

July 1980

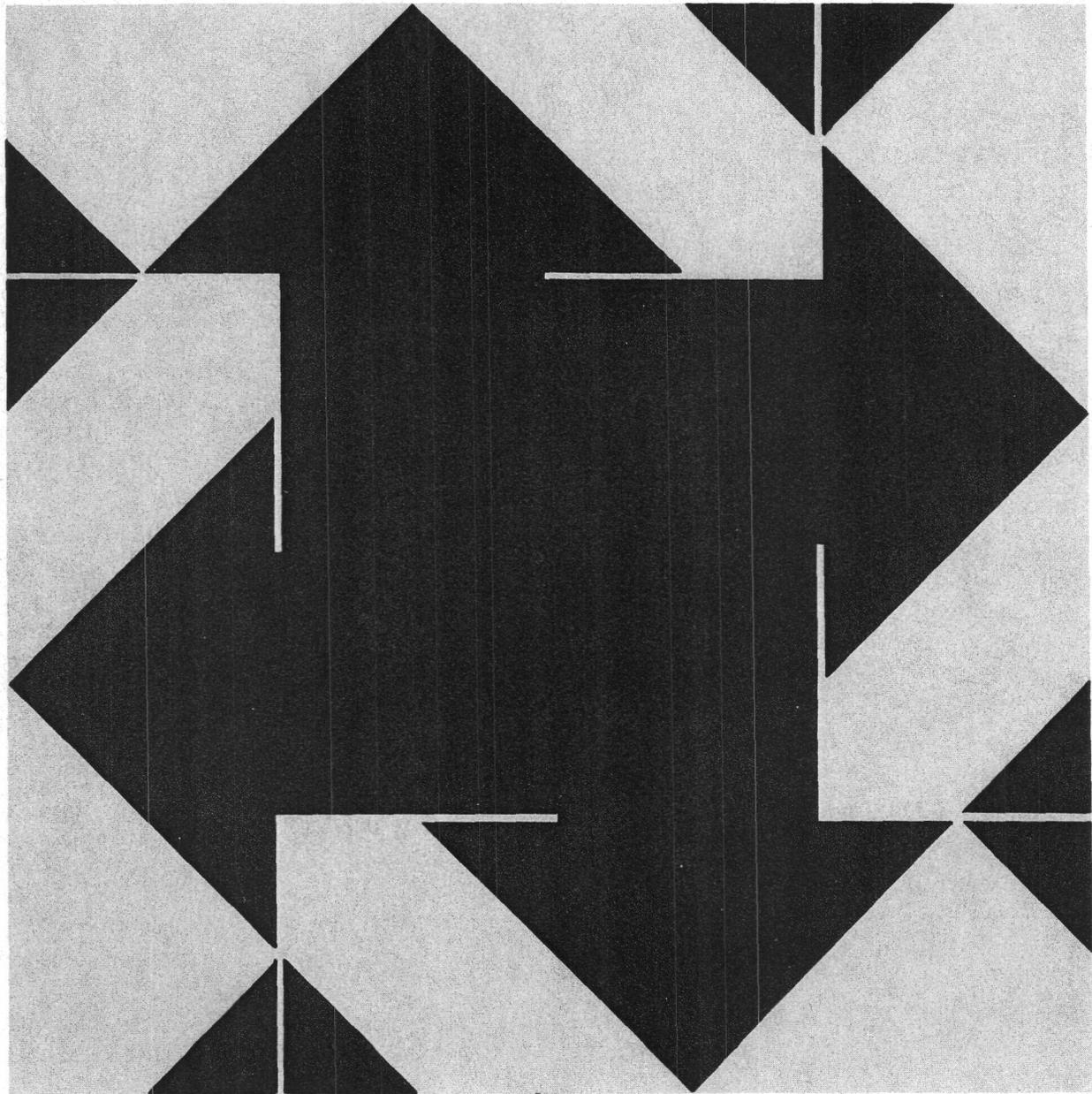
THE ECONOMIC OUTLOOK AT MIDYEAR 1980

A Report to the
Senate and House
Committees on the Budget

As Required by Public Law 93-344

NOTICE

There Should Be No Release
of This Document Until
10 a.m. (E.D.T.)
Wednesday, July 23, 1980



CONGRESS OF THE UNITED STATES



CONGRESSIONAL BUDGET OFFICE

THE ECONOMIC OUTLOOK AT MIDYEAR 1980

**The Congress of the United States
Congressional Budget Office**

For sale by the Superintendent of Documents, U.S. Government Printing Office
Washington, D.C. 20402

NOTES

All data are seasonally adjusted unless noted otherwise.

Shaded areas between P and T lines on some graphs represent periods of cyclical downturn, as designated by the National Bureau of Economic Research (NBER). Periods of peak cyclical economic activity since 1970 were November 1973 and January 1980; they are designated by P lines. Periods of trough or low cyclical activity occurred in November 1970 and March 1975; they are designated by T lines.

PREFACE

The Economic Outlook at Midyear 1980 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, Joan D. Schneider, Frank Russek, Stephen Zeller, Marvin Phaup, Lawrence DeMilner, Peter Taylor, Robert Dennis, Christopher Kask, Susan Helper, Richard Baldwin, Joseph Ritter, Sherry Edwards, and Irene Fang, under the direction of William J. Beeman and James E. Annable, Jr. Robert L. Faherty and Francis S. Pierce edited the manuscript; Debra M. Blagburn, Dorothy J. Kornegay, Marsha L. Mottesheard, and Kathleen M. Quinn typed the many drafts.

Alice M. Rivlin
Director

July 1980

CONTENTS

	<u>Page</u>
PREFACE	iii
SUMMARY	xi
CHAPTER I. INTRODUCTION	1
CHAPTER II. CURRENT ECONOMIC DEVELOPMENTS	5
Constant-Dollar Economic Activity	6
Indicators of Economic Welfare	29
CHAPTER III. RECENT POLICY DEVELOPMENTS	39
Monetary Policy	39
Federal Fiscal Policy	44
CHAPTER IV. THE ECONOMIC OUTLOOK	49
CHAPTER V. FISCAL POLICY STRATEGIES FOR THE SHORT AND LONG RUN	55
The Inflation Problem	56
Antirecession Policies	58
Declining Productivity Growth	62
Summary and Conclusion	71

TABLES

	<u>Page</u>
TABLE 1. CHANGE IN INDUSTRIAL PRODUCTION	8
TABLE 2. REAL FINAL SALES	9
TABLE 3. NOMINAL RETAIL SALES	11
TABLE 4. AUTO SALES	12
TABLE 5. REAL PERSONAL INCOME	14
TABLE 6. PERSONAL SAVING AS A PERCENT OF DISPOSABLE INCOME	15
TABLE 7. CONSUMER ATTITUDES	15
TABLE 8. HOUSEHOLD DEBT BURDEN AS A PERCENT OF DISPOSABLE INCOME	16
TABLE 9. PERCENT DISTRIBUTION OF TOTAL DEPOSIT BALANCES AT INSURED SAVINGS AND LOAN ASSOCIATIONS	19
TABLE 10. BUSINESS FIXED INVESTMENT AND CAPACITY UTILIZATION	21
TABLE 11. ENERGY PRODUCT IMPORTS	27
TABLE 12. REAL STATE AND LOCAL GOVERNMENT PURCHASES .	28
TABLE 13. LABOR MARKET INDICATORS	30
TABLE 14. CHANGES IN PRIVATE ESTABLISHMENT EMPLOY- MENT, BY INDUSTRY	33
TABLE 15. CPI INFLATION, BY SELECTED CATEGORY . . .	34
TABLE 16. ILLUSTRATIVE CONTRIBUTIONS OF LOWER MORTGAGE INTEREST RATES TO THE DECELERATION OF CPI INFLATION	36

TABLES CONTINUED

	<u>Page</u>
TABLE 17. RECENT WAGE BEHAVIOR	37
TABLE 18. ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS, FISCAL YEARS 1979 TO 1981	45
TABLE 19. CHANGE IN THE FULL-EMPLOYMENT BUDGET BALANCE, FISCAL YEARS 1975-1981	47
TABLE 20. ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1980 AND 1981, BASED ON POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1981	51
TABLE 21. SAVING BY HOUSEHOLDS (FLOW-OF-FUNDS BASIS), AS PERCENT OF DISPOSABLE PERSONAL INCOME, 1970-1979	65
TABLE 22. SELECTED FISCAL POLICY OPTIONS: A TENTATIVE EVALUATION	72

FIGURES

	<u>Page</u>
FIGURE 1. CBO CURRENT POLICY FORECAST RELATIVE TO PREVIOUS BUSINESS CYCLES	2
FIGURE 2. INDUSTRIAL PRODUCTION AND COMPONENTS	7
FIGURE 3. HOUSEHOLD SECTOR CONDITIONS	13
FIGURE 4. HOUSING MARKET CONDITIONS	18
FIGURE 5. BUSINESS FIXED INVESTMENT, ADJUSTED FOR INFLATION	20
FIGURE 6. INDICATORS OF BUSINESS FIXED INVESTMENT	23
FIGURE 7. INVENTORY-TO-SALES RATIOS, ADJUSTED FOR INFLATION	25
FIGURE 8. NET EXPORTS OF GOODS AND SERVICES, ADJUSTED FOR INFLATION	26
FIGURE 9. STATE AND LOCAL GOVERNMENT PURCHASES, ADJUSTED FOR INFLATION	28
FIGURE 10. LABOR MARKET CONDITIONS	31
FIGURE 11. UNEMPLOYMENT RATES FOR SELECTED LABOR FORCE GROUPS	32
FIGURE 12. BEHAVIOR OF CONSUMER PRICE INDEX, EXCLUDING FOOD, ENERGY, AND MORTGAGE INTEREST COSTS	35
FIGURE 13. INTEREST RATE BEHAVIOR	40
FIGURE 14. MONETARY AGGREGATES: TARGET RANGES AND ACTUAL LEVELS	42

SUMMARY

Following more than a year of rapid inflation and slow economic growth, the U.S. economy has entered its seventh recession since World War II. The downturn began in February and has proceeded rapidly since.

The recession has been characterized by a sharp drop in real consumer spending, particularly for autos and houses, owing to reduced growth in spendable earnings, heavy consumer debt burdens, and tight credit conditions. In response to weak sales and sharp cutbacks in industrial production, the unemployment rate has risen dramatically since February, and advance indicators suggest that real gross national product (GNP) declined by a near record rate in the second quarter of this year.

The likely course of the economy in the months ahead will be a major factor in the deliberations on the Second Concurrent Resolution on the Budget for Fiscal Year 1981. At present, the consensus view of forecasters is that the downturn will be the second most severe decline in the postwar period. There is further consensus that, although a recovery in economic activity will begin toward the end of 1980 or early in 1981, it will be relatively weak and unemployment will remain high throughout 1981. Moreover, only moderate progress is projected in the next few years in reducing the trend rate of inflation, despite the severity of the recession, and the rebound in productivity growth during the recovery is expected to be weak by historical standards. Thus, the Congress faces the difficult task of designing an appropriate fiscal policy response to a sharp cyclical rise in unemployment combined with longer-run problems of chronic inflation and lagging productivity growth.

THE CBO FORECAST

Forecasts of economic activity are significantly influenced by assumptions about government policies, energy prices, and so on. The Congressional Budget Office (CBO) forecast, prepared to assist the Congress in its deliberations on the second budget resolution for fiscal year 1981, is based on the following fiscal and monetary policy assumptions:

- o Federal spending and tax policies are assumed to be those contained in the first resolution for fiscal year 1981. Unified budget outlays are projected to be \$580 billion in fiscal year 1980 and \$630 to \$635 billion in fiscal year 1981. No tax cuts are included in the projection, and previously legislated increases in social security and windfall profits taxes are assumed to take place.
- o Growth of the money aggregate M1B over the two-year period ending in the fourth quarter of 1981 is assumed to be near the midpoint of the Federal Reserve's currently announced long-run target range of 4 to 6-1/2 percent. During 1980, however, money aggregate growth is assumed to fall below the midpoint of the range.

In addition, the CBO forecast is based on the following assumptions about food and energy prices:

- o Food price increases are assumed to accelerate to about a 10 percent annual rate during the second half of 1980 and to continue rising at that rate through 1981.
- o Prices of refined petroleum products are assumed to rise by nearly 24 percent during 1981 because of continued increases in world oil prices and decontrol of prices of domestically produced oil.

Given these policy assumptions, the CBO economic forecast, shown in Summary Table 1, is as follows:

- o Gross national product in 1972 dollars (real GNP) is projected to drop by 2.3 to 4.3 percent from the fourth quarter of 1979 to the fourth quarter of 1980. Output is expected to recover during 1981, with real GNP rising between 2.5 and 4.5 percent.
- o The unemployment rate is projected to rise rapidly to between 8.4 and 9.4 percent by the fourth quarter of 1980 and to remain at a high rate throughout 1981.
- o Although the consumer price index is expected to moderate substantially during the second half of 1980 (in part because of declining mortgage interest rates), broader measures of inflation are expected to show only small improvement. The implicit GNP price deflator is projected

to rise between 8.3 and 10.3 percent from the fourth quarter of 1979 to the fourth quarter of 1980, and to decelerate somewhat to a 7.7 to 9.7 percent range during 1981.

SUMMARY TABLE 1. ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1980 AND 1981, BASED ON POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1981

Economic Variable	1978:4 to 1979:4 (actual)	1979:4 to 1980:4	1980:4 to 1981:4
Nominal GNP (percent change)	9.9	3.7 to 7.8	10.4 to 14.6
Real GNP (1972 dollars, percent change)	1.0	-4.3 to -2.3	2.5 to 4.5
General Price Index, GNP Deflator (percent change)	8.9	8.3 to 10.3	7.7 to 9.7
Unemployment Rate, End of Period (percent)	5.9	8.4 to 9.4	8.4 to 9.4

SOURCE: Congressional Budget Office.

The peak-to-trough fall in real GNP is now projected to be under 4 percent, with about two-thirds of that fall having already occurred in the second quarter of 1980. This is larger than the average postwar decline but still considerably smaller than the decline in the 1974-1975 recession.

THE DECLINE AND RECOVERY

The current recession is notably different from that in 1973-1975. The latter was preceded by high inflation that encouraged speculative business investment (inventories and commercial

construction) and increased saving by consumers. A decline in output followed, as businesses attempted to bring investment back in line with final demands. By contrast, the rapid inflation that preceded the present recession generated strong household demands and reduced the saving rate, apparently reflecting expectations of further price increases as well as the attempt by consumers to maintain living standards in the face of declining real earnings. The period of declining saving rates was followed by the sharpest drop in consumer spending in the postwar period. The decline was initially concentrated in housing and auto sales, where tight credit conditions and rising gasoline prices generated added weakness. Credit controls instituted in March may have also contributed to the abrupt decline in consumer spending.

The unique role of consumer spending makes it difficult to forecast the depth and duration of this recession. CBO's best estimate is that economic activity will turn around by year-end, led by a moderate recovery in housing and auto sales. The projected upturn in residential construction reflects the current easing of credit conditions and the growing number of young families (an indication of a strong underlying demand for housing). Sales and production of domestic autos are expected to pick up later this year, in part because of the need to replace existing autos and because of the introduction of new, more fuel-efficient domestic models. Business firms also need to replace their capital stock that has become outmoded by rising energy prices. As a result, investment spending is expected to be stronger than in most recessions.

The projected growth in 1981, however, is not as vigorous as in past recoveries. The major factors accounting for the modest recovery are:

- o Slow growth in workers' real earnings due to rapidly rising energy and food prices;
- o Rising tax burdens due to higher payroll taxes, personal income tax "bracket creep," and increased effective corporate income tax rates caused by the failure of depreciation charges to keep pace with replacement costs;
- o Reduced growth in federal spending, given the budget assumptions; and
- o A gradual rise in interest costs due to the cyclical recovery and Federal Reserve anti-inflationary policies.

The CBO forecast is made in an environment of unusual uncertainty about the future strength of final demands. The behavior of consumers in an inflationary environment has proved especially difficult to predict. If consumer pessimism prevails, the saving rate could be higher than expected, retarding the near-term recovery in consumer spending. On the other hand, it is possible that consumers will again return to a buy-in-advance psychology if inflation does not moderate as much as they expect.

Other factors also add to the uncertainty. Most notably, an unexpected supply shock (for example, an interruption of petroleum supplies or a crop failure) or a substantial decline in the international exchange value of the dollar could generate higher inflation and prompt tighter monetary policies, reducing real economic growth.

POLICY OPTIONS

By most measures, federal fiscal policy has been expansive in fiscal year 1980. The acceleration in spending growth and the decline in economic activity have caused the deficit to rise to an estimated \$63 billion. By contrast, the budget plan embodied in the first resolution for fiscal year 1981 is very restrictive. Although the first resolution passed in June had outlays and receipts in balance, economic conditions are worse than were anticipated last spring, and the tax and spending plans of the first resolution are now estimated to result in a \$25 billion to \$35 billion deficit for fiscal year 1981 (see Summary Table 2). The projected deficit occurs even though the growth in spending is expected to be sharply reduced. Revenues are expected to grow rapidly in 1981 because of increased payroll and personal income tax rates, and increased windfall profits taxes.

Given the pessimistic outlook for output and employment through 1981, together with the longer-run problems of chronic inflation and slow growth in productivity, what budget policies are appropriate for fiscal year 1981? Probably no single policy could address all of these issues. Indeed, policymakers face a difficult trade-off between long- and short-run goals for the economy. A quick return to a full-employment economy may require a substantial tax cut to boost consumption and/or increased federal spending. But improvement in longer-run growth and productivity requires more investment; at full employment, greater investment must come at the expense of consumption or government spending.

SUMMARY TABLE 2. ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS,
FISCAL YEARS 1979 TO 1981 (Billions of dollars,
unified budget basis)

	1979	1980		1981	
	Actual	Revised Second Resolution	CBO Estimate Based on Action to Date	First Concurrent Resolution	CBO Estimate with Policies of First Concurrent Resolution
Receipts	465.9	525.7	517	613.8	600 to 605
(Percent Change)	(15.9)	(12.8)	(11.0)	(16.7)	(16.5)
Outlays	493.7	572.7	580	613.6	630 to 635
(Percent Change)	(9.5)	(16.0)	(17.5)	(7.2)	(9.1)
Deficit (-) or Surplus	-27.7	-47.0	-63	0.2	-25 to -35

SOURCE: Congressional Budget Office.

The CBO economic report issued last January contained an analysis of fiscal policy choices in an environment of rising unemployment, rapid inflation, and slow productivity growth. This report is a continuation of that analysis. The major conclusions are:

- o If the recovery begins by year-end as projected by CBO, then it is too late for fiscal stimulus measures to reduce the economic contraction significantly. However, quick implementation of general fiscal stimulus measures-- such as personal income tax cuts or increased spending-- could boost demands and lower unemployment during the recovery.
- o Such short-run stimulus measures run the risk of increasing inflation if their major effect is delayed until the economy is near or at high levels of capacity utilization.

- o Moreover, even if demand management policies are implemented in a timely fashion, by themselves they are not likely to ensure achievement of productivity goals. Satisfactory growth in productivity may require longer-term policies to divert resources from consumption and/or government spending to saving and investment.
- o Tax policies to encourage saving are not likely to have a large effect on productivity within the first five years or so of enactment. But additional productivity gains may be attained by fiscal measures to change the composition of saving. This may involve eliminating the bias in tax and credit policies that favors the channeling of saving into housing and other durable goods, and away from plant and equipment.
- o If the objective of business tax incentives is to increase productivity growth in the industrial sector, a tax cut will be more effective if it is directly related to industrial investment. Several tax proposals now being discussed provide a major incentive to invest in commercial property, which is not likely to contribute significantly to productivity growth.

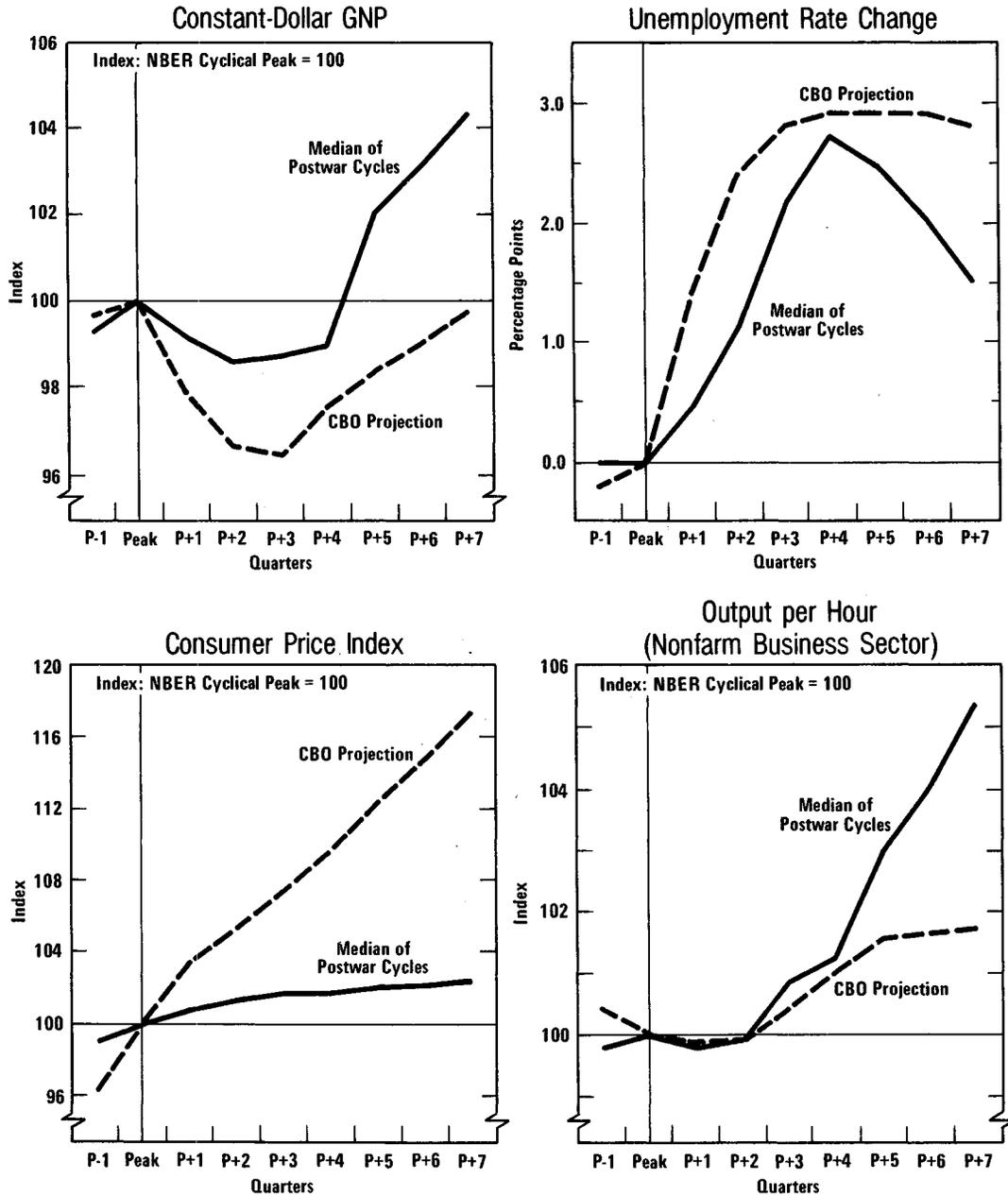
CHAPTER I. INTRODUCTION

The state of the economy will be a key ingredient in the deliberations on the Second Concurrent Resolution on the Budget for Fiscal Year 1981. Five factors are especially significant:

- o The economy is in a recession that could prove to be the second most severe downturn since World War II.
- o It is too late to ameliorate significantly the contraction in economic activity with altered fiscal policies; if enacted, tax cuts and/or changed spending will not be felt until the recovery phase of the business cycle, expected to begin later this year.
- o With no changes in fiscal policy from the first budget resolution, the recovery in economic activity is expected to be weak, causing the unemployment rate to remain quite high throughout 1981.
- o Inflation, as measured by the consumer price index (CPI), is expected to moderate during the second half of the year, and productivity growth is forecast to increase. But, in both cases, the improvement will likely be short-lived.
- o Given the structure of the economy, the longer-term problems of chronic inflation and lagging productivity growth will not be cured by the projected recession. A longer-run approach to fiscal policy and regulation will be needed to improve the outlook for productivity and inflation.

The seventh postwar recession began in February. The Congressional Budget Office (CBO) projects that the contraction in real gross national product (GNP) will be roughly twice as large as the median postwar downturn (see Figure 1). About two-thirds of this decline has already occurred. The recession will reduce federal revenues, increase unemployment-related spending, and consequently push the fiscal year 1980 and 1981 budgets toward sizable deficits.

Figure 1.
CBO Current Policy Forecast Relative to Previous Business Cycles



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

NOTES: The broken lines represent the midpoints of CBO's forecast ranges. The first quarter of 1980 is the peak quarter for the CBO projection.

Given a continuation of the policies embodied in the first budget resolution for 1981, the recovery in economic activity next year is expected to be quite weak relative to recoveries from previous recessions. The doldrums in 1981 will result from a variety of factors: higher payroll taxes, income tax "bracket creep," decontrol of domestic oil prices, the windfall profits tax, further price hikes by the Organization of Petroleum Exporting Countries (OPEC), and the need by households and firms to restructure their balance sheets.

Designing fiscal policy for 1981 is complicated by two other problems: persistent inflation and lagging productivity growth. Consumer price inflation will likely slow later this year, in part because of the recession's impact on sensitive prices but mostly because of the recent drop in mortgage interest rates, which affect the CPI with a lag of one quarter. After mortgage rates bottom out, however, CPI inflation is expected to accelerate again, despite the slack economy. As shown in Figure 1, the rapid momentum of inflation expected in 1980 and 1981 presents policymakers with a far different environment than occurred in most postwar recession-recovery periods.

Productivity growth is also expected to show a temporary rebound, as the economy moves into the recovery phase of the business cycle. But, given the relatively weak upswing in output, as well as the existing distribution of resources between consumption and investment, the prospects for productivity growth remain poor. In addition, the rise in output per hour is expected to lag behind the typical recovery's advance.

Thus, the appropriate economic policy response to the 1980 recession is not an easy matter. Policymakers are pursuing at least three economic goals: a recovery in economic activity, a reduction of inflation, and greater productivity growth in the future. Stimulating the growth of total spending by the standard mix of tax cuts and/or increased purchases and transfers would help increase production and jobs in the short run, but such a policy carries the risk of rekindling inflation and would likely do little to improve productivity. A more complete policy response would also attempt to break down structural rigidities in the economy that lessen the capacity to adapt to change, to shift resources from current consumption to productive investment, and to reduce the use of imported oil.

The next chapter reviews the recent developments in the economy for clues about the severity of the recession. Chapter III analyzes the current fiscal and monetary policies, and Chapter IV presents the near-term outlook for economic activity. The final chapter analyzes some fiscal policy options, with emphasis on longer-term strategies.

CHAPTER II. CURRENT ECONOMIC DEVELOPMENTS

The U.S. economy is now without question in its seventh recession since World War II. Rather, the questions are how severe the downturn will be, how robust the recovery will be, and how policymakers should respond. This chapter addresses the first of these questions by analyzing developments in the economy since the beginning of the year.

The most useful benchmark for judging the dimensions of the current contraction is the 1973-1975 recession. In many respects, the basic contours of the two downturns are similar. Both are characterized by periods of sharp contraction, preceded by a year of relative stagnation and rapid inflation. But there are differences. The most important is the changed response of business and household spending to high inflation.

In 1973-1974, businesses built inventories rapidly, attempting to beat future price hikes. The contraction in economic activity in late 1974 and early 1975 was aggravated by the liquidation of these stocks. In contrast to businesses, consumers resisted speculative buying and, instead, responded to the uncertainty bred by rapid inflation by saving a relatively high proportion of their incomes.

In 1979-1980, businesses generally pursued relatively lean inventory policies. But households bought heavily in advance of expected inflation, causing the saving rate to drop to very low levels. The beginning of the contraction in February 1980 was associated with a rebound in household saving. The length and depth of the current recession hinges to a large extent on the future course of the saving rate.

The saving issue is even more complex when the outlook is extended beyond the next year or so. Economic policy goals include high employment, low inflation, and high productivity growth. Yet, at full employment, an important way to enhance productivity growth is to shift resources from consumption to investment--in other words, to raise the saving rate.

Thus, policymakers face a dilemma. In the short run, if the structure of the economy is fairly rigid, a sharp rise in

household saving will contribute to a slowdown in economic activity. Over the longer term, however, if more rapid productivity growth is desired, more saving is needed to finance the additional investment. One way out of this quandary is to pursue structural policies that will improve the capacity of the economy to adapt to changed spending patterns. 1/

The next section of this chapter briefly reviews the recent drop in industrial production, with special attention given to the sectoral pattern of decline. It then analyzes the major components of total spending in the economy. In the second section, the behavior of the labor market and inflation over the past six months is examined.

CONSTANT-DOLLAR ECONOMIC ACTIVITY

INDUSTRIAL PRODUCTION

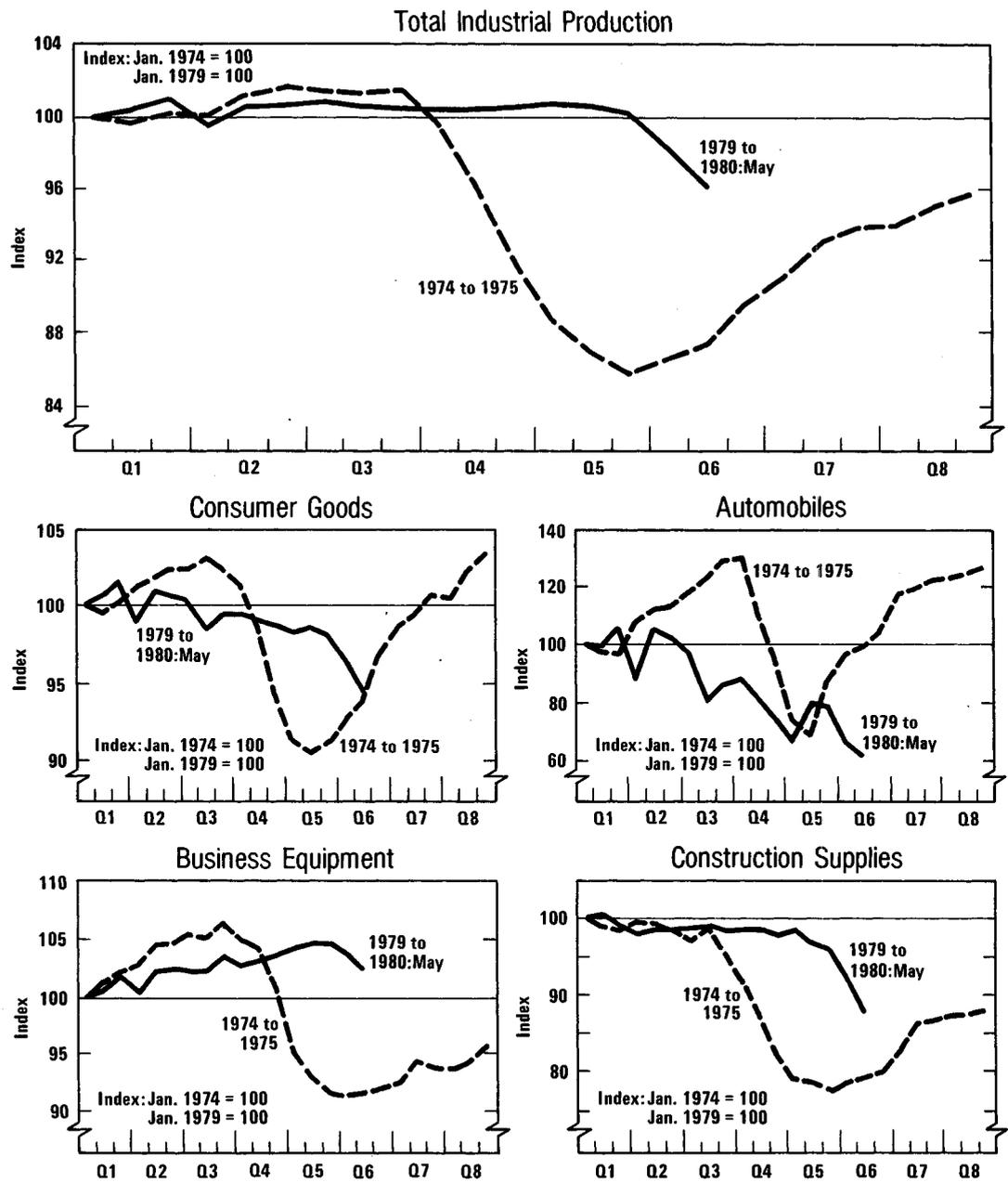
Perhaps the best monthly indicator of the current state of the economy is the index of industrial production, which measures the output of the nation's factories, mines, and utilities. During the five months that followed the business cycle peak in January 1980, total industrial production fell at a 17 percent annual rate, with most of the drop in the second quarter.

The contraction in output has not been evenly distributed by industry (see Figure 2). During a recession, housing construction and durable goods consumption tend to be hard hit early. Declines in business equipment usually come later, while consumption of nondurable goods and services demonstrates less cyclical sensitivity. The 1980 recession is conforming to this typical pattern.

The drop in production has been led by sharp cuts in the output of motor vehicles and construction supplies (see Table 1). Auto production has been decreasing since the spring of 1979, reflecting the year-long sales slump of domestic models. By contrast, the cutback of construction supplies is concentrated

1/ Some possible structural policies were reviewed in Congressional Budget Office, Entering the 1980s: Fiscal Policy Choices (January 1980), Chapter V.

Figure 2.
Industrial Production and Components



SOURCE: Federal Reserve System, Board of Governors.
NOTE: Q1 = 1974:1 for broken line, 1979:1 for solid line.

in 1980, coinciding with soaring interest rates and the collapse of housing sales and starts. The weakness in residential construction has also contributed to reduced output of durable home goods--appliances, carpeting, furniture, and the like--so far this year.

TABLE 1. CHANGE IN INDUSTRIAL PRODUCTION (Percent change, annual rate)

	January 1979 to January 1980	January 1980 to June 1980
Total Industrial Production	0.7	-17.0
Larger impact sectors		
Durable consumer goods	-11.2	-22.3
Auto and utility vehicles	-37.2	-21.1
Home goods	0	-26.5
Intermediate products		
Construction supplies	-1.7	-37.6
Nonenergy materials	1.3	-26.0
Smaller impact sectors		
Nondurable consumer goods	2.6	-7.8
Business equipment	4.1	-8.9
Energy materials	-0.1	-0.9

SOURCE: Federal Reserve System, Board of Governors.

Other sectors have also experienced declines in output as the recession has spread throughout the economy. Between February and May, only one-fifth of the 235 industries that make up the industrial production index increased production.

FINAL SALES

Industrial production tends to be more volatile than overall economic activity around cyclical turning points. This is because

industrial production excludes the output of services, which are less cyclically sensitive. Services account for nearly half of total final sales in the U.S. economy.

Although less volatile, constant-dollar final sales have recently experienced roughly the same pattern as industrial production--doldrums in 1979, followed by a sharp drop in the first half of 1980 (see Table 2). The sectoral pattern is also similar, with spending weakness skewed toward consumer durables and residential construction.

TABLE 2. REAL FINAL SALES (Percent change, annual rate)

	1977:4 to 1978:4	1978:4 to 1979:4	1979:4 to 1980:2 <u>a/</u>
Total Final Sales	4.8	1.7	-4
Personal consumption expenditures	4.5	1.6	-5
Durable goods	6.8	-3.6	-24
Nondurable goods	3.5	0.9	-4
Services	4.5	4.2	1
Fixed investment	7.2	0.4	-15
Nonresidential	10.5	3.4	-6
Residential	-0.2	-7.0	-37
Government purchases	1.7	0.4	1
Federal	-2.5	1.8	7
State and local	4.0	-0.3	-2
Exports	17.0	9.2	14
Imports	10.5	3.1	-4

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

a/ Estimate based on partial data.

The size of the cutback in personal consumption expenditures is unprecedented in the postwar period. The decrease in the

neighborhood of 5 percent (annual rate) estimated during the first half of 1980 is roughly twice the decline during any other two-quarter period. ^{2/} Such extraordinary behavior supports the notion that consumers, attempting to maintain living standards despite falling real incomes, had become seriously overextended by the end of 1979.

The Household Sector

The key to the 1980 recession is the behavior of household spending. Despite being buffeted by high inflation, slowed employment growth, declining real income, and record high interest rates, households kept spending--on consumption and housing--at a surprising rate during the second half of 1979.

Such behavior, however, could not continue indefinitely. Savings had been drawn down; loan repayment burdens became onerous; tight credit conditions reduced home sales and slowed the taking of capital gains in housing. In February 1980, the bubble burst. Since then, retail sales have experienced their sharpest fall in nearly three decades.

Retail Sales

Total retail sales, before adjustment for inflation, fell at a 12 percent annual rate between January and June (see Table 3). The weakness was concentrated in postponable items--a spending pattern reflecting overextended consumers cutting back where possible.

Purchases of durable goods were curtailed most, with sales of automotive dealers down at a 42 percent annual rate. Unit sales of domestically produced autos fell to a 5.5 million unit annual rate in the second quarter of 1980--the lowest level since the second quarter of 1961 (see Table 4). The housing slump adversely affected the sales of building materials stores (off at a 38 percent annual rate) and furniture and appliance outlets (down at a 13 percent annual rate).

As is typical in a recession, sales of nondurable goods have slowed less, but even here the pattern of postponing where possible

^{2/} The previous largest reduction in real personal consumption expenditures over two quarters was 2.4 percent between 1974:3 and 1975:1.

is evident. Reduced spending occurred at general merchandise stores, clothing stores, and eating and drinking places. The sharp jump in sales at gasoline service stations was the result of a sizable increase in oil prices.

TABLE 3. NOMINAL RETAIL SALES (Percent change, annual rate)

	January 1979 to January 1980	1980		
		January to June	January to March	March to May
Total Retail Sales	11.5	-12.0	-20.2	-16.5
Durable goods	6.6	-32.9	-50.0	-36.3
Auto dealers	2.1	-41.8	-59.7	-49.1
Furniture, etc.	13.1	-13.3	-30.3	-2.7
Building materials	13.0	-38.1	-56.3	-28.2
Nondurable goods	14.2	0.3	0.5	-5.7
General merchandise	11.6	-2.9	-23.4	13.1
Food stores	10.1	1.9	8.4	-5.1
Gasoline service stations	34.8	15.3	44.4	-9.6
Apparel	9.3	-2.6	-25.5	17.4
Eating and drinking places	13.7	-8.2	-13.8	-16.6
Drug stores	12.2	6.8	-9.8	25.1

SOURCE: U.S. Department of Commerce, Bureau of the Census.

The imposition of selected credit controls by the Federal Reserve in mid-March may have hastened the decline in consumer spending. ^{3/} As shown in Table 3, however, the drop in retail sales was somewhat more severe in the January-March period than in the March-May period, when the controls would be expected to have had more impact. More important causes of the decline include

^{3/} The credit controls program is described in Chapter III.

falling real income, heavy debt burdens, and high interest rates. The sharp retrenchment by consumers during the first half of 1980 likely would have happened without credit controls.

TABLE 4. AUTO SALES (Millions of units, annual rate)

	1978	1979	1979				1980	
			Q1	Q2	Q3	Q4	Q1	Q2
Total Auto Sales	11.3	10.7	11.6	10.5	10.8	9.9	10.8	7.7
Domestic models	9.3	8.3	9.3	8.1	8.6	7.5	8.0	5.5
Imported models	2.0	2.3	2.3	2.5	2.2	2.4	2.8	2.2

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

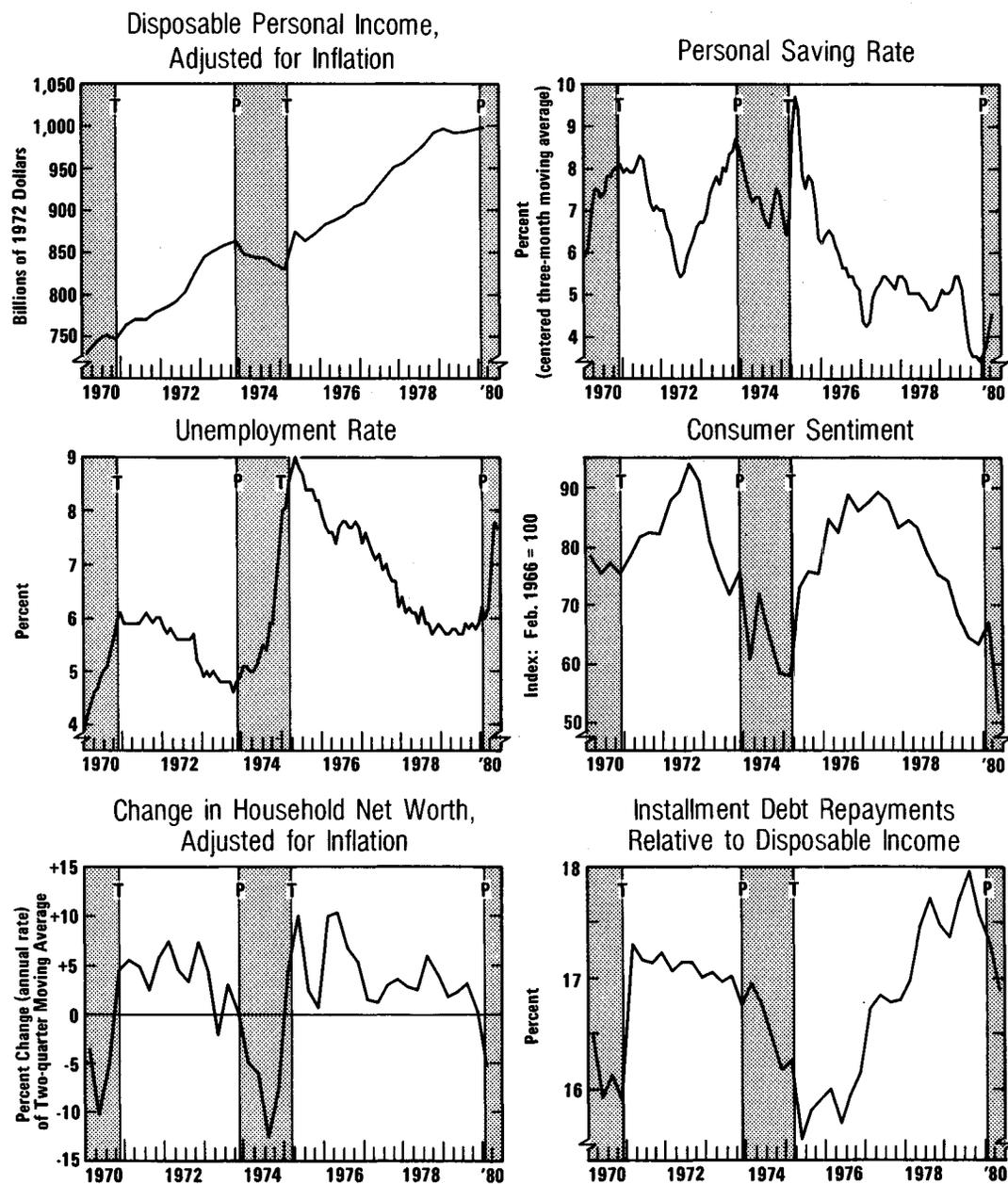
Indicators of Consumer Spending

The determinants of consumer spending include growth in disposable income, attitudes about the future, household financial positions, and consumption behavior in the past (see Figure 3). Recent sales data suggest that the decline in real personal consumption spending may have bottomed out; there was an increase in retail sales in June. But the indicators do not presage a sustained, rapid recovery in household spending.

Personal Income and Saving. Constant-dollar disposable personal income dropped at an 8 percent annual rate from January to April, after remaining roughly stable during the previous year (see Table 5). The recent decline in income largely resulted from consumer price inflation in excess of average wage gains and the recession-induced declines in employment and average weekly hours.

Wages and salaries, which account for about two-thirds of personal income, also fell by about an 8 percent annual rate, after adjustment for inflation, between January and April. Among other types of income, farm proprietors have been hit especially hard. Farmers' income plummeted by 35 percent (not an annual rate) in the four months after January. Farm prices have been depressed

Figure 3.
Household Sector Conditions



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

NOTE: For debt repayments relative to income, 1980:2 value is based on April and May data.

TABLE 5. REAL PERSONAL INCOME (Percent change, annual rate)

	January 1978 to January 1979	January 1979 to January 1980	January 1980 to April 1980
Total Personal Income	5.0	1.5	-8.0
Wages and salaries	4.9	-0.1	-7.7
Other labor income	6.2	5.5	1.6
Proprietors' income <u>a/</u>	9.3	-3.8	-45.9
Farm income <u>a/</u>	17.6	-13.7	-82.4
Rental income	-0.8	-9.0	-9.0
Dividends	5.4	-0.6	3.9
Personal interest income	10.3	9.0	7.0
Transfer payments	0.9	6.0	-8.4
Unemployment insurance	-26.9	17.4	93.3
Total Disposable Personal Income	4.7	1.0	-8.0

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

a/ With inventory valuation and capital consumption adjustments.

by the record harvests for most major crops in 1979 and the near-record meat supplies. In turn, low farm income has hurt the sales of tractors and farm implements.

Reductions in hours worked in response to the weakness in final sales will prevent the growth in wages and salaries from inducing greater consumption spending in the near future. Also working in the same direction are the general expectation of less rapid inflation, which reduces the impetus to buy in advance, the expectation of higher unemployment, and the high existing burden of debt. All of these factors are reflected in the recent increase in the saving rate (see Table 6). If the saving rate continues to rise, as is typical in a period of economic uncertainty, household consumption spending will remain weak.

TABLE 6. PERSONAL SAVING AS A PERCENT OF DISPOSABLE INCOME

	1979				1980				
	Q1	Q2	Q3	Q4	Jan.	Feb.	Mar.	Apr.	May
Saving Rate	5.0	5.4	4.3	3.5	3.4	3.8	3.9	4.7	4.9

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

Consumer attitudes. A dramatic shift in household attitudes occurred during the first half of 1980 (see Table 7). Expectations of higher unemployment rose, while expectations of inflation moderated. By midyear, unemployment was assessed to be about as important an economic problem as inflation. In addition, assessments of whether the present is a good time to buy autos or large household goods have deteriorated further from the end of 1979. The shift in attitudes is consistent with slower consumption spending and a higher rate of saving.

TABLE 7. CONSUMER ATTITUDES (Percent of respondents)

	1979				1980			
	Q1	Q2	Q3	Q4	Q1	Apr.	May	June
Expect Unemployment to Increase (during next 12 months)	38.1	42.0	59.3	56.7	52.3	62.0	72.0	63.0
Expectation of Inflation (during next 12 months) <u>a/</u>	9.9	11.1	10.4	10.2	11.9	11.1	8.2	8.1
Which Problem More Serious								
Unemployment	25.0	20.7	26.3	25.7	25.0	26.0	40.0	43.0
Inflation	65.3	68.7	63.3	63.3	65.7	59.0	43.0	45.0
Equally serious	6.7	7.3	8.7	8.7	7.3	14.0	16.0	11.0
Bad Time to Buy								
House	41.0	41.0	48.0	59.7	60.3	74.0	74.0	66.0
Car	39.3	47.0	48.0	48.3	46.7	55.0	61.0	49.0
Large household goods	24.3	27.0	28.7	35.3	32.3	47.0	58.0	48.0

SOURCE: University of Michigan, Survey Research Center.

a/ The average inflation rate expected during the next 12 months by the survey respondents.

Consumer Financial Positions. Consumer debt relative to income also shows some evidence of retrenchment. This ratio has receded from its peak reached in 1979, although it remains high (see Table 8). The amount of consumer credit outstanding actually fell in April and May 1980, for the first time in almost five years. A slowing in the pace of repayments and fairly steady increases in the delinquency rate on consumer installment loans suggest that households are experiencing increased difficulty in meeting their financial obligations.

TABLE 8. HOUSEHOLD DEBT BURDEN AS A PERCENT OF DISPOSABLE PERSONAL INCOME

	1976	1977	1978	1979	1979				1980
					Q1	Q2	Q3	Q4	Q1
Installment and Mortgage Credit Outstanding	63.3	66.3	69.4	72.2	70.9	72.1	72.7	73.1	72.5
Installment Credit and Mortgage Repayments	20.3	21.3	22.2	22.8	22.4	22.8	23.1	22.7	22.5

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

Various measures of consumers' net worth reinforce the argument that resources available to support future spending are slim. After growing rapidly following the 1973-1975 recession and then more modestly in recent years, real household net worth actually declined as 1980 began. In addition, capital gains available from house sales, which appear to have supported some spending through last year, have been hard to realize in a market in which turnover has fallen sharply. Similarly, record interest rates generated capital losses for holders of many debt issues, although some of this was reversed after April. It is true that such capital losses may be "on paper" rather than actually realized; nonetheless, such adversities tend to lower consumers' evaluations of their wealth, with a consequent dampening influence on their willingness to spend.

Housing

The other important area of household spending is for residential construction. Outlays for housing plummeted in early 1980 as credit conditions tightened dramatically and the costs of buying a home became prohibitive for many potential buyers. In the second quarter of this year, indicators of housing activity worsened to levels comparable to the lowest of the 1973-1975 recession (see Figure 4).

After declining sharply during 1979, new single-family home sales fell dramatically further in 1980. In April and May, average sales were at a 419,000 unit annual rate, about half the level of a year earlier. Sales of existing houses were also down substantially. The weak home sales resulted in a buildup of unsold houses and a cutback in production. In April and May, average housing starts dropped to a 979,500 annual rate, also about half of the level of a year ago and nearly matching the low point in the 1973-1975 recession.

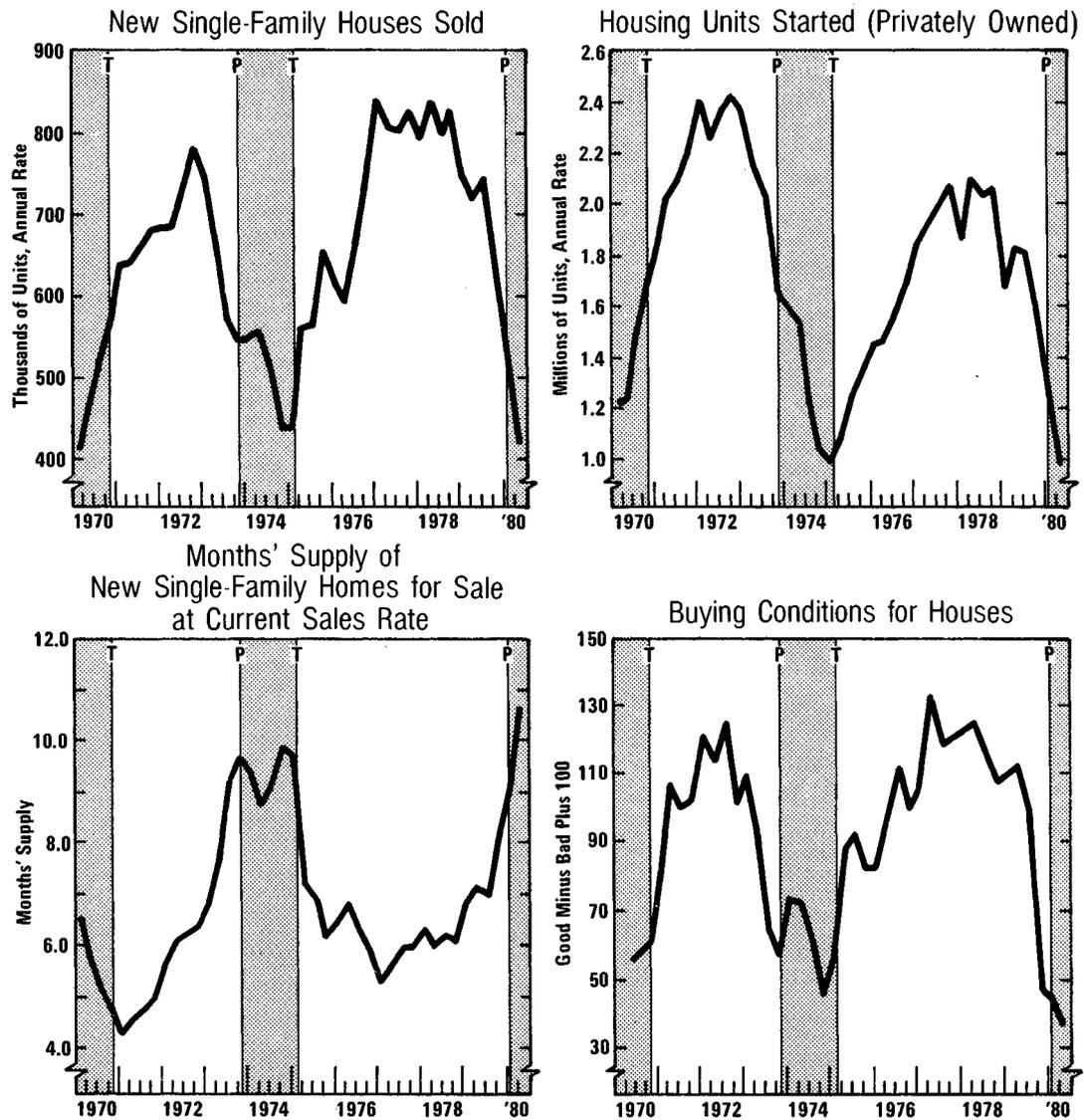
Indicators of Housing Spending

The fundamental demand for housing should be relatively strong over the next few years, with the continued movement of the postwar baby boom into household formation age. During the next year or so, however, more short-term influences will predominate. In large part, the behavior of housing will depend on the extent to which the inducement to buy provided by declining mortgage interest rates offsets the depressing influences of rising unemployment and weak growth in real household income.

Credit Conditions. Effective mortgage interest rates for an 80 percent loan were recently around 13.5 percent, down from a peak of 16.6 percent in April. During previous recessions, the decline in interest rates was often sufficient to increase residential construction before the rest of the economy had reached the trough of the business cycle. But current mortgage rates remain exceptionally high, so the historical analogy may not hold.

A scarcity of mortgage funds apparently will not hamper a recovery in housing. Thrift institutions are now permitted to pay on money market certificates (six-month maturity, \$10,000 minimum denomination) interest rates that are at least one-quarter percentage point above the yield on six-month Treasury bills. They may also pay up to 9.5 percent on smaller-denomination, 30-month

Figure 4.
Housing Market Conditions



SOURCES: U.S. Department of Commerce, Bureau of the Census; U.S. Department of Housing and Urban Development; University of Michigan, Survey Research Center.

NOTES: For houses sold, houses started, and months' supply, points for 1980:2 are the averages of April and May values. Buying conditions reflect the percent of respondents saying it is a "good time to buy" minus the percent saying it is a "bad time to buy" plus 100.

certificates. These sources of funds, together with the recent relaxation of regulatory limits on borrowing by savings and loan associations, help assure that mortgage financing will be available to potential homebuyers. ^{4/}

However, the cost of funds to thrift institutions is raised by increased reliance on accounts that pay market-related interest rates. Consequently, mortgage interest rates will be higher than if a larger share of thrift deposits were in regular passbook accounts paying 5.25 percent interest. As shown in Table 9, the proportion of total deposit balances in regular savings accounts at insured savings and loan associations has dropped by almost one-third in the last 16 months. The popular six-month money market certificates, in contrast, now account for close to 40 percent of the total deposits of these institutions.

TABLE 9. PERCENT DISTRIBUTION OF TOTAL DEPOSIT BALANCES AT INSURED SAVINGS AND LOAN ASSOCIATIONS

	Accounts Earning Regular Passbook Rate or Less	Large Certi- ficates (\$100,000 or more)	6-Month Money Market Certi- ficates	2-1/2 Year Certi- ficates ^{a/}	Other Certi- ficates Earning More Than Regular Rate
January 1979	30.5	3.6	13.7	—	52.3
July 1979	29.1	4.7	20.4	—	45.9
April 1980 ^{b/}	21.8	6.9	37.2	2.8	31.2

SOURCE: Federal Home Loan Bank Board.

^{a/} Introduced January 1980.

^{b/} Preliminary.

Although mortgage interest rates cannot be expected to show the great flexibility recently exhibited by rates on U.S. Treasury securities (as discussed in connection with recent monetary developments in Chapter III), the increasingly close linkage

^{4/} In May, the Federal Home Loan Bank Board predicted savings flows for savings and loan associations in 1980 would total \$36.5 billion, compared with \$38.5 billion in 1979.

between open-market rates and the cost of funds to thrift institutions suggests some further reductions in mortgage rates in the near term. This bodes well for an early, recession-moderating recovery in residential construction.

The Business Sector

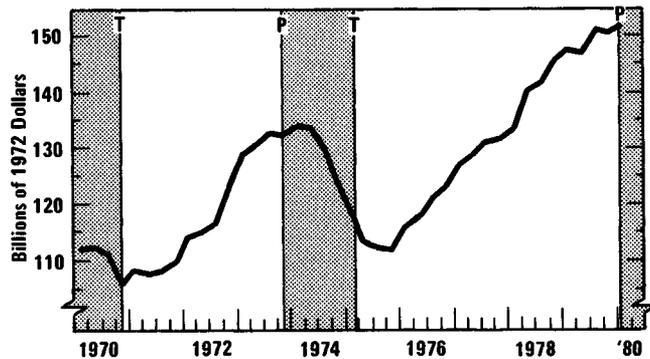
After adjustment for inflation, business spending for structures, equipment, and inventories has been relatively flat for some time. Relatively modest increases in fixed investment outlays have been partly offset by cautious inventory practices.

Business Fixed Investment

Real business fixed investment (BFI) is estimated to have increased at an annual rate of less than 2 percent in the first quarter of 1980, continuing the slowdown in BFI growth that began in 1979 (see Figure 5).

Business spending for structures slowed noticeably relative to the previous year while motor vehicle purchases decreased less, partly because of advantageous rebates available on some models in February and March (see Table 10). The slowing in BFI paralleled the declines in the rate of capacity utilization at manufacturing establishments.

Figure 5.
Business Fixed Investment,
Adjusted for Inflation



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

TABLE 10. BUSINESS FIXED INVESTMENT AND CAPACITY UTILIZATION

	1978:4 to 1979:4	1979:4 to 1980:1	1980:1 to 1980:2
	<u>Percent Change (annual rate)</u>		
Total Real BFI	3.4	1.7	N.A.
Structures	7.7	1.2	N.A.
Producers' durable equipment	1.5	2.0	N.A.
Autos, trucks, buses	-21.3	-13.7	
Other	10.9	5.7	
	<u>Output as a Percent of Capacity</u>		
Capacity Utilization of Manufacturing Firms			
End of period	84.3	83.1	76.1

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

Indicators of Future Business Fixed Investment

Most indicators of the future course of constant-dollar BFI have weakened recently. Surveys of anticipated spending on plant and equipment taken in May and June found that firms plan to increase their nominal outlays by 10 to 12 percent in 1980. After adjustment for likely inflation, these plans imply real spending growth of about 1 percent, which would be significantly less than the increase realized in 1979. Furthermore, surveys of anticipated spending tend to overestimate the strength of BFI at the beginnings of recessions. Many firms will stretch out, or even cancel, expansion plans as the utilization of existing capacity drops and corporate cash flow weakens.

Constant-dollar new orders for nondefense capital goods, a lead indicator of BFI, have declined from their peak in the spring

of 1979, as have factory utilization rates decreased (see Figure 6). Since the beginning of 1980, construction contracts for commercial and industrial buildings have fallen dramatically.

The financial positions of firms also suggest little near-term strength in fixed capital spending. Nominal nonfinancial corporate profits, with inventory valuation adjustment and without capital consumption adjustment, decreased 2.1 percent between the first quarters of 1979 and 1980, before the full brunt of the recession was felt with its adverse effect on earnings. Moreover, even with the decline, these data are an overly optimistic indicator of profits for most firms because of the extremely large increase in petroleum company earnings. Excluding petroleum and coal products industries, nonfinancial corporate profits fell 14.5 percent between the first quarters of 1979 and 1980. The share of total nonfinancial domestic earnings going to petroleum and coal products industries rose from 11 to 22 percent during the same period.

Even when non-oil profits pick up again, they may not be used in normal proportions to buy capital goods until corporate balance sheets are put in better order. The bottom left-hand panel of Figure 6 suggests that firms' current need to retire short-term debt is even greater than it was in late 1974, a period of corporate financial disarray.

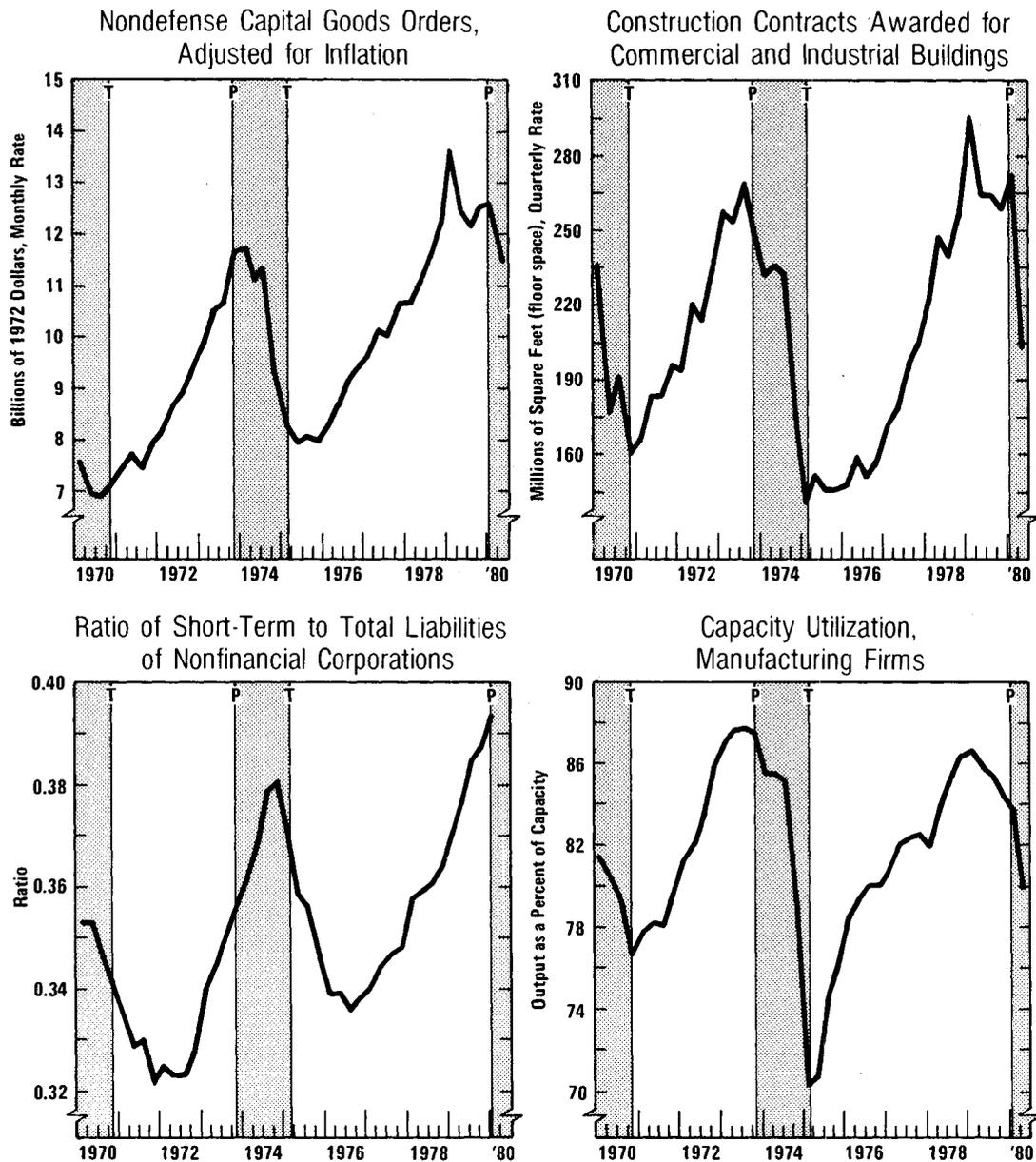
Inventory Investment

The fall-off in final sales growth has generated renewed concern that inventories relative to sales are rising significantly beyond desired levels. The typical response to unwanted inventory accumulation is cutbacks in production until inventories fall back in line with the pace of sales. The inventory correction now underway, however, is likely to be less severe than in the 1973-1975 downturn for several reasons.

Most important, firms appear to have pursued cautious inventory policies over the past year, largely resisting the temptation to stock up in advance of price increases. As a result, the accumulation of inventories, after adjustment for inflation, has been significantly smaller than in the year before the onset of the 1973-1975 recession. This time around, when final sales fell, there were smaller stocks to be worked down.

Real inventory investment amounted to \$13 billion--about 1.0 percent of total output--in the year leading up to the fourth

Figure 6.
Indicators of Business Fixed Investment



SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis; McGraw-Hill Information Systems Company; Federal Reserve System, Board of Governors.

NOTE: For orders, contracts, and capacity utilization, points for 1980:2 are based on April and May values.

quarter of 1973. In that quarter, final sales began to drop, and the accumulation of stocks shot up at a \$25 billion annual rate. In contrast, real inventory investment was \$9.7 billion in 1979--only 0.7 percent of total output--and the rate of accumulation slowed as the year progressed. In the first quarter of 1980, real inventories were little changed--up at only a \$0.3 billion annual rate.

The high interest rates of the past year and a half significantly increased the costs of holding inventories, contributing to conservative stockpiling policies. The lack of significant growth and anticipation of a recession, along with fresh memories of the costly stock liquidations in the last downturn, were reinforcing influences.

As final sales declined in the second quarter, the ratio of inventories to sales began to rise. The current increase appears to be largely concentrated at manufacturers rather than at retail and wholesale traders. The ratios of real inventories to sales of wholesalers and retailers are currently about the same as a year ago (see Figure 7). It is at the manufacturing level--in both durable and nondurable goods--that real inventories have risen relative to real sales over the past year. The worsening of manufacturers' inventory positions suggests some need to reduce stocks in this sector, although the liquidation will not be as great as in the last recession unless sales weaken dramatically further.

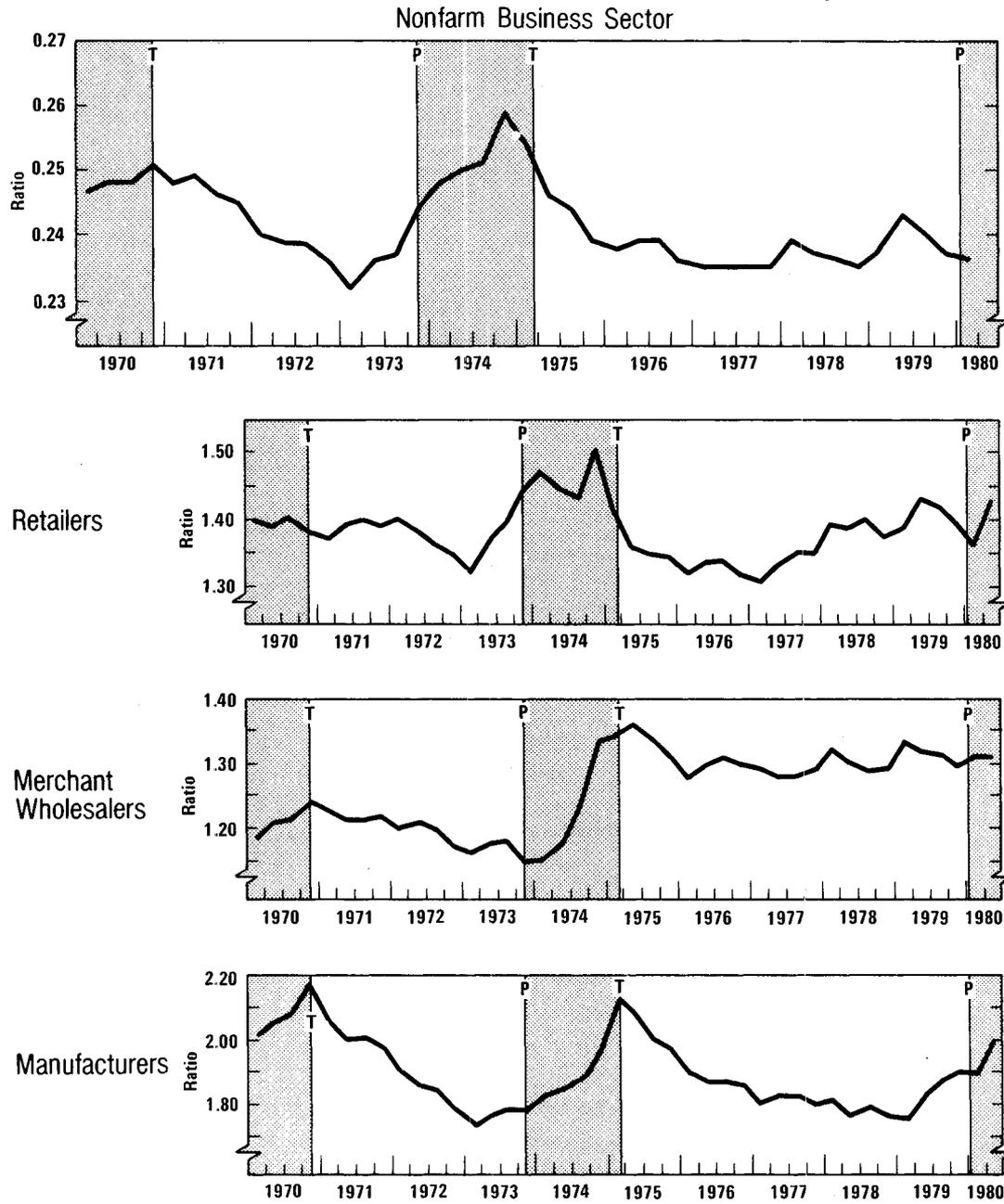
International Trade Sector

Measured in constant dollars, exports continued to grow faster than imports in the first quarter of 1980, pushing up the net export balance for goods and services to \$25 billion at an annual rate. The growth in real net exports continues the upward trend in this sector since that began early in 1978 (see Figure 8).

Measured in current dollars, however, the trade balance tells a different story. Import growth in the past six months exceeded the growth of exports, largely because of the rising world price of petroleum. Current-dollar imports exceeded exports by about \$14 billion in the first quarter of 1980.

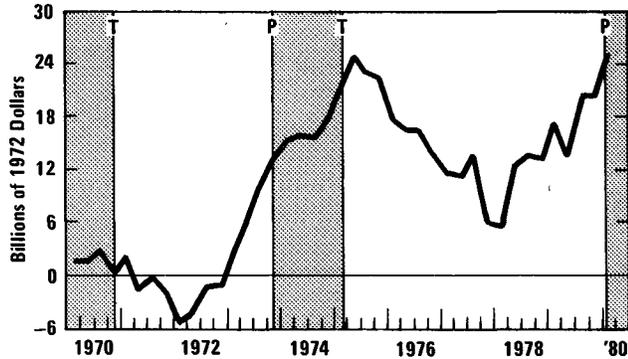
The key to the current-dollar trade imbalance is, of course, the rapidly rising price of oil. The United States has been paying increasing amounts for its energy product imports, despite cutting

Figure 7.
Inventory-to-Sales Ratios, Adjusted for Inflation



SOURCES: U.S. Department of Commerce, Bureau of the Census and Bureau of Economic Analysis.
NOTE: Points shown for 1980:2 are CBO estimate.

Figure 8.
 Net Exports of
 Goods and Services,
 Adjusted for Inflation



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

back on the volume imported. The volume of energy imports fell nearly 8 percent between the first quarters of 1979 and 1980, while the dollar cost rose 86 percent (see Table 11). Relative to national income, the U.S. bill for oil imports will increase from 2.5 percent in 1978 to an estimated 4 percent for all of 1980.

Excluding trade in energy products, the net merchandise balance has recently shown a positive balance. The improvement is largely accounted for by the relatively strong growth of agricultural and manufactured exports over imports. In part, the increase in net exports, exclusive of energy products, resulted from lagged effects of the 1978 decline in the exchange rate of the dollar. Also contributing was the sluggish U.S. economic activity relative to that of U.S. major trading partners.

Indicators of future trade flows, exclusive of petroleum, suggest that this sector will again contribute positively to the U.S. economy through 1980. Most important, except for Canada, the major trading partners of the United States are not yet in recession. As a result, foreign demand for U.S. output will likely be strong relative to U.S. demand for imports.

TABLE 11. ENERGY PRODUCT IMPORTS

	1979				1980	
	Q1	Q2	Q3	Q4	Q1	Q2 <u>a/</u>
Volume (millions of barrels, monthly rate)	260.4	246.5	249.3	249.1	240.7	200.2
Percent change	5.1	-5.3	+1.1	-0.1	-3.4	-16.8
Value (millions of dollars, f.a.s. basis)	3,643.2	4,033.2	5,245.4	5,898.0	6,776.9	6,200.4
Percent change		10.7	30.1	12.4	14.9	-8.5
Average price per barrel (dollars)	13.99	16.36	21.04	23.68	28.15	(30.97)
Percent change	5.3	16.9	28.6	12.6	18.9	(10.0)

SOURCE: U.S. Department of Commerce, Bureau of the Census.

a/ Average of April and May values.

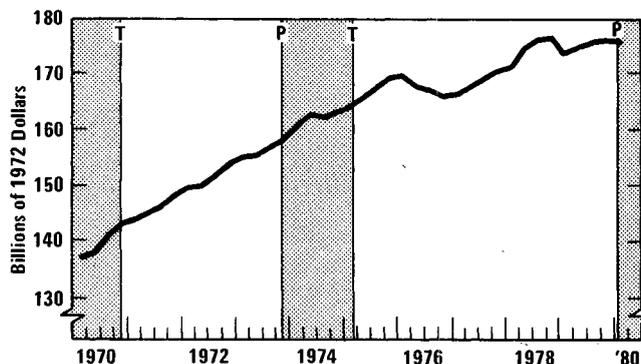
State and Local Government Sector

Total state and local government purchases of goods and services, after adjusting for inflation, fell at a 0.7 percent annual rate in the first quarter of 1980, compared with a 0.2 percent rise in 1979 as a whole. Construction accounted for most of the decline, reflecting both high interest rates and continuing pressures to slow the growth of government spending.

The recent behavior of constant-dollar purchases suggests that state and local spending during the 1980 recession could be considerably weaker than that observed in the 1973-1975 downturn (see Figure 9). During the course of that recession, there was only one quarter in which inflation-adjusted purchases declined; measured from the peak to the trough, real purchases rose by 3.6 percent.

The budget positions of state and local governments also suggest weakness in the sector. By the first quarter, budget

Figure 9.
State and Local
Government Purchases,
Adjusted for Inflation



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

deficits (excluding social insurance trust funds) had persisted for four consecutive quarters, and the deficits are likely to get worse before they get better.

Historically, the budget positions of states and local governments deteriorate during recessions as spending and revenues respond to increasing levels of unemployment and slower growth in tax bases. Between the peak and the trough of the 1973-1975 recession, for example, budget balances (excluding social insurance trust funds) declined by \$9.4 billion to a deficit level of \$8.3 billion, despite a substantial rise in federal grants.

TABLE 12. REAL STATE AND LOCAL GOVERNMENT PURCHASES

	1979				1980
	Q1	Q2	Q3	Q4	Q1
Purchases (billions of 1972 dollars)	173.6	174.3	175.6	176.0	175.7
Percent change	-6.6	1.6	3.0	0.9	-0.7

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

INDICATORS OF ECONOMIC WELFARE

Contractions in economic activity directly affect people's living standards through lost jobs, reduced hours of work, and the downturn's impact on inflation and the future course of productivity growth. Examination of these welfare indicators shows that the cost of a recession is not evenly distributed throughout the population.

Employment and Unemployment

The labor market weakened dramatically during the first half of 1980. Between December and June, the jobless rate jumped from 5.9 percent to 7.7 percent; total employment (according to the household survey) decreased by nearly 1.4 million; the average workweek for private production and nonsupervisory workers fell almost three-quarters of an hour; and the factory workweek dropped by more than one hour (see Table 13). By midyear, the number of unemployed had risen by 1.9 million. Even with no further deterioration in the labor market, the December-to-June changes in unemployment, employment, and hours would be roughly in line with the average postwar recession. To date, however, the worsening in labor market conditions has not been as severe as in 1974-1975 (Figures 10 and 11).

The distribution of increased unemployment has not been neutral with respect to demographic characteristics of workers or industries. The largest relative rise in joblessness has been among adult men--up 2.5 percentage points between December and June. The high lay-off rate resulting from production cutbacks in manufacturing and construction has meant that almost all of the increase in unemployment has come from job losers--not from those who quit jobs voluntarily, from new entrants to the labor force, or from reentrants.

Employment has fallen in three sectors. Roughly two-thirds of the decline occurred in manufacturing. Most of the remainder was in construction, although employment in transportation and public utilities also fell slightly. Overall, jobs in service-producing industries tend to be relatively immune to recessions. So far, the 1980 downturn is no exception. Between December and June, establishment employment in wholesale and retail trade, in finance, insurance, and real estate, and in services increased, although at a much diminished rate from the pace in 1979 (see Table 14).

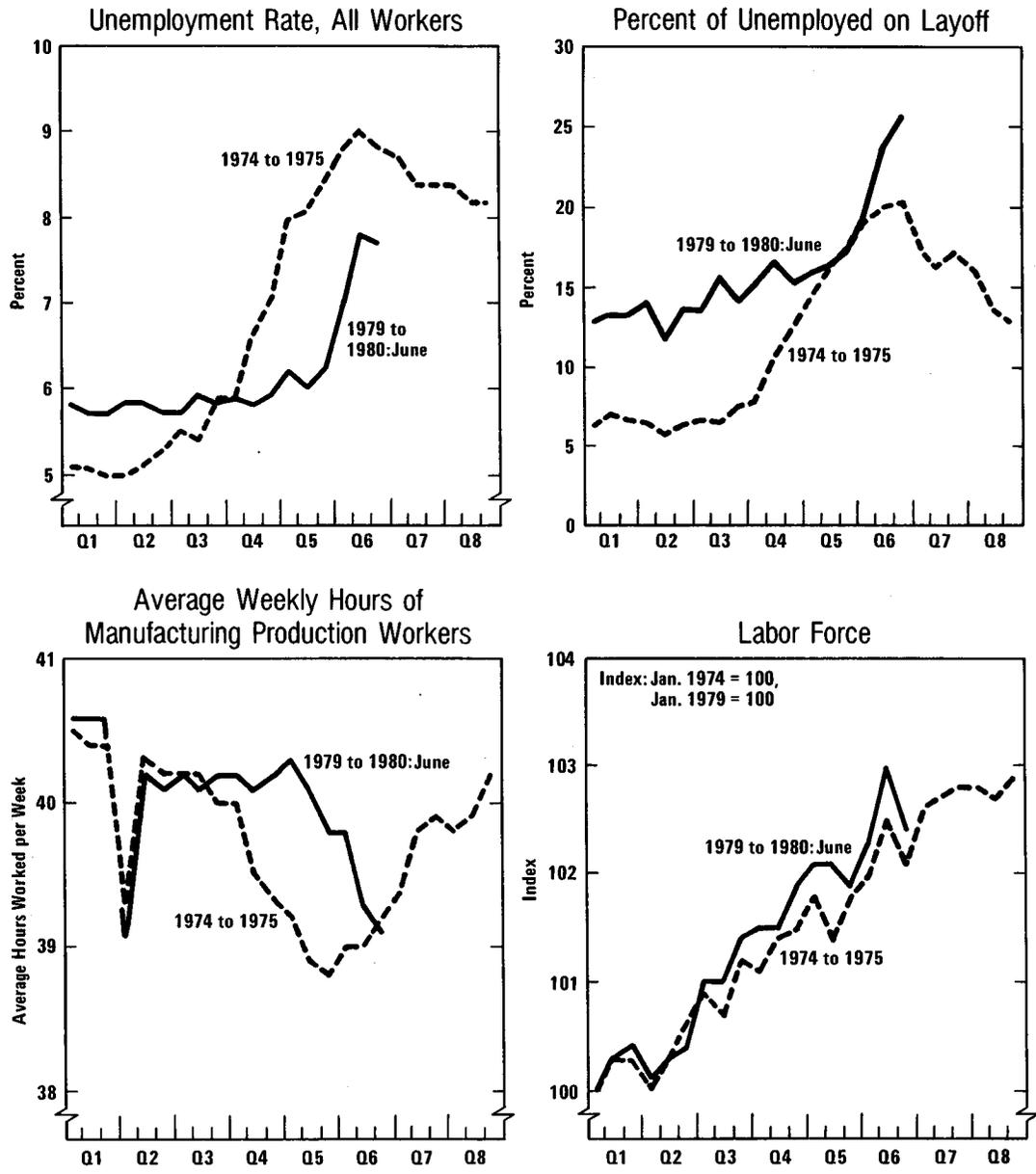
TABLE 13. LABOR MARKET INDICATORS

	Levels		
	December 1978	December 1979	June 1980
Unemployed Workers (thousands)	6,012	6,087	8,006
Unemployment Rates (percent)			
All workers	5.9	5.9	7.7
Adult men	4.1	4.2	6.7
Adult women	5.8	5.7	6.5
Teenagers	16.4	16.0	18.5
Married men, spouse present	2.6	2.8	4.9
Married women, spouse present	5.5	5.0	6.1
Whites	5.1	5.1	6.8
Blacks and others	11.4	11.3	13.6
Average Weekly Hours Worked			
Total private nonfarm sector	35.8	35.7	35.0
Manufacturing sector	40.6	40.2	39.1

	Changes (thousands)		
	December 1978 to December 1979	December 1979 to June 1980	
Employed Workers (household survey)	+2,081	-1,375	
Unemployed Workers	+75	+1,919	
Job losers	+224	+1,897	
Workers Employed Part-time for Economic Reasons	+481	+480	

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

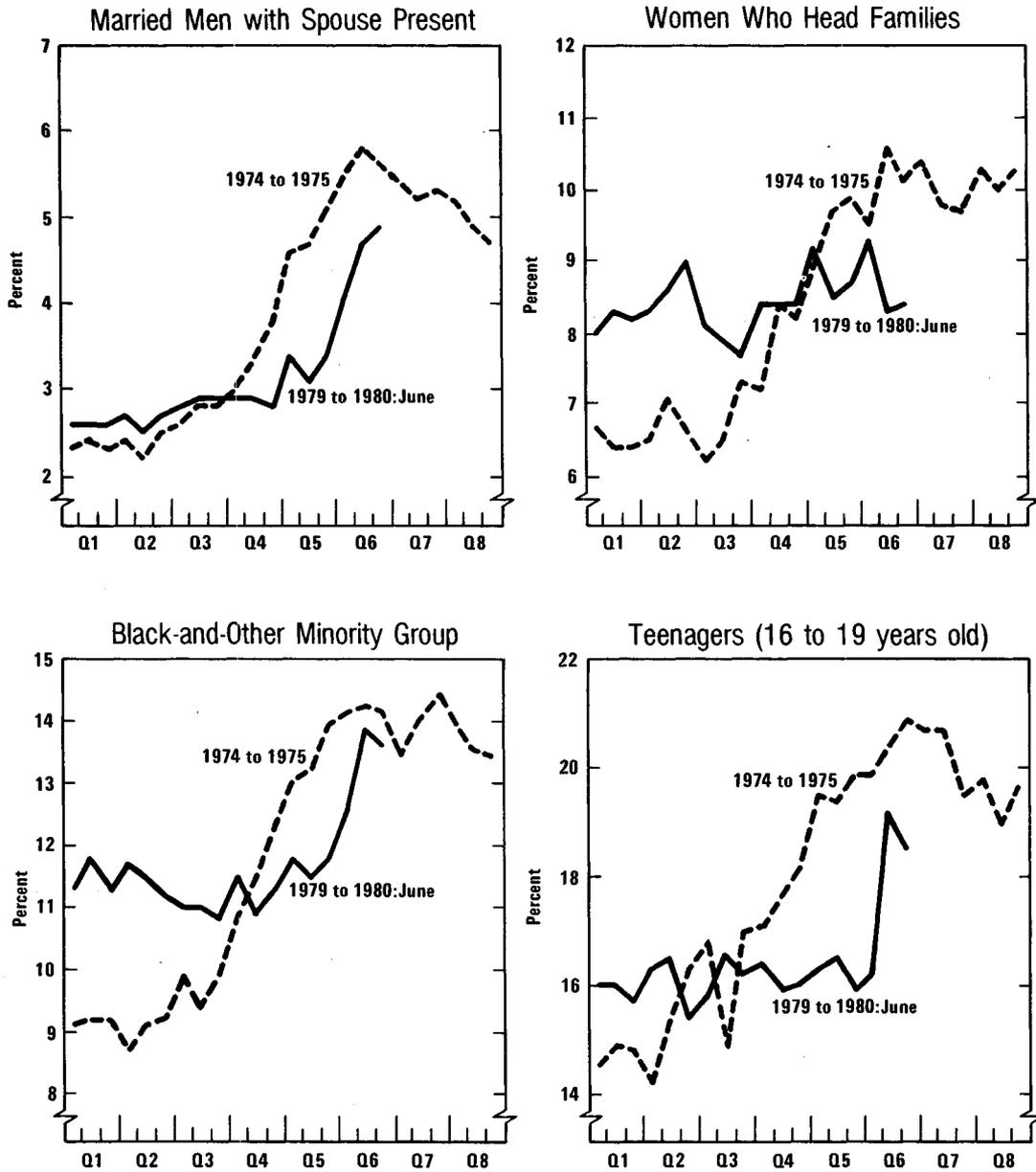
Figure 10.
Labor Market Conditions



SOURCE: U.S. Department of Labor, Bureau of Labor Statistics.
NOTE: Q1 = 1974:1 for broken line, 1979:1 for solid line.

Figure 11.

Unemployment Rates for Selected Labor Force Groups



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

NOTE: Q1 = 1974:1 for broken line, 1979:1 for solid line.

TABLE 14. CHANGES IN PRIVATE ESTABLISHMENT EMPLOYMENT, BY INDUSTRY
(In thousands)

	December 1978 to December 1979	December 1979 to June 1980
Total Private Establishment Employment	+1,888	-973
Mining	+68	+29
Construction	+309	-238
Manufacturing	0	-1,014
Durable	+33	-801
Nondurable	-33	-213
Transportation and public utilities	+170	-69
Trade	+409	-26
Finance, insurance, real estate	+209	+89
Services	723	+256

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

Prices

The inflation story so far in 1980 has three major parts:

- o The rate of change in the CPI accelerated sharply in the first quarter of 1980.
- o The CPI upswing slowed in the second quarter and is expected to continue to decelerate in the second half; this improvement, however, is a misleading indicator of fundamental inflation trends in the economy and largely reflects extremely jagged rates of change in interest rates and world oil costs.
- o The momentum of inflation, coming largely from the continued rise in production costs, will likely remain strong, despite the downturn in economic activity.

From December to March, the CPI increased at greater than an 18 percent annual rate, well above the postwar record 13.3 percent rise in 1979 (see Table 15). Most of the acceleration was attributable to extraordinary increases in energy prices and mortgage interest costs; smaller increases in food prices worked to hold down the overall rate. Excluding these three categories, which are all influenced heavily by factors other than overall capacity utilization in the economy, the acceleration was smaller but still substantial: an 10.4 percent annual rate in the first quarter of 1980 versus a 8.7 percent rate for all of 1979.

TABLE 15. CPI INFLATION, BY SELECTED CATEGORY (Percent change, annual rate)

	Dec. 1977 to Dec. 1978	Dec. 1978 to Dec. 1979	Dec. 1979 to Mar. 1980	Mar. 1980 to May 1980
All Items, CPI	9.0	13.3	18.1	13.2
Energy items	8.0	37.4	64.8	10.5
Mortgage interest costs	22.0	31.2	53.8	47.3
Food	11.6	10.0	3.8	5.2
All Items, Except Energy, Mortgage Interest Costs, and Food	7.3	8.7	10.4	9.4

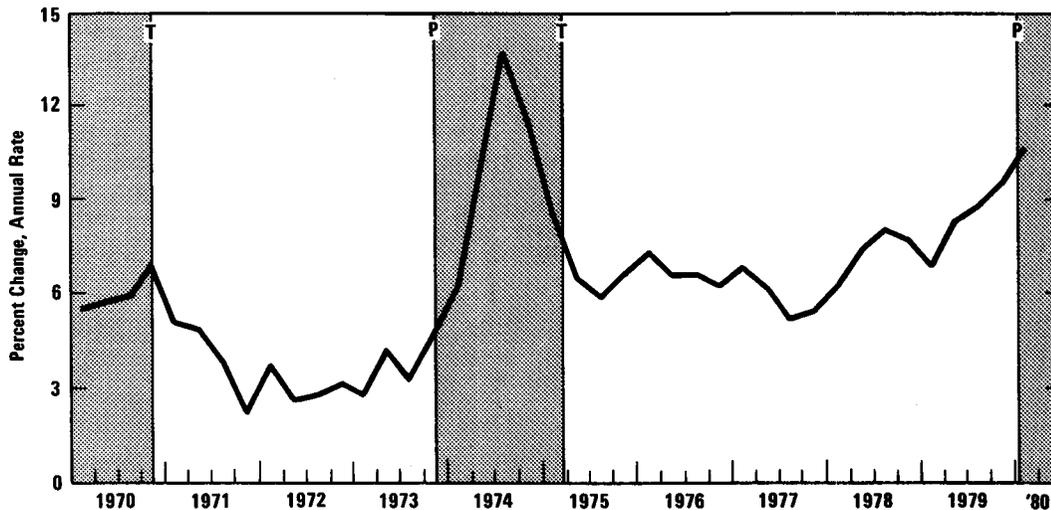
SOURCE: U.S. Department of Labor, Bureau of Labor Statistics; Congressional Budget Office.

NOTE: December to December changes are based on not seasonally adjusted data.

Subsequently, the CPI upswing has slowed sharply. Between March and May, consumer prices rose at a 13.2 percent rate, still quite rapid but well below the first-quarter pace. About four-fifths of this deceleration is traceable to a moderation in energy price increases. Excluding energy, mortgage interest costs, and food, the improvement in consumer inflation was much less: rising at a 9.4 percent rate from March to May, as compared with

10.4 percent in the first quarter of 1980 and 8.7 percent for all of 1979. This stripped-down inflation rate had been moving on an upward trend since mid-1977 (see Figure 12).

Figure 12.
Behavior of the Consumer Price Index, Excluding Food, Energy,
and Mortgage Interest Costs



SOURCE: Congressional Budget Office, based on data from U.S. Department of Labor, Bureau of Labor Statistics.

The slowing of overall CPI inflation that began in the April-June quarter will likely continue in the second half of 1980. In part, this results from the depressive effect of slack markets on some prices and wages. But mostly it will result from declines in mortgage interest rates that have already occurred. Changes in the market rate for home mortgage loans enter the CPI with about a three-month lag, so that the second-quarter reduction in the market rate will be reflected in the CPI during the third quarter of 1980.

Since the movement of mortgage rates is very large, the impact on the CPI is substantial. The magnitude of the effect is illustrated in Table 16. It is assumed in the table that the mortgage rate remains at its June 1980 level (12.7 percent) for the remainder of the year. To isolate the influence of changes in mortgage interest rates, it is also assumed that all other prices continue to change at the same rate as they did from December 1979 to May 1980.

TABLE 16. ILLUSTRATIVE CONTRIBUTIONS OF LOWER MORTGAGE INTEREST RATES TO THE DECELERATION OF CPI INFLATION (Percent change, annual rate)

	<u>Actual</u>	<u>Hypothetical</u>	
	Dec. 1979 to May 1980	May 1980 to Dec. 1980	Dec. 1979 to Dec. 1980
CPI Inflation Rate	15.3	11.1	12.8

Given the June mortgage rate and with all other price changes the same, CPI inflation would decelerate by about 4-1/4 percentage points during the second half of 1980. Since the actual slowdown will also be influenced by the fact that world oil prices will not double in 1980, as they did in 1979, the CPI will present a misleading picture of how much inflation has improved during the second half of the year.

The principal determinant of trend inflation--business cost increases--will continue to rise largely unabated throughout the year, presaging a possible return to near double-digit consumer price inflation next year.

Why does inflation continue, even during recession? The momentum of inflation is fed by a variety of factors. Government actions play a large role here. Decontrol of domestic oil prices is estimated to add 1-1/2 percentage points to CPI inflation in 1980 and about 2 percentage points in 1981. The January 1981 increases in social security taxes and the federal minimum wage may add 0.4 percentage point. Moreover, a variety of government economic regulations work to protect the real incomes of selected groups, often pushing up the price level. To cite just one current example, restricting foreign steel imports has aggravated inflation.

The momentum of inflation is also rooted in private-sector behavior. Recessions squeeze profit margins; when these margins are widened during the recovery in economic activity, prices are pushed further upward. In addition, and most important, labor costs--about three-quarters of total business costs--continue

to rise. This upward movement of wages results largely from the ability of many workers to obtain wage increases that more than keep up with inflation even during periods of rising unemployment.

Wages respond to inflation with a lag. The upward push on wages from the rapid 1979 inflation has become evident recently (see Table 17). The hourly earnings index, which is adjusted for interindustry employment shifts, began accelerating in the second half of 1979. By June, it stood about 9-1/2 percent above its level of a year ago. A better measure of wage trends, the employment cost index, shows a similar acceleration. Both measures show gains well above the Administration's wage standards.

The rapid inflation through the first half of 1980 implies a further upward push on wages later this year and in 1981. The higher wages will then push product prices upward. This price-wage spiral assures a substantial momentum of inflation throughout next year despite the weakened product demands.

TABLE 17. RECENT WAGE BEHAVIOR (Percent change from 12 months previous)

	1979				1980	
	Mar.	June	Sept.	Dec.	Mar.	June
Wage Indexes						
Hourly earnings index	8.2	7.8	8.2	8.4	8.9	9.4
Employment cost index	7.8	7.6	7.7	8.7	9.1	NA

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



CHAPTER III. RECENT POLICY DEVELOPMENTS

The alarming acceleration in the rate of inflation in 1979 and earlier this year, together with the efforts of the Federal Reserve to reduce that inflation, were major factors contributing to the slowdown in economic growth during 1979 and the sharp decline early this year. Credit regulations instituted by the Federal Reserve in March, which may have added to the economic decline by dampening consumer spending, are currently being phased out. In contrast, federal fiscal policy appears not to have been an immediate cause of the recent drop in economic activity. Rising federal tax burdens undoubtedly contributed to reduced growth in business and consumer spending, but at the same time federal expenditures have grown rapidly.

The future course of monetary and fiscal policies is one of the major uncertainties in the economic outlook. Whether the Federal Reserve achieves its money growth targets in the months ahead will significantly influence the course of inflation and the timing of the recovery. Regarding fiscal policy, the budget plan embodied in the first resolution for fiscal year 1981 is restrictive. Proposals for tax cuts and increased spending under consideration, however, could significantly strengthen the economic recovery, though at the risk of worsening inflation.

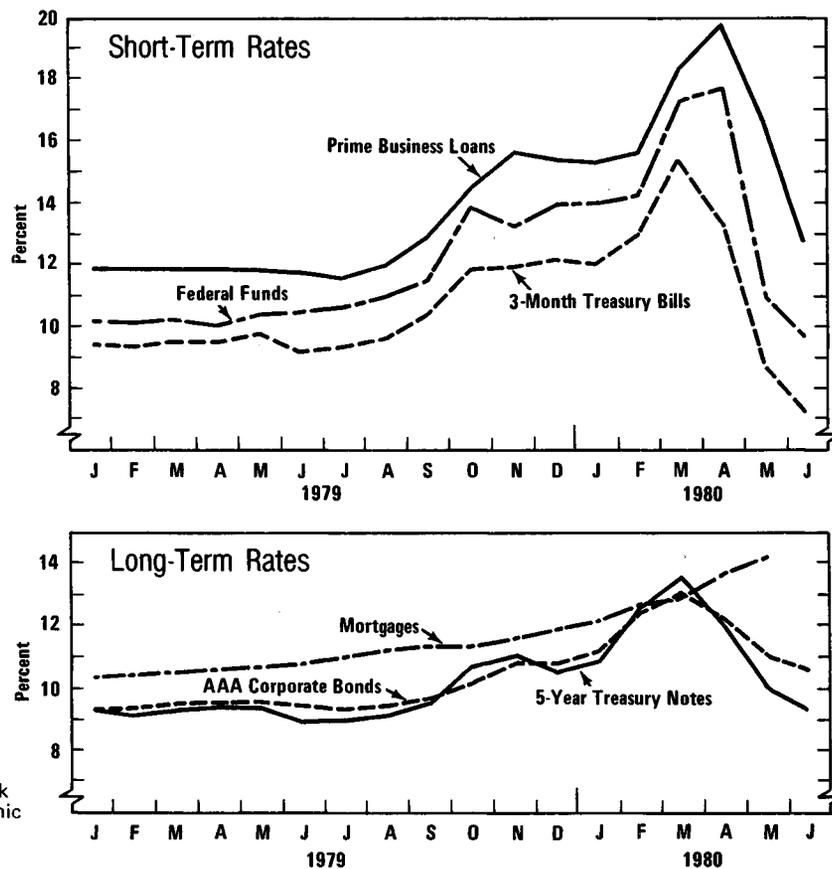
MONETARY POLICY

Interest rates have changed more and faster over the past year than in any year since World War II. The weekly average federal funds rate rose from 12.8 percent in February to 19.4 percent in April and then fell below 10 percent in May. ^{1/} In March, the discount rate on three-month Treasury bills was 15.6 percent; by May, the yield was down around 8 percent. The prime rate charged by large commercial banks to their most creditworthy customers fell from 20 percent in April to 11.5 percent recently. Corporate

^{1/} Federal funds are immediately available funds, usually loaned for one day in an interbank market. The federal funds rate is probably more immediately sensitive to Federal Reserve monetary policy actions than any other interest rate.

AAA-rated bond yields dropped two percentage points within two months (see Figure 13). In addition, the increased use by savings institutions of money market certificates transmitted interest rate changes to consumer markets very quickly. The large swings in interest rates resulted from three factors: the changing economic outlook, sharp movements in the rate of inflation, and the October 1979 change in the short-run operating target of monetary policy.

Figure 13.
Interest Rate
Behavior



SOURCES:
Federal Reserve System,
Board of Governors;
Federal Home Loan Bank
Board, Office of Economic
Research.

The sharp increases in rates early this year resulted partly from rapidly changing views concerning the economic outlook. Economic growth was unexpectedly strong at the end of 1979, and inflation accelerated in the first months of 1980. At the same time, inflationary expectations appear to have been raised by the Administration's January budget, which critics viewed as too expansionary, and by an expected acceleration in defense spending

due to the Soviet invasion of Afghanistan. As expectations of an imminent recession and a decline in inflation waned, the demand for credit surged and interest rates jumped to record levels.

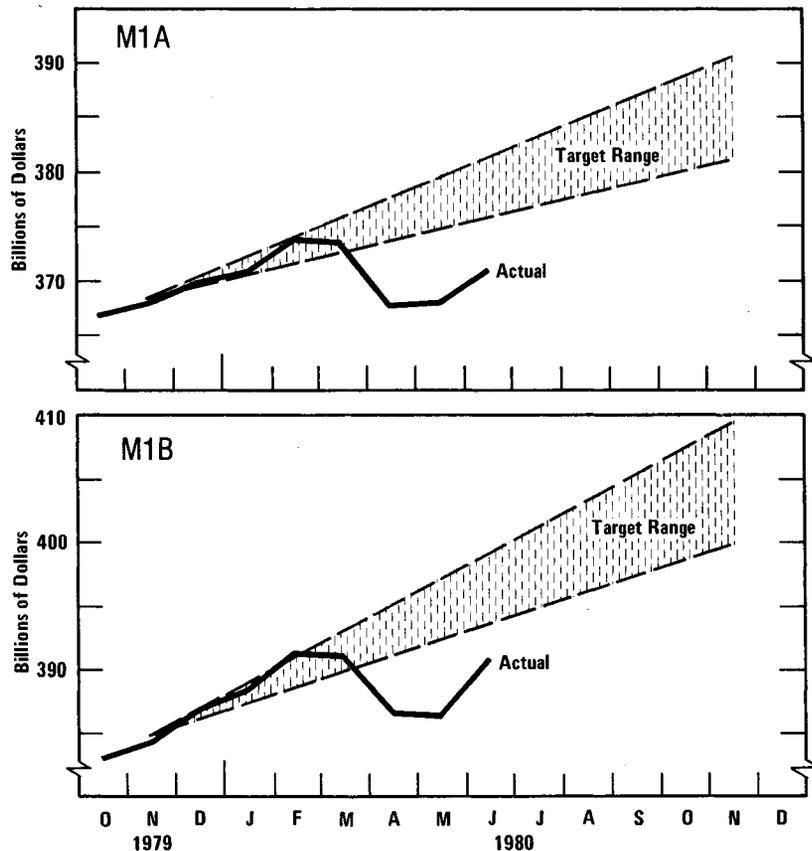
Before October 1979, some moderation in these rate pressures could have been expected from the Federal Reserve's intervention in the credit markets. But the Federal Reserve's new operating procedure places greater emphasis on maintaining specified growth of bank reserves and less emphasis on controlling movements in short-term interest rates. ^{2/} Thus, the Federal Reserve permitted the rapid run-up of interest rates in late January and February in response to strong credit demands. At that time, the growth of bank reserves and money was near the top of the target ranges that Chairman Volcker described as "appropriate and consistent with reduced inflationary pressures over time." ^{3/} If the Federal Reserve had resisted the rise in interest rates by stepping up its purchases of securities in the open market, it would have provided more reserves than it believed were consistent with its aggregate targets. In April and May, as consumer and business spending weakened, credit demand declined and interest rates began a free-fall. The Federal Reserve's commitment to the reserve and money target policy permitted rates to fall more rapidly than in past recessions.

Delayed effects of extraordinarily high interest rates and the decline in economic activity and loan demand pulled actual money growth well below the Federal Reserve's target ranges, despite the new operating procedures (see Figure 14). In fact, at present, the narrow measures of money, M1A and M1B, have not risen above the levels reached in mid-February. To get money growth back to the target ranges, the Federal Reserve would have to accelerate the growth of bank reserves and deposits by increasing its purchases of government securities. This correction would add to the downward pressure on short-term interest rates. Lower interest rates might adversely affect the value of the dollar in the foreign exchange markets. Indeed, the desire to avoid a further depreciation of the dollar may explain the caution that the Federal Reserve is showing in moving money growth back into the target ranges.

^{2/} For a discussion of this change in operating method, see CBO, Entering the 1980s: Fiscal Policy Choices, pp. 47-53.

^{3/} Paul A. Volcker, chairman of the Board of Governors, Federal Reserve System, speech, May 14, 1980.

Figure 14.
 Monetary
 Aggregates:
 Target Ranges
 and Actual
 Levels



SOURCE:
 Federal Reserve System,
 Board of Governors.

The desirable course of money growth during the second half of the year presents the Federal Reserve with a dilemma. If the decision is to return quickly to the target ranges, short-term interest rates could drop further. In that situation, spending that is sensitive to interest rates would rebound more quickly than in past recessions, when a policy of stabilizing short-term interest rates was pursued. To be weighed against the higher production and employment that would result from the greater spending are the potential damage to the exchange value of the dollar and the upward push on inflation. If the decision is to allow money to remain below target, the trade-offs are reversed. ^{4/}

^{4/} The CBO forecast assumes that the growth of the money aggregate M1B over the two-year period ending in the fourth quarter of 1981 will be near the midpoint of the Federal Reserve's currently announced long-run target range of 4 to 6-1/2 percent. During 1980, however, money aggregate growth is assumed to be below the midpoint of the range.

The trade-offs faced by the Federal Reserve may be even more difficult next year. The expected recovery in economic activity, combined with the continued high momentum of inflation, implies a sharp increase in the demand for money next year. An attempt by the Federal Reserve to hold money growth within this year's target range would likely cause interest rates to increase, thereby restraining the rebound of production and employment. On the plus side of such a restrictive monetary policy is the improved strength of the dollar in foreign exchange markets and continued downward pressure on inflation.

The Recent Experience with Credit Controls

Although monetary policy influences the economy principally through the purchase and sale of securities in the money markets and the attendant effects on money growth and interest rates, in March the Federal Reserve adopted measures to restrain and control credit more directly. The Federal Reserve:

- o Requested banks to restrict the growth of bank credit (loans and investments) to 6 to 9 percent in 1980.
- o Required suppliers of consumer credit--including financial institutions, retail establishments, and credit card companies--to establish special, non-interest-bearing reserve accounts, thereby raising the cost of extending credit to consumers. Initially, the firms were required to deposit 15 percent of the increase in outstanding credit from March 14 levels. A number of exceptions were granted to this requirement, including credit advanced to purchase autos, homes, and home furnishings, and for health and education expenditures.
- o Levied a special, non-interest-bearing deposit requirement on money market mutual funds and some other financial intermediaries such as investment companies. The deposit requirement was 15 percent of the increase in fund assets from March 14 levels.
- o Raised the marginal reserve requirement on managed liabilities (for example, large, short-term deposits or Eurodollar borrowings) at banks from 8 percent to 10 percent.

- o Instituted a 3 percent discount rate surcharge on Federal Reserve advances to large commercial banks that borrow frequently from the Federal Reserve.

The higher reserve requirements, special deposits, and discount rate surcharge were intended to reduce credit flows through the targeted institutions and instruments by "taxing" or reducing the profitability of such credit. A number of these provisions were relaxed in May. In early July, the Federal Reserve announced plans to dismantle all of these controls in July and August.

The bank credit restriction guideline appears to have had little, if any, effect on credit growth because credit demand weakened before the guideline was issued. On balance, the principal effect of the March credit control measures appears to have been a temporary heightening of uncertainty among consumers about the cost and availability of credit. Some economists believe that this contributed to the continued fall in retail sales.

FEDERAL FISCAL POLICY

In spite of rising tax burdens, federal fiscal policy in fiscal year 1980 is expansive. The reason is that spending has risen sharply. By contrast, the first concurrent resolution for fiscal year 1981, passed by the Congress last June, provides a very restrictive budget. This shift in fiscal policy toward considerable restraint reflects a planned slowdown in the growth of spending together with a sharp rise in effective tax rates.

In the revised second concurrent resolution for fiscal year 1980, the deficit was set at \$47.0 billion (see Table 18). CBO now estimates, however, that the fiscal year 1980 deficit will total about \$63 billion; the increase is largely attributable to the impact of deteriorating economic conditions. In the first budget resolution for fiscal year 1981, outlays were set at \$613.6 billion, \$200 million less than the revenue target of \$613.8 billion. This balancing of the budget targets--the first accomplished since enactment of the Congressional Budget Act of 1974--represents a substantial amount of fiscal restraint, because it eliminates a sizable budget deficit despite the assumption of considerable economic slack.

The achievement of a balanced budget for 1981, however, now appears unlikely in view of the worsening economic outlook. Based on the economic forecast presented in this report, CBO estimates

TABLE 18. ACTUAL AND PROJECTED FEDERAL BUDGET TOTALS, FISCAL YEARS 1979 TO 1981 (Billions of dollars, unified budget basis)

	1979	1980		1981	
	Actual	Revised Second Resolution	CBO Estimate Based on Action to Date	First Concurrent Resolution	CBO Estimate with Policies of First Concurrent Resolution
Receipts (Percent Change)	465.9 (15.9)	525.7 (12.8)	517 (11.0)	613.8 (16.7)	600 to 605 (16.5)
Outlays (Percent Change)	493.7 (9.5)	572.7 (16.0)	580 (17.5)	613.6 (7.2)	630 to 635 (9.1)
Budget Balance	-27.7	-47.0	-63.0	0.2	-25 to -35

SOURCE: Congressional Budget Office.

that, with the policies of the first resolution, the 1981 budget would be in deficit by about \$30 billion. Even with a deficit of this size, however, fiscal policy would still be quite restrictive; departure from the balanced budget target of the first resolution would largely reflect the impact of the economy on the budget rather than discretionary fiscal stimulus.

Despite the projected weak economy, CBO estimates that, under current budget policies, budget receipts will rise sharply--by approximately \$85 billion in fiscal year 1981--as a result of legislated increases in social security taxes, the windfall profits tax on oil, and the rise in effective personal income tax rates due to bracket creep. Personal income tax collections are expected to increase by about \$34 billion in fiscal year 1981; \$13 billion of this projected increase reflects the interaction between inflation-induced growth of nominal incomes and the progressive income tax structure. Payroll taxes are estimated to grow by about

\$21 billion, approximately \$10 billion of which results from the January 1981 scheduled increase in the combined (employer-employee) social security tax rate from 12.26 percent to 13.30 percent, and the scheduled rise in the maximum taxable income base from \$25,900 to \$29,700. ^{5/} Finally, net of offsets to individual and corporate income taxes, the windfall profits tax is estimated to add about \$18 billion to fiscal year 1981 receipts, \$14 billion more than in fiscal year 1980.

Given the CBO forecast and the policies of the first concurrent resolution for fiscal year 1981, total federal spending would rise by an estimated 9.1 percent in fiscal year 1981. This rate of increase is substantially below the 17.5 percent rise estimated by CBO for fiscal year 1980, and reflects reduced growth in all of the major categories of spending except defense purchases. By broad function, defense spending and transfers to persons are expected to exhibit the most rapid percentage increases in fiscal year 1981. The growth in net interest payments is expected to slow considerably, while nondefense purchases and grants to state and local governments would decline in dollar terms.

The Full-Employment Budget

The fiscal restraint in the first budget resolution for 1981 is most evident when revenues and expenditures are measured at constant unemployment rates or at a hypothetical full-employment level of economic activity. The shift toward restraint in fiscal year 1981 is estimated to be about \$69 billion--a record shift, if realized--reflecting a 1.7 percentage points increase in the ratio of full-employment taxes to potential GNP, and a 0.7 percentage point decline in the corresponding ratio for spending (see Table 19). Such a large amount of fiscal restraint during fiscal year 1981 would retard improvement in the unemployment rate, but at the same time it would contribute to the goal of reduced inflation.

The restrictive budget policies of the first resolution would not be fully realized, of course, if the tax cuts and/or spending increases now under consideration are enacted. But even with a moderate tax cut and some increase in spending above the amount

^{5/} During calendar year 1981, the impact of these changes in social security taxes is estimated to be \$15.0 billion.

TABLE 19. CHANGE IN THE FULL-EMPLOYMENT BUDGET BALANCE, FISCAL YEARS 1975-1981 (Billions of dollars)

	1975	1976	1977	1978	1979	1980	1981
Change in Full-Employment Balance	--	-18.1	+2.8	+0.4	+21.1	-8.0	+69.0

SOURCE: Congressional Budget Office.

specified in the first resolution, fiscal policy in fiscal year 1981 would still be restrictive according to the full-employment measure. In contrast, when the economy was recovering from the 1973-1975 recession, the full-employment budget indicated a stimulative fiscal policy shift of approximately \$18 billion during fiscal year 1976.

CHAPTER IV. THE ECONOMIC OUTLOOK

Assuming a continuation of the policies of the latest budget resolution, CBO forecasts the second most severe postwar recession in 1980, followed by a weak recovery in 1981. Unemployment is projected to rise to the neighborhood of 9 percent in 1981, with underlying inflation moderating only slightly.

The CBO Forecast: Assumptions and Details

The CBO forecast incorporates the spending and tax policies of the first concurrent budget resolution for fiscal year 1981. The specific policy assumptions are:

- o Unified budget outlays of \$580 billion in fiscal year 1980 and \$630 to \$635 billion in fiscal year 1981.
- o Currently legislated tax laws, including increases in the social security tax rate and base starting January 1981, and the windfall profits tax. Tax cuts currently under consideration are not included.
- o Growth in the monetary aggregate (M1B) over the two-year span of the forecast of 4 to 6-1/2 percent, near the midpoint of the Federal Reserve's announced long-run target range. In 1980, however, it is assumed to fall below the midpoint of the target range.

In addition, the CBO forecast is based on the following assumptions about food and energy prices:

- o Food price increases are assumed to accelerate to about a 10 percent annual rate during the second half of 1980 and to continue to increase at that rate through 1981.
- o Prices of refined petroleum products are assumed to rise by nearly 24 percent during 1981 because of decontrol of domestically produced oil prices and continued increases in world oil prices.

With these assumptions, the CBO forecast, shown in Table 20, shows:

- o A change in real GNP of -4.3 to -2.3 percent from the fourth quarter of 1979 to the fourth quarter of 1980. The economy recovers in 1981, with real GNP rising 2.5 to 4.5 percent between the fourth quarters of 1980 and 1981.
- o A rise in the unemployment rate over the balance of 1980, reaching 8.4 to 9.4 percent by the fourth quarter of the year and then remaining fairly steady throughout 1981.
- o A substantial moderation of the rate of inflation as measured by the CPI but only small improvement in broader measures of inflation. The CPI is expected to moderate significantly in the second half of 1980 because of declining mortgage interest rates. The implicit price deflator for GNP, however, is projected to rise between 8.4 and 10.4 percent from the fourth quarter of 1979 to the fourth quarter of 1980 and then to decelerate to a 7.6 to 9.6 percent range over the four quarters of 1981.

The Depth and Duration of the Recession

The business cycle peak occurred during the first quarter of 1980. ^{1/} Real GNP grew by only a 1.2 percent annual rate in the first quarter of 1980 and the data now available for the second quarter of 1980 point to a decline in real output that is very large by historical standards. In addition, advance indicators suggest suggest a further decline in real GNP in the third quarter of this year.

The CBO forecasts a 2.7 to 4.7 percent peak-to-trough decline in real output--significantly larger than the average rate of decline in postwar recessions but considerably less than the 5.7 percent decline experienced during the 1973-1975 recession. The

^{1/} The National Bureau of Economic Research dates January 1980 as the peak month.

TABLE 20. ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1980 AND 1981, BASED ON POLICIES OF THE FIRST BUDGET RESOLUTION FOR FISCAL YEAR 1981

Economic Variable	Levels			Rate of Change (percent)		
	1979:4 (actual)	1980:4	1981:4	1978:4 to 1979:4 (actual)	1979:4 to 1980:4	1980:4 to 1981:4
GNP (billions of current dollars)	2,457	2,547 to 2,648	2,811 to 3,036	9.9	3.7 to 7.8	10.4 to 14.6
Real GNP (billions of 1972 dollars)	1,440	1,378 to 1,407	1,413 to 1,471	1.0	-4.3 to -2.3	2.5 to 4.5
General Price Index (GNP deflator, 1972=100)	171	185 to 188	199 to 206	8.9	8.3 to 10.3	7.7 to 9.7
Consumer Price Index (1967=100)	228	252 to 257	273 to 283	12.7	10.5 to 12.5	8.3 to 10.3
Unemployment Rate (percent)	5.9	8.4 to 9.4	8.4 to 9.4	--	--	--

SOURCE: Congressional Budget Office.

forecast is consistent with the view that most of the decline in final sales has already occurred. Modest declines in some spending categories are expected during the balance of the year, as well as some adjustment in production to reduce inventory accumulation. An upturn is forecast to occur by year-end. The reasons for a gradual firming of the economy in the second half of the year are:

- o Credit conditions have eased dramatically in recent months and deposit inflows at thrift institutions--a major source of funds to the housing market--are beginning to show some strength.
- o The growing number of young people setting up households provides underlying demand for housing that can be realized as financial conditions improve.
- o Inventories are believed to be in relatively good shape in most sectors, other than durable goods manufacturing despite the sharp deceleration in final demands. This is because of cautious policies followed over the last year.
- o The recent surge in energy prices and the near-term outlook for retail gasoline prices has led consumers to regard much of the existing auto stock as highly fuel-inefficient. Thus, domestic auto sales are expected to pick up later this year when new fuel-efficient models are introduced.
- o The rise in energy prices has made certain business fixed capital outmoded. When effective capacity utilization begins to move up and the outlook for cash flow improves, businesses could accelerate the replacement of energy-outmoded capital stock.

The Persistence of Inflation

Experience shows that recessions result in only a moderate slowing of the rate of inflation. The current recession should be no exception. A large deceleration is expected in the CPI later this year, because of the decline in mortgage interest rates, but this decline does not reflect fundamental inflationary forces. Other measures of inflation, particularly the GNP implicit price deflator, are expected to exhibit much less deceleration.

The rapid momentum of inflation, even during periods of economic slack, is the product of a variety of forces. As noted above, food and oil prices are expected to rise at double-digit rates. Other factors include the following:

- o Wage gains have accelerated recently and are expected to remain high throughout the forecast period as workers attempt to catch up to the rapid rates of inflation in late 1979 and early 1980;
- o Compensation rates will rise further because of the social security tax increase and a scheduled increase in the federal minimum wage, both scheduled for January 1981;
- o Productivity performance is expected to remain relatively poor throughout the forecast period;
- o Profit margins are being squeezed severely this year and will likely be rebuilt somewhat during 1981;
- o Capital replacement costs, especially for structures, will continue to rise rapidly; and
- o Interest rates will likely rise in 1981 as the recovery in real activity progresses.

The Slow Recovery in 1981

Two sectors--autos and housing--are projected to lead the recovery during 1981. In addition, by midyear business fixed investment should be showing signs of recovery. The overall recovery is quite weak, however, compared with earlier cyclical recoveries, in part because of continued high rates of inflation during 1981 and slow growth in real earnings. The recovery will also be slowed by sharply rising tax burdens during the next year--given policies of the first budget resolution--and reduced growth in federal spending:

- o Personal taxes will rise as the progressive tax structure interacts with high inflation to raise effective marginal and average tax rates;
- o Social security tax rate and base increases scheduled for January 1981 will raise these taxes in fiscal year 1981 by \$10 billion;

- o Receipts from the newly passed windfall profits tax are expected to total \$14 billion in fiscal year 1981--up substantially from the previous year;
- o Real federal government purchases are expected to decline in 1981, despite increases in defense spending; and
- o Purchases at the state and local level will also decline after adjustment for inflation, in part because of declines in federal grants.

In addition, the sharp profits of domestic and foreign oil producers are not likely to be fully respent (invested) in the U.S. economy in 1981. The demand for exports should fall in 1981 as many major trading partners of the United States experience slower growth next year. Finally, the markets for automobiles and housing--which are projected to lead the recovery--will be held back somewhat because of the slow recovery in incomes, adverse consumer sentiment stemming from high unemployment, and historically high (and rising) financing costs. Interest rates, including mortgage rates, are expected to begin rising again in early 1981.

Risks to the Forecast

While CBO views a weak recovery as being most likely, a number of potential developments could significantly change the economic outlook. Among such possibilities are the following:

- o The personal saving rate could rise unexpectedly, retarding the near-term recovery in consumer spending. On the other hand, consumers could reduce saving and return to a buy-in-advance-of-price-rise psychology, which would boost economic growth in 1981.
- o If the credit controls actually did greatly inhibit consumer spending, then their elimination might induce a rebound in consumption expenditures that is both larger and quicker than now anticipated.
- o Inflation faster than forecast, perhaps due to a "crisis" in world petroleum markets or a smaller than projected farm crop, would have adverse effects on the recovery.
- o A substantial change in the exchange value of the dollar on international markets could prompt a changed outlook for inflation and for domestic monetary policy.

Along with a recessionary rise in the unemployment rate, the U.S. economy is faced with longer-term problems of declining productivity growth, high inflation, continuing energy dependence, and structural unemployment. What is to be done? It is not likely that a single fiscal policy exists that would counter all of these adverse developments. Indeed, policymakers face a trade-off between long-run and short-run goals. On the one hand, a rapid return to a full-employment economy might require substantial stimulus to consumption. On the other hand, long-run growth requires more investment which, at full employment, must be made at the expense of consumption or government spending.

The traditional tools of demand management--general tax cuts and increased spending--can, if appropriately applied, help alleviate the cyclical rise in unemployment. The drawback of such policies is that they add to inflationary pressures, especially if their major economic impact occurs when the economy is near or at full utilization of resources. In addition, they do not address the longer-term problems of the U.S. economy. Certainly, a primary consideration of budget policies should be the prospects for a sustained recovery and for future productivity and noninflationary growth.

The CBO economic report issued last January analyzed fiscal policy choices in an environment of rising unemployment, rapid inflation, and slow productivity growth. ^{1/} This chapter provides some further information on that subject. Its major conclusions are:

- o It is too late for fiscal stimulus measures to affect output and employment significantly this year, but they could strengthen the recovery and reduce unemployment

^{1/} See CBO, Entering the 1980s: Fiscal Policy Choices. The report highlighted several long-run economic problems that worsened considerably in the 1970s, including inflation, slower productivity growth, and energy dependence.

in 1981, at some cost in terms of inflation. The continuation of high inflation limits the attractiveness of expansive policies.

- o Demand management policies, by themselves, are probably insufficient to achieve productivity goals. Satisfactory growth in productivity may require longer-term policies that will divert resources from consumption and government spending to saving and productivity-enhancing forms of investment.
- o Present U.S. tax and credit policies tend to channel saving into housing and consumer durable goods at the expense of productivity-enhancing investment, especially during inflationary periods.
- o Investment incentives should be carefully designed and implemented. For example, there is a danger that legislated phasing in of accelerated depreciation, or even the discussion of proposals for investment incentives, may cause businesses to postpone some investment projects. Moreover, if the objective of a tax policy is to increase growth in productivity, it likely will be more successful if the tax incentive is concentrated in the industrial sector as opposed to commercial or residential sectors.
- o An emphasis on multiyear, long-term fiscal policy planning is likely to be more effective than a one-year budgetary horizon.

THE INFLATION PROBLEM

The recent high rates of inflation can be divided into two facets: an "underlying" inflation and a "shock" component from such factors as OPEC price increases or sharp food price increases resulting from supply reductions. There are some longer-term measures that might blunt supply shocks, making the economy less vulnerable. Basically, however, not much can be done about the supply shocks, however, at least in the short run.

An attack on inflation must be directed mainly at underlying inflation. Even here the difficulties are great, and available policy instruments operate with considerable lags. The underlying rate derives from the momentum of inflation. Once begun, inflation

tends to perpetuate itself through "catch-ups" in wage contracts and through the general expectation that inflation will continue into the future. Proposed anti-inflation policies include:

- o Restrictive fiscal and monetary policies;
- o Selective tax cuts that reduce cost pressures;
- o Programs to correct market imperfections by making markets more competitive and attempting to reduce their inflationary biases;
- o Direct controls over prices and incomes, or tax-based incomes policies;
- o The elimination of bottlenecks in critical areas of the economy; and
- o Promotion of economic growth, principally by diverting resources from consumption to investment in business capital, research and development, and worker skills.

Each of these approaches imposes substantial costs on one group or another. Moreover, with the possible exception of wage and price controls, each makes only a small contribution to lowering inflation in the short run. A major difficulty with restrictive monetary and fiscal policies as a way of fighting inflation is that they initially result in lower output and higher unemployment, and generally affect prices only after a considerable lag. In addition, if very restrictive policies are applied over a prolonged period, they may impair business investment, which is sensitive to demand conditions.

On the other hand, the maintenance of some economic slack for a considerable period may be necessary to offset some of the impact of repeated inflationary shocks. Moreover, if an incomes policy is desired, it is more likely to be successful in an economy operating with some slack.

Wage and price controls could slow inflation, at least temporarily. But this approach involves burdensome administrative problems and, if extended over time, is likely to produce distortions in the economy and inhibit its growth. At present, the consideration of wage and price controls by the Congress would

likely stimulate anticipatory price increases. The impact of recent proposals for tax-based incomes policies is uncertain, and they are generally thought to be difficult to administer.

Policies to improve productivity and raise economic growth are of a long-run nature and can make only a modest contribution to reducing inflation in the next few years. To raise productivity growth by as much as one percentage point over several years would be of major importance for long-run economic growth, but it would not do much to offset the current underlying inflation rate of nearly 10 percent.

ANTIRECESSION POLICIES

How might policymakers respond to the short-run problem of recession occurring in the midst of high inflation? The first level of fiscal response to recession occurs "automatically," as tax receipts begin to taper off while government outlays--particularly for unemployment insurance payments--increase in response to higher unemployment. This automatic budgetary response is already occurring.

The second level of budgetary response is usually discretionary tax cuts and/or spending increases. The recession is probably too far advanced for such demand management policies to have much effect on the contraction. But a more expansive fiscal policy than current budget policies might stimulate the recovery, when it begins.

Tax Measures

Tax cuts have different effects, depending on whether they are directed at consumers or at businesses. Consumer tax cuts, involving either income or payroll taxes, appear to be relatively effective antirecession policies if implemented quickly. Most estimates indicate that it takes only a year or so before the full impact occurs. By contrast, business tax cuts are not a useful antirecession measure because they require much more time to take effect; their importance would be in spurring investment for long-run growth.

Unfortunately, reducing taxes to spur consumption might add to the danger of inflation if the impact occurs when the

recovery is already advanced. A cut in payroll taxes would provide some short-run stimulus while possibly helping to reduce inflationary pressures because lower payroll taxes would reduce employers' wage costs. (It would, however, also reduce balances in the social security trust fund, unless it was done as an income tax credit for payroll taxes paid.) 2/

Most general reductions in personal taxes stimulate consumption in the short run. 3/ But to achieve higher economic growth, lower long-run consumption may be needed to free resources for productivity-enhancing investment. Thus, if long-run growth is a priority, antirecessionary measures should not be inconsistent with a long-run reduction in the share of GNP absorbed by personal consumption and government spending.

A possible alternative would be to target carefully any reduction in individual income taxes so as to have a maximum effect on incentives to work and to save. Reducing marginal income tax rates, for example, would have more impact on incentives than increasing the standard deduction. It would, however, take many years to have a substantial effect on aggregate savings and effects on work effort are small. The benefit would likely be greater for upper-income people. Some measures to influence individual saving behavior might also be considered.

Spending Measures

On the spending side, frequently mentioned antirecession policies include:

- o An extension of unemployment insurance benefits;
- o An expansion of (or maintenance of) the number of CETA countercyclical public service employment (PSE) slots;

2/ H.R. 7046 provides for an income tax credit for social security taxes.

3/ Business investment would be indirectly stimulated somewhat because of stronger demand.

- o An increase in training programs;
- o An expansion in youth employment and training programs;
- o Countercyclical public works; and
- o Antirecession fiscal assistance (ARFA).

In general, countercyclical spending programs have the advantage that they can be designed to benefit groups or geographic areas hardest hit by recession, though such targeting may be difficult to achieve politically. Their major disadvantages are: first, the tendency for state and local governments to use the funds as a substitute for other expenditures; second, in some cases, the tendency to affect the economy too slowly; and third, the tendency to make inflation worse. ^{4/}

Countercyclical PSE, public works, and antirecession fiscal assistance, all used in the last recession, have their own advantages and disadvantages as antirecession measures. The countercyclical PSE approach creates a relatively large number of jobs per billion dollars of budget cost, although fiscal substitution reduces the net impact. Moreover, the jobs are in the public and not-for-profit sectors, and it may be difficult to phase them down later on. Countercyclical public works involve substantial time lags, although they can be targeted on areas most severely affected by recession. ARFA monies can be targeted to local governments that need them most, but it is not clear that the federal dollars would be quickly spent.

One of the most important arguments for the countercyclical programs is that they can be targeted. Recessions generally have a disproportionate impact on particular groups, such as minority youth, and an uneven effect on different geographic areas. In the past recession, most of these countercyclical measures were used to

^{4/} Countercyclical spending measures have been discussed in more detail in earlier CBO reports; see Entering the 1980s: Fiscal Policy Choices. The stimulus package of 1977 may have contributed to the inflation psychology, especially if it was interpreted as a sign that monetary and fiscal policies were going to be inflationary.

provide temporary stimulus to employment, particularly for disadvantaged groups of workers. But it may be necessary in this recession to adapt countercyclical spending to a situation in which inflation and slower productivity growth loom as serious, long-term problems. A key question, therefore, is: Which measures can assist workers in the face of recession in ways that contribute to longer-term growth and overall price stability, or at a minimum, interfere least with these long-run objectives?

One approach would be to emphasize measures that draw workers into private-sector employment--such as job training and the targeted jobs tax credit. Countercyclical job training has not been a prominent element of antirecession strategies in the United States, although it has been important in several European countries. Militating against it are the time required to establish training programs, the difficulty of knowing what to train people for, and the fact that most people thrown out of work want jobs not training. But training workers for private-sector jobs has greater potential for increasing their long-run productive capability than does public service employment. Moreover, the social or opportunity cost of training is lower during periods of high unemployment, when workers in the training programs would tend otherwise to be unemployed.

Complementary to this would be an expansion in youth employment training programs. There is some evidence to suggest that unemployment causes long-run labor market problems for disadvantaged, minority youths.

The targeted jobs credit provides an incentive to employers to hire from certain disadvantaged groups, including unemployed youths from low-income families. The size and impact of this program, however, may depend significantly on how it is administered, both at the national and local levels.

Work-sharing, which is practiced in a number of European countries in response to recessions, helps workers maintain their jobs and skills while working at less than full time. The adoption of work-sharing in this country might encourage employers to invest more in their employees, since there would be more assurance of a long-term employment relationship. However, the unemployment insurance systems in most states discourage work-sharing. In California, the unemployment insurance system

pays pro-rated benefits in some circumstances to workers on reduced workweeks. 5/

Should the recession be prolonged, unemployment insurance benefits could be extended. This measure has the advantage of phasing out automatically when no longer needed. Unlike training, however, unemployment benefits do nothing to help to increase the longer-term productivity of the labor force, and there is some evidence to suggest that the unemployed may delay returning to work as a result of extended benefits. The unemployment insurance system might be modified to encourage skill development by permitting payment of benefits in some circumstances to workers in school or training programs, after a waiting period.

DECLINING PRODUCTIVITY GROWTH

In addition to inflation and the short-run problem of higher cyclical unemployment, the economy has been experiencing much slower productivity growth. The causes of the productivity slowdown are not fully understood, but there is widespread agreement about some ways to stimulate productivity growth. In particular, the economy can be made more productive by (1) saving and investing more and (2) channeling investment into modern plant and equipment. Other measures to foster productivity growth include policies to stimulate innovation--including investments in research--together with investments in "human capital" such as training.

Previous CBO reports have discussed the use of particular fiscal measures to stimulate business investment and to encourage aggregate saving. 6/ For example, one way to stimulate national saving in the long run is to increase public saving (reduce government deficits). This report adds to the earlier discussion by considering policy options that might increase the proportion of personal saving that gets channeled into productivity-enhancing capital formation.

5/ H.R. 7529 would encourage other states to pay unemployment benefits for workers on reduced workweeks.

6/ CBO, Entering the 1980s: Fiscal Policy Choices, Chapter V.

Personal Saving

Earlier CBO reports have reviewed economic evidence that indicates that it is not clear that general cuts in income tax rates can achieve a substantial increase in aggregate saving. ^{7/} However, an additional effect may be achieved by changing the composition of saving and investment. The composition of saving and investment is important because some kinds of saving-investment behavior contribute significantly to long-run productivity growth while others do not. For example, investment in new plant and equipment contributes directly to productivity growth, while investment in owner-occupied housing does not. Again, if land and art appear to be better investments than purchases of common stock or corporate bonds, the economic climate for investment in new plant and equipment will not be favorable. Similarly, to the extent that the credit mechanism is used to finance consumer purchases, there will be fewer funds to finance modern plant and equipment.

Tax policy (as well as government regulation) has a powerful effect on the composition of saving and investment, particularly in determining what proportion of resources are devoted to productivity-enhancing capital formation and what proportion to other uses such as housing and purchases of durable goods. The reason is that saving and investment decisions are influenced by the after-tax return on alternative assets. Research suggests that in recent years the combination of inflation and the income tax structure has reduced the after-tax return on financial assets and business fixed investment as compared with that from owner-occupied housing and consumer durables which do not produce taxable income. ^{8/}

^{7/} Congressional Budget Office, An Analysis of the Roth-Kemp Tax Cut Proposal (October 1978), Chapter II.

^{8/} Frank de Leeuw and Larry Ozanne, "Investment in Housing and the Federal Income Tax," in Henry J. Aaron and Joseph A. Pechman, eds., The Economic Effects of Taxes (Brookings Institution, forthcoming); Patric H. Hendershott and Sheng-Cheng Hu, "Government-Induced Biases in the Allocation of the Stock of Fixed Capital in the United States," in George von Furstenberg, ed., Capital, Efficiency and Growth, Vol. III (Ballinger Publishing Company, 1980), pp. 323-60; and Vito Tanzi, Inflation and the Personal Income Tax: An International Perspective (Cambridge University Press, 1980), Chapters 5 and 6.

Recent Trends in the Composition of Saving

People can "save" in various ways. The most common notion of saving is a bank account or some other form of financial asset. However, people can also save by putting their income into tangible assets such as houses, durable consumer goods, and art. These nonfinancial forms of saving do not contribute directly to the pool of funds available for business investment and may detract from this pool if they are debt financed. Moreover, not all forms of financial savings contribute directly to the financing of business investment. For example, the deposit of money in savings and loan institutions does not directly help to finance new plant and equipment, although there may be some positive effect on business investment if the additional saving causes interest rates to decline.

The Federal Reserve's Flow of Funds (FoF) accounts provide a useful measure for analyzing shifts in the composition of saving over time. ^{9/} This measure of saving includes net increases in durable goods and treats household debt as dissaving. The rationale for including durables is that, since only part of a new TV, refrigerator, or automobile is "consumed" in a year, the remainder represents a form of saving. Debt is simply the mirror-image of financial assets.

The composition and behavior of the FoF measure of household saving is shown in Table 21. One conclusion to be drawn from the table is that the saving rate of households changed very little from 1970 to 1979, when it declined. A second conclusion is that in the last few years an increasing share of disposable income has been "saved" in the form of tangible assets, whereas household financial assets, net of debt, have declined. People appear to be borrowing more to finance purchases of housing and other assets. Such borrowing competes with business borrowing. The saving that could contribute substantially to business capital formation is financial saving--such as pension contributions, and purchases of stocks and bonds.

^{9/} A more common measure of personal saving is the National Income Accounts (NIA) measure. For purposes of analyzing the composition of saving, however, the flow-of-funds saving measure is sometimes more useful because it includes changes in household debt and net purchases of durable goods.

Table 21. SAVING BY HOUSEHOLDS (FLOW-OF-FUNDS BASIS) AS A PERCENT OF PERSONAL DISPOSABLE INCOME, 1970-1979

	Increase in Tangible Assets	- Depre- ciation	+ Increase in Financial Assets	- Increase in Household Debt	= Net Household Saving
1970	16.7	11.6	11.1	3.6	11.8
1971	18.1	11.7	13.4	6.5	12.6
1972	19.7	11.7	15.4	8.8	12.2
1973	19.3	11.4	15.9	8.5	13.8
1974	17.3	11.9	12.9	5.2	13.1
1975	16.7	12.2	14.2	4.8	13.8
1976	18.6	12.3	15.9	8.2	13.9
1977	20.0	12.3	16.8	11.1	13.3
1978	20.5	12.4	17.0	11.4	13.7
1979	19.4	12.6	15.7	10.3	12.2

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

Why have households devoted such a large (and increasing) share of their saving to tangible assets such as housing and durable goods rather than to financial assets? Although part of this shift may be cyclical, one explanation is that inflation has magnified the tax system's bias against financial savings. Specific features of current law that may have contributed to this shift include:

- o The deductibility from adjusted gross income of real estate taxes and of interest payments on home mortgages and consumer debt (including the inflation component) even though the flow of income from owner-occupied housing and from durable goods is excluded;
- o Regulation Q limits on the nominal interest rates paid on savings accounts--in recent years, such returns were considerably below the inflation rate;
- o Relatively high taxation of capital gains on financial assets compared to those on owner-occupied housing, because no capital gains tax is owed on houses if the proceeds of a

sale are used to purchase a house of equal or greater value and each taxpayer is entitled to a \$100,000 lifetime exemption; and

- o The taxation of corporate income both at the corporate level and at the personal level, if profits are distributed as dividends.

These features may create a bias in favor of houses and durable goods and against the accumulation of financial assets, especially during inflationary periods. It is true that current U.S. law contains some provisions that encourage financial saving, such as favorable tax treatment of pension plan contributions and an interest-dividend exclusion. On the whole, however, especially during inflationary periods, the tax system may discourage households from financial forms of saving and encourage them to go into debt.

Most industrialized countries do not have such strong disincentives to household accumulation of financial assets during inflationary periods as does the United States. Canada is a case in point. The Canadian program to encourage financial saving by households includes:

- o Personal tax exemption for the first \$1,000 of investment income.
- o Deferral of taxes on income paid into a Registered Retirement Savings Plan (RRSP)--up to \$3,500 per year or 20 percent of total income, whichever is less, if the taxpayer is covered by a pension plan; \$5,500 or 20 percent of total income if he is not covered by an employer's pension plan.
- o No ceiling on interest rates paid by financial institutions as in the United States.
- o No deductibility of interest on consumer installment debt from taxable income, or of interest on mortgages of owner-occupied houses. 10/

10/ Several countries tax the imputed value of owner-occupied houses, although Canada does not.

Policy Options for Influencing Personal Saving

If the Congress wished to change the composition of saving and investment to favor productivity-enhancing capital formation, several approaches are possible. The proportion of personal saving in the form of financial assets might be increased by raising the after-tax rate of return on these assets, or by reducing that on nonfinancial assets, especially those financed by borrowing. More specifically, the income tax deductibility of interest paid on mortgages and on consumer credit could be eliminated. ^{11/} Alternatively, the income tax could be replaced by a consumption tax that would treat houses and durables as part of consumption. Less far-reaching measures that have been discussed include:

- o Limiting the interest deduction on owner-occupied homes to a specific amount or to a single home.
- o Raising the interest income exclusion for tax purposes or adopting some form of indexing of the tax base.
- o Separating labor and investment income for tax purposes in order to reduce the marginal tax rate on investment income.
- o Exempting from taxation or deferring taxation on income saved up to a specific limit or providing a tax credit on saving. Establishing a threshold saving tax credit is another possibility. An example would be a 50 percent tax credit for financial and some forms of noncorporate investment (excluding consumer durable goods and owner-occupied homes) above a threshold saving rate that increases with income.

Credit policies could also be used to encourage more saving to flow into business capital formation. One way would be to increase the interest rates charged in financing the purchase of consumer durables, or to reduce the payback period. Such interferences with

^{11/} For a review of the arguments for and against tax deductions for interest paid on home mortgages and consumer loans, see Richard Goode, The Individual Income Tax (Brookings Institution, 1976), pp. 148-53.

credit markets are not required, however. An alternative would be to modify existing regulations of banks and thrift institutions to encourage a freer flow of saving into business investment in plant and equipment.

While these various approaches could take many forms, certain general economic principles should be noted. First, an incentive that works at the margin (on the last dollar earned and saved) is likely to be more effective in raising saving than one that does not. Thus, the recently legislated \$200 interest exclusion (\$400 for a joint return) in the federal income tax may not have much effect on saving behavior, because most of the saving is done by taxpayers who have much more than \$200 in interest-dividend income per year. Moreover, among those who have less interest income than \$200, their tax rate is likely to be relatively low, making the exclusion worth less.

Second, the design of the saving incentive may be important in the distribution of the benefits by income groups. Thus, a dollar of tax credit is worth the same (\$1 dollar) for all taxpayers who have tax liability, but an exemption is worth more to taxpayers in higher brackets.

Third, if the Congress adopted a policy that succeeded in shifting the composition of saving markedly toward financial assets, the effect on the level and composition of aggregate demand could be substantial. The demand for debt-financed consumer durables and housing would decline relative to that for the investment sector, and possibly even in absolute terms. The demand for financial assets, including deposits in financial institutions, corporate debt and equity, and noncorporate equity, would increase. But employment in housing construction and consumer durables would be less buoyant than without such a policy. In some industries, the growth of the workforce would slow and some workers might lose jobs and would need to find employment elsewhere. Moreover, during the interim, growth in aggregate income might fall temporarily. It would be difficult to synchronize such changes so that reductions in demand and in employment in the consumer sector would be offset by increases in the business investment sector. It seems likely that employment in the investment sector would expand more slowly. A somewhat more expansive monetary policy might be needed to smooth the transition. The essential point, however, is that resource shifts, painful as they may be, would be necessary to change the basic structure of the economy.

Business Saving, Investment, and Tax Policy

Many analysts believe that the present business tax system has contributed to the decline in productivity growth. One of its features in particular, historical cost depreciation, in conjunction with high inflation, may have reduced business saving and dulled incentives to invest in productive capital. In addition, the application of an investment tax credit to equipment but not to structures may have distorted business investment decisions.

Selective reductions in business taxes might stimulate business saving and productivity investment. Business saving includes corporate retained earnings and business depreciation of capital investment. Among the ways of stimulating business saving and increasing incentives for business investment are: accelerating depreciation or indexing depreciation, increasing or liberalizing the investment tax credit, and lowering the corporate income tax rate. These measures have been analyzed in earlier CBO reports. 12/

Not all business investment has equal impact on productivity, and therefore tax measures to stimulate productivity investment can be made more efficient by targeting. For example, tax incentives on residential property or commercial property (such as shopping centers and hotels) are not likely to contribute significantly to productivity.

Changes in tax policies could inadvertently distort the timing of investment, unless caution is exercised. In a good many cases, businesses have some discretion over the timing of investment; they could delay investment to take advantage of more favorable tax treatment at a later date. Legislative consideration of investment incentives might therefore induce businesses to postpone some projects, contributing to the near-term weakness in business capital spending. 13/ The same caveat applies to the recent proposal to phase in more rapid depreciation over a period of

12/ See CBO, Entering the 1980s: Fiscal Policy Choices, pp. 71-80.

13/ Traditionally, proposals for tax changes affecting investment have been made retroactive to avoid this type of "anticipation effect."

years, thereby creating some incentive to postpone investment projects. 14/ Moreover, unless carefully designed, business tax policies may distort the allocation of investment among short- and long-lived equipment and structures, which could reduce productivity growth.

14/ S. 1435 and H.R. 4646.

SUMMARY AND CONCLUSION

The United States faces policy options that involve choosing between long-run and short-run goals for the economy. In the long run, simply because they cannot be accomplished in the short term, the aims of U.S. economic policy include: stable prices, higher productivity, reduced energy dependence, and economic opportunities for those who currently have few marketable skills. In the short term, antirecessionary measures such as an across-the-board tax cut and increased spending tend to increase inflation and worsen U.S. energy dependence. On the other hand, long-term measures to raise productivity growth and slow inflation such as accelerated depreciation and lower taxes on capital income, would not substantially reduce the severity of the current recession.

What is to be done? Should fiscal policy fight the recession now and then perhaps turn to the longer-term goals of the economy once it is back at full employment? Or should fiscal policy ignore the recession no matter how severe and instead look to improving the long-term prospects of the U.S. economy? Or should it attempt a middle course, endeavoring to soften the force of the recession and yet do something for the future, even though this approach is likely to result in some policies working at cross-purposes with one another?

No matter which approach is selected, the Congress will be required to choose from among policies of varying effectiveness. At the risk of oversimplifying, Table 22 on the following page is intended to provide a rough indication of some advantages and disadvantages of illustrative policy options.

TABLE 22. SELECTED FISCAL POLICY OPTIONS: A TENTATIVE EVALUATION

Policy Option	Cyclical: Output and Employment	Productivity	Inflation	Administration
Personal Taxes				
Income tax rate cut	Effective	Possible positive effect through increased incentives	Adds to inflationary pressures	Easy to administer
Credit for social security taxes	Effective	Uncertain effect	Slightly reduces inflation in the short run	Relatively simple to administer, but complicates tax code further
Liberalize Individual Retirement Account	Small, negative effect	Possibly effective	Tends to reduce inflation	Relatively simple to administer
Cap mortgage interest deduction	Would reduce demand for housing	Tends to shift investment to more productive uses	Reduces inflationary pressures	Simple to administer
Business Taxes				
Corporate income tax rate cut	Small, positive effect	Moderately effective	Reduces inflation in the long run	Easy to administer
Accelerated depreciation	Small, positive effect	Effective	Reduces inflation in the long run	Easy to administer; difficult to reverse; may affect investment timing
Investment tax credit	Small, positive effect	Effective	Reduces inflation in the long run	Easy to administer; may affect investment timing
Gasoline Tax	Reduces aggregate demand; raises unemployment in auto industry	Uncertain effect	Adds to inflation in the short run but reduces long-run dependence on foreign oil	Relatively simple to administer

a/ The long-run effect depends on the extent to which the corporate income tax is shifted forward to consumers or backward to employers.

Budget Implications	Structural Unemployment	Energy Import Dependence	Resource Allocation	Group Affected
Revenue loss grows with nominal income, more rapidly if it reduces progressivity	Slight, positive effect	Adds to energy demand	Reduces distortions that vary with tax rates	Effect depends on specific cut, but tends to favor high income groups
Backdoor general revenue financing of social security	Slight, positive effect	Adds to energy demand	Induces some substitution of labor for capital	Benefits wage earners, employers, and self-employed
Revenue loss depends on level of exemption and saving response	Negligible effect	Negligible effect	Encourages saving	Benefits middle- and upper-middle-income groups
Increases tax receipts	Short-run increase in unemployment in construction	Negligible effect	Shifts resources from housing to business sector	Increases taxes on upper- and middle-income groups
Revenue loss grows with corporate profits	Negligible effect	Negligible or uncertain effect	Reduces distortions that result from corporate income tax	Benefits high-income groups <u>a/</u>
Revenue loss is small at first but grows very rapidly for several years	Can cause job loss for unskilled	Replacement of energy-inefficient capital	Depends on design	Benefits high-income groups
Revenue loss grows with investment level	Can cause job loss for unskilled	Replacement of energy-inefficient capital	Depends on design	Benefits high-income groups
Revenue increase depends on tax rate and level of gasoline consumption	Uncertain	Reduces import dependence and conserves energy	Encourages more efficient use of gasoline	Could create hardship for some individuals

(Continued)

TABLE 22. SELECTED FISCAL POLICY OPTIONS: A TENTATIVE EVALUATION (Continued)

Policy Option	Cyclical: Output and Employment	Productivity	Inflation	Administration
Spending Programs				
Countercyclical public service employment	Effective; can be expanded quickly but may be difficult to cut back; fiscal substitution limits job impact	Negligible effect	Adds to inflationary pressures	Somewhat difficult to administer; targeting adds to administrative burden
Training	Moderately effective	Moderately effective	Upgrades skills, reducing inflationary pressures	Somewhat difficult to administer
Countercyclical public works	Not very effective because of spending lags	Negligible effect	Adds to inflationary pressures	Somewhat difficult to administer; projects have to be selected
Antirecession fiscal assistance	Not very effective because of spending lags	Negligible effect	Adds to inflationary pressures	Relatively simple to administer
Extended unemployment insurance benefits	Effective; provides "automatic stabilizer" for income but encourages unemployment	Negligible effect	Adds to inflationary pressures and raises non-inflationary unemployment rate	Relatively simple to administer

Budget Implications	Structural Unemployment	Energy Import Dependence	Resource Allocation	Group Affected
Large number of jobs per billion dollars	Short-run positive effect, though does little in the long run	Negligible effect	Enlarges government and non-profit sector; expands services in these areas	Targeted on disadvantaged
Depends on amount of stipend	Moderately effective	Small, positive effect if training is for jobs in energy	Contributes to labor mobility	Can be targeted on disadvantaged
Outlays committed for several years	Most hired are not disadvantaged	Negligible effect	Addes to community infrastructure	Helps construction industry and areas with high unemployment
Federal spending can be quick, but delays occur at local level	Negligible effect	Negligible effect	Enlarges government sector; helps to maintain public services	Helps communities severely affected by recession
Spending increases and decreases automatically with unemployment rate	May increase structural unemployment	Negligible effect	Reduces labor mobility	Benefits workers in cyclically affected industries