CHAPTER 1

Economic Policy and Outlook

THE STORY OF THE PAST YEAR was one of inflation and recession. Several of the forces that added to the rate of inflation also exerted downward pressure on economic activity. The sharp rise in oil prices resulted in a large transfer of purchasing power to the oil-producing countries. Inflation, strong demands for credit, and the unwillingness of the monetary authorities to underwrite a continued acceleration of inflation drove interest rates upward, causing a slump in housing. Another debilitating effect of the higher and variable rate of inflation was the sharp rise in uncertainty regarding future rates of price increase. The general rise in prices was instrumental in reducing real incomes in another way. Inflation pushed individuals into higher tax brackets thereby causing a significant transfer of real income from individuals to the government sector. Inflation also caused a similar updrift in the tax liabilities of business. The result was to shift the budget in the direction of restraint, by considerably more than had been anticipated at this time last year.

As 1975 begins, the unemployment rate stands at its highest level since 1958 and production and employment are declining sharply. The decline in activity during the closing months of the year gathered so much momentum that developments beyond the current quarter are difficult to gauge. It is quite likely, however, that the contraction of business activity and rising unemployment will continue for several more months. Although the rate of inflation is still high, it has begun to moderate. One can observe actual declines in prices of crude industrial materials and a slowdown in the rate of price advance among important categories of goods sold in wholesale and retail markets.

The most pressing concern of policy is to halt the decline in production and employment so that growth of output can resume and unemployment can be reduced. The momentum of the decline is so great that a quick turnaround and a strong recovery in economic activity are not yet assured. But prompt action on the Administration's proposals to stimulate the economy should hasten the end of the recession and contribute to the pace of recovery during the second half of the year. The policies that we use to support the economy in 1975 must be consistent with a further reduction in inflation in 1976 and thereafter. This will obviously require discipline both in the Federal budget and in the monetary policies of the Federal Reserve.

The formulation of economic policy is complicated by the need for much stronger actions to tackle the Nation's energy problems. New energy policies have been proposed which will provide an enduring framework for the adjustment that began after the oil embargo. The adjustment to lower levels of consumption and importation will impose further costs upon the economy in the short run in order to avoid mounting political and economic costs in the long run. The energy program will raise prices at a time when inflation is serious. On balance, however, the program will provide important benefits. Moreover, as formulated it is consistent with the values and the objectives of an efficient market-oriented economy.

THE PROGRAMS TO STIMULATE THE ECONOMY AND CONSERVE ENERGY

To provide support for the economy, the President on January 13 proposed tax relief for individuals and business. For individuals the program calls for a tax rebate equivalent to 12 percent of total 1974 personal tax liabilities up to a limit of $1,000 per return. The rebate would total approximately $12 billion and would be paid in two instalments, the first in May and the second in September.

For business the President proposed a 1-year increase in the investment tax credit to 12 percent. Except for utilities, which now have a 4 percent credit, the present credit is equal to 7 percent of investment in equipment. For electric utility investment in generating capacity that does not use oil or gas, the higher tax credit would remain in force through 1977. The increase in the tax credit is expected to reduce tax liabilities of businesses by approximately $4 billion during 1975. The credit will apply to machinery and equipment put into service during 1975, as well as to orders placed during 1975 and put into service by the end of 1976.

The tax cut will not prevent a decline in real output from 1974 to 1975 but it will reduce the extent of the year-over-year decline—perhaps by one-half of 1 percent to 1 percent in terms of real GNP—and will contribute to the recovery in the second half of 1975. An assessment of the economic effects of the stimulus program is complicated by a number of factors. We cannot be certain how much of the tax cut will be saved rather than spent, but past experience suggests that most of the tax cut will be spent, and a large fraction of it this year. Saving will be high initially, but as the year progresses spending will increase.

The investment tax credit may have some immediate effect in stimulating purchases of certain types of equipment, but it is most likely to begin to affect spending appreciably in the second half of 1975. Because of the time limitations applicable to the tax credit, businessmen have an incentive to undertake some investment now that they would otherwise have undertaken only later. In view of the fact that new orders for durable goods generally and for machinery and equipment specifically have fallen rapidly in recent months, any addition to orders at the present time is quite important in itself, even if it does not raise fixed investment immediately.

The Administration's energy program aims at discouraging energy consumption and encouraging domestic production by raising the relative price of energy. Prices are increased through removal of controls in combination with a series of taxes, but the tax proceeds are refunded so as to keep consumer purchasing power roughly unchanged once the program has become fully effective. The major components of the Administration's energy program are:

—Price decontrol for crude oil and deregulation for new natural gas.
—A windfall profits tax on crude oil.
—An import fee which will rise to $2 per barrel on imported oil, accompanied by an excise tax of $2 per barrel on domestic oil and an equivalent tax of 37 cents per thousand cubic feet on natural gas.
—Creation of a strategic oil reserve of up to 1.3-billion barrels with early action to require the stepped-up holding of private oil inventories.
—Protection of domestic energy producers against excessive risks from abrupt declines in prices of imported petroleum.
—Expanded production from the Naval Petroleum Reserves and other Federal oil deposits.
—Expanded production and use of coal and nuclear energy.
—Development of a synthetic fuels industry.
—Various measures designed to increase the efficiency of energy consumption.

An important source of uncertainty regarding the stimulus program concerns the timing of the energy package. The reasoning behind the decision to embark on an energy conservation program is outlined further on. Here we note some of the price and fiscal aspects of the energy program.

It is estimated that the imposition of import fees, excise taxes on crude oil and natural gas, and the decontrol of domestic crude oil by April 1, 1975, will directly add about $30 billion (annual rate) to the Nation's oil and gas bill. Ultimately prices should rise by an equivalent amount. The windfall profits tax (WPT) is designed to capture the increase in profits of domestic oil producers attributable to decontrol. The increase in receipts from import fees, excise taxes, and the windfall profits tax will be returned to individuals, businesses, and governments mainly through a set of tax reductions, with a portion taking the form of increased Federal Government expenditures.

The energy program will be introduced gradually. On February 1 an import fee of $1 per barrel was imposed through Presidential action. This fee will rise to $2 on March 1 and to $3 on April 1. However, for purposes of economic projections the Administration has assumed that Congress will levy a $2 tax on domestic crude oil and pass the balance of the energy program with an effective date of April 1 of this year. This would make the final increase in the import fee unnecessary.

The initial effect of the import fee will be to raise prices of imported oil and of domestic oil that is now uncontrolled. Together these constitute some 60 percent of total U.S. oil consumption. This effect will be reinforced on April 1 by the decontrol of the remaining part of domestic petroleum production. In the second quarter of the year, the average price of crude oil is expected to rise by approximately $4.20 per barrel over current levels as a result of decontrol and the $2 per barrel excise tax. It is expected that the increase will be reflected with a lag in higher prices for gasoline, fuel oil, and other petroleum products and eventually in higher electricity prices. By the end of the second quarter of 1975, when all of the program will be effective, the consumer price index is estimated to be 1.3 percent higher than it would be without the proposed program. Not all of the higher price of crude oil and natural gas will affect prices in final markets this quickly. At first some of the higher petroleum prices will reduce profits rather than increase the prices charged by users of refined petroleum inputs, especially where prices are regulated. The profits squeeze is not expected to last long, however, and by the latter part of 1976 all of the increased cost should show up in the form of higher prices of those goods and services that consume crude oil and natural gas directly and indirectly. The $30-billion impact is estimated to be about 2 percent of GNP. About 90 percent of it will be reflected in higher prices by the fourth quarter of this year. For all of 1975 we estimate that the GNP deflator will be about 1 percent higher than it would have been without the program.

Rising prices not compensated for by offsetting tax cuts will reduce real incomes to a slight extent in the first half of 1975. Consequently, the effect of the stimulus proposals will be partially offset by the energy proposals during the first half of the year. On the other hand, to the extent that oil imports and hence the transfer of purchasing power to foreign oil producers are reduced the demand for domestic goods would be increased. By the third quarter the stimulus from both programs will be substantially greater.

THE ENERGY TAX OFFSETS

The energy taxes are to be turned back to the economy in a variety of ways. (Estimates below are annual rates based on calendar year 1975.)

—For individual taxpayers, rates are being reduced and the low-income allowance is being raised in such a way that total taxes will be cut by an estimated 12 percent from what they would otherwise be in 1975. The increase in the low-income allowance to $2,600 for joint returns from its present level of $1,300 means that a family of four will pay no taxes if its income is $5,600 or less. This part of the program, which would involve a reduction in withholding schedules starting June 1, would return an estimated $16 billion.

—Low-income households that pay no taxes and certain low-income taxpayers will receive a special distribution of up to $80 per adult after application to the Internal Revenue Service. This would return $2 billion. Disbursements are expected to start in the summer of this year.

—The program calls for a tax credit of 15 percent of expenditures—up to a maximum expenditure of $1,000 per homeowner—for outlays that improve residential thermal efficiency. Credits could be claimed during the next 3 years. This aspect of the program would return $0.5 billion per year.

—The Federal Government would use $3 billion to cover its share of the costlier energy bill, while State and local governments would receive an additional $2 billion in revenue sharing grants.

—Business would receive $6 billion through a reduction in the corporate tax rate from 48 percent to 42 percent.

SUMMARY

Table 1 brings together the various parts of the Administration's stimulus and energy programs. Receipts and expenditures, defined on the national income accounts (NIA) basis, are shown as seasonally adjusted quarterly totals, not at annual rates.

The stimulus or temporary part of the combined program appears as reductions in personal and corporate tax receipts. In addition to refunds to individuals of part of their 1974 tax liabilities, personal tax receipts include an allowance for the investment tax credit applicable to unincorporated business. This credit is considered a reduction in liabilities for the entire year and consequently is spread over all quarters of 1975.

The import fees, excise taxes, and windfall profits taxes, which are viewed as permanent, are all treated as indirect business taxes. The permanent offsets to these taxes appear as reductions in personal and corporate income taxes and as increases in Government expenditures.

Proceeds from the energy taxes are returned to those individuals who pay income taxes primarily by reductions in withholding schedules. Withholding schedules will be adjusted in the second quarter of 1975 in such a way that an entire year's reduction in tax liabilities will be made over a 7-month period. Consequently, withholding will be increased after the fourth quarter of 1975 but not up to the rates of early 1975.

Low-income households, who pay less than $80 per adult in income taxes, will receive transfer payments starting in the third quarter. Government purchases are increased in the budget to cover the Federal share of the higher oil bill, while State and local governments are the beneficiaries of increased grants from the Federal Government.

These figures are an accounting of receipts and expenditures and do not necessarily reflect their impact on the behavior of individuals and businesses. Nonetheless they demonstrate that energy taxes partially offset tax cuts in the spring and that the impact of the program is greatest in the second half of 1975, especially in the third quarter.

THE FISCAL 1976 BUDGET

Because of concern that a too expansionary budget carries the risk of worsening the inflation, the Administration has proposed a slower rate of increase in spending from fiscal 1975 to fiscal 1976 than from fiscal 1974 to fiscal 1975. The new budget calls for outlays of $349.4 billion, a rise of 11.5 percent compared to a rise of 16.8 percent from fiscal 1974 to fiscal 1975. The President has proposed a moratorium on new spending programs except for energy as well as numerous actions to reduce spending in existing programs. The reductions total $17.5 billion and embrace $7.8 billion in proposals made last year and $9.7 billion in new reductions. Taking into account the $16 billion in tax cuts to stimulate the economy, receipts are expected to total $297.5 billion, a rise of 6.7 percent over fiscal 1975.

The deficit is expected to rise from an estimated $34.7 billion to $51.9 billion. These are large deficits but they reflect the shortfall in receipts and increased unemployment benefits stemming from the weak economy.

TABLE 1.—*Federal budget receipts and expenditures associated with stimulus and energy programs, national income accounts basis, 1975–76*

[Billions of dollars; seasonally adjusted quarterly totals]

Receipt or expenditure	1975				1976	
	I	II	III	IV	I	II
By type:						
Total receipts	−0.1	−1.6	−9.7	−3.0	0.4	0.0
Personal taxes	0	−7.7	−15.4	−8.4	−4.8	−4.9
Stimulus	0	−5.1	−7.3	0	−.3	−.3
Energy	0	−2.6	−8.1	−8.4	−4.5	−4.6
Indirect business taxes	2.2	8.3	8.1	7.9	7.7	7.6
Corporate taxes	−2.2	−2.2	−2.4	−2.5	−2.6	−2.7
Stimulus	−.8	−.8	−.8	−.8	−.8	−.8
Energy	−1.4	−1.4	−1.5	−1.7	−1.8	−2.0
Total expenditures	0	.5	1.8	1.8	1.8	1.8
Purchases of goods and services	0	0	.8	.8	.8	.8
Grants-in-aid to State and local governments	0	.5	.5	.5	.5	.5
Transfer payments	0	0	.5	.5	.5	.5
Total expenditures minus total receipts	.1	2.1	11.4	4.8	1.4	1.7
By program:						
Stimulus taxes	−.8	−5.9	−8.1	−.8	−1.1	−1.1
Net energy taxes	.8	4.3	−1.5	−2.2	1.4	1.0
Import fees, excises, and windfall profits taxes	2.2	8.3	8.1	7.9	7.7	7.6
Tax offsets	−1.4	−4.0	−9.6	−10.1	−6.3	−6.6
Energy expenditures	0	.5	1.8	1.8	1.8	1.8
Total expenditures minus total receipts	.1	2.1	11.4	4.8	1.4	1.7

Note.—Detail may not add to totals because of rounding.

Sources: Department of the Treasury, Department of Commerce (Bureau of Economic Analysis), and Council of Economic Advisers.

For the calendar year the full-employment surplus on a national income accounts basis is expected to decline by $9 billion from 1974 to 1975.

FINANCING THE DEFICIT

The financing of the large deficits will pose problems which are not easy to evaluate. The economic circumstances of 1975 are quite different from those encountered in past recessions, like the recession of 1958. If prices are stable, any large decline in output lowers the demand for private credit, and this slack is taken up only in part by the normal increase in the budget deficit resulting from lower tax collections and higher unemployment benefits. Even a discretionary stimulus that would partly counteract rather than merely cushion a large decline of aggregate demand would probably not create serious financing problems under such conditions. The reason is that if unemployment is widespread and factors of production are in highly elastic supply, cost pressures are minimal and private investment and credit demands are likely to be low.

The present situation is far different from past recessions, but the deficit as presently estimated can probably be financed without serious problems in 1975. The private demand for credit will decline at least somewhat, and probably substantially, as the direct result of the low level of housing, reduced consumer purchases of durable goods, and the sharp swing from inventory accumulation to inventory liquidation. The drop in real output, however, has brought less relief in the credit markets than it would have under less inflationary conditions. Furthermore, imbalances have developed in the financial structure of businesses in recent years because of the disproportionate reliance on debt financing in general and short-term debt in particular. As the desired private refinancing is made more difficult by the deficit financing, businesses may abandon investment projects more readily than in the past, rather than risk further unbalancing their capital structure and increasing their credit market exposure.

One way of preventing significant displacement of private investment in a substantially underemployed economy would be to increase the rate of money supply growth to reduce Federal financing pressures. Under such conditions, an increase in monetary growth need not be inflationary in the short run, especially if there is a large unsatisfied demand for liquidity. On the other hand, should large deficits continue well after the recovery has taken hold, maintaining such a course of monetary accommodation could spark an increase in the rate of inflation. For this reason it is essential that any monetary accommodation to large fiscal deficits be permitted only so long as the effective underemployment of resources remains large and there is ample room for above-average growth. Otherwise, future price level trends will be affected adversely and the deficit will become increasingly "unproductive" in real terms.

Monetary policy faces great difficulties in the year ahead and will require careful and continuous evaluation by the Federal Reserve. The uncertainties that underlie the outlook for 1975 add to the importance of a flexible monetary policy. Monetary policy must be conducted so as to encourage a near-term recovery in the economy and a resumption of sustainable economic growth. Toward this end, reasonable growth in money and credit will be required—growth which, one hopes, will encourage a freer flow of credit and lower interest rates in private credit markets. Whether more accommodating credit conditions will in fact develop depends importantly on the ease with which the enlarged Federal deficit is financed, and also on the progress that is achieved in moderating the Nation's rate of inflation as 1975 progresses.

A special problem for monetary policy is posed by the energy conservation program, the initial effects of which will be to raise the price level. To a degree, this one-time increase in prices will require additional financing, so as to avoid a contractive effect on the real economy. However, rapid monetary growth would run the risk that inflationary pressures would once again be increased, later on if not in 1975, undermining the Nation's fundamental need to regain the basis for reasonable price stability. That must not be permitted to happen.

AID TO THE UNEMPLOYED

In response to the sharp rise in unemployment in the latter part of 1974, and in anticipation of further increases in 1975, the Administration initiated legislation to increase the duration and coverage of unemployment insurance benefits and to create employment by funding additional public service jobs. In December 1974, the President signed the Emergency Unemployment Compensation Act, which extends the duration of benefits by 13 weeks beyond the prevailing limits. Unemployed workers can now receive up to 52 weeks of benefits. The Emergency Jobs and Unemployment Assistance Act, also signed in December, grants unemployment benefits, for up to 26 weeks, for the first time to workers in occupations and industries that were not covered by the regular State or Federal programs. This act provides coverage for an estimated 12 million workers, primarily agricultural, domestic, and State and local government employees. While these programs are administered by the States, the funds are entirely from Federal sources.

The Emergency Jobs and Unemployment Assistance Act also amends the Comprehensive Employment and Manpower Training Act (1973) to expand Federal funding for State and local public service jobs. The budget provides funds that will permit an increase in the number of public service jobs from 85,000 in fiscal 1974 to 280,000 in 1975 and 1976.

THE OUTLOOK WITH NEW POLICIES

Given the above assumptions regarding energy, fiscal, and monetary policies, the economy is likely to continue its downward course in the first half of 1975 and to move onto the road of recovery in the second half. The first-half decline is likely to be severe, however, and the subsequent recovery will still leave the level of output in the fourth quarter about the same as a year earlier. For 1975 as a whole real GNP will probably be about 3 percent below the average of 1974. The rate of inflation will be very high in the first half of the year—higher than it would be in the absence of the energy policy—but it should subside in the second half. For all of 1975, prices as measured by the GNP deflator should be 11 percent higher than prices in 1974. By the final quarter an inflation rate of about 7 percent is projected, not counting the pay increase scheduled for Federal civilian and military personnel. The projections of real GNP and the deflator yield a nominal GNP of about $1,500 billion, which is some 7¼ percent greater than the 1974 figure. Given the large decline in real output, the unemployment rate should average about 8 percent for the year, moving above that level before midyear but coming down from the peak in the second half.

The uncertainties are so great at the present time that the projections cited above, although presented as specific numbers, are subject to an unusually wide margin of error. The past several months have witnessed a progressive scaling down of output projections and a scaling up of unemployment projections.

NONRESIDENTIAL FIXED INVESTMENT

Early in January the Department of Commerce published a survey of plant and equipment plans that projected a rise of 4½ percent in nominal outlays from 1974 to 1975. In view of the prospective rise in capital goods prices the survey results imply a sizable decline in real outlays. Large nominal increases ranging from 14 to 28 percent were scheduled by producers of basic materials, such as steel, paper, chemicals and petroleum, and by mining firms, railroads, and gas utilities. Very small rises or decreases were projected by electric utilities, air transport, and commercial firms. The deterioration of sales, output, and profits since this survey was taken will probably lead to a scaling down of even this small overall planned increase, although the large expansion plans of a number of basic industries will provide an element of stability. The plans reported in this survey came in too early to be affected by the proposed investment tax credit.

There seems little likelihood of preventing a decline in real nonresidential investment in the first half of 1975. The pronounced slump in real outlays for producers' durable equipment in the final quarter of 1974 was heavily concentrated in outlays for automobiles and trucks. But the closing months of the year also witnessed decreases in the production of a broad range of machinery and equipment as businessmen canceled orders or delayed deliveries on contracts made earlier. These cutbacks will take the form of reduced deliveries in the first half. The liberalization of the investment tax credit, coupled with the turnaround in economic activity and a rebound in profits, should bring rising real outlays in the second half. The main impact of a liberalized investment tax credit will be felt late in the year. For