ECONOMIC POLICY AND THE OUTLOOK FOR THE ECONOMY

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NOTES

Shaded areas between P and T lines on some graphs represent periods of cyclical downturn, as designated by the National Bureau of Economic Research. Periods of peak cyclical economic activity since 1950 are July 1953, August 1957, April 1960, December 1969, November 1973, and January 1980; they are designated by P lines on the graphic figures. Periods of trough or low cyclical activity occurred in May 1954, April 1958, February 1961, November 1970, March 1975, and midsummer 1980; they are designated by T lines.

Data are seasonally adjusted or not, according to conventional economic usage.

PREFACE

The Congressional Budget Office is required by Section 202(f) of the Congressional Budget Act of 1974 (Public Law 93-344) to submit to the Committees on the Budget of the House of Representatives and the Senate an annual report. This year's report examines the state of the economy and analyzes alternative fiscal policy options. In accordance with CBO's mandate to provide objective analysis, the report contains no recommendations.

The report was prepared by George R. Iden, Joan D. Schneider, Frank S. Russek, Jr., Stephen H. Zeller, Robert A. Dennis, Peter M. Taylor, Christopher D. Kask, Marvin M. Phaup Jr., Lawrence E. DeMilner, Joseph A. Ritter, Robert W. Staiger, and John W. Straka, under the direction of William J. Beeman and James E. Annable, Jr.

Robert L. Faherty and Francis S. Pierce edited the manuscript. Debra M. Blagburn, Dorothy J. Kornegay, Kathleen M. Quinn, and Marsha L. Motteshead typed the many drafts. Art Services, Inc., prepared the graphic figures.

Alice M. Rivlin
Director

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SUMMARY

In 1980, a combination of rapid inflation, high unemployment, lagging productivity, and record high interest rates battered the U.S. economy. In response to the poor performance of the economy, President Reagan has proposed a dramatic shift in economic policies designed to reduce inflation and increase economic growth. The proposed policies include large tax cuts, a reduction in the growth of federal spending, tight monetary policy, and substantial deregulation of the economy.

Inflation in 1980, as measured by the Consumer Price Index (CPI), remained near the record level of the previous year. Relatively large increases occurred in energy prices and mortgage interest costs; but sharp price increases were more widespread than in 1979, reflecting an acceleration in production costs. The rapid inflation had adverse effects throughout the economy.

The economy experienced a very sharp, though brief, decline in real output in the spring of 1980--the seventh recession since World War II. This was followed by a relatively weak recovery in the second half of the year. Along with the drop in output, the unemployment rate rose abruptly from 6 percent at the end of 1979 to 7.6 percent in May, and declined only slowly thereafter. An unusual factor was the unprecedented swings in interest rates: after hitting record highs early in the year, interest rates dropped sharply as credit demands declined during the recession. But as the recovery gained momentum, credit demands increased and interest rates rose sharply again--reaching new highs by year-end. As the new year began, economic growth, as measured by real gross national product (GNP), accelerated but many forecasters expected a slowing or even a decline during the spring as a result of the high interest rates.

THE "CURRENT POLICY" FORECAST

The Congressional Budget Office (CBO) "current policy" forecast for 1981 and 1982 is a forecast of economic performance assuming the budget policies of the Second Concurrent Resolution on the Budget for Fiscal Year 1981:

- Total federal spending on a unified budget basis is assumed to be $660 billion in fiscal year 1981 and $743 billion in fiscal year 1982.

- The second concurrent resolution incorporates an unspecified tax cut. The forecast assumes that the tax cut takes the form of a 10 percent reduction in federal personal income taxes beginning in July 1981 and a retroactive (effective to January 1981) business tax reduction based on the Senate Finance Committee's proposal for "2-4-7-10" accelerated depreciation.

In addition, growth in monetary aggregates over the next two years is assumed to be somewhat above the Federal Reserve's announced target ranges. The economy is expected to encounter persistent inflation and high nominal demands that will make it difficult for the Federal Reserve to achieve its announced targets without a significant increase in unemployment. The forecast also incorporates the following assumptions about food and fuel prices:

- Consumer food prices increase 12.3 percent in 1981 and 11.7 percent in 1982; and

- The world price of oil continues rising--reaching a level at the end of 1982 that is 28 percent higher than at the end of 1980.

The Current Policy Forecast

The highlights of CBO's current policy forecast, shown in Summary Table 1, are:

- Real GNP is projected to rise slowly during 1981, between 0.8 and 2.8 percent. A modest acceleration in real growth, to the 1.8 to 3.8 percent range, is projected over the four quarters of 1982.

- Inflation is expected to remain very high over the forecast period. The projected increase in the GNP implicit price deflator is from 9.0 to 11.0 percent over the four quarters of 1981 and from 8.0 to 10.0 percent over the four quarters of 1982.

- The unemployment rate is likely to rise gradually in 1981, to a range of 7.3 to 8.3 percent by the fourth

SUMMARY TABLE 1. THE CBO "CURRENT POLICY" FORECAST

Economic Variable	Actual: 1979:4 to 1980:4	Projected: 1980:4 to 1981:4	Projected: 1981:4 to 1982:4
Nominal GNP (percent change)	9.4	10.0 to 14.0	10.0 to 14.0
Real GNP (1972 dollars, percent change)	-0.3	0.8 to 2.8	1.8 to 3.8
GNP Implicit Price Deflator (percent change)	9.8	9.0 to 11.0	8.0 to 10.0
Unemployment Rate, End of Period (percent)	7.5	7.3 to 8.3	7.1 to 8.1

quarter, and then to decline slightly to a range of 7.1 to 8.1 percent by the end of 1982.

Reasons for the Forecast of Weak Growth

Some advance indicators suggest that economic activity may weaken this spring or summer: income growth, adjusted for inflation, has been weak; consumer confidence has declined; the saving rate has fallen to low levels; housing starts have declined sharply in response to high interest rates; and the sales promotions that have recently boosted auto sales are scheduled to end soon. However, a decline in interest rates, resulting from the projected weakness, and the assumed tax cut in July are expected to set the stage for a rebound later in the year.

Real economic growth is not expected to be vigorous next year, however, since it will be severely restrained by rising interest rates resulting from high inflation coupled with tight monetary policy. Strong economic growth in 1982 is likely only if there is a rapid slowing of inflation; thus, a key aspect of the economic outlook is the momentum of inflation.

Inflation Momentum and Economic Growth

The CBO forecast incorporates the view that inflation is not likely to decelerate rapidly during the next few years despite relatively tight monetary policy. In addition to the food and fuel price assumptions noted above, the important reasons for this view are:

- o Wage demands are expected to remain high as workers seek to "catch up" to recent price increases.
- o Legislated increases in payroll taxes and the minimum wage are expected to add about 0.8 percentage point to labor compensation in 1981 and a smaller amount in 1982.
- o Productivity growth is projected to be below the postwar average during the next few years.
- o Businesses will probably seek to rebuild profit margins as economic growth picks up.
- o Because inventories are relatively lean, a typical inventory cycle is not expected, thus providing little reason for significant retail price cutting.

If inflation persists, as the CBO forecast suggests, it will have a detrimental effect on economic growth over the next few years. The present monetary policy targets of the Federal Reserve are consistent with a decline in the growth of nominal GNP. This means that, if inflation remains high, there will be little, if any, room for growth in real activity. Even if money aggregates grow somewhat faster than the targets, rapid growth of output is unlikely.

Uncertainty in the Outlook

A number of important factors could change economic performance substantially. For example, given the Federal Reserve's determination to reduce inflation, monetary policy might turn out to be substantially more restrictive than assumed by CBO. As indicated earlier, such a policy is likely to reduce inflation more quickly than in the CBO projection, but at the cost of less growth and more unemployment.

Recent experience suggests that the most important factor may be the behavior of commodity prices, especially for food and fuel. With a given monetary policy, higher commodity prices would lead temporarily to higher general inflation and interest rates and to lower real growth. On the other hand, lower commodity prices would have a more favorable effect. Simulations with various large econometric models indicate that if both food and fuel prices rise only a little--specifically, if each of these prices is 20 percent lower by the end of 1982 than assumed in the CBO forecast--the general price level and the unemployment rate might be 1.7 percent and 0.4 percentage points lower, respectively, by the last quarter of 1982.

THE OUTLOOK WITH ADMINISTRATION POLICIES

The Administration's budget proposals involve a fundamental shift in federal priorities from nondefense to defense spending and from public allocation of resources to increased private allocation. The spending proposals include:

- o Rapid growth in defense spending, averaging about 9 percent per year in real terms during the 1980-1986 period; and

- o Large reductions in nondefense spending, building from about $48 billion in fiscal year 1982 to $138 billion in 1984, relative to the spending proposals in the January budget of the Carter Administration. The spending cuts are mostly concentrated in grants to state and local governments, in nondefense purchases, and in transfer programs.

Individuals and businesses would receive substantial tax cuts. Specifically, the Administration's major tax proposals are:

- o For individual income taxes, three 10 percent rate cuts would occur in July 1981, July 1982, and July 1983.

- o Businesses would receive much faster tax depreciation of capital and some liberalization of the investment tax credit. The depreciation proposal is similar to the "10-5-3" proposal (with somewhat longer depreciation lives for structures). The first phase of the business tax cuts would be retroactive to January 1, 1981, followed by additional phases in 1982 through 1985.

These fiscal policy changes lead the Administration's budget estimates to show a marked reduction in the growth of federal

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spending, a reduction in the federal sector's share of GNP, and a balanced budget by 1984 (see Summary Table 2).

In addition to the above budget policies, the Administration's economic program includes:

- o Strong support for a steady reduction in the growth of money aggregates; and

- o Substantial deregulation of the economy.

SUMMARY TABLE 2. ADMINISTRATION'S BUDGET TOTALS (By fiscal year, in billions of dollars)

	Actual	Projected			
	1980	1981	1982	1983	1984
Revenues	520.0	600.3	650.3	709.1	770.7
Target Outlay Ceiling	579.6	655.2	695.3	732.0	770.2
Target Surplus or Deficit (-)	-59.6	-54.9	-45.0	-22.8	0.5
Percent of GNP					
Revenues	20.3	21.1	20.4	19.7	19.3
Target outlay ceiling	22.6	23.0	21.8	20.3	19.3
Percent Growth					
Revenues	11.6	15.4	8.3	9.0	8.7
Outlays	17.4	13.0	6.1	5.3	5.2

SOURCE: Executive Office of the President, Office of Management and Budget.

The Outlook with the Administration's Policies

Estimates of the economic impact of policy changes are always difficult to make. The course of the economy without policy changes cannot be forecast with a high degree of reliability; the effects of policy changes add even more uncertainty, especially when they are as large as those proposed by the Administration. Using econometric models that incorporate the U.S. experience with economic activity since World War II, CBO has analyzed the effects that the Administration's budget policies might be expected to have on inflation and growth. That analysis suggests that, compared with a policy that involved no tax or spending cuts, the Administration's proposals would significantly increase real economic growth and reduce unemployment, while causing some upward pressure on inflation, particularly in later years. The inflationary demand pressures from the personal income tax cut would be largely offset by increases in productive capacity, resulting largely from the business tax cuts, together with cuts in federal spending.

Nevertheless, this CBO five-year projection incorporating the Administration's budget policies--referred to as the CBO alternative--is not as optimistic as the Administration's own economic scenario (see Summary Table 3). There are only minor differences between them in 1981, when both foresee lackluster real growth and continued high inflation. Between 1982 and 1986, however, the differences become more substantial. The CBO projection shows a more gradual improvement in inflation, reflecting the historical experience with the momentum of inflation. The CBO projection also shows weaker growth in the near term, but its growth rates approach the Administration's in out-years when the stimulative impact of tax cuts overcomes the restrictive effect of spending cuts.

Reasons for Different Projections

There are four likely, not mutually exclusive, explanations of why the CBO economic projection derived from historical experience is more pessimistic than the Administration's projection:

- The economic baselines from which the effects of changed fiscal policies have been calculated may differ. The Administration has not provided the Congress with its assessment of how the economy would behave absent its proposed fiscal policy changes, but its baseline projection may be more optimistic in its assumptions about such things as world oil prices, weather, and international economic relations.

- The Administration's fiscal policies, especially the tax cuts, could have a more favorable effect on economic

SUMMARY TABLE 3. A COMPARISON OF ECONOMIC ASSUMPTIONS (By calendar year)

Economic Variable	1981	1982	1983	1984	1985	1986
GNP (percent change, year over year)						
Administration	11.1	12.8	12.4	10.8	9.8	9.3
CBO Alternative a/	11.8	11.9	11.5	11.4	11.7	10.9
Real GNP (percent change, year over year)						
Administration	1.1	4.2	5.0	4.5	4.2	4.2
CBO Alternative a/	1.3	2.5	2.7	3.0	3.8	3.7
GNP Deflator (percent change, year over year)						
Administration	9.9	8.3	7.0	6.0	5.4	4.9
CBO Alternative a/	10.3	9.2	8.6	8.1	7.5	7.0
CPI (percent change, year over year)						
Administration	11.1	8.3	6.2	5.5	4.7	4.2
CBO Alternative a/	11.3	9.5	8.9	8.2	7.7	7.1
Unemployment Rate (percent, annual average)						
Administration	7.8	7.2	6.6	6.4	6.0	5.6
CBO Alternative a/	7.8	7.9	7.8	7.7	7.5	7.2
Three-Month Treasury Bills (percent, annual average)						
Administration	11.1	8.9	7.8	7.0	6.0	5.6
CBO Alternative a/	12.6	13.7	11.5	10.2	9.7	9.3

NOTE: These projections were prepared using the Commerce Department's preliminary estimates of GNP data for 1980.

a/ Based on the Administration's budget assumptions, derived by removing from the current policy baseline all tax changes not already legislated, and then incorporating the effects of the Administration's proposals.

SOURCES: Executive Office of the President, Office of Management and Budget; Congressional Budget Office.

growth than historical experience suggests. It is possible that the marginal income tax rate cuts will have a larger effect on saving and work effort than indicated by postwar experience. At most, however, they would not greatly increase economic growth during the next few years. In addition to such incentive effects the rate of saving could be pushed up as a result of the distribution of the individual income tax--about five-sixths of the relief would go to households earning more than the median income.

- The monetary policy assumed in CBO's estimates differs from that of the Administration's scenario. In addition, the Administration assumes that a steady decline in money growth would reduce inflationary expectations relatively quickly. If so, the impact on inflation might occur more quickly than indicated by past experience.

- The Administration is assuming unspecified, but apparently substantial, changes in government regulations. These could affect prices, resource allocation, and economic growth. The CBO estimates assume no regulatory changes.

Budget Implications of CBO's Alternative Projection

Economic projections are subject to substantial error, and the range of error can be wider than the difference between the projections of the Administration and of CBO. Nevertheless, the differences in projections have significant budgetary implications. A reestimate of the Administration's budget outlays on the basis of the more pessimistic CBO projection shows sizable increases in Social Security and other indexed benefit payments, unemployment insurance compensation, net interest costs, and defense fuel costs. In sum, applying the CBO economic projection to the Administration's policies adds over $35 billion to outlays by fiscal year 1984. On the revenue side of the budget, however, the differences between the two projections are slight. CBO's projection of lower growth is offset by higher inflation, so that the projection for nominal income (the tax base) is very close to that of the Administration.

CONCLUSION

The U.S. economy experienced high inflation and lagging productivity during the last several years. CBO's forecast