - 6.4   |
| 7,600 - 11,900    | 18                | 14   | 8.3 - 11.8       | 6.4 - 9.1   |
| 11,900 - 16,000   | 21                | 16   | 11.8 - 14.2      | 9.1 - 10.9  |
| 16,000 - 20,200   | 24                | 18   | 14.2 - 16.2      | 10.9 - 12.4 |
| 20,200 - 24,600   | 28                | 22   | 16.2 - 18.3      | 12.4 - 14.1 |
| 24,600 - 29,900   | 32                | 25   | 18.3 - 20.7      | 14.1 - 16.0 |
| 29,900 - 35,200   | 37                | 28   | 20.7 - 23.2      | 16.0 - 17.8 |
| 35,200 - 45,800   | 43                | 33   | 23.2 - 27.8      | 17.8 - 21.3 |
| 45,800 - 60,000   | 49                | 38   | 27.8 - 32.8      | 21.3 - 25.3 |
| 60,000 - 85,600   | 54                | 42   | 32.8 - 39.1      | 25.3 - 30.3 |
| 85,600 - 109,400  | 59                | 45   | 39.1 - 43.5      | 30.3 - 33.5 |
| 109,400 - 162,400 | 64                | 49   | 43.5 - 50.2      | 33.5 - 38.5 |
| 162,400 - 215,400 | 68                | 50   | 50.2 - 54.6      | 38.5 - 41.4 |
| 215,400+          | 70                | 50   | 54.6+            | 41.4+       |

NOTE: This table has not been adjusted to take account of tax credits.

SOURCES: 1981 U.S. Master Tax Guide, Schedule Y; Economic Recovery Tax Act of 1981.

(\$39,150)--approximately the projected increase in the general price level--they would have a 1984 tax liability of \$7,578 and a marginal tax rate of 33 percent. <sup>4/</sup> Their average tax rate,

<sup>4/</sup> While the 1984 marginal tax rate is higher than that for 1980, it is ten percentage points below the 43 percent rate that would have been applicable if there had been no reduction in statutory rates. Thus, to the extent that personal saving and work effort are affected by the level of marginal tax rates, this hypothetical couple would not be induced to save or work more in 1984 than in 1980, but they would be less likely to reduce their saving and their work effort as might have occurred had the rate reductions not been enacted.

however, would decline from 20.4 percent in 1980 to 19.4 percent in 1984. 5/

In contrast, a couple with a taxable income of \$150,000 in 1980, with a marginal tax rate of 64 percent (on unearned income) paid \$73,528 in taxes. Despite a 35 percent increase in taxable income (to \$202,500), their marginal tax rate in 1984 would be only 50 percent--a decline of 14 percentage points--and their 1984 tax liability would be \$82,650, implying an average tax rate of 40.8 percent compared to 49 percent in 1980.

Payroll Taxes. While bracket creep has raised effective tax rates on both earned and unearned income, increases in payroll taxes have contributed significantly to the growth of the tax burden on wages and salaries. 6/ Combined employer, employee, and self-employed contributions for social insurance programs averaged 4.5 percent of wages and salaries in the 1950s; 7.6 percent in the 1960s; and 11.2 percent in the 1970s. 7/ They rose further to 13.7

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5/ In this example, bracket creep places the couple two tax brackets higher in 1984 than in 1980. If the couple were in the lower range of the \$24,600-\$29,900 tax bracket in 1980, with taxable income of \$25,000, their 1984 marginal tax rate would be reduced to 28 percent.

6/ In the National Income and Product Accounts, over 80 percent of federal social insurance contributions consists of Social Security (OASDHI) taxes. The remainder consists largely of contributions for unemployment insurance and federal employee retirement. Increases in the effective social insurance tax rate primarily have reflected changes in Social Security taxes, including upward adjustments in the Social Security tax rate, increases in the ceiling on maximum taxable earnings, and extensions of coverage to groups previously not covered under the Social Security program.

7/ Research indicates that some of the employers' share of social insurance contributions is shifted backward to employees (in the form of lower compensation) or forward to consumers (through higher product prices).