

THE FISCAL POLICY RESPONSE TO INFLATION

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Congressional Budget Office

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PREFACE

The Congressional Budget Office is required by Section 202(f) of the Congressional Budget Act of 1974 (Public Law 93-344) to submit an annual report on budgetary options. This year, the report is in two parts: The Fiscal Policy Response to Inflation and Five-Year Budget Projections and Alternative Budgetary Strategies for Fiscal Years 1980-1984.

Part I, The Fiscal Policy Response to Inflation, is one of a series of reports on the state of the economy issued periodically by the Congressional Budget Office. In accordance with CBO's mandate to provide objective analysis, the report contains no **recommendations**. The report was prepared by George **Iden**, Cornelia Motheral, Steve Zeller, Lawrence **DeMilner**, **Nariman** Behravesh, Joan Schneider, Marvin Phaup, Yolanda Kodrzycki, Rebecca **Summerville**, Toni Gibbons, John Jacobson, and Asa Strong, under the direction of William J. Beeman and James E. Annable. Marion F. Houstoun and Robert L. Faherty edited the manuscript; Dorothy J. Kornegay, Judy Deason and Marsha Mottesheard patiently typed the many drafts.

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Director

January 1979

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SUMMARY

In 1978, unemployment declined appreciably, but inflation accelerated to near record levels for the postwar period. Today, there is widespread agreement that inflation is the major problem facing **policymakers**. As a result, the Administration has proposed spending cuts and introduced a new wage/price guidelines program, and the Federal Reserve has adopted tighter monetary policies.

A major question before the Congress is what can, or should, fiscal policy do to mitigate inflation? The most discussed options **are:**

- o Holding the fiscal year 1980 budget at current policy levels, as set forth in the second budget resolution for 1979;
- o Reducing spending moderately below current policy levels (similar to the **Administration's proposal**); or
- o Cutting spending substantially below current policy **levels**.

The adoption of a restrictive fiscal policy would complement the anti-inflation program of the Administration and the Federal Reserve. The available evidence, **however**, indicates that the resulting reduction in inflation would be small, unless restrictive economic policies were maintained **for a prolonged period**. Meanwhile, unemployment would increase and remain relatively high.

Even if the current policy budget were **enacted**, unemployment is expected to rise in 1979. The Congressional Budget Office (**CBO**), like the majority of forecasters, now predicts a downturn in economic activity sometime during 1979, with jobless rates through 1980 well above current levels. In addition to rising unemployment, a significant weakening of the economy is expected to bring larger budget deficits, as a result of reduced revenue growth and increased spending for unemployment **compensation** and other social **programs**.

THE CBO CURRENT POLICY FORECAST

Forecasts of economic activity and inflation depend critically on assumptions about fiscal and monetary policy. The CBO economic projection **is** based upon the following policy assumptions:

- o Federal tax and spending policies in fiscal year 1979 are as given in the budget resolution enacted last fall; the same policies are also assumed to continue in fiscal year 1980. Current policy outlays are estimated to total about \$494 billion in fiscal year 1979 and \$551 billion in fiscal year 1980.
- o Neither the real wage insurance proposed by the Administration as part of its wage/price guidelines program nor any tax **changes**, other than those already enacted, are included in the forecast. Expenditure cuts proposed by the Administration are also not included. 1/
- o Monetary authorities **are** assumed to continue in the recently announced program to reduce **inflation** and prevent further depreciation of the dollar. This policy is assumed to prevent the growth in the broadly defined money stock (**M2**) from exceeding Federal Reserve targets and to result in a further rise in short-term interest rates through the second quarter of 1979.

Given those assumptions, the CBO forecast, shown in Summary Table 1, is as follows:

- o Growth in constant dollar gross national product (GNP) will slow from over 4 percent last year to a 0 to 2 percent range from the fourth quarter of 1978 to the fourth quarter of 1979. During 1980, real economic growth will recover moderately, rising to a 3 to 5 percent range.

1/ A CBO forecast based upon the Administration's fiscal assumptions will appear in the CBO document, An Analysis of the President's Budgetary Proposals for Fiscal Year 1980 (January 1979).

- o Unemployment is expected to rise from current levels to a range of 6.2 to 7.2 percent by the last quarter of 1979, with little change in 1980.
- o Prices are expected to rise by 7.0 to 9.0 percent during 1979, moderating **somewhat**, to 6.5 to 8.5 percent, in 1980.

SUMMARY TABLE 1. SUMMARY OF CBO ECONOMIC PROJECTIONS UNDER CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

Economic Variable	1976:4 to 1977:4 (actual)	1977:4: to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (current dollars, percent change)	11.9	12.9	7.0 to 11.1	9.7 to 13.9
GNP (1972 dollars, percent change)	5.5	4.3	0.0 to 2.0	3.0 to 5.0
Consumer Price Index (percent change)	6.6	8.9	7.0 to 9.0	6.5 to 8.5
Unemployment Rate, End of Period (percent)	6.6	5.8	6.2 to 7.2	6.2 to 7.2

The economy is not projected to weaken immediately. Available data on real activity do not yet show the widespread imbalances that typically precede a downturn. But CBO does foresee a modest decline in real GNP beginning in the second half of 1979. 2/

2/ The CBO forecast satisfies the popular definition of a recession--two consecutive quarters of decline in real GNP--but it may not conform to the National Bureau of Economic Research definition of recession, which takes many other factors into account.

Sources of Uncertainty

The Major Uncertainty. The outlook for the economy in 1979 is unusually uncertain. The critical factors in this uncertainty are the future course of inflation and the response of monetary policy. Restrictive monetary policies already in place have increased the probability of a downturn in economic activity in the year ahead, and most forecasters, including CBO, expect credit conditions to tighten further in response to continued rapid inflation. But that outcome is by no means assured. Forecasts of inflation are subject to substantial error, and the Federal Reserve's policy response to inflation and other developments in the coming months is also uncertain. If inflation slows significantly in the months ahead, the Federal Reserve may be able to avoid a prolonged period of credit restraint, which would considerably improve the prospects of avoiding a recession this year.

Other Sources of Uncertainty. Other events that could significantly affect the outlook include: the possibility of major strikes, in response to business firms' efforts to comply with the Administration's wage/price guidelines; prolongation of the current "buy-in-advance" psychology, born of a general expectation of rising prices; fuel shortages, arising from the political disturbances in Iran or other causes; a sharp shift in the value of the dollar in foreign exchange markets, despite stabilization efforts; and exceptionally large or small harvests, causing large unexpected movements in food prices.

Reasons for a Downturn in 1979

Although the economy does not yet show significant signs of weakening, continued high rates of inflation appear to be sowing the seeds of a downturn. The momentum of inflation is very strong and CBO expects that the Administration's wage/price guideline program will not quickly slow that momentum. Thus, the Federal Reserve, which has responded to accelerating prices by tightening credit, is expected to continue to pursue a tight monetary policy. The prospect of continued high and rising interest rates for many months makes a subsequent downturn in economic activity the most likely outcome.

Tight credit conditions are expected to slow housing activity and business investment. But the predicted decline in housing starts has been delayed longer than in earlier periods of high

interest rates. The availability of funds for mortgage lending has not been reduced to the usual extent because deposit flows have been boosted by the **six-month** money market savings certificate introduced by savings institutions last spring. Virtually all analysts, however, expect a decline in housing activity during 1979, both because of declining demand and reduced availability of mortgages. Recent surveys of business investment plans also indicate a slowdown in 1979. Moreover, retail sales appear vulnerable. Indications of slower future growth in consumer spending **include:**

- o High rates of inflation, which have eroded real income growth and contributed to a buy-in-advance psychology that may have improved recent sales at the expense of sales later in the year;
- o A decline in consumer confidence; and
- o Historically high consumer debt burdens.

Reasons for a Mild Downturn and Recovery

Although some forecasters now expect a deep recession beginning late this year, CBO concludes that the projected late 1979 downturn will be neither deep nor prolonged **because:**

- o Businesses appear to have maintained relatively lean inventories; hence, any inventory adjustment should be mild;
- o Net exports are projected to be a source of considerable strength, as a result of an expected improvement in the economic growth of U.S. trading partners and because of the depreciation of the dollar last year;
- o The cut in income taxes early in 1979 is expected to provide stimulus to business and consumer spending throughout the year;

- o Large backlogs in orders in capital goods industries will provide support to total spending during the slowdown; and
- o The state and local sector is expected to continue to work down operating surpluses.

CBO predicts a less robust recovery in 1980 than the typical postwar upswing because the downturn is expected to be mild and inflation is forecast to **remain** high. As a result, monetary policy is not projected to respond as much as usual to the elevated unemployment rates. Furthermore, federal fiscal policy (with current policy) will exert a drag on economic activity in 1980, as the interaction of inflation and the progressive tax structure causes effective personal income tax rates to rise.

BUDGET OPTIONS

Economic assumptions are a critical aspect of budget estimates. When there is a slowdown in real economic activity, the budget responds automatically to increase the deficit, thereby cushioning the downturn. That is, outlays for unemployment insurance, social security, and other social programs increase without Congressional action, and federal receipts grow more slowly as a result of reduced growth in income, especially in corporate profits.

The slowdown in economic activity that CBO projects under current policy to occur late in 1979 results in a projected rise in the federal deficit in fiscal year 1980. **CBO's** estimate of the deficit that year (under current policy) is about \$49 billion, \$20 billion above the **Administration's** estimate (see Summary Table 2).

Economic assumptions account for a significant part of that discrepancy. The differences between the **Administration's** proposed budget and CBO's current policy budget estimate are largely on the spending side. 3/ The President has proposed cuts

3/ Administration and CBO revenue estimates are more similar because the weaker economy in the CBO forecast is largely offset by the projected higher rate of inflation. Real wage insurance is the major policy difference affecting revenues.

SUMMARY TABLE 2. THE FEDERAL BUDGET OUTLOOK UNDER CURRENT POLICY,
FISCAL YEARS 1977-1980: IN BILLIONS OF DOLLARS

	<u>Actual</u>		<u>Projected</u>	
	1977	1978	1979	1980
Receipts	356.9	402.0	453.3	502
Outlays	401.9	450.8	493.8	551
Deficits	45.0	48.8	40.5	49

amounting to about \$11.5 billion relative to current policy. In addition, differences in estimating procedures and the **Administration's** more optimistic forecast for inflation and unemployment reduce **outlays** by about \$8.5 billion relative to **CBO's** current policy estimate. Thus, if **CBO's** economic forecast is correct, reaching the **Administration's** goal of a \$30 billion deficit in fiscal year 1980 would require a larger cut in spending than that proposed by the **Administration**. 4/

Because of the uncertainty in the economic outlook and the automatic response of the budget to economic conditions, the federal deficit cannot be controlled with precision. Furthermore, because the deficit reflects the level of economic activity as well as changes in budget policy, it is a misleading indicator of the impact of fiscal policy on the economy. Discretionary policy changes in the budget are a more useful measure of the economic effects of fiscal policy.

4/ The **Administration's** budget was not available in time to be analyzed in detail in this report.

Given the objective of reducing inflation, the discretionary budget choices for fiscal year 1980 appear to be:

- o Enact the current policy budget;
- o Cut spending moderately as in the **Administration's** proposal, or more **sharply**, as proposed by others; or
- o Combine a spending cut with a cut in taxes.

As usual, CBO's forecast is based upon the first option. To assist Congress in its budget decisions, CBO has also examined the impact of a \$15 billion and a \$25 billion cut in spending below current policy levels. The composition of the spending cuts and rough estimates of their economic impact are shown in Summary Table 3. Those estimates reveal that spending cuts would rapidly result in employment losses, but their impact on inflation would be relatively small during the first two years. If these more restrictive policies were maintained, however, the eventual response of inflation would be significantly larger.

A third option, also shown in Table 3, is a \$25 billion spending cut combined with a \$15 billion **payroll** tax cut. This option would reduce the size of the government sector while limiting its restrictive effect on the economy. A cut in payroll taxes would reduce inflation more than other types of tax cuts. The disadvantage of this option, however, is that it would require financing social security from a source other than the payroll tax.

In choosing among such options, maintaining a considerable degree of flexibility seems desirable because of the uncertainty in the economic outlook. If, for example, the downturn is sharper than expected, the Congress might want to cut income **taxes--usually** the easiest and quickest stimulative budget change to enact and **implement**. On the other **hand**, if a slowdown does not **develop**, more restrictive measures may be desired, in order to prevent inflation from accelerating as a result of excess demand.

SUMMARY TABLE 3. ESTIMATED EFFECTS OF THREE FISCAL POLICY OPTIONS FOR FISCAL YEAR 1980 AFTER EIGHT QUARTERS

Economic Variable	\$15 Billion Spending Cut	\$25 Billion Spending Cut	\$25 Billion Spending Cut and \$15 Billion Payroll Tax Cut
GNP (billions of current dollars)	-28	-46	-32
GNP (billions of 1972 dollars)	-13	-20	-6
Unemployment Rate (percent points)	0.3	0.6	0.3
Employment (thousands)	-500	-900	-500
Consumer Price Index (percent change from base)	-0.2	-0.4	-0.8

NOTE: The composition of the expenditures reductions are as follows:

<u>\$15 Billion</u>		<u>\$25 Billion</u>	
Transfers	\$7.0	Transfers	\$11.0
Purchases	5.0	Purchases	6.0
Grants	3.0	Grants	8.0
PSE	0.2	PSE	5.3

The disproportionately large impact of the \$25 billion spending cut on employment and unemployment is due to the heavy reduction in public service employment (PSE).

LONG-TERM ECONOMIC GOALS

The Congress recently enacted legislation setting forth long-run goals for reducing **unemployment**, inflation, and the federal budget deficit. The 1978 Humphrey-Hawkins Act established a goal of not more than 4.0 percent unemployment and 3.0 percent inflation by 1983. 5/

These goals may not be achievable with traditional fiscal and monetary policies, because such policies reduce inflation by creating slack in the economy. Postwar experience indicates that, given the current momentum of inflation, a reduction in inflation to 3.0 percent by 1983 could be achieved only by maintaining high rates of unemployment for a prolonged period. Even if inflation and unemployment could be reduced to Humphrey-Hawkins levels in the time period **mandated**, it may be impossible to maintain these rates with traditional policies. Four percent employment implies tight labor and product markets, which would likely lead to accelerating inflation.

Thus, in addition to budget questions, the Congress will be asked to consider whether inflation should be fought with monetary and fiscal policies alone or whether other tools, such as the **Administration's** real wage insurance, should be introduced. Although there is little experience by which to judge that proposal, it is not likely that the **Administration's** wage/price program could reduce inflation enough to achieve the Humphrey-Hawkins goals by 1983. To do so would require a degree of voluntary cooperation unprecedented in peacetime.

5/ This act gives primacy to the unemployment rate goal.

Prices increased rapidly in 1978. The Consumer Price Index (CPI) rose about 9 percent--the highest rate of inflation in 30 years, except for 1974. Inflation is thus a key factor in the short-term and longer-term prospects for the economy and strongly influences the fiscal policy choices now facing the Congress.

The Short-Term Outlook. The current rapid rate of inflation is planting the seeds for a slowdown in economic growth:

- o In response to the acceleration in inflation and the associated decline in the international exchange value of the dollar, the Federal Reserve has **significantly** tightened credit conditions since mid-1978; the resulting higher cost of borrowed funds is expected to slow economic activity later this year, especially in housing and business investment;
- o Consumer surveys suggest that rapid inflation has led to a buy-in-advance psychology, boosting current sales at the expense of consumption later;
- o In part because sharp increases in prices tend to be followed by downturns in economic activity, consumer and business confidence in future economic conditions has dropped **substantially**, and apparently has contributed to the **adoption** of cautious spending plans for 1979.

Although inflation has resulted in conditions that may lead to a slowdown in the economy later this year, the current momentum of growth in economic activity is strong. Year-end gains in retail sales, production, employment, and new orders were substantial, portending continued growth into the beginning of 1979. These two **crosscurrents--pressures** for a slowdown, resulting from rapid inflation, and the current strength of overall **activity--make** the details of the short-term outlook very uncertain. There is, however, widespread consensus that overall growth will slow as 1979 progresses, causing the unemployment rate to rise. Indeed, many forecasters believe that this slowing of growth will turn into a recession late in the year, with the economy rebounding somewhat in 1980.

This short-term outlook and the fiscal policy choices associated with it occupy the bulk of this report. Chapter II reviews current economic trends, with special emphasis on the cross-currents caused by the current momentum in both real activity and inflation. Chapter III presents the CBO forecast, which assumes continuation of current fiscal policy; Chapter IV analyzes alternative fiscal policies with particular emphasis on spending cuts.

The Longer-Term Outlook. The current momentum of inflation will also make it very difficult for the Congress to achieve its longer-term goals for unemployment and inflation. As stated in the 1978 Humphrey-Hawkins Act, by 1983, unemployment should not exceed 4 percent and inflation should not be above 3 percent. But, given the current rate of inflation, the Humphrey-Hawkins goals may not be achievable by monetary and fiscal policies alone. This is because fiscal and monetary policies slow inflation by creating slack product and labor markets, and the evidence is that inflation responds relatively slowly to slack markets. Moreover, even if these goals were achieved, they probably could not be sustained after 1983. (See Chapter V for analysis of the consistency of the Humphrey-Hawkins employment and price targets.)

Anti-Inflation Policy. The two principal questions to be decided about the appropriate role of the budget in combating inflation are:

- o How restrictive should the initial budget be?
- o If the unemployment rate does rise later this year or next, what budgetary **action--if any--should** be taken?

A major message of the report is that the two questions are not independent of each other. Restrictive fiscal and monetary policies can slow inflation, but past performance shows that the resulting improvement in prices comes slowly and only at the expense of depressed growth and higher **unemployment**. The choices are difficult, but there is no simple and cost-free way to reduce inflation quickly.

A related message is that the federal deficit can be a misleading indicator of the impact of fiscal policy on inflation. Adopting the **Administration's** proposed spending cuts, or enacting even larger reductions, does not ensure a deficit of \$30 billion or less in fiscal year 1980. If the unemployment rate does rise **significantly**, the growth in federal revenues will slow

and spending will increase, resulting in a greater deficit. Even with a higher deficit, however, the additional slack in labor and product markets would help constrain wage and price inflation.

CHAPTER II. RECENT ECONOMIC TRENDS

As the Congress begins considering the first concurrent budget resolution, the outlook for the economy is very uncertain. Much of the uncertainty results from conflicting current economic **trends**:

- o Growth in economic activity was strong at the end of 1978, as reflected in the sizable fourth-quarter gains in retail sales, production, **employment**, and orders;
- o But inflation accelerated from an already high rate, leading to tighter credit conditions and faltering consumer and business confidence. 1/

This chapter reviews current economic trends by sector and **em**-phasizes the crosscurrents set in motion by the momentum of growth and continued inflation.

TRENDS IN FINAL SALES

In 1978, growth in constant dollar final sales slowed somewhat from the 1977 pace; **nevertheless**, it was still high for the fourth year of an expansion (see Table 1). In the final quarter of the **year**, final sales grew at a particularly rapid 6.6 percent pace.

Consumer spending in 1978 rose more slowly than during 1977, while housing expenditures were at about the same high level as the previous year. After a rapid rise in 1977, real federal outlays were also about unchanged during 1978. State and local spending grew a little more slowly. Fixed **nonresidential** investment continued to rise at a relatively rapid rate. In addition, there was help from the international sector, as constant dollar exports rose sharply while import growth remained near the 1977 rate.

1/ For an analysis of inflation momentum, see Congressional Budget Office, Inflation and Growth; The Economic Policy Dilemma (July 1978), Chapter III.

TABLE 1. CHANGES IN FINAL SALES AND ITS MAJOR COMPONENTS: PERCENT CHANGE, IN CONSTANT DOLLARS

	1976:4 to 1977:4	1977:4 to 1978:4
Total Final Sales	4.9	4.3
Personal Consumption Expenditures	4.8	3.8
Fixed Investment	11.1	5.5
Residential	15.3	-0.8
Nonresidential	9.1	8.3
Government Purchases	5.1	2.0
Federal	6.3	-0.3
State and local	4.3	3.5
Exports	-1.3	17.3
Imports	10.3	9.4

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

Consumer Spending

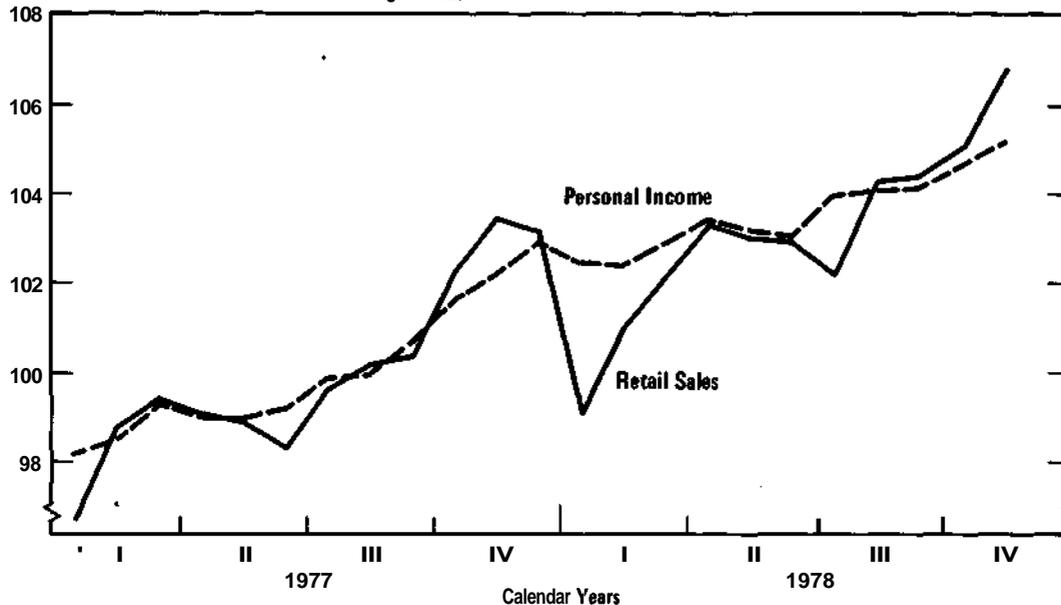
Growth in real personal disposable income slowed last year from the 1977 rate, partly because inflation and real growth raised effective personal tax rates, but mainly because inflation outstripped income growth. Nevertheless, consumer spending expanded significantly more than income. Late in 1978, as sales gains outstripped income gains (see Figure 1), saving as a percent of disposable personal income fell to below the 1977 average.

Consumer spending will be affected by conflicting trends in 1979 and 1980. On the plus side, the late 1978 employment and income gains are expected to spur retail sales into 1979. In contrast to the continued momentum resulting from the brisk pace of economic activity at year-end, however, other factors appear to be slowing expansion of consumer spending:

- ° Consumer confidence appears to have dropped significantly in recent months;

Figure 1.
Personal Income and Retail Sales

Indexes of Constant Dollar Values (1977 Average = 100)



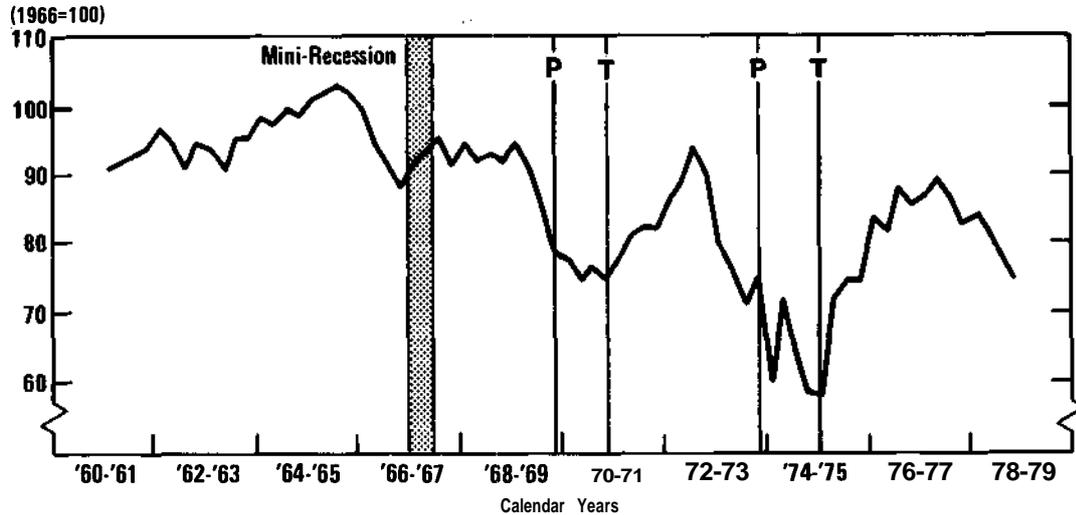
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Latest point shown is for November 1978.

- o Consumer attitude surveys also suggest that the current growth in retail sales is propelled in part by an inflation-induced, buy-in-advance psychology, which may be borrowing sales from the future;
- o Consumer installment debt is at a record high level, relative to disposable income; and
- o The 1979 social security tax increases, together with the higher tax rates resulting from the combination of a progressive income tax structure and rapid inflation, will nearly offset the income tax cut that went into effect on January 1 (see Chapter III).

Consumer Confidence. Surveys of consumer confidence indicate that assessments of personal and general economic conditions, as summarized in an overall index of consumer confidence, have been deteriorating. For example, the Index of Consumer Sentiment compiled by the University of Michigan Survey Research Center has dropped **significantly** during the last 18 months. As shown in Figure 2, such declines are typically followed by a slowing of economic activity.

Figure 2.
Index of Consumer Sentiment



SOURCE: University of Michigan, Survey Research Center.

NOTES: P = business cycle peak } As designated by the National
T = business cycle trough } Bureau of Economic Research.

Shaded area indicates January to May 1967 "Mini-Recession."

The reported decline in consumer confidence resulted primarily from greater pessimism about business conditions in the future; in particular, the higher inflation and interest rates have led consumers to expect a weakening of economic activity.

Buy-in-Advance Psychology. In the 1972-1974 period, accelerating inflation and deteriorating confidence were accompanied by a rising saving rate. The current low saving rates point to a different response to the recent inflation; consumers have evidently decided that buying now, before prices rise **further**, is the appropriate response to inflation. This inference is supported by evidence from the Michigan survey. In November 1978, 34 percent of all families indicated that now is a good time to buy **large** household goods, because prices are going up and will not come down. That response is now occurring much more frequently than it did in 1972-1974. Buy-in-advance **sentiment** about automobiles is also relatively high.

To the extent that consumers have acted on buy-in-advance sentiment and purchased durable goods sooner than they would have otherwise, current sales have been borrowed from the future. Some analysts believe, for example, that auto sales have been above the fundamental trend rate for some time now.

Consumer Debt Burdens. The ratio of consumer installment debt to disposable income reached record highs in 1978 (see Figure 3), suggesting that credit expansion is unlikely to **fuel** consumer spending in 1979 to the same degree. 2/ Reduced monetary growth will also compel cutbacks in some form of borrowing, with consumer credit a possible **candidate**.

The ratio of installment debt repayments to disposable income also reached new highs in 1978, as shown in Figure 4. An unusually high level of debt is now being supported with these payments, in part because of the movement to longer-term auto loans. As car prices have risen, loans have been made for four and even five years rather than for the traditional three years (see Table 2). Although longer-term auto loans enable a relatively greater level of borrowing at a given level of income, they are likely to reduce auto spending eventually, as consumers postpone purchase of their next car because of the longer debt payoff period.

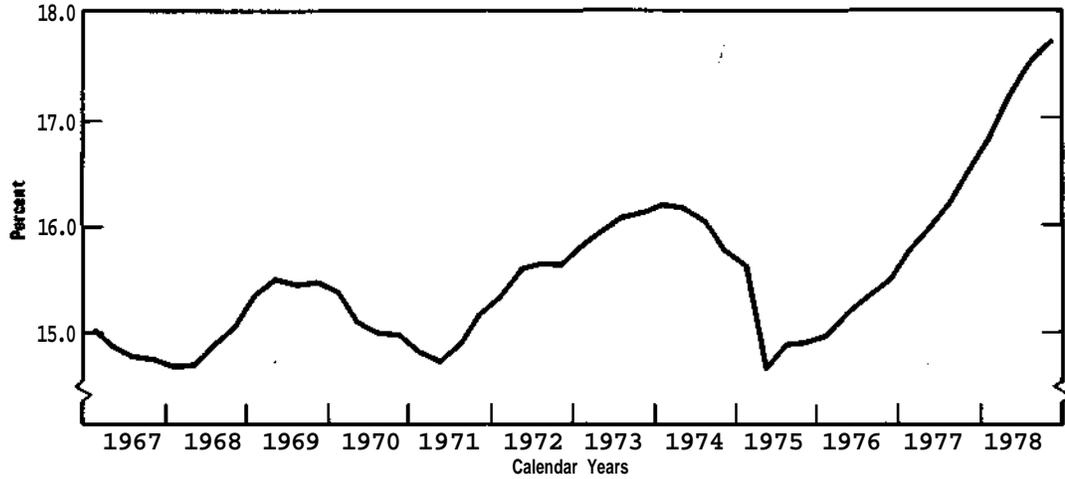
TABLE 2. AVERAGE MATURITY OF NEW CAR INSTALLMENT LOANS AT FINANCE COMPANIES

	Average Maturity (in months)
Calendar Years	
1972	34.8
1975	37.6
1976	38.8
1977	40.7
September 1978	43.4

SOURCE: Board of Governors of the Federal Reserve System.

2/ Consumer debt excludes home mortgages.

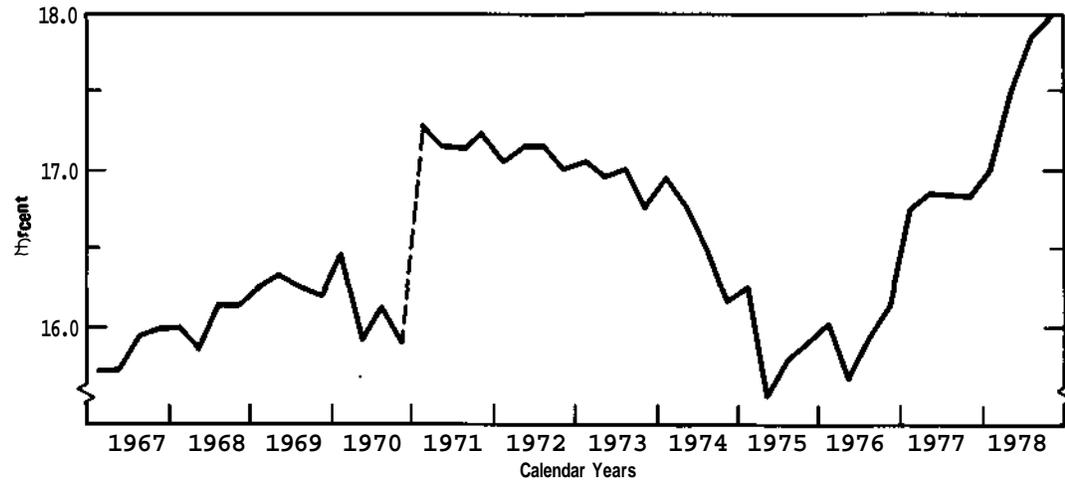
Figure 3.
 Consumer Installment Credit Outstanding as a Percent of
 Disposable Personal Income (Annual Rate)



SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Installment Credit data for 1967-69 linked to revised 1970 data by CBO; beginning in 1971, the data include gasoline credit cards used by individuals.

Figure 4.
 Consumer Installment Credit Repayments as a Percent of
 Disposable Personal Income



SOURCES: Board of Governors of the Federal Reserve System; U.S. Department of Commerce, Bureau of Economic Analysis.

NOTE: Installment Credit data for 1967-69 linked to revised 1970 data by CBO; beginning in 1971, the data include gasoline credit cards used by individuals.

Housing

Construction of new housing remained at a relatively high 2.0 million units started in **1978--the** same as in 1977. Although housing starts remained high in the face of rapidly rising interest **rates**, they did not increase and **therefore** exerted a dampening influence on overall economic activity.

The housing sector did not, however, develop many of the imbalances that typically occur toward the end of a building cycle. Vacancy rates for rental units remained low, and the "absorption rate" of **apartments--that** is, the percent rented within three months of going on the **market--was** about unchanged from the high level of the previous two years (see Table 3). Both facts suggest that overbuilding of **multifamily** units has not occurred. Nor is overbuilding generally evident in the market for single-family housing; however, the inventory of new houses for sale in November 1978 was somewhat higher, both absolutely and relative to sales, than it was a year earlier. Overall, the basic demographic structure of the population suggests a fundamental need for just over 2 million new housing units a **year--about** equal to the production rate for the past year and a half.

A major imbalance in past building **cycles--a** widespread shortage of mortgage **funds--did** not occur in 1978. In the past, funds available for housing finance declined when short-term interest rates moved above the maximum rates permissible on savings accounts in banks and **savings-and-loan** associations (see Figure 5). Many depositors withdrew their funds from savings accounts and purchased higher-yielding assets (Treasury bills, for **example**), thereby reducing the amount of **funds** available for home mortgages. To prevent such an outflow of funds when interest rates rose last year, regulations were changed, effective June 1, 1978, to allow banks and savings-and-loan associations to issue two new types of **certificates**:

- o **Six-month** \$10,000 certificates with maximum yields about equal to those available on 26-week Treasury bills, and
- o Eight-year \$1,000 savings certificates with yields of 7-3/4 to 8 percent per annum.

The availability of these new **certificates--especially** the one linked to rates paid on Treasury **bills--caused** savings flows

TABLE 3. THREE-MONTH ABSORPTION RATE FOR UNFURNISHED APARTMENTS AND RENTAL VANCANCY RATE

Calendar Year	Number of Units Absorbed	3-Month Absorption Rate (in percents)	Rental Vacancy Rate (in percents)
1972	497,900	67.5	5.5
1973	531,700	69.3	5.8
1974	405,500	68.3	6.2
1975	223,100	71.0	6.0
1976	157,000	81.3	5.6
1977	195,600	80.0	5.2
1978	201,000 <u>a/</u>	80.5 <u>a/</u>	5.0 <u>b/</u>

SOURCES: U.S. Department of Commerce, Census Bureau; U.S. Department of Housing and Urban Development.

a/ Based on first two quarters of 1978.

b/ Based on first three quarters of 1978.

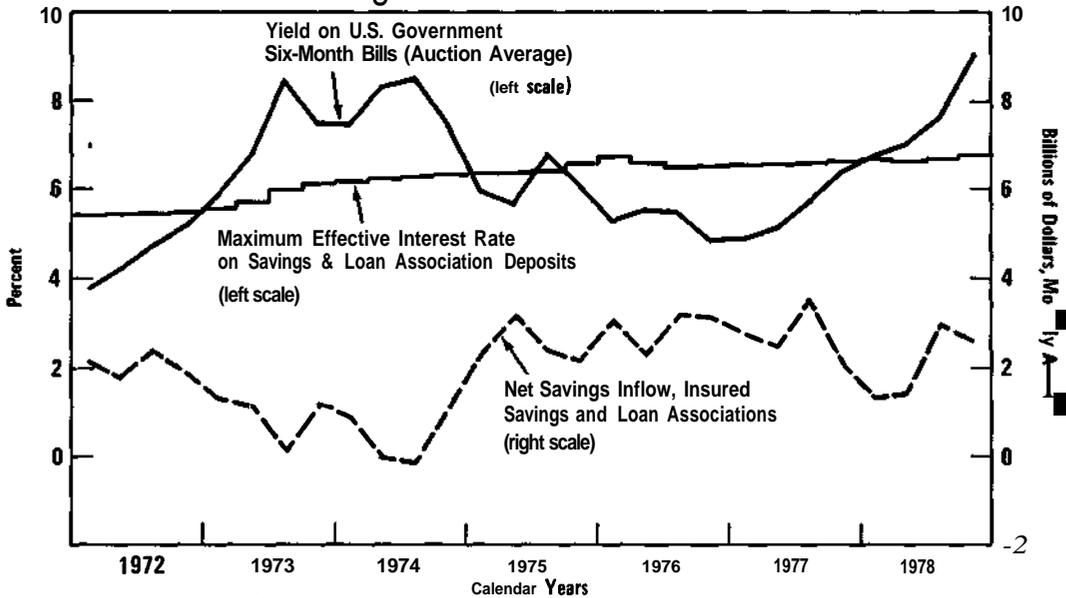
to recover and prevented the outflows of funds from **savings-and-loan** associations that would ordinarily have been caused by rapidly increasing interest rates.

Despite these new certificates, tighter credit conditions are expected to reduce the **numbers** of housing starts in 1979, for two principal reasons:

- o At year-end, in nearly half the country (by population) there were usury ceilings of 10 percent or lower on mortgage interest rates; although many of these ceilings are likely to be raised this **year**, they will still disrupt the flow of funds to mortgage finance early in the year;

- The higher costs of mortgages will limit the effective demand for housing. This will result from an increasing unwillingness as well as greater inability to pay exceptionally high mortgage costs. According to the Michigan survey, consumers still regard houses as a good buy because of expected price rises; however, late in 1978, there was a sharp **increase--from 10 to 20 percent--in** the proportion of families who responded that now is a bad time to buy houses because of high interest rates.

Figure 5.
Interest Rates and Savings Flows



SOURCES: Federal Home Loan Bank Board, seasonally adjusted by CBO; Board of Governors of the Federal Reserve System.

NOTE: Latest point shown for Net Savings Inflow is for October-November 1978.

Business Fixed Investment

Business spending on plant and equipment was strong last year, rising more than 8 percent in real **terms**. Although this rate of growth was only slightly lower than the 1977 rate, the composition of expenditures changed significantly, as Table 4 **demonstrates**. In **1977**, the increase was concentrated in light equipment, particularly autos and trucks. In 1978, there was a sharp rise in spending for structures, which had been lagging since the 1974-1975 recession.

TABLE 4. BUSINESS FIXED INVESTMENT AND CAPACITY UTILIZATION

	1975:4 to 1976:4	1976:4 to 1977:4	1977:4 to 1978:4
	Percent Change in Constant Dollars		
Nonresidential Fixed Investment, Total	8.6	9.1	8.3
Structures	3.0	7.0	12.6
Producers' Durable Equipment, Total	11.4	10.1	4.8
Autos, trucks and buses	21.5	27.0	8.7
Other machinery and equipment	8.3	4.2	3.2
	Output as a Percent of Capacity		
Manufacturing Capacity Utilization			
Calendar Year	80.2	82.4	84.2
December	81.2	83.0	85.9

SOURCES: U.S. Department of **Commerce**, Bureau of Economic **Analysis**;
Board of Governors of the Federal Reserve System.

Clearly, the rise in capacity utilization has contributed to recent strength in **structures**, and continuation of the utilization rate registered in December 1978 would encourage further rises in spending to expand capacity.

The outlook for business fixed investment, like that for consumption and housing, is clouded by **crosscurrents**: the momentum of growth versus signs of weakening, which are ultimately associated with the current rapid rate of inflation. The momentum for continued expansion of spending on plant and equipment is evident in contracts and orders for plant and equipment, which in October and November were running 9 percent above the third quarter in real terms. This series tends to lead actual spending by one or two **quarters**.

Despite its current momentum, there are indications that spending on plant and equipment may slow significantly. **Manufacturers'** capital appropriations have been trending down since early 1978. The fall McGraw-Hill survey suggested a spending rise of only 2 percent in real terms in 1979, and the Department of Commerce (BEA) survey taken in late November and early December indicates an increase in 1979 of 11.2 percent in dollar **value--**perhaps 3 percent in real **terms**. This is an important signal. Many forecasters have found that the Commerce survey of spending intentions is the best available single predictor of actual spending behavior.

Two factors would help cause such a slowdown in business fixed **investment**:

- o The higher cost of borrowed funds, at a time when business liquidity has declined and the stock market is relatively low; and
- o The general expectation of a slowdown in overall economic activity next year.

Higher interest rates may not greatly affect many large capital spending projects, like those associated with the expected move to a new generation of aircraft or those necessitated by mandated efficiency standards for automobiles. Tightened credit conditions may, however, slow commercial construction and expenditures on more discretionary additions to equipment.

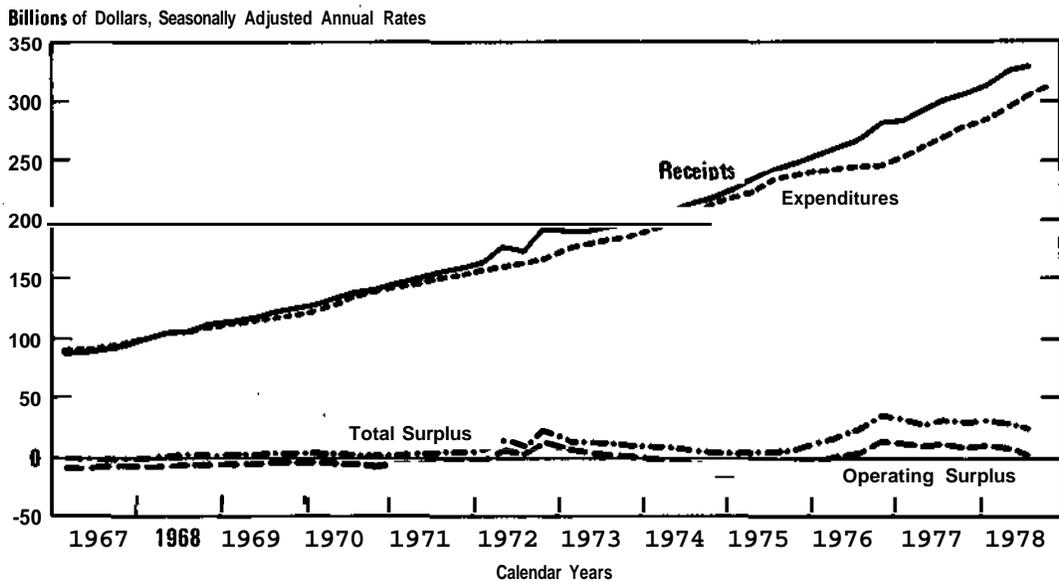
Widespread pessimism about future economic activity is indicated by the Conference Board survey of business confidence. The composite measure of business **executives'** assessment of future economic conditions fell from 49 in August to 40 in November 1978; for comparison, the measure was 75 when this survey was inaugurated in March 1976.

State and Local Government Spending

One measure of the impact of the state and local government sector on the overall economy is the size of its surplus or deficit. State and local receipts have exceeded spending by substantial amounts for the last six **years**, as shown in Figure 6. A large part of this surplus represents the excess of receipts over expenditures needed to fund future pension **requirements**, which is **expected** to continue. But in 1976-1978, the total of "operating" state and local budgets (which exclude social insurance funds) was also in surplus. The availability of existing surplus balances should help many state and local governments comply with measures they enacted last year to limit taxes without an immediate proportionate limitation on spending.

Figure 6.

State and Local Government Receipts, Expenditures, and Surpluses



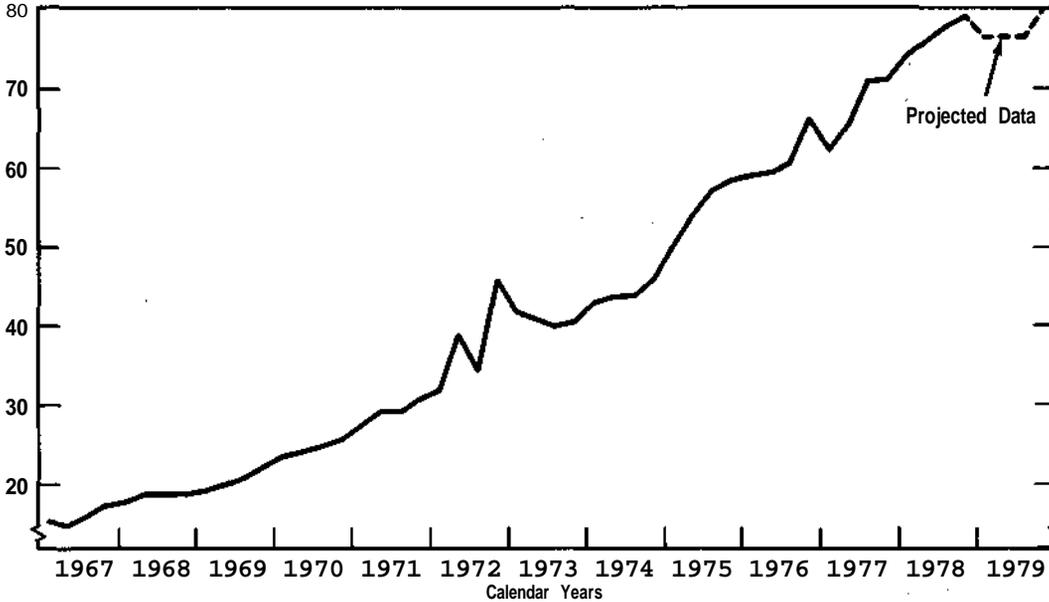
SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis.

As a result of the passage of Proposition 13 in California, the total operating surplus was reduced substantially, as California property tax liabilities were cut sharply while spending continued little changed. This development in California and tax and spending measures passed by other **state** and local governments suggest a continued reduction in the operating surplus of this sector in the coming year.

Federal grants to state and local governments, under the Second Concurrent Resolution for Fiscal Year 1979, will show no growth in real terms during 1979; however, under current policy, they will return to trend growth in 1980 (see Figure 7). The lack of growth in federal grants in 1979 is the result of cuts in public service employment and the expiration of countercyclical revenue sharing at the end of fiscal year 1978.

Figure 7.
Federal Grants-in-Aid to State and Local Governments

Billions of **Dollars**, Seasonally Adjusted Annual Rates



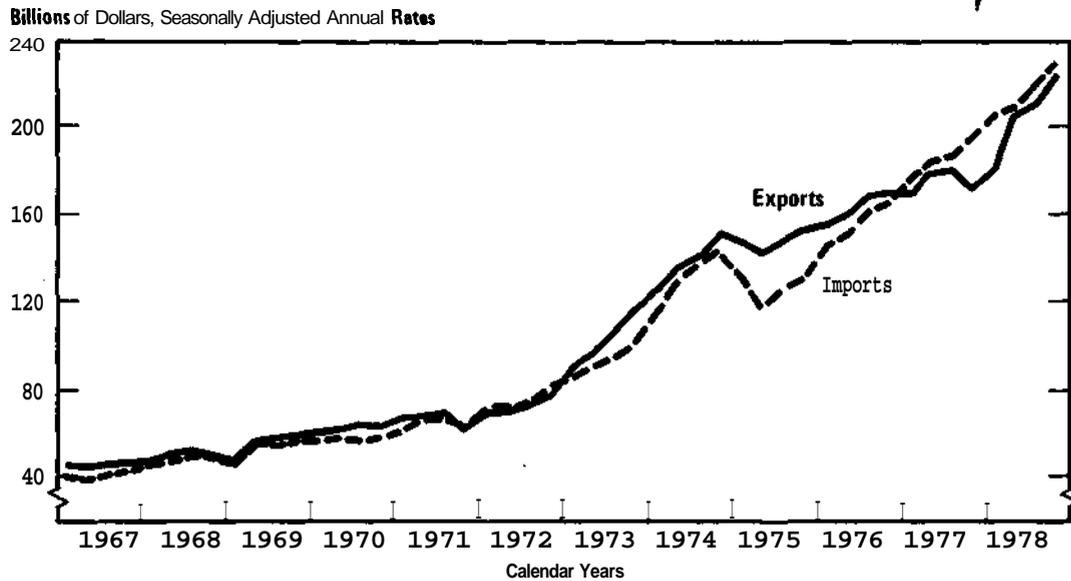
SOURCES: Actual Data—U.S. Department of Commerce, Bureau of Economic Analysis.
Projected Data—Congressional Budget Office.

International Sector

The net export balance of the United States stopped deteriorating in the second quarter of 1978. Current dollar **goods-and-services** imports averaged only about \$8 billion (annual rate) more than exports in the second through fourth quarters, far less than the \$23.7 billion rate of net imports in the previous two quarters (see Figure 8).

Advance indicators of export demand for durable goods strengthened recently, and the gap between imports and exports of goods and services is expected to continue shrinking in 1979. Delayed effects of the 14 percent depreciation in the **dollar's** weighted exchange rate since 1977, more than enough to offset the rise in U.S. prices relative to foreign prices, are working to raise exports and slow future import growth and will result in net stimulus to total domestic demand. Faster economic growth in some U.S. major trading **partners--which** is forecast by many **analysts--**would reinforce this. The trade balance would improve even further if reduced U.S. growth also lowers import **demand**.

Figure 8.
Imports and Exports of Goods and Services, NIA Basis



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

The improvement in the trade balance resulting from the recent depreciation of the dollar is probably just beginning to be significant. The amount of time between depreciation of a **currency's** exchange value and improvement in that **country's** trade balance is often estimated to be a year or more. This is because the initial impact of depreciation is to increase import prices and worsen the trade balance for a period before real import and export flows react to the changed competitive position. A gradual improvement in the balance of trade for manufactured goods and a decline in the U.S. trade deficit with Japan are seen as indicators that trade flows are being influenced by the lower exchange value of the dollar. Imports are also being limited by various "orderly marketing agreements" and the steel **price-referencing** system, which slow import growth without imposing formal quotas or tariffs.

OUTPUT AND INVENTORY INVESTMENT

The growth rate of aggregate output during 1978 was 4.3 **percent**, the same as the growth of final sales. Inventory-sales ratio changed little over the year and are at relatively low levels. Thus, analysts generally have concluded that inventories are currently in good balance with sales and there is little danger of large unintended accumulations of the kind that have aggravated recessions in the past.

This judgment needs some **qualification**. Inventory-sales ratios seldom rise while final sales growth is strong, but a slowdown or decline in real final demand for goods is usually accompanied by a rise in these ratios. Producers typically maintain output levels for a period following a decline in demand, which leads to unintended inventory accumulation. Recent low ratios are therefore no guarantee against future unintended **accumulations**. Furthermore, inventory-sales ratios are high for some categories of consumer spending, notably general merchandise and related retail stores. Although business inventory positions must be considered vulnerable to a slowdown in **sales**, current indicators do not point to anything like the over-ordering that led to a pronounced inventory cycle in 1973-1975.

TRENDS IN EMPLOYMENT, WAGES, AND PRICES

The increase in total output last year was accompanied by large increases in employment and capacity utilization. In addition, both inflation and the growth of labor costs accelerated.

Employment

By the fourth quarter of 1978, total household employment was estimated to be more than 3.5 percent (or some 3.3 million jobs) above its level a year earlier. Labor force growth was also strong at about 2.8 **percent**, but the more rapid employment growth reduced the employment rate from 6.6 percent in the fourth quarter of 1977 to 5.8 percent in the fourth quarter of 1978.

Black/white discrepancies in employment narrowed in 1978, though differences in unemployment rates did not. Black employment rose 7 percent, well above the employment growth rate for whites, but black labor force growth was also more rapid. The ratio of black to white unemployment rates was little changed, with the black rate 2.3 times the white rate in the fourth quarter of 1978. Black labor force participation rates remain well below rates for whites, so there remains room **for** further relative increases in black employment and labor force participation.

Associated with the large increase in employment was a slowdown in the measured growth of labor productivity. For the **nonfarm** business sector, output per hour was about unchanged in 1978, as compared with gains of 1.3 percent in 1977 and 2.8 percent in 1976. The reasons for this slowdown are not clear; therefore, it is not known whether the recent slowdown is permanent or temporary.

Labor Costs

The growth in hourly labor compensation accelerated last year, rising by more than 9 percent in the private nonfarm business sector, as compared with a 7.6 percent gain in 1977. Since productivity was virtually unchanged, unit labor costs also increased at nearly a double-digit pace, placing sharp upward pressure on **prices.**

There are a number of reasons why labor compensation accelerated in 1978:

- o Large government-mandated increases occurred in the minimum wage and in payroll taxes. The statutory minimum wage increased from \$2.30 to \$2.65 per hour, up about 15 percent. Payroll taxes for social security and unemployment insurance funds were also increased. Taken together, the mandated increases added about 1 percentage point to the increase in labor compensation;

- o The acceleration in inflation has increased, and will continue to increase, labor compensation. This occurs because the incomes received by many groups are **linked**, formally or informally, to the movement of consumer prices; and
- o Although apparently not yet widespread, some labor shortages have occurred in selected geographical **areas--for** example, in parts of the sun **belt--and** in selected occupations--such as some nonunionized building trades. Table 5 shows that one measure of labor-market **slack--the** jobless rate for married **men--has** dropped below its 1972 levels and is nearing its rate in 1973, a year of general scarcity and excess demand inflation.

TABLE 5. MEASURES OF LABOR MARKET SLACK

Unemployment Rates for Selected Groups (as Percent of Civilian Labor Force)	1972	1973	Fourth Quarter 1978
All Workers	5.6	4.8	5.8
Married Men, Wife Present	2.8	2.3	2.5
Professional and Technical Workers	2.4	2.2	2.7
Craft and Kindred Workers	4.3	3.7	4.5

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

These factors will continue to place upward pressure on labor costs in 1979. A 9.4 percent increase in the minimum wage took effect on January 1; another round of social security tax increases also occurred. If past relationships hold, the major impact on wages of the recent **acceleration** of inflation will be felt in 1979, especially since it is a heavy bargaining year. In addition, where labor shortages do exist, firms will be bidding up wages in order to fill vacancies, at least until the anticipated rise in joblessness later in this year.

Prices

Consumer prices rose 9.0 percent in 1978, as compared with 6.8 percent during 1977. In order to highlight the anatomy of inflation in 1978, recent rates of change in the **CPI**, some of its components, and other price measures are displayed in Table 6.

Food prices were a major contributor to inflation in 1978. Consumer food prices accelerated more in the first half of 1978 than they had in the first half of 1977, and they failed to return to the low rate of increase registered in the second half of 1977.

Food prices are not the whole story, however. Measures of inflation that exclude food and other volatile components also show acceleration. A "stripped" consumer price index (which excludes food, energy, used cars, and mortgage interest rates) increased by 7.0 percent during **1978--up** from the 6.4 percent rate in 1977. Producer prices for crude and intermediate **nonfarm** products also appear to be **accelerating**, as do producer prices for consumer goods other than food. The overall price acceleration last year may mainly reflect the rise in unit labor costs.

The downtrend in the foreign currency price of the dollar, which began late in 1977 and accelerated from May through early November of 1978, was another potential contributor to inflation. In the most recent period, the value of the dollar relative to the currencies of major trading partners was 14 percent below its 1977 average. Yet the GNP price index for imports increased only slightly more during 1978 than it had in 1977. In part, this is because the OPEC price freeze offset price rises for other imports; in part, it may be because foreign sellers are accepting reduced profit margins in order to maintain their market shares.

In addition to pushing up the prices of imports, dollar depreciation can contribute to inflation in other ways. It can permit the widening of profit margins for domestically produced goods that compete with imports. Dollar depreciation can also increase aggregate demand, by raising the demand for exports in real terms as well as by decreasing the price advantage of imports. In fact, as discussed earlier in this chapter, the U.S. export-import balance has indeed improved recently in real terms, because of an improving balance for manufactured goods as well as large farm-product exports.

TABLE 6. RATES OF CHANGE IN PRICES: PERCENT CHANGES, ANNUAL RATE

Selected Price Measures	1977		1978	
	First Half	Second Half	First Half	Second Half
GNP Fixed-Weighted Index , Total	7.2	5.7	8.9	8.1
Exports	6.9	-0.3	10.4	9.7
Imports	10.6	4.4	7.5	8.6
Consumer Price Index, Total	8.9	4.7	10.4	7.8
Food and Beverages	12.5	3.1	17.8	5.4
Energy <u>a/</u> "Stripped" (excluding food , energy, used cars, and mortgage interest payments)	11.4	3.1	9.1	7.0
6.7	6.1	6.9	7.1	
Producer Price Indexes				
Farm Products	0.4	-3.7	33.7	4.7
Crude Nonfarm Products	11.5	11.9	13.9	15.8
Intermediate Nonfarm Products	7.2	5.6	7.9	8.5
Finished Goods , Total	8.2	5.0	10.5	7.6
Consumer foods	10.9	2.4	17.9	6.1
All other consumer	8.4	4.3	8.2	8.4
Capital equipment	5.9	8.4	7.9	8.1

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

NOTE: Changes are calculated from the month or quarter at the end of the preceding time period to the month or quarter at the end of the reference period.

a/ Not seasonally **adjusted**.

The rise in manufacturing capacity utilization has also been dramatic enough to raise concern about the amount of room for further expansion without accelerating inflation. According to Federal Reserve Board estimates, manufacturing utilization in December 1978 was only 2.4 percent below its 1973 high. In 1973, however, the principal capacity problem was bottlenecks in materials-producing industries, which helped drive up prices. At 88 percent, the December 1978 capacity utilization at materials industries was still 6 percentage points below the very high 1973 level. In addition, reports of materials delivery delays increased in 1978, though they remained still well below the extreme shortage rates of 1973.

In sum, the upward pressures on prices are strong. Labor attempts to restore traditional real wage growth, if not matched by faster productivity growth, will increase unit costs. When beef producers start to rebuild herds, beef prices will rise further. The OPEC price increase for crude oil is larger than was expected and will add to inflation. Another social security tax increase went into effect January 1, as did a 9.4 percent rise in the minimum ~~wage--not~~ as large as the 1978 increase, but in excess of the recent growth in wage rates. A significant portion of the effects of dollar depreciation has yet to be felt. And the effects of tightening in labor and capital utilization during 1978 and the beginning of this year may place additional upward **pressure** on wages and prices. These upward pressures, of course, might be offset by unforeseen supply increases (an exceptionally good harvest, for example) or an effective wage/price guideline program.

RECENT POLICY DEVELOPMENTS

Economic growth was strong at the end of 1978; nevertheless, most economic forecasts show a downturn in activity in 1979. The critical element in these forecasts is the outlook for inflation and the assumed response of economic policies. Although some shift away from expansive economic policies was evident earlier, policy announcements made by the Administration and the Federal Reserve in late October and early November, as well as subsequent policy actions, have been widely interpreted as indicating that the primary policy goal for the next few years will be to reduce inflation and prevent further **depreciation** of the dollar. The question of whether this restrictive policy shift will trigger a recession remains clouded by:

- o Uncertainty in the outlook for inflation, including the effects of the **Administration's** wage/price standards;
- o Uncertainty as to whether planned policies will actually be implemented, particularly if the economy shows signs of **weakening**; and
- o Recognition that the economic consequences of any particular economic policy path cannot be forecast with precision.

If current fiscal policies are continued, the shift toward restraint will not have a major effect on economic activity until fiscal year 1980. But the anti-inflationary monetary policies are expected to have important consequences for real activity before the end of 1979. If the wage/price guidelines fail to reduce the rate of inflation **significantly**, restrictive macroeconomic policies are more likely to produce a recession. But if the guidelines succeed in reducing inflation, or if inflation should slow for some other unforeseen reason, credit conditions may ease enough to avoid a downturn in activity.

IMPACT OF FISCAL POLICY

CBO projects that, under current policy, the federal deficit will decline slightly to about: \$40 billion in fiscal year 1979 and rise to nearly \$50 billion in fiscal year 1980. The deficit could be much larger, if the economy turns out to be substantially weaker than forecast by CBO, or it could be much smaller, if CBO has underestimated inflation or economic growth. A rule of thumb is that a 1 percentage point rise in unemployment increases the deficit by roughly \$20 billion, while a 1 percentage point increase in inflation reduces the deficit by roughly \$3 billion.

CBO's estimate of the current policy deficit in fiscal year 1980 is about \$49 billion, \$20 billion above the deficit projected in the President's budget. Nearly half of the difference between the Administration and CBO budget estimates reflect CBO's more pessimistic assumptions about inflation and unemployment as well as different estimating methodology; the remaining discrepancy reflects different policy assumptions, primarily concerning proposed cuts in spending below current policy and real wage insurance. The differences in overall budget figures are mainly on the spending side, where the Administration has proposed cutting spending below current policy by about \$11.5 billion. Differences in the **Administration's** estimating procedures and their more optimistic economic forecast reduce the Administration estimates of outlays by about \$8.5 billion **relative** to CBO's current policy estimate. 1/

The rise in the 1980 current policy deficit projected by CBO reflects its projected downturn in economic activity. This points out one of the shortcomings of the budget deficit as a measure of fiscal policy: the deficit reflects both the impact of the budget on the economy and the impact of the economy on the budget. The deficit is neither an easily controlled magnitude nor a good measure of fiscal policy. Thus, in order to assess the economic significance of budget deficits, it is useful to isolate the force of (discretionary) budgetary policy changes scheduled to take effect in the forecast period.

1/ Administration and CBO revenue estimates are quite similar because the effect of the weaker economy in the CBO forecast is largely offset by higher inflation. The **Administration's** budget was not available in time to be analyzed in detail in this report.

Under current policy **assumptions**, the growth in federal budget outlays will slow markedly in fiscal year 1979, with a substantial recovery in 1980 (see Table 7). A major part of the weakness in unified budget spending growth in 1979, however, reflects year-to-year variations in loan activity, a component of budget outlays that is thought to have a relatively small impact on the economy. When these loan transactions are removed, spending growth, on a current policy basis, is somewhat stronger in 1979 and in 1980. 2/ The strength in federal spending in 1980, however, results in part from the rise in unemployment projected in the CBO forecast. **Thus**, with current policies, discretionary changes in spending will not add **significantly** to economic growth in 1980. At the same time, it also appears that projected federal spending under current policies will not be **significantly** restrictive.

In terms of short-run economic impact, the most significant tax policy changes included in the current policy budget in fiscal years 1979 and 1980 are:

- o Increases in social security tax rates, in January 1979, and in the tax base, in both 1979 and 1980;
- o Income tax reductions made by the Revenue Act of 1978, effective January 1979.

The revenue effects of the personal income tax cuts in 1979 are expected to exceed the 1979 and 1980 social security tax increase by about \$5 billion each fiscal year. But, in an inflationary economy, the expansive thrust of tax rate cuts can be offset over time by the automatic tax rate increases that arise from inflated incomes and the progressive tax system.

This point is demonstrated by the full-employment surplus, an estimate of what the federal budget position would be if the economy were operating at full potential 3/; it reflects the

2/ The growth in federal spending **accelerates** in 1979 and 1980 on a national income accounts basis (**NIA**), a budget concept which excludes asset transactions.

3/ Potential GNP assumes approximately 4.9 percent unemployment.

TABLE 7. FEDERAL BUDGET UNDER CURRENT POLICY, FISCAL YEARS 1977-1980: IN BILLIONS OF DOLLARS

	1977	1978	1979	1980
Unified Budget				
Receipts	356.9	402.0	453.3 <u>a/</u>	502 <u>a/</u>
Outlays	401.9	450.8	493.8 <u>a/</u>	551 <u>a/</u>
(Percent change)	(7.7) <u>b/</u>	(12.2)	(9.5)	(11.6)
Deficit	45.0	48.8	40.5	49
Measures of Economic Impact				
Federal Spending, NIA Basis (percent change)	8.4 <u>b/</u>	8.9	10.9	11.1
Full-Employment Surplus or Deficit, NIA Basis	-10.3	-11.2	1.5	18.9

SOURCES: U.S. Treasury; Congressional Budget Office; Office of Management and Budget.

- a/ Current policy budget (based on second budget resolution for 1979).
- b/ Adjusted for transition quarter between fiscal years 1976 and 1977.

effect of discretionary spending and tax policy changes as well as the inflation-tax interaction. As may be seen in Table 7, the full-employment budget position would shift toward restraint in fiscal year 1979 and would become even more restrictive in 1980, if current policy were maintained.

This shift is one basis for the view that fiscal policy may have a restraining influence on the economy during the forecast period, even without the cuts in spending that the Administration has proposed.

Fiscal Uncertainties. These budgetary **projections--and** particularly, the measures of fiscal **stimulus--must** be regarded as extremely tentative. The Congress may change current policies, and budgetary projections are **significantly** affected by their economic assumptions. Higher inflation and higher economic growth would both tend to lower the budget deficit. In addition, aggregate measures of fiscal policy do not reflect changes in the composition of the budget, which can have important implications for judging the economic impact of budget **changes**.

Conclusion. On balance, taking into account some of the many difficulties inherent in an attempt to translate federal budgetary data into an estimate of fiscal impact, CBO's judgment is that, if current policies are continued, the federal government's projected taxing and spending activities would exert a moderate but increasingly restrictive influence on the pace of economic activity in the next two **years**. If **the** cuts in outlays proposed by the Administration were enacted, the budget would be more restrictive in fiscal year 1980.

THE ADMINISTRATION'S \$30 BILLION DEFICIT GOAL

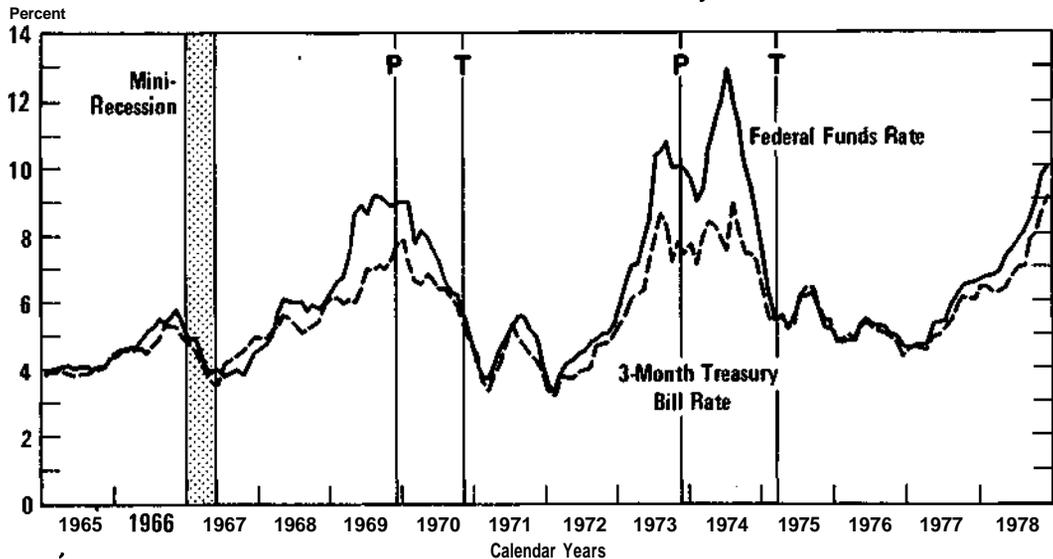
The Administration has proposed a budget **deficit, of \$29 billion** for fiscal year 1980. The CBO current policy deficit, shown in Table 7, is \$20 billion above that target. Given CBO's economic and budget estimates, achieving the **Administration's** goal would require reducing outlay growth substantially below the level needed to maintain current programs with full adjustment for inflation. Such a shift would represent a very restrictive policy.

Should economic growth or inflation during the next two years **significantly** exceed CBO's estimates, the spending cuts needed to achieve the **Administration's** deficit goal would, however, be smaller.

MONETARY POLICY

During the two-year period ending in December 1978, the federal funds rate, which is under the direct control of the Federal Reserve, increased from a cyclical low of about 4.6 percent

Figure 9.
Federal Funds Rate and Three-Month Treasury Bill Rate



SOURCE: Board of Governors of the Federal Reserve System.

NOTES: P = business cycle peak 1 As designated by the National
T = business cycle trough Bureau of Economic Research.

Shaded area indicates January to May 1967 "Mini-Recession."

percent to about 10.0 percent at the end of December (see Figure 9). ^{4/} Because of the fast growth in incomes, boosted by rapid inflation, the continued ratcheting up of the funds rate was not sufficient to slow the growing demand for money balances. There appeared to be little slowing in the growth of M1, at least through the third quarter of 1978 (see Table 8), and M1 growth exceeded the upper end of the Federal Reserve target range for most of that period.

^{4/} The federal funds rate is the interest rate charged on very short-term (immediately available) interbank loans. It is the short-term operating target used by the Federal Reserve to achieve its monetary policy objectives.

TABLE 8. INTEREST RATES AND ANNUAL GROWTH RATES OF SELECTED MONETARY AGGREGATES, CALENDAR YEARS 1976-1978

	Annual Rate of Growth		Interest Rates	
	M1 <u>a/</u>	M2 <u>b/</u>	Corporate AAA Bonds	Conventional Mortgages for New Homes
	1976: 1	4.7	11.1	8.56
2	7.1	10.4	8.53	8.93
3	3.8	9.0	8.46	9.02
4	7.7	13.3	8.18	9.07
1977: 1	7.2	11.3	8.03	9.00
2	8.6	9.5	8.01	8.96
3	8.4	10.3	7.95	9.02
4	7.6	8.3	8.10	9.08
1978: 1	6.4	7.0	8.45	9.20
2	10.3	8.1	8.67	9.38
3	7.8	9.2	8.75	9.67
4	4.4	7.7	9.03	9.91

SOURCES: Federal Reserve Board; **Moody's** Investor Services; Federal Home Loan Bank Board.

a/ M1: Coin, currency, and demand deposits held by the nonbank public, seasonally adjusted data.

b/ M2: M1 plus time and savings deposits at commercial banks other than negotiable certificates of deposit issued in denominations of \$100,000 or more, seasonally adjusted data.

Although the increase in the federal funds rate was especially rapid beginning in May 1978, a shift in policy was not widely perceived until the fall. On November 1, 1978, after a prolonged decline in the international value of the dollar that some feared would turn into a collapse, the U.S. Treasury and the Federal

Reserve jointly announced a more restrictive monetary policy, as well as other measures to support the dollar:

- o Federal Reserve banks raised the interest rate at which they lend to member commercial banks from 8.5 percent to 9.5 percent, an unusually large increase. The federal funds rate quickly rose thereafter, from about 9.25 percent to 9.75 percent;
- o Reserve requirements on large denomination time deposits were raised 2 percent, or about \$3 billion, given the outstanding volume of such deposits; and
- o The Treasury announced a number of steps to increase U.S. holdings of foreign currencies, to be used to defend the foreign exchange value of the dollar.

These measures were widely interpreted as signaling a determination on the part of the Administration and the Federal Reserve to support the dollar and persist in an anti-inflationary monetary policy.

The intent of the more restrictive monetary policy is to reduce the growth of credit, thereby slowing sales and employment growth and reducing inflationary pressures; it seeks to reduce inflationary momentum without creating too much slack. Policy-makers have found, however, that aggregate demand cannot easily be restrained precisely enough to slow inflation without at the same time creating a recession and rising **unemployment**. Following the November 1 **announcement**, many forecasters concluded that a mild recession with little impact on inflation was the most likely **outcome**.

Nevertheless, it was not evident by the end of that year that **1978's** high and rising short- and long-term interest rates and the slowdown in money growth had **significantly** affected real activity. Three factors appear to account for their **ineffectiveness**:

- o When inflation rates are high, high interest rates cost less in real terms;
- o Mortgage funds remained unusually plentiful at savings institutions because of the new **six-month** money market savings certificates introduced in the spring of 1978; and

- o The rapid rise in interest rates during the second half of 1978 had not been in effect long enough to have had widespread effects on demand.

Although rising mortgage rates have undoubtedly had some effect on housing starts, the introduction of the new savings certificates was particularly significant in maintaining residential construction at high levels. Without this instrument, an increase in Treasury bill rates well above the savings and loan passbook savings rate would be expected to trigger an outflow of funds from savings deposits to higher-yielding market instruments. In the past, such deposit outflows have greatly reduced the availability of mortgages and housing construction. Because of this new instrument, many analysts now believe that the impact of rising interest rates on the economy is likely to be more diffuse and more delayed than in the past. The new savings instrument therefore introduces more uncertainty with regard to the timing and size of monetary policy impact.

In the last two months of 1978, there was a significant slowdown in the growth of demand deposits. Unfortunately, because of recent institutional changes, it is impossible to determine whether the increase in short-term rates accounted for this slowdown. ^{5/} The growth of the broader money aggregate, M2 (currency, checking accounts, and commercial bank savings deposits other than large certificates of deposit), slowed somewhat in the year before the November 1978 **announcement**; since that time, there has been a substantial further reduction in growth, though a trend has not clearly been established.

The Near-Term Outlook for Monetary Policy

Assumptions about the future course of monetary policy are important for any forecast of economic activity. Many economists believe that continued growth in M2 at the reduced pace of recent months (about 3 percent at annual rates) will ensure an economic downturn. Yet the degree of uncertainty about monetary policy and its impact on the economy is very great. To a large extent, the effect of monetary policy will depend on how long high interest

^{5/} In November 1978, the Federal Reserve permitted automatic transfer of funds from savings deposits to checking accounts.

rates persist, how much further (if any) rates move up, and how much lagged effect on economic activity will occur because of the previous increase in rates.

There is a considerable delay in the impact of monetary policy changes on economic activity. **If**, as many believe, monetary policy will gradually tighten until there is a clear signal that economic activity is **weakening--such** as a rise in unemployment **rates--a recession** may be unavoidable because it will be too late to offset lagged effects. Even if policymakers follow such a path, however, the timing of such a downturn could not be known in advance. If, on the other hand, inflation and money demand should slow significantly in the months ahead, credit conditions could ease before severe effects on real activity occur.

Unless inflation begins to subside, it may be very difficult for the Federal Reserve to reverse its present more restrictive policy. The behavior of the dollar in foreign exchange markets greatly complicates the current outlook. Market participants appear to believe that an easing of policy by the Federal Reserve would increase pressures for further depreciation of the dollar, a development the Administration and the Federal Reserve clearly want to avoid. (The monetary policy assumptions in **CBO's** current policy forecast are described in the section on the CBO forecast.)

WAGE/PRICE STANDARDS

The task of estimating the effects of current macroeconomic policy is further complicated by the uncertainty created by the President's new wage/price standards. This program is designed to reduce the rate of inflation to between 6 and 7 percent in 1979. But the outcome of this program is very uncertain. One source of uncertainty stems from the fact that real wage insurance, an important component of the program, requires Congressional action, which may not be forthcoming. There is also considerable uncertainty regarding the degree of compliance by those covered by the program as well as the size of wage and price increases by those who are exempt. A large portion of the labor force is explicitly or tacitly exempt from the wage standard, and about 60 percent of the goods and services that comprise the Consumer Price Index are also formally or tacitly exempt from the price standard. Full compliance by nonexempt groups may be difficult to obtain. Labor unions in particular may find it difficult to comply, because

it would require giving up accustomed gains in real income. (See Appendix A for a discussion of the **Administration's** wage/price guidelines **program**.)

THE CBO FORECAST

Policy Assumptions. Any forecast of economic activity depends critically on its policy assumptions. The CBO forecast of the economy through 1980 is based on the following current policy budget assumptions:

- o Federal outlays (unified budget) of \$494 billion in fiscal year 1979 and \$551 billion in fiscal year 1980; and
- o Current tax laws, including reductions in personal and corporate taxes in January 1979 and scheduled increases in social security taxes in both 1979 and 1980.

Thus, the CBO forecast assumes neither the cut in spending below current policy levels proposed in the **Administration's** budget for fiscal year 1980, nor the real wage insurance proposed by the Administration as part of its new wage/price program.

With regard to monetary policy, **CBO's** forecast assumes that M2 will increase to near the upper end of the Federal Reserve target range during the first half of 1979. With demands expected to remain strong, short-term interest rates are projected to continue to rise in the first and second quarters of 1979, reaching a peak when real activity begins to weaken in the second half of the **year**.

The Forecast. The forecast of the economy through 1980, based on the key assumptions outlined **above** as well as the recent economic developments discussed in Chapter II, *is* summarized in Table 9. Growth in real gross national product is expected to slow **significantly** in 1979, to the 0 to 2.0 percent range on a **quarter-to-quarter** basis, and then to rise at a 3.0 to 5.0 percent pace in 1980. The unemployment rate is expected to rise to a 6.2 to 7.2 percent range by the fourth quarter of 1979, with little change by the fourth quarter of 1980. Throughout the period, the rate of inflation, as measured by the consumer price index, is projected to remain high. The increase in this index is projected to range between 7.0 and 9.0 percent in 1979 and from 6.5 to 8.5 percent in 1980.

TABLE 9. ECONOMIC PROJECTIONS BASED ON CURRENT POLICY, CALENDAR YEARS 1979 AND 1980

Economic Variable	Levels			Rates of Change (Percent)		
	1978:4 (actual)	1979:4	1980:4	1977:4 to 1978:4 (actual)	1978:4 to 1979:4	1979:4 to 1980:4
GNP (billions of current dollars)	2211	2365 to 2457	2595 to 2800	12.9	7.0 to 11.1	9.7 to 13.9
Real GNP (billions of 1972 dollars)	1412	1412 to 1440	1455 to 1512	4.3	0.0 to 2.0	3.0 to 5.0
General Price Index (GNP deflator, 1972=100)	157	168 to 171	178 to 185	8.3	7.0 to 9.0	6.5 to 8.5
Consumer Price Index (1967=100)	202	216 to 220	230 to 239	8.9	7.0 to 9.0	6.5 to 8.5
Unemployment Rate (percent)	5.8	6.2 to 7.2	6.2 to 7.2	-	-	-

The Persistence of Inflation. The continuing of high rates of inflation in the forecast is predicated on business and labor both striving to maintain their accustomed growth in real income. 5/ Higher wages reflecting inflation "catch up" will then feed into higher prices, as firms seek to pass on their increased costs. Increases in social security taxes and in the minimum wage will also provide upward pressure on compensation and prices. Adding more upward thrust to the projected advance of prices in 1979 and 1980 are assumed 10 percent increases in farm prices and producer fuel prices in both years. No significant further devaluation in the dollar is assumed, although import prices may continue to rise during the forecast period as a result of the lagged effect of earlier dollar depreciation.

The Downturn. The projected low growth in real GNP between the fourth quarter of 1978 and the fourth quarter of 1979 reflects expected weakness in three sectors of the economy:

- o Residential construction is projected to turn down in 1979. Although housing starts have not yet declined significantly, the supply of mortgage funds is already being cut back in the 18 states where market-determined levels of mortgage rates are above usury ceilings. The demand for housing is also expected to taper off as the combined impact of high housing prices and interest rates removes many would-be home buyers from the market;
- o Business fixed investment is expected to be weak in 1979. The recent surveys of business spending intentions described in Chapter II point to relatively weak growth. Because utilization rates fall off as the economy weakens, this sector is also not anticipated to be a source of strength in 1980;

5/ In an earlier report, CBO analyzed the persistence of inflation and its recent acceleration. See Congressional Budget Office, Inflation and Growth; The Economic Policy Dilemma (July 1978), Chapter III.

- o Finally, consumer spending is expected to weaken in 1979. Consumer sentiment has been declining. With a rising debt burden and a below-average saving rate, consumers are projected to cut back on consumption, particularly for autos and other durable goods in the months to come. Inventories should begin to pile up around midyear, and this will quickly be followed by reductions in orders by **firms.**

According to the CBO **forecast**, economic growth will not weaken immediately. But the forecast does include a modest decline in real GNP during the second half of 1979, resulting mainly from persistent inflation and tightening credit conditions. The downturn is not expected to be deep or prolonged because:

- o Businesses appear to have maintained relatively lean inventories; thus, any inventory adjustment should be mild;
- o Net exports are projected to be a source of considerable strength as a result of an expected improvement in the economic growth of U.S. trading partners and because of the depreciation of the dollar last year;
- o The cut in personal income taxes provides stimulus early in 1979 and overall federal fiscal policy does not appear to be a significant drag on the economy until 1980;
- o There are large order backlogs at capital goods industries, which will provide support to total spending during the slowdown.

The Recovery. The recovery in the 1980 CBO forecast is less robust than the typical postwar upswing because the downturn is not deep and inflation is projected to remain high. As a result, monetary policy will not respond as much as usual to the elevated unemployment rates, and short-term interest rates will rise from already high levels during the recovery. Furthermore, federal fiscal policy (even with current policy) will exert a drag on economic activity in fiscal year 1980, as the interaction of inflation and the progressive tax structure causes personal income tax rates to rise.

Uncertainties in the Forecast. Several major uncertainties are associated with this forecast:

- o As explained in the introduction to this chapter, the major uncertainty in the forecast is the behavior of prices and the monetary policy response to continued inflation. The degree of compliance with the **Administration's** proposed wage/price standards cannot be known with certainty. If inflation abated unexpectedly, for example, credit conditions might ease somewhat, and the real economy would respond favorably;
- o There is no assurance that the dollar has stabilized in world markets. If it should begin to slide once again, significant further **tightening** by the Federal Reserve Board is quite possible. Reduced money growth and higher interest rates could lead to a recession of much greater proportions than the minor slowdown envisioned in the forecast described above; and
- o Prolonged strikes are possible as a result of attempts by business firms to abide by the **Administration's** wage standards. A major strike could affect the timing and depth of a economic downturn.

This chapter focuses on the role of fiscal policy in combating inflation. In recent **months**, monetary policy has become increasingly **tight**. With current policies, the fiscal year 1980 budget would also be a restraining force on the economy. The Administration proposes adding to budgetary restraint by reducing expenditures below current policy. The Congress will have the opportunity to weigh the benefits and costs of such an anti-inflationary policy shift.

In addition to determining the role of fiscal policy in controlling inflation, policymakers must also decide about the appropriate size of the government sector. Those who favor spending cuts generally do so as much out of a belief that the government is too costly to **taxpayers**, does too much, and is sometimes wasteful, as out of a belief that fiscal policy requires a smaller deficit. These two issues can be considered separately, however, because fiscal policy can involve about the same degree of restraint with substantial differences in the size of the federal sector.

In formulating fiscal policy in the current situation, it seems particularly important to maintain flexibility, because the outlook is so **uncertain--especially** regarding the severity of the expected slowdown in 1979, and the **effectiveness** of the Administration's wage/price standards in slowing inflation.

Due to uncertainty in economic conditions, policymakers cannot control the level of the deficit in the short run with any degree of precision. Moreover, it may not be desirable to try to prevent automatic shifts in the deficit, because such shifts in the budget tend to cushion the economy in a period of severe recession or excess demand.

Policy **changes** adopted for short-run economic objectives tend to have implications for longer-run objectives as well. Decisions concerning the mix of fiscal policies are thus important, since some fiscal instruments are more effective in attaining specific long-run goals than others. For example, tax incentives to invest might contribute to longer-term growth; lowering payroll taxes

could stimulate the economy while reducing inflationary pressures. Similarly, employment policies and programs might be used as a means of implementing the recently enacted Full Employment and Balanced Growth **Act**.

FISCAL POLICY ALTERNATIVES FOR 1980

Anti-Inflation Fiscal Strategies

As indicated in Chapter III, the federal budget in 1980, under current policy assumptions, will be moderately restrictive. The Administration has emphasized that its proposal for tightening fiscal policy is an important component of its overall anti-inflation strategy. To this end, the President has proposed cutting federal spending for fiscal year 1980 below current policy levels. Stringent fiscal and monetary policies might also improve the chances of success for the wage and price standards: with lower demand pressures, businesses and unions would be more apt to go along with the wage/price **standards**.

The effects on the economy of cutting federal outlays depend in part on the composition of the reductions. In general, a reduction in transfers is thought to have a smaller impact on real **GNP** and prices than a similar size cut in government spending for goods and services. Reductions in spending for public service employment are thought to have a comparatively large impact in raising unemployment. 1/

For illustrative **purposes**, CBO compared the economic effects of two kinds of reductions in federal outlays for fiscal year 1980 with the effects of current policy: a \$15 billion cut involving across-the-board reductions in all of the major categories of the budget, and a \$25 billion reduction cutting much deeper into some programs. The \$15 billion option appears to be a bigger discretionary spending cut from current policy than the Administration proposed. The larger \$25 billion reduction assumes, for example, that the countercyclical public service employment program is almost completely eliminated. In each case, the reductions are assumed to involve a step change effective October 1, 1979.

1/ For a more detailed discussion, see Congressional Budget Office, Understanding Fiscal Policy (April 1978) .

Impact Estimates. Estimates of the approximate economic effects are summarized in Table 10. With the \$15 billion cut in outlays, the Consumer Price Index (CPI) would be about 0.2 percent lower by the end of 1981. The unemployment rate would be about 0.3 percentage points higher by late 1980, and GNP (measured in constant dollars) about 0.8 percent lower. The fiscal year 1980 deficit would be about \$10 billion less.

TABLE 10. ESTIMATED ECONOMIC EFFECTS OF \$15 BILLION AND \$25 BILLION REDUCTIONS IN FEDERAL EXPENDITURES FROM CURRENT POLICY, FISCAL YEAR 1980 BUDGET

Economic Variable	<u>\$15 Billion</u>		<u>\$25 Billion</u>	
	1980:4	1981:4	1980:4	1981:4
GNP (billions of current dollars)	-22	-28	-36	-45
GNP (billions of 1972 dollars)	-12	-11	-19	-17
Unemployment Rate (percentage points)	0.3	0.3	0.6	0.6
Employment (thousands)	-400	-450	-800	-900
Consumer Price Index (percent change from base)	-0.1	-0.2	-0.1	-0.4

SOURCE: Congressional Budget Office estimates.

NOTE: The composition of the expenditure reductions is as follows:

<u>\$15 Billion</u>		<u>\$25 Billion</u>	
Transfers	7.0	Transfers	10.9
Purchases	5.0	Purchases	6.0
Grants	3.0	Grants	8.1

The \$25 billion reduction would produce substantially larger **effects**, especially in **unemployment**, due to the assumed sharp reduction in the countercyclical public service employment program. By late 1980, the unemployment rate would be 0.6 percentage point higher. By late the following year, the **CPI** would be an estimated 0.4 percent lower. The **fiscal** year 1980 deficit would be about \$16 billion less.

Estimates of the effects of changes in fiscal policy, like those presented in Table 10, are subject to a great deal of uncertainty. Economics and economic models have not progressed to the point at which very accurate estimates are possible. In addition, the estimated impact of the cuts in outlays would be affected by alternative assumptions about monetary policy.

Achieving Spending Cuts. **Several** factors would make it difficult to cut outlays by as much as \$15 billion to \$25 billion in **fiscal** year 1980. A **significant** proportion of **federal** outlays (about 57 percent) is for interest and entitlement **programs--such** as social security, unemployment insurance **payments**, and agricultural price supports. To some extent, these programs are viewed as relatively fixed commitments. A reduction in outlays in these areas would require specific legislation to change existing legal **commitments**; one possible way of reducing spending on entitlements (which would also require legislation) might be to cap automatic increases resulting from inflation. In the area of purchases, lead times are sometimes quite long, with a substantial part of outlays in any one year resulting from budget authority in prior years. This makes it difficult to cut outlays quickly. Even in the case of relatively "discretionary" areas of the budget, policymakers might wish to phase in budget cuts gradually, to allow time for adjustment by individuals and state and local governments.

The Size of the Federal Sector

The size of the **federal** sector could be determined independently of decisions concerning the appropriate posture for fiscal policy. A smaller government and a reduced role for government could be achieved with minimum cost and disruption if undertaken systematically over a period of several years. The aggregate

effects on the economy of lower federal spending could be approximately offset by carefully **structuring** reductions in taxes. 2/

In the short run, however, to the extent that the reductions in outlays involved cuts in structural employment programs, this strategy could result in somewhat higher **unemployment--thereby** moving further away from the employment objectives of the Full Employment and Balanced Growth Act. **Nevertheless**, the objective of reducing the size of government could be achieved without significantly affecting overall economic growth.

The \$25 billion cut in federal spending, without any offsetting tax cuts, would reduce federal spending to about 21.3 percent of **GNP**, as compared with 21.9 percent under current policies. Two factors keep this reduction from being larger: first, the cut in spending also lowers GNP, which is the denominator, and, second, the resulting increase in unemployment causes some offsetting increases in **expenditures**, particularly for unemployment insurance. Policymakers may want to consider reducing the relative size of the federal sector while offsetting some or all of the restraining effect of the cut in outlays itself.

Payroll Tax Cuts. If the objective of policy were to reduce the size of the federal sector and to reduce inflation, one possible strategy would be to combine a cut in payroll taxes with a cut in federal **outlays**. Like other tax reductions, a payroll tax cut would offset some of the effect of reducing outlays on real activity. But unlike most other tax cuts, which increase prices, payroll tax cuts would be expected to have a beneficial effect on inflation, at least in the short run. The two major federal payroll **taxes--the** social security tax and the federal portion of the unemployment insurance **tax--are** part of employers' costs and therefore provide a direct instrument for affecting inflationary **pressures**.

2/ Most **economists** believe that reductions in federal purchases have a somewhat larger impact on real GNP than a reduction in taxes of a similar amount, at least in the short run. See Congressional Budget Office, Understanding Fiscal Policy (April 1978).

The 1977 amendments to the Social Security Act raised current policy tax receipts considerably: by an estimated **\$6.6** billion for calendar year 1979, \$9.8 billion by 1980, and \$19.8 billion by 1981. These measures were taken to improve the condition of the trust funds and to meet future expansion in program outlays. Unless program benefits were also reduced, the payroll tax reduction described above would be contrary to the goal of making the program **self-financing**.

CBO recently analyzed the impact of a \$10 billion change in the social security tax **3/--**a reduction of that magnitude would approximately offset the impact of the increases for 1979 and 1980 resulting from the 1977 amendments, as compared with prior law. A cut of that size was estimated to reduce the Consumer Price Index by about 0.3 percent after eight quarters and to increase real GNP by 0.6 percent.

A \$10 billion cut in social security taxes, effective on January 1, 1980, would offset roughly **one-half** of the effect on real GNP and employment that would result by late 1980 from the \$15 billion cut in outlays analyzed earlier. The positive impact on inflation from the spending cut would be augmented by the cut in payroll taxes, causing about a 0.4 percent reduction in prices by late 1981, as compared with the baseline. A cut in social security taxes of this magnitude would offset a smaller proportion of the impact on real activity of the \$25 billion cut in spending on real GNP. The combined policy **changes, however**, would reduce the price level by about **0.6** percent by 1981.

Determining the Mix of Fiscal Policy

In addition to determining the extent of overall stimulus or restraint exerted by the federal budget and the size of the federal sector, policymakers may also affect economic goals by choosing the particular mix of taxes and spending programs. For example, the composition of tax policy can influence the goals of price stability and longer-term economic growth. Similarly, the composition of tax and spending policies affects the degree and types of structural unemployment.

3/ Congressional Budget Office, Aggregate Economic Effects of Changes in Social Security Taxes, Technical Analysis Paper (August 1978).

Investment Incentives. If the fiscal package involves business tax reduction, policymakers may want to consider substituting a targeted fiscal incentive to invest for a reduction in the corporate income tax rate, or vice versa.

In an earlier report (The Economic Outlook, February 1978), CBO compared the effects of three different types of business tax changes: accelerating depreciation, increasing the investment tax credit, and reducing the maximum corporate income tax rate. The results of that analysis (updated in Appendix B for changes in the corporate income tax rate and in accelerated depreciation) suggest that the accelerated depreciation and investment tax credit strategies have a substantially larger impact on investment per dollar of tax reduction than the cut in the corporate tax rate. Nevertheless, there is a great deal of uncertainty about the quantitative effects of these three kinds of changes in business taxes, in part because their effects on investment occur with relatively long lags.

Tax-Based Incomes Policies. Tax-based incomes policies (TIP) provide another approach to combating inflation. The basic idea behind TIP is to use the tax system to encourage noninflationary behavior and to discourage inflationary behavior. 4/ This strategy is related to the broader notion of the "social compact"; that is, it is an agreement (sometimes informal) among labor, management, and government to act in certain ways to moderate inflation.

The Administration's proposal for real wage insurance is a form of TIP, and constitutes an important part of the Administration's wage-price program because it serves as an incentive to encourage compliance with the 7 percent standard for pay increases. The probable degree of success of this proposal and other forms of TIP is difficult to evaluate, in part because they have not been tried in the past. 5/

4/ Arthur M. Okun and George L. Perry (eds.), "Innovative Policies to Slow Inflation," Brookings Papers on Economic Activity, Vol. 2 (1978).

5/ For a more detailed analysis of the Administration's proposal, see Appendix A.

MAINTAINING SHORT-RUN BUDGET FLEXIBILITY

It would be very difficult to control **short-run** movements in the federal deficit, and it is questionable whether this would be desirable, even if **feasible**. The principal reason it is difficult to control is that economic forecasts are quite uncertain. Moreover, a flexible budget can make a contribution toward stabilizing the economy. If the economy turns out to be weaker than expected toward the end of 1979 and in 1980, the deficit will probably be higher, without any policy changes. This "automatic" response of the budget could cushion the downturn.

Over a longer period of time, **however**, the size of the federal deficit may have an important bearing on saving and capital accumulation. 6/ Hence, it may be desirable to maintain short-run flexibility of fiscal policy, but in the context of long-run objectives concerning the relative size of government and the need to encourage saving and investment.

Automatic Budget Response To Recession

To some extent, the federal budget "automatically" cushions a slowdown in economic activity. During a downturn in activity, personal and corporate income taxes tend to decrease more than GNP, thereby reducing the burden of taxes and increasing the deficit. On the spending side, the unemployment insurance system is one of the most important automatic stabilizers. Other spending areas that respond automatically include welfare programs and the social security system. CBO estimates that transfer program outlays automatically increase by about \$7 billion for each

6/ Under some **circumstances**, particularly when the economy is operating at high rates of resource utilization, large deficits may crowd out **investment**.

1 percentage point increase in the unemployment **rate.** 7/

Rising inflation during a downturn in economic activity can reduce the automatic cushioning effect of the budget on real GNP. The progressive income tax system can operate as an automatic **stabilizer** if the slowdown in real growth is associated with a slowing in the growth of money incomes. But if the slowdown is associated with high inflation, tax revenues may decrease very little or even increase, thus adding to restraint of both output and inflation. Inflation will also increase spending, though generally less than the increase in revenues. 8/

Discretionary Budget Responses

Recent experience indicates that stimulative policies can be put in place rather quickly if there is a consensus for doing so. For example, legislation was passed in May 1975 to pay rebates on 1974 taxes, and most rebates had been paid by July 1. In early 1977, in response to a slowdown in the economy, the Congress passed a Third Concurrent Resolution on the Fiscal Year 1977 Budget to provide for the economic stimulus package enacted in the summer of that year.

7/ Some spending categories which are not entitlement programs **may** also respond to increased unemployment rates. In the recently enacted reauthorization of the Comprehensive Employment and Training Act (**CETA**), the recommended number of job slots for the countercyclical public service employment program is tied to projections of the unemployment rate by the Administration. The CETA countercyclical jobs **program**, however, is not an entitlement program, and it is unclear whether budget authority would be adjusted according to levels recommended in the Act. According to the formula in CETA, an increase of 1 percentage point in the projected unemployment rate (from the current level of slightly less than 6 percent) would call for an increase in funding of approximately \$2 billion and an additional 200,000 job slots.

8/ CBO estimated that approximately 60 percent of federal outlays in 1975 were adjusted automatically for increases in the price level, although not all of the adjustment takes place in the same fiscal year. See Congressional Budget Office, The Effects of Inflation on Federal Expenditures (1976).

If the 1980 outlook for the economy appears significantly weaker by this summer, a number of budget measures might be considered. One approach would be simply to **defer** or omit planned reductions in outlays, particularly in the areas of countercyclical programs and policies.

A second approach would be to reduce either payroll taxes or individual income taxes, because their effects would be felt relatively quickly. The effects of a reduction in payroll taxes have already been discussed, but as a short-run stimulus to the economy, timing would be **an important consideration.**

CBO also analyzed the effects of a \$15 billion cut in individual income taxes that might be used to stimulate the economy. Two alternative effective dates were considered: July 1, 1979 and January 1, 1980. The results, summarized in Table 11, are rough estimates, considerably influenced by assumed initial economic conditions as well as by the assumed response of monetary policy.

Finally, the Congress might want to consider **strengthening** the automatic response of the federal budget to changes in the economic situation. Two ways in which this might be done would be to:

- o Provide budget authority for spending programs (such as the CETA countercyclical jobs program) that **respond** by formula to the unemployment rate; and
- o Adjust income tax rates automatically by formula.

ESPECIALLY SEVERE UNEMPLOYMENT PROBLEMS

Great disparities in **unemployment--by race, income level, and geographic area--still** remain, and decisions regarding both overall fiscal policy and the composition of fiscal policy could **significantly** affect these disparities in future **years.**

Under current policy, the emphasis in employment programs has become focused on disadvantaged **groups--in** both countercyclical and structural policies and programs. The principal instruments for targeting on the employment problems of the disadvantaged

TABLE 11. ESTIMATED ECONOMIC EFFECTS OF \$15 BILLION REDUCTION IN FEDERAL INDIVIDUAL INCOME TAXES, EFFECTIVE JULY 1, 1979 OR JANUARY 1, 1980

Economic Variable	Effective July 1, 1979			Effective January 1, 1980	
	1979:4	1980:4	1981:4	1980:4	1981:4
GNP (billions of current dollars)	9	20	22	15	24
GNP (billions of 1972 dollars)	6	10	8	8	11
Unemployment Rate (percent)	-0.1	-0.3	-0.2	-0.2	-0.3
Employment (thousands)	100	400	400	300	400
Consumer Price Index (percent change from base)	0.0	0.1	0.2	0.0	0.1
Net Budget Cost, Fiscal Year (billions of current dollars)	3	10	7	9	9

SOURCE: Congressional Budget Office estimates.

Include the recently modified CETA program 9/ and a relatively untested, targeted jobs tax credit, which is focused on particular groups of workers. 10/ Available enrollment data collected by the Department of Labor suggests that a relatively high proportion of those enrolled in the CETA programs are economically **disadvantaged**. For example, data for fiscal year 1978 (before the eligibility criteria were tightened further) suggest that approximately 80 percent of participants in the countercyclical program were economically **disadvantaged--that** is, they either had incomes below the Census Bureau's poverty standard or below 70 percent of the Bureau of Labor Statistics "lower living standard."

More restrictive fiscal and monetary policies run a substantial risk of increasing disparities **in** unemployment rates. To begin with, cuts in spending below current policy in the employment area would have important implications for the level and composition of unemployment in both fiscal year 1980 and thereafter. In the short **run**, reductions in employment programs appear to have greater **effects** on employment and unemployment than do similar size cuts in the federal budget in **general**. 11/ **Thus**, groups that traditionally have had especially high unemployment could be faced with a dual problem in 1979: when the economy softens, the unemployment rates for such groups as blacks and

9/ For a recent review of the results of employment and training programs and related issues, see Congressional Budget Office, CETA Reauthorization Issues (August 1978) .

10/ **The** targeted jobs **credit--part** of the Revenue Act of 1978-- provides a tax credit of 50 percent of qualified wages the first year of employment and 16 2/3 percent the second year of **employment**. Seven groups of workers were designated as eligible, including economically disadvantaged youths. Eligibility is to be certified by the Labor Department, with the credit applying to the first \$6,000 of an eligible worker's wages. See "The Revenue Act of 1978" (P.L. 95-600) .

11/ For a comparison of the impact of changes in the public service employment program with that of other fiscal instruments, see Understanding Fiscal Policy.

youths would increase more (in percentage points) than for the labor force in general. **12/** In addition, if part of the **anti-inflation** strategy involves large cuts in employment programs, this would have a disproportionate effect on the groups and geographic areas most affected by softness in the economy. **13/**

For the intermediate term, targeted training and employment programs and policies may be an essential component of any comprehensive strategy for achieving the reduction in unemployment and inflation called for in the Full Employment and Balanced Growth Act. Since it takes time to build up such programs (or to phase them **down**), major cuts in existing programs could postpone the implementation of the Full Employment and Balanced Growth Act by several **years**.

CONCLUSION

One of the most difficult issues for fiscal policy is how to respond to an acceleration in inflation. Spending cuts can make a **limited--but significant--contribution** to lowering inflation, but the effect is neither sudden nor dramatic. The principal disadvantage of spending cuts, **however**, is that they lower real growth and increase **unemployment**, when unemployment is already expected to increase. Restrictive policies may also increase disparities in unemployment rates for different groups in the labor force. One way to achieve a considerable reduction in spending and inflation without greatly increasing unemployment is to combine spending cuts with a reduction in payroll **taxes**.

12/ See Congressional Budget Office, Youth Unemployment; The Outlook and Some Policy Strategies (April 1978), and The Unemployment of Nonwhite Americans; The Effects of Alternative Policies (July 1976).

13/ The withdrawal of stimulus funds could also cause adjustment problems for some local governments, **particularly** in areas suffering from longer-term economic adjustments. See **House Budget Committee**, Phasing Down Antirecession Programs; Fiscal Year 1979 Budget Issues (November 1978).

Uncertainty **in** the economic outlook implies uncertainty is the size of the federal deficit, because the budget responds to changes in the economy; to some extent, the budget automatically cushions the impact of a slowdown in the private economy. More-**over**, in the event of a more severe slowdown than expected, policy-makers might want to take additional discretionary measures, which would also affect the size of the federal deficit.

CHAPTER V. LONGER-RUN ECONOMIC GOALS

Decisions on the fiscal year 1980 budget will not just affect the economy in 1980; they **will** also affect economic performance in later years and have a bearing on the extent to which longer-term national goals are achieved. Last year, the Full Employment and Balanced Growth Act (the Humphrey-Hawkins Act) was passed, establishing unemployment and inflation goals to be reached by 1983. 1/

This chapter analyzes these goals, especially the question of whether they are achievable and consistent with each other in the time period mandated.

THE HUMPHREY-HAWKINS GOALS

The **Humphrey-Hawkins** Act sets specific unemployment goals of 3 percent unemployment in the adult civilian labor force (20 and older) and a corresponding 4 percent unemployment in the aggregate civilian labor force (16 and older) by 1983. The act also sets goals for **inflation--the** rate of change in the **Consumer Price Index--of** 3 percent by 1983, and zero percent by 1988; but it specifically states that **anti-inflation** policies shall not impede achievement of the unemployment **goals**. Other goals, including a balanced federal **budget**, were also adopted. 2/

1/ Other longer-term goals that affect budget planning were also enacted in 1978. An amendment to a bill dealing with the International Monetary Fund declares that by fiscal year 1981, "total budget outlays of the Federal Government shall not exceed its receipts," and Section 3 of the Revenue Act links future tax cuts to slower growth in federal spending and overall budget balance.

2/ The full list of general goals is as follows: "full employment and production, increased real income, balanced growth, a balanced federal budget, adequate productivity growth, proper attention to national priorities, achievement of an improved trade balance through increased exports and improvement in the international competitiveness of agriculture, business, and industry, and reasonable price stability."

These unemployment and inflation goals are not outside the range of past experience. Unemployment was 4 percent or lower in 1947-1948, 1951-1953, and 1966-1969. Inflation was 3 percent or lower in most years between 1948 and 1968 (see Figure 10). In the early 1980s, however, it will be difficult to reach either goal--let alone reach both **simultaneously--using** only aggregate monetary and fiscal policies. The first section of this chapter will discuss the unemployment goal; the second section, the inflation goal; and the third section will review evidence indicating that even if one or the other goal is achieved, it is unlikely that both can be reached **simultaneously**, using aggregate policies alone. The **Humphrey-Hawkins** Act recognizes the limitation of standard monetary and fiscal **policies**. It states **that**, in recent experience, "aggregate monetary and fiscal policies alone have been unable to achieve" concurrently low rates of unemployment and inflation. The final section of this chapter will thus discuss measures which might further both goals **simultaneously**.

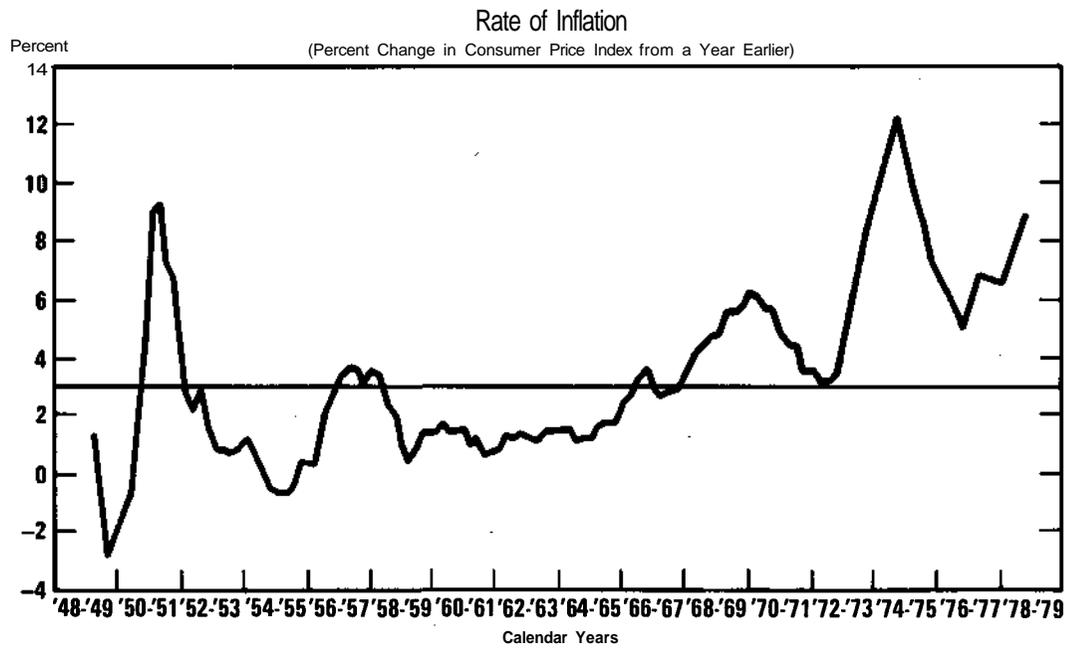
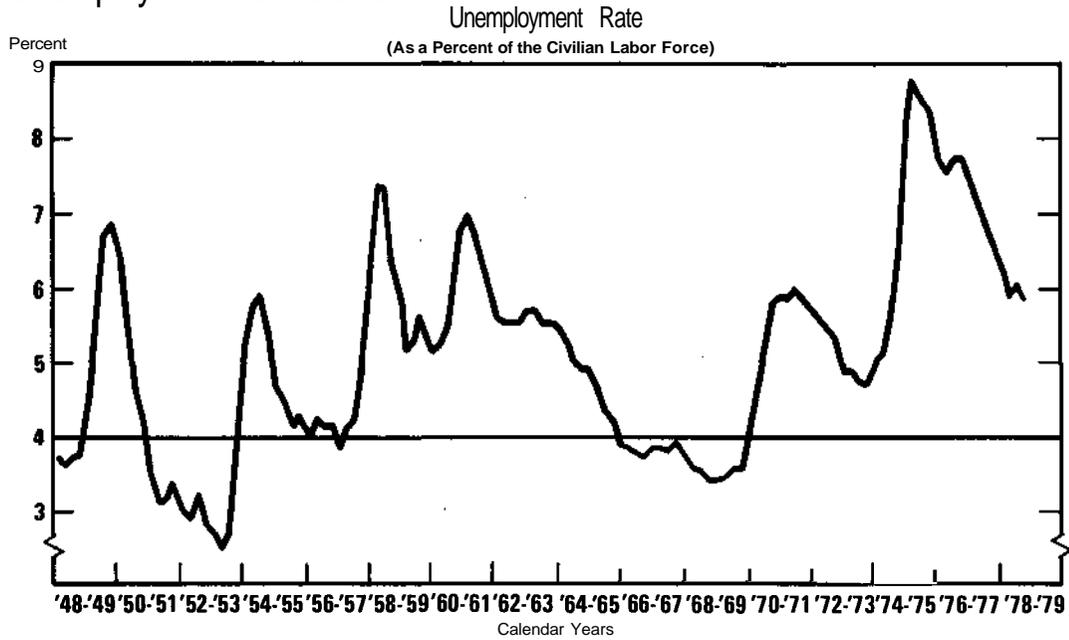
Unemployment Targets

Although 4 percent unemployment has been achieved in the past, most analysts believe that it is now more difficult to reach that measured rate of joblessness. Two reasons are generally cited for this increased difficulty:

- o Shifts in the demographic structure of the labor force, and
- o Institutional changes that raise the measured unemployment rate associated with a given level of labor market slack.

Shifts in Composition of the Labor Force. One of the most generally accepted factors contributing to the upward drift of the unemployment rate during the past two decades is the rising proportion of women and young people in the labor force. In the case of women, this has resulted from the dramatic rise in their **labor force** participation. In the case of young persons, there has been a rise in both their share of the working-age population and their labor force participation rates. The rise in their share of the working-age population results from the movement of the large postwar baby-boom generation into the working **years**.

Figure 10.
Unemployment and Inflation



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.
NOTE: Latest point shown for CPI is based on average for October and November.

The changing structure of unemployment and the labor force by major age-sex group during the past two decades is shown in Table 12. At high employment in 1956, unemployment rates for **groups** of workers under 25 were 1.5 to 4 times as high as for the corresponding "prime-age" (25 to 54 years old) workers of the same sex, and the rate for prime-age women was higher than that for prime-age **men**. If that higher unemployment for women and young people reflects the job search and information gathering necessary to obtain satisfactory employment for recent labor-force entrants and **re-entrants--rather** than a general scarcity of **jobs--then** it follows that the rising proportion of women and young people in the labor force should be accompanied by a rising unemployment rate.

TABLE 12. UNEMPLOYMENT RATES AND SHARES OF LABOR FORCE BY AGE-SEX GROUP

	<u>Unemployment Rate</u>				<u>Percent of Total Civilian Labor Force</u>			
	1956	1967	1973	1977	1956	1967	1973	1977
	All Workers	4.1	3.8	4.9	7.0	100.0	100.0	100.0
Males, Total	3.8	3.1	4.1	6.2	67.8	63.3	61.1	59.0
16 to 19	11.0	12.3	13.9	17.3	3.7	4.7	5.3	5.1
20 to 24	6.9	4.7	7.3	10.7	5.2	6.5	8.0	8.1
25 to 54	3.0	1.9	2.5	4.3	45.6	40.4	37.8	36.7
55 and older	3.5	2.5	2.5	3.9	13.3	11.7	10.0	9.1
Females, Total	4.8	5.2	6.0	8.2	32.3	36.7	38.9	41.0
16 to 19	11.0	13.5	15.3	18.3	2.8	3.7	4.3	4.4
20 to 24	6.3	7.0	8.4	11.2	3.7	5.1	6.3	6.7
25 to 54	4.1	4.1	4.4	6.4	20.6	21.6	22.4	24.3
55 and older	3.3	2.5	2.8	4.5	5.2	6.2	5.9	5.6

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

Estimates of the increase in the high-employment unemployment rate resulting strictly from changes in labor-force composition range from 0.4 to 0.9 percentage **points**. Some reversal of this shift can be expected in future years, as the baby-boom generation moves into the prime-age, low-unemployment **years**; but by 1983, it appears that no more than two-fifths of the upward shift will have been reversed.

Institutional Changes. It also has been argued that the rate of unemployment has increased because changes in institutions--especially in federal government policies--have raised the measured unemployment rate associated with any given level of labor market slack. There have been several policy changes which many believe to have had such effects:

- o Increases in the level of unemployment insurance (UI) benefits relative to the after-tax wage, and increases in the coverage of the UI system;
- o Increases in the level and coverage of the minimum wage, which--according to most available evidence--limit job opportunities, especially for young workers; 3/ and
- o Work registration requirements for food stamp and welfare recipients, instituted in 1972, which can be expected to raise reported labor force participation and unemployment without much, if any, **increase** in labor availability.

Estimating the amount by which these policy changes have raised the rate of **unemployment**, other things being equal, is a difficult problem. The simplest to evaluate, because it operates only through labor force **participation**, is the work registration requirement. The most reliable evidence indicates that this requirement raised the reported unemployment rate by 0.2 to 0.4 percentage points in 1977. 4/ Estimates as high as 2.0 percentage points have been made; 5/ however, these high estimates have

3/ See, for example, Jacob Mincer, "Unemployment Effects of Minimum Wages," Journal of Political Economy (August 1976).

4/ Philip Cagan, "The Reduction of Inflation and the Magnitude of **Unemployment**," in Fellner, (ed.), Contemporary Economic Problems 1977 (American Enterprise Institute); Cornelia **Motheral** and Rebecca **Summerville**, "The Impact of Federal Policies on Labor Force Participation and **Unemployment**," presented at the Southern Economic Association Meeting, November 1978 (processed).

5/ Kenneth Clarkson and Roger Meiners, "Government Statistics as a Guide to Economic Policy: Food Stamps and the Spurious Increase in the Unemployment Rates," Policy Review (Summer 1977).

significant methodological problems. Philip Cagan has estimated that changes in UI raised the high-employment unemployment rate by 0.34 percentage points between 1956 and 1977, and estimates that minimum wage increases and their interaction with labor force composition may have raised it by as much as 0.63 percentage points over the same period. 6/ It should be noted, however, that to the extent that these programs raise **unemployment** by raising labor force participation of groups other than prime-age **males**, at least part of these effects may already be accounted for by the estimated effect of changing labor force shares.

The Inflation Target

A combination of two factors makes reducing the rate of inflation to 3 percent by 1983 difficult: the current rapid rate of inflation, and the widespread practice of linking income adjustments to past inflation. The Consumer Price Index increased by 9 percent in 1978; to the extent that wages and other production costs are subsequently escalated in response to such price increases, great momentum is built into inflation. 7/ **Consequently**, it is difficult to slow the pace of inflation quickly.

The indexing of current income adjustments to past consumer price change occurs in a variety of **ways**, including:

- o Many **union** members receive periodic wage increases based on the movement of the **CPI**; about 60 percent of all workers covered by major collective bargaining **agreements--and** a much higher share of those covered by multiyear **contracts--**benefit from **cost-of-living** escalator clauses. This periodic escalation in **combination** with first-year wage catch-up and annual improvement adjustments are designed to maintain the traditional growth of **workers'** real wages;

6/ Cagan, "The Reduction of Inflation and the Magnitude of Unemployment."

7/ For a more detailed analysis of the nature of inflationary momentum, see CBO, Inflation and Growth; The Economic Policy Dilemma (July 1978), Chapter III.

- o The wages paid to a large number of nonunionized workers are informally indexed to the past rate of inflation; employers provide informal escalation for a variety of **reasons**, including the threat of unionization and the maintenance of employee morale and **productivity**;
- o Professional organizations often use their economic and political power to maintain the traditional growth in members' real income; and
- o A variety of government actions explicitly or implicitly attempts to reduce the impact of inflation on living standards: indexation of social security benefits as well as other income transfer programs, periodic adjustments of the minimum wage, increased farm price supports, and restrictions on competition from imports.

The momentum imparted to inflation by this widespread indexation of income claims to past price movements makes it **difficult--but not impossible--to** slow inflation quickly by standard monetary and fiscal policies alone. According to mainstream economic analysis, restrictive policies slow inflation by creating excess **capacity--high** unemployment and idle plant and **equipment--** which puts downward pressure on wage and price adjustments. The degree of economic slack necessary to lower the rate of inflation **significantly** by 1983 through the use of standard macroeconomic tools and the related question of the consistency of the Humphrey-Hawkins unemployment and inflation goals are analyzed in the next section.

THE TRADE-OFF BETWEEN INFLATION AND UNEMPLOYMENT

The extent of the trade-off between unemployment and inflation can be measured by comparing alternative five-year projections, using a wage-price framework that is typical of most large econometric models of the economy. In this framework, nominal wages are assumed to depend on slack in labor markets (measured by the unemployment rate) and inflation catch-up and **expectations**. Prices are assumed to be a markup over **costs**.

Although there has been a great deal of debate about how much of an **unemployment-inflation** trade-off exists in the long run, there is a considerable amount of empirical evidence that the trade-off in a four- to five-year period exists, and that this

trade-off is costly in the sense that lower unemployment means higher inflation and vice versa. To demonstrate **this**, a base five-year projection path is compared with two paths that alternately show the effects of lowering unemployment and the effects of lowering inflation, using standard fiscal and monetary policies (see Figure 11).

Base Five-Year Projections Path

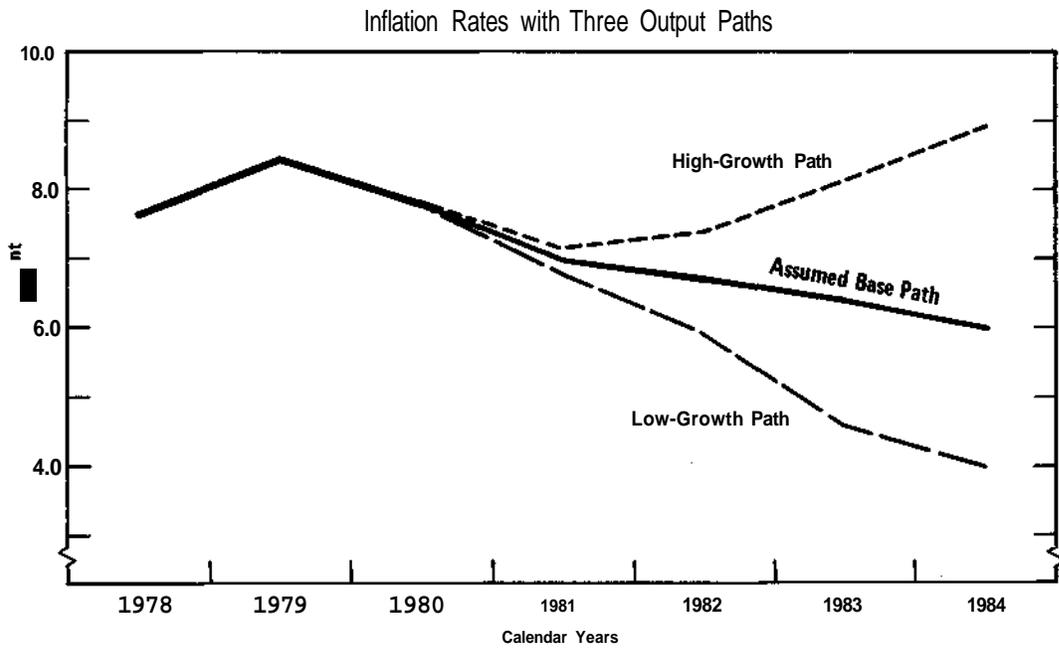
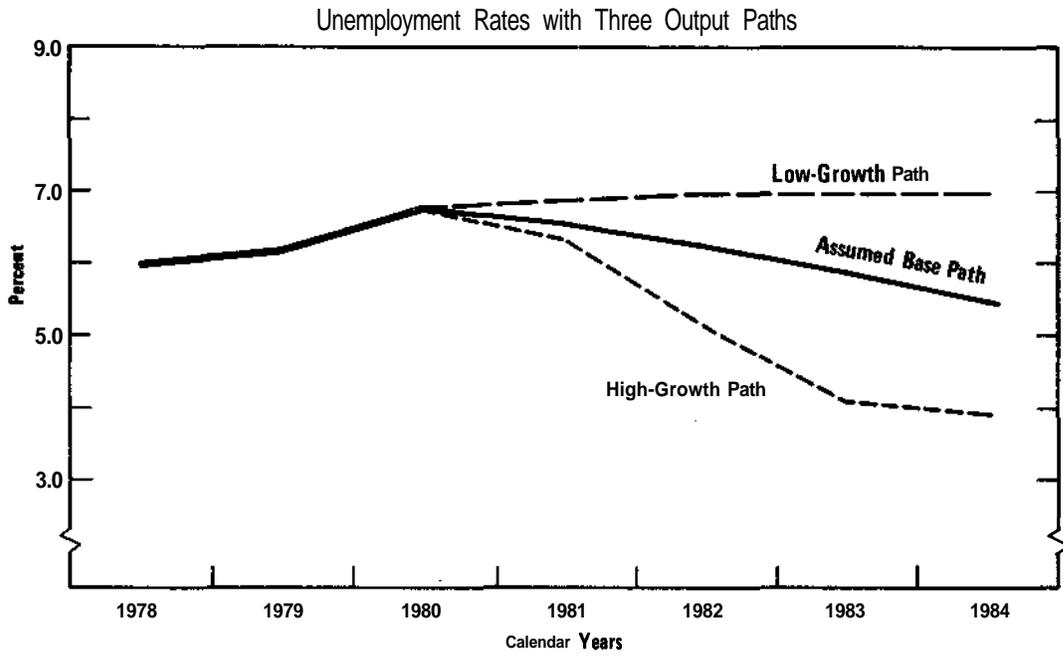
The base path begins with the CBO forecast for 1980. The unemployment rate is assumed to drop gradually from 6.8 percent in 1980 to 5.5 percent in 1984. The 5.5 percent unemployment target was chosen as a rough estimate of the unemployment rate below which inflation accelerates; the results would not be much different if somewhat higher or somewhat lower rates were chosen. The growth in real GNP required to reach this target is estimated to be about 4.5 percent annually from 1981 to 1984. The inflation pattern that is consistent with these growth rates shows a gradual decline to 6 percent in 1984. This path is not meant to be a forecast; instead, it describes a possible five-year scenario in the absence of major shocks to the economy.

Lower Unemployment

In the high-growth path, the unemployment rate is assumed to drop to 4 percent by 1983 and to hold there. This requires real GNP growth rates between 5.5 percent and 7 percent from 1981 through 1983. As a **consequence**, the inflation rate bottoms out at 7 percent in 1981 and rises to 9 percent by the end of 1984. Since most estimates associate 4 percent unemployment with accelerating wage and price increases, in the absence of additional inflation-reducing policies (or additional structural employment **policies**), holding the unemployment rate at 4 percent would continue to raise the inflation rate. 8/

8/ The magnitude of the changes needed to achieve the Humphrey-Hawkins goals and the goals discussed in the lower inflation scenario would require fairly large changes in fiscal and monetary policy. However, it is difficult to estimate with any degree of certainty exactly how much policy would need to be changed. For a further discussion of this problem, see the CBO background paper entitled, An Analysis of the Roth-Kemp Tax Cut Proposal (October 1978).

Figure 11.
Alternative Five-Year Paths



Lower Inflation

The efficacy of reducing inflation by inducing protracted slack in the economy has recently received a lot of attention. The rationale behind this type of fiscal policy is that keeping the unemployment rate high will, over a sufficiently long period of time, lower the inflation rate.

In this five-year low-growth scenario, the unemployment rate is assumed to remain near the 7 percent range from the end of 1979 to 1984. This implies 3.5 percent growth in real **GNP** from 1981 to the end of the period. As a result of the prolonged economic slack, the inflation rate drops to the neighborhood of 4 percent in 1984.

The direct costs of such a policy are quite high. Compared with the base path, GNP in 1984 would be about \$100 billion (1972 dollars) lower and about 1.5 million jobs would be lost. It is relatively easy to estimate the cost of rising unemployment in terms of the value of lost output. But other costs of high unemployment are not included in the above **estimate--permanent** loss of skills and work habits, family disruption, crime, and alienation have all been attributed to high unemployment by some analysts. Higher inflation also has substantial costs that are difficult to **estimate.**

Can The Trade-off Be Improved?

The results given above demonstrate the costly trade-off between unemployment and inflation and suggest that the 1983 inflation and unemployment goals specified in the Humphrey-Hawkins Act are not simultaneously achievable using monetary and fiscal policies alone. There is currently a great deal of inflationary momentum in the U.S. economy; lowering the inflation rate by reducing aggregate demand would require that high unemployment rates be sustained for many **years.** On the other hand, aiming for a 4 percent unemployment rate in 1983 would be highly inflationary because the unemployment rate at which the rate of inflation neither accelerates nor decelerates may be in the neighborhood of **5.5** to 6 percent now and will decline only modestly by **1983** if there are no changes in supply and labor market policies. The high costs of reaching the Humphrey-Hawkins unemployment goals (in terms of inflation) and its inflation goals (in terms of lost output and jobs) underline the inefficiency of using fiscal and monetary policies alone. The simultaneous achievement of the two goals may

only be feasible if supply-enhancing and income policies are used in conjunction with demand management **policies**. These types of policies are described in the next section.

REDUCING BOTH UNEMPLOYMENT AND INFLATION

The Humphrey-Hawkins Act states that, "...sole dependence upon fiscal or monetary policies or both to combat inflation can exacerbate both inflation and **unemployment....the** coordinated use of fiscal and monetary policies in conjunction with specific targeted policies are necessary to combat inflation." Another passage reads, "In choosing means to achieve the goal for the reduction of unemployment and choosing means to achieve the goal of reasonable price stability, those means which are mutually reinforcing shall be used to the extent **practicable.**" This concluding section will discuss policies suggested in the Humphrey-Hawkins Act to improve the chances of achieving the target rates of unemployment and inflation simultaneously.

Supply-Enhancing Programs. In recent **years**, significant increases in inflation have been caused by what are generally called supply **shocks**; the two most **familiar** examples are bad weather, which reduces the supply of farm products and raises their prices, and the large energy price increase initiated by **OPEC's** exercise of market power. Another supply change that continues to contribute to inflation is the slowdown in the growth of productivity (output per hour **worked**). Unfavorable supply shocks can increase both unemployment and inflation. Policies that increase supply, on the other hand, can lower both unemployment and inflation. Most supply-enhancing policies are not likely to be cost-free; they may require federal budget resources, either through spending or through tax incentives.

The list of supply policies that might reduce both unemployment and inflation is **substantial--though** some of the policies conflict with other provisions of Humphrey-Hawkins or with other Congressional goals expressed in past legislation. For example:

- o Reduction or postponement of increases in the minimum wage would likely reduce both unemployment and inflation;

- o Reducing the benefits or coverage of the unemployment insurance system during high employment (while retaining the countercyclical features specified in **Humphrey-Hawkins**) could reduce inflation and **unemployment**; taxing **UI** benefits could have a similar outcome;
- o Increased federal research and development or research and investment tax incentives may improve productivity; the most effective tax incentives for investment, per dollar of revenue loss, are thought to be the investment tax credit and accelerated depreciation;
- o Monitoring bottlenecks. Bottleneck problems arise when shortages of capital or skilled labor limit output of commodities which cannot be easily substituted for in the short run, thus limiting the expansion of aggregate output in response to rising demand and causing inflation. Bottlenecks appear to have been an important factor in the 1973-1974 inflation, but avoiding future bottlenecks is difficult and not a cure-all: inflation can accelerate as utilization **rises, even** without specific bottlenecks. Even if materials or labor shortages can be accurately anticipated, means of alleviating **them--given** that Humphrey-Hawkins prohibits production **controls--are** not easily formulated, and the essence of a "bottleneck" factor of production is that it takes time to produce and put in **place**;
- o Energy policy. Keeping energy prices from rising can conflict with the goals of encouraging domestic energy production and conservation;
- o Competition policy. Among the suggestions in Humphrey-Hawkins for increasing competition are strengthening antitrust laws and changing regulation. The recent deregulation of airline passenger fares provides an example of what can be accomplished through changing federal regulatory policy. Humphrey-Hawkins emphasizes competition in product markets but does little to encourage greater competition in labor markets; for example, there is no suggestion of modifying the Davis-Bacon Act, which tends to require high wages for government construction projects;

- o Reduction of trade barriers; and
- o Regulation for environmental and related goals has lowered measured productivity and raised measured inflation. Humphrey-Hawkins leaves it to the Congress to decide what regulation of this type is **"necessary:"** Another suggested approach is to achieve environmental goals by more cost-effective means than direct regulation, such as effluent **taxes.**

Targeted Employment Policies. To reduce **unemployment,** **Humphrey-Hawkins** specifically mentions targeted employment tax credits, wage vouchers, and other employment incentives to private sector businesses. The 1978 tax law provides for a targeted employment tax credit. Targeting can be effective in reducing unemployment without raising inflation, if labor markets are segmented by skill or location. In that respect, targeting can be regarded as a substitute for reducing the minimum wage or otherwise reducing barriers to the employment of certain groups. Similarly, targeted public employment can reduce unemployment with less inflationary pressure than a comparable employment expansion stimulated by a tax **cut.**

Farm Policy. Federal policies to raise or maintain market prices of farm products can be of two types: production restriction or stockpiling. Production restriction raises average farm prices and farm income, accelerates inflation, and increases instability in prices. Some economists believe that stockpiling raises farm prices, farm incomes, and inflation less than production restrictions, and results in more stable prices and production.

Incomes Policies. Three of the four postwar periods of low unemployment and low inflation were characterized by some form of incomes **policy--either** price and wage guidelines or controls. Incomes policies are not mentioned in **Humphrey-Hawkins,** and wage and price controls are specifically disavowed.

It is not likely that any incomes **policy--voluntary** or **compulsory--can** effectively control inflation arising either from supply shocks or from **overstimulating** the economy. What a well-designed incomes policy may be able to do is slow the wage-price **spiral--the** momentum of **inflation--with** less cost in terms of lost production and employment than can fiscal and monetary policies alone.

In conclusion, achieving both the unemployment and inflation goals of Humphrey-Hawkins is highly unlikely if only monetary and fiscal policies are used. Adopting any or all of the structural policies outlined above could increase the chances of achieving inflation and unemployment goals simultaneously; but the structural policies require difficult choices and the magnitude of their effects is not easily predicted.

APPENDIXES

APPENDIX A. THE ADMINISTRATION'S WAGE/PRICE PROGRAM

In October 1978, President Carter announced a new anti-inflation program:

- o The 1980 budget submitted to **Congress** would give top priority to moderating inflation; the federal spending share of GNP would be reduced to 20 percent in fiscal year 1980, and the deficit would be less than \$33 billion; 1/
- o Government regulations that increase costs and prices would be reviewed;
- o Numerical standards for price and wage changes in the year ahead were established **along** with proposed incentives for compliance and penalties for **nonobservance**.

Many analysts have concluded that the wage/price program must be successful if a recession is to be avoided in 1979 or 1980. This appendix describes the program and assesses its chances of success.

Description of the Wage/Price Program

The program can be divided into three parts: standards, **enforcement**, and exemptions.

Standards. The price standard is that the average price increase by a firm during the year should be 0.5 percentage point below its average annual rate of increase in 1976-1977, with a maximum of 9.5 percent. The wage standard is that the average annual increase in wages and new privately financed benefits for any given employee group of a firm cannot exceed 7 percent. (A firm's workforce is divided into four employee groups: management employees, employees covered by collective bargaining agreements, employees earning \$4 per hour or less, and all other employees.)

1/ The fiscal year 1980 budget just released has an even smaller deficit of \$29 billion.

Enforcement. The proposed enforcement mechanism has both sanctions and rewards. The potential sanctions for not complying with the standards **include:**

- o Firms with government contracts in excess of \$5 million must be certified as complying with the wage-price standards or possibly lose the contracts;
- o Limitations on imports competitive with products of noncomplying firms could be loosened;
- o Rate and entry regulations governing noncomplying firms could be **reviewed;**
- o **Noncompliance** by certain **industries--for example, construction--could result** in modifications of industry-specific minimum wage and price legislation; and
- o Compliance may be required in order to receive assistance from the **U.S.** Import-Export Bank.

The principal carrot for compliance is on the wage **side--real** wage insurance. Groups of employees who comply with the wage standard become eligible for a tax refund equal to the excess of the **CPI** increase over 7 percent applied to the **employee's** wages. The Administration proposes two caps on its real wage insurance, limiting its coverage to the first \$20,000 in earnings and limiting the range of compensated inflation to 10 percent.

Effective monitoring is limited to the wage and price actions of the largest **firms--primarily** those with sales in excess of \$250 million per year. In addition, the Council on Wage and Price Stability will follow developments in collective bargaining agreements where 1,000 or more workers are covered.

Exemptions. There are a number of explicit and tacit exemptions to the wage/price standards. These will be reviewed in some detail below.

Problems with Achieving Reduced Inflation

There are three types of problems that reduce the chances that the voluntary wage/price program will result in a quick reduction in the rate of inflation:

- o A large portion of prices included in the **CPI** are officially or tacitly exempt from the **program--including** food at the farm, interest rates, **energy**, products produced by firms with low profit margins relative to recent experience, imports, and products produced by relatively small firms;
- o A large portion of wage earners are officially or tacitly exempt from the **wage standard--including** those paid less than \$4.00 per hour, those whose wages have been previously contracted (plus those in close **tandem**), and those employed by small firms; and
- o Voluntary compliance may be difficult to obtain, especially from unions being asked to accept reductions real wages.

Price Standard Exemption. There are three major areas of exemption to the price standard. First, some goods and services are explicitly excluded:

- o food at the farm,
- o government goods and services (**taxes**),
- o interest rates,
- o imports, and
- o regulated energy **products**, such as natural gas. †

Second, some goods and services are affected by the rule that essentially permits firms to maintain their before-tax profit margins on sales to the average margin in their best two out of the past three fiscal years. This exemption could affect:

- o retail food (if raw food prices rise **significantly**),
- o gasoline and other petroleum products (as a result of OPEC price increases and domestic **decontrol**), and
- o public utilities and other regulated areas of the economy, where prices are already typically set to ensure a fair rate of return.

Finally, a large number of goods and services are tacitly exempt because enforcement is directed only at large **corporations**:

- o new and existing homes sales,
- o used car sales,
- o automobile maintenance and repair,
- o household **services**,
- o apparel **services**,
- o medical care **services**,
- o restaurants and lodging,
- o entertainment services,
- o personal care services, and
- o educational services.

The exemptions account for roughly 60 percent of the Consumer Price Index, and the exempted goods and services accounted for much of the acceleration in inflation in 1978. They rose at an 11 percent annual rate during the first 10 months of the year, as compared with a 7 percent rate for the **nonexempt** products. The prices of the nonexempt products rose at about a 5.5 percent average annual rate in 1976-77; therefore, a .5 percent price deceleration implies that these **prices** would increase in the neighborhood of 5 percent in 1979. If the officially and tacitly exempt product prices continue to rise as rapidly as they did before the program in 1978, then consumer price inflation would be about 8.7 percent in **1979--even** with a full .5 percent deceleration by the nonexempt group. 2/

Wage Standard Exemptions. There are two, **nonmutually** exclusive, types of exemptions from the wage standard. First, some workers are officially **exempt**:

- o Workers earning \$4.00 per hour or less;
- o Workers who have previously contracted wage adjustments for next year;
- o Workers who have recorded exceptionally large productivity gains resulting **from** work rule changes; and

2/ It is, of course, not known to what extent the tacitly exempt group will change their behavior in response to the wage-price **standards**.

- o Workers whose wages have historically maintained a close tandem relationship to another employee group whose wage adjustment occurred prior to the announcement of the program.

Second, there are the employees of relatively small firms who are tacitly exempt because enforcement is directed only at large **firms.**

Extrapolating trends **from** the Current Population Survey's weekly and hourly earnings data, about 40 percent of workers paid at hourly rates will receive less than \$4.00 an hour next year. If these workers were to receive the overall average hourly compensation gain recorded from the third quarter of 1977 to the third quarter of 1978, average hourly compensation per worker would rise above the 7 percent standard. In addition, if the 6 million workers who will be covered by continuing major collective bargaining agreements next year also receive increases greater than 7 percent, the hourly payment per worker would increase still further. It is unknown how many employees of small firms will comply.

Voluntary Compliance. Obtaining voluntary compliance with the program's standards from the nonexempt groups is not assured; labor unions will find compliance especially difficult. This conclusion follows from two characteristics of wage determination under collective **bargaining:**

- o Unions attempt to maintain the loyalty of their members, and an important aspect of this maintenance of loyalty is satisfying their members' wage aspirations;
- o Workers tend to evaluate whether wages are satisfactory more on ethical than economic criteria; the old labor slogan of "a fair **day's** work for a fair day's pay" provides an important insight into workers' wage aspirations.

In general, equity in wage determination has two dimensions. First, there are interpersonal or intergroup comparisons. Orbits of comparison or wage patterns tend to become established over time and through the process of repetition come to be accepted as fair by wage earners. For example, **steelworkers'** wage settlements tend to pattern after autoworkers' settlements, and to break this orbit would result in workers feeling that they were treated unfairly. **Second,** there are comparisons over time. Workers become accustomed to a standard rate of increase in their real wage

over time; to receive less would be perceived as inequitable. Thus, multi-year collective bargaining contracts are typically characterized by three types of wage adjustments: a first-year catch-up to compensate for past inflation, an annual improvement factor, and a **cost-of-living** escalator.

A problem with the wage standard is that it requires unions to violate both dimensions of equity and to do this, from their members' perspective, voluntarily:

- o Intergroup equity. The unions that bargain in 1979 are being asked to settle for a 7 percent annual increase in wages and new benefits when other unions have recently negotiated and received much more (for example, mine workers received 13 percent and railroad workers received more than 10 **percent**); and
- o Equity over time. In order to comply with the wage standard, the unions bargaining in 1979 must in general settle for reductions in real wage trends for their members, rather than maintain traditional real wage increases. This is true even if the real wage insurance proposal is enacted, because the standards permit no first-year catch-up to past inflation and permit at best a 1 percent real wage rise over the life of the **contract--** well below trend rates for the teamsters, auto workers, electrical workers, rubber workers, and meatpackers. It is noteworthy that the Kennedy guidelines and the Nixon standards permitted real wages to rise more than 1 percent **annually**.

Given the pressures from their membership, it will be difficult for unions to comply with the wage standard voluntarily. Reasons that may be used to justify noncompliance include:

- o A delay in the passage of real wage insurance (or the rejection of the program by the **Congress**), which would support the rationale that the program is not operative;
- o A continued rapid pace of inflation, which would provide the rationale that the price standards are not working and, **therefore**, the program is not operative; and
- o Any examples of wage increases greater than 7 percent, which would support the contention that the wage standards are being ignored.

If management attempts to comply with the published standards (and the penalties facing large corporations for not complying are potentially severe), the outcome could be a sharp increase in industrial conflict. A long and bitter strike in a critical area would place pressure on the Administration to modify its wage/price program.

Summary

By itself, the **Administration's** wage/price program announced October 24 appears to have little chance of achieving its announced goal of a 6 to 6.5 percent rate of inflation in 1979. The current momentum of inflation appears to be too great to achieve such a rapid reduction without widespread slack in the economy. In addition, most of the goods and services that have exerted the greatest upward pressure on the price level are officially or tacitly exempt from the price standards, and a large portion of the labor force is officially or tacitly exempt from the **wage** standard. Finally, given the nature of the American labor movement, unions will find it difficult to comply voluntarily with the wage standards.

APPENDIX B. EFFECTS OF CHANGES IN THE CORPORATE INCOME TAX RATE
AND IN ACCELERATED DEPRECIATION: SIMULATIONS WITH
THREE MACROECONOMIC MODELS

In last year's report on The Economic Outlook, CBO compared the effects of three business tax **changes**: increases in the investment tax credit, accelerated depreciation, and reductions in the corporate income tax rate. 1/ The analysis was based on simulations using three different macroeconomic models. The report emphasized that there was not much consensus among the models over the quantitative effects of particular changes in business taxes. **Nevertheless**, the simulations indicated **that**, as a method of stimulating business fixed investment, the investment tax credit and accelerated depreciation methods were more effective per dollar of direct tax reduction than reductions in the corporate income tax rate. 2/

CBO recently updated this analysis for two of these three types of changes in business taxes: corporate rate reductions and accelerated depreciation. Two types of simulations were performed using three econometric models:

- o Reduction in the maximum corporate income tax rate, lowering receipts by about \$4 billion; and
- o Increase in the asset depreciation range (ADR) for equipment by 20 percentage points, and introduction of a 20 percent ADR for structures.

As discussed in last year's report, the revenue effects of accelerated depreciation tend to be small at first and to grow as an increasing proportion of the capital stock becomes eligible

1/ Congressional Budget Office, The Economic Outlook (February 1978), Appendix A, pp. 47-49.

2/ In the interim, the investment tax credit was liberalized and made **permanent**, and there were corporate income tax rate reductions, including a reduction in the maximum from 48 percent to 46 percent. The capital gains tax was also reduced.

for the faster tax write-offs. For this particular change, the direct budget cost was estimated to average about \$3 billion for the first three years.

The results of these simulation, which are summarized in Table **B-1**, are similar to those described in last **year's** annual report. Compared with the effects of lowering the corporate tax rate, the accelerated depreciation allowances have a larger impact on investment and real GNP during the simulation period. The effects of both types of reductions occur with considerable lags.

TABLE B-1. EFFECTS OF CHANGES IN BUSINESS TAXES: A COMPARISON OF RESULTS BASED ON THREE MACROECONOMIC MODELS

Economic Variable	First Year	Second Year	Third Year <u>a/</u>
<u>Corporate Income Tax Rate Cut of \$4 Billion</u>			
Change in Real GNP (billions of 1972 dollars)	0.2 to 1.1	1.3 to 2.3	1.5 to 2.5
Change in Real Business Fixed Investment (billions of 1972 dollars)	0.1 to 0.5	0.5 to 1.0	0.8 to 1.3
Percent Change in Price Level (GNP deflator)	0.0	-0.1 to 0.0	-0.1 to 0.1
<u>Accelerated Depreciation of Plant and Equipment <u>b/</u></u>			
Change in Real GNP (billions of 1972 dollars)	0.3 to 1.0	1.7 to 3.2	2.7 to 5.0
Change in Real Business Fixed Investment (billions of 1972 dollars)	0.1 to 0.5	0.7 to 2.2	1.1 to 3.5
Percent Change in Price Level (GNP deflator)	0.0	-0.1 to 0.0	-0.2 to 0.1

a/ In some cases, these represent estimates based on incomplete data.

b/ Assumes a 20 percent increase in the asset depreciation range in the tax life of plant and equipment. See text for discussion of revenue loss.