

CHAPTER 2

Economic Outlook and Policy

THE ECONOMY is entering its fourth consecutive year of sustained growth, and the prospects for continuation of the recovery in the near term are quite favorable. Final sales were up strongly at the end of 1977, and the effects of last year's stimulus package continue to build, setting the stage for a resumption of healthy production gains in the early part of 1978.

Over the longer term, however, without additional fiscal measures, economic growth would slow below the rate necessary to maintain satisfactory progress toward our goal of returning to high employment. The non-Federal sectors of the economy do not appear to possess sufficient strength on their own to support a sustained high rate of real output growth throughout 1979. In addition, Federal fiscal policy would itself gradually become more restrictive as the spending increases contained in the 1977-78 stimulus package gradually diminish, and as Federal receipts show rapid gains because of income growth and payroll tax increases. While it is difficult to determine precisely when economic growth would slow, the underlying trends in the economy—together with the effects of fiscal policy—point clearly to a reduction in the pace of expansion later this year or early in 1979. Therefore, to ensure that the economy continues to grow at a satisfactory rate in 1979 and beyond, the Administration is proposing a \$25-billion tax cut for individuals and businesses to take effect in the fourth quarter of 1978.

ECONOMIC POLICY IN THE NEAR TERM

THE NEED FOR TAX REDUCTION

Personal consumption and housing have been the key sectors leading the economic recovery since 1975. In 1976 and early 1977 the personal saving rate fell well below its average over the past 20 years, and housing starts rose to more than 2 million units at an annual rate by the middle of last year. However, the saving rate has now returned to just under 6 percent and is expected to remain in this vicinity during 1978 and 1979. The boom in residential construction may also be reaching a peak, as interest rates are likely to be somewhat higher in 1978 than in 1977. Hence, these sectors cannot be counted on to sustain above-trend growth in total demand.

Both the foreign and the State and local sectors are currently withdrawing much more from the spending stream than they are returning to it. Our international current account balance is likely to remain in substantial deficit in the near term. Oil imports will continue at high levels over the next several years, and the economies of our major trading partners are expected to show only moderate improvement. In the State and local sector, budgetary surpluses have been rising as receipts have grown more rapidly than expenditures, particularly during the last 2 years. These surpluses are expected to decline gradually, but they will remain high—partly because a significant proportion is the result of secular growth in State and local employee pension funds.

The Federal sector would also have a restraining influence on the economy if there were no further adjustments in fiscal policy. Federal outlays are rising strongly in fiscal 1978, but the increase in fiscal 1979 will be small—less than 2 percent in real terms. Moreover, the combination of higher payroll taxes and rising effective personal tax rates due to inflation and real growth will increase Federal receipts substantially in 1978 and 1979. Hence significant tax reductions are needed just to neutralize the fiscal restraint built into the Federal budget.

Finally, a major uncertainty in the near-term outlook concerns the behavior of business fixed investment. Strong and steady growth of capital spending is essential to continuation of satisfactory growth in aggregate demand and new productive capacity. But the performance of investment has been disappointing thus far in the recovery and plans for increased spending remain modest. In the absence of tax reductions, the usual strengthening of investment plans that takes place during an economic upswing might not occur.

THE ADMINISTRATION'S TAX PROPOSALS

There are three main components of the Administration's proposed tax reduction.

1. A \$17-billion net reduction in individual income taxes, effective October 1, 1978. Tax reduction is achieved by substituting a \$240 per capita credit for the existing \$750 personal exemption and the general tax credit, and by reducing personal tax rates.
2. A \$6-billion net tax reduction for businesses in the form of permanent rate cuts on corporate profits and a liberalization of the investment tax credit. The corporate tax rate would be lowered from 20 percent to 18 percent on the first \$25,000 of profits, from 22 percent to 20 percent on the next \$25,000, and from 48 percent to 45 percent on profits above \$50,000. These changes would take effect on October 1, 1978. There would be a further 1-percentage point reduction in the tax rate on corporate profits above \$50,000 on January 1, 1980, thereby lowering this rate to 44 percent. In addition, the 10-percent investment tax credit on investment in equipment would be made perma-

ment and extended to industrial and utility structures; the full 10-percent credit would be available for investment in specified pollution abatement facilities that also qualify for accelerated depreciation; and the investment credit could be used to offset 90 percent of tax liability in any one year. Except for the last proposal, these changes in the investment credit would become effective January 1, 1978.

3. A \$2-billion cut in payroll and excise taxes. The 4-percent telephone excise tax, already being phased out, would be repealed on October 1, 1978. In addition, the Federal unemployment insurance tax rate would be lowered from 0.7 percent to 0.5 percent on January 1, 1979.

The \$25 billion in tax reductions proposed by the Administration is net of \$9 billion in revenue-increasing reforms of the tax structure. The reform elements of the program are discussed in detail in Chapter 5 of this *Report*.

The proposed tax reductions, together with the projected increases in Federal expenditures and the effects of the 1977 tax cut, will result in a \$5-billion net increase in the high-employment Federal budget deficit between calendar years 1977 and 1979. The personal tax reduction will augment after-tax incomes of individuals and increase the demand for consumer goods. The strengthening of these markets will in turn improve the prospects for business investment spending. Moreover, the cut in corporate tax rates will increase cash flow of business enterprises, and the changes in the investment credit will directly lower the cost of new capital investment. The reduction in excise and payroll taxes will lead to a modest lowering of price levels, as well as providing fiscal stimulus.

MONETARY POLICY

Under current economic conditions, monetary and fiscal policy can reinforce each other in fostering stable economic growth and the increased rate of investment needed to avoid the emergence of capacity limitations in the future. Interest rates moved up early in 1978; a level of short-term interest rates moderately higher than in 1977 would be consistent with a normal cyclical expansion of demands for money and credit relative to supplies. If the rise in short-term interest rates is limited, long-term interest rates may change very little. The prospects for relatively stable long-term rates are greatly enhanced by the fact that supplies of both labor and capital are sufficiently ample to permit rising aggregate demand to be translated into real growth in output rather than a higher rate of inflation. The growth in monetary aggregates that will be consistent with this favorable interest rate environment will depend significantly on factors affecting velocity, which were discussed in Chapter 1.

THE OUTLOOK FOR 1978

Growth of real output during 1978 is expected to be in the 4½- to 5-percent range if the proposed tax cut is approved by the Congress (Table 9). Expansion in the first half of the year will be sustained by higher spend-

ing for public service employment and public works programs and by larger than normal tax refunds. By midyear the effects of the jobs programs will have reached their peak, but consumer spending and business investment are expected to accelerate in the second half in response to the tax reduction.*

TABLE 9.—*Key economic measures, 1977-78*

[Seasonally adjusted, except as noted]

Measure	Unit	1977 IV ¹	Forecast range 1978 IV	Percent change
Real GNP.....	Billions of 1972 dollars ²	1,361	1,422 to 1,429	4½ to 5
Real personal consumption.....	do.....	876	914 to 918	4¼ to 4¾
Real business fixed investment.....	do.....	130	139 to 141	7 to 8
Real residential construction.....	do.....	60	59 to 61	-1 to 1½
Real government purchases.....	do.....	277	287 to 289	3¾ to 4¼
Unemployment rate.....	Percent.....	6.6	6 to 6¾	(³)
Consumer price index ⁴	1967=100.....	185	196 to 197	5¾ to 6¼

¹ Preliminary.

² Annual rates.

³ Not applicable.

⁴ Not seasonally adjusted.

Sources: Department of Commerce (Bureau of Economic Analysis), Department of Labor (Bureau of Labor Statistics), and Council of Economic Advisers.

The rate of inflation is expected to be close to 6 percent in 1978. Food and fuel prices, which rose sharply in the first half of last year because of the severe winter weather, will contribute much less to the increase in prices this year. Continued slack in labor markets and the absence of a large number of significant collective bargaining settlements will help moderate the rate of increase in workers' average hourly earnings. On the other hand, federally mandated increases in labor costs will add about one-half percentage point to the price level during the year. Widespread cooperation with the President's program of deceleration would make it possible to reduce inflation to the lower end of the range shown in Table 9.

The projected growth of output this year should expand the number of jobs by about 2¾ million. The extent to which this increase in employment is translated into a reduction in the unemployment rate will, of course, depend on how rapidly the labor force grows. It is expected that labor force growth will remain relatively high, at a rate between 2¼ and 2½ percent in 1978. The unemployment rate should decline by about one-half percentage point over the year.

BUSINESS FIXED INVESTMENT

Business fixed investment is expected to become a stronger force in the expansion of output during the course of 1978 as a consequence of the

* Unless otherwise noted, growth rates in this chapter are measured from fourth quarter to fourth quarter.

stimulative effects of the proposed liberalization of the investment tax credit, and the reductions in personal and corporate income taxes. An increase of 7 to 8 percent in real terms is anticipated over the course of the year. The most recent Department of Commerce survey of plans for new plant and equipment expenditures indicates that investment spending in nominal terms will rise only 10 percent in 1978, year over year. However, if allowances are made for increases in capital goods prices of about 5½ percent and for underestimates in the last two surveys, this survey would imply a real increase in spending for plant and equipment of 6 to 7 percent. The recent behavior of some important leading indicators of investment activity suggests a stronger investment performance than the plant and equipment survey does. Data on the value of new orders for nondefense capital goods, new plant and equipment projects started by manufacturers, and their new capital appropriations all show increases of 20 percent or more (annual rate) over the last half year.

As the dimensions of the energy program become more certain and the new tax proposals increasingly influence business expectations, it is anticipated that plans for plant and equipment outlays will be raised above their current levels.

GOVERNMENT DEMAND

Government purchases will be an important source of support to the expansion this year. In real terms, they are expected to rise about 4 percent. Though defense purchases in real terms were up last year and may rise further, the principal sources of strength this year will be in the Federal non-defense and State and local government areas. Nondefense Federal purchases (excluding Strategic Petroleum Reserve and Commodity Credit Corporation expenditures) are projected to rise 16 percent in current dollars. The real increase in these expenditures should also be large, though it may fall short of the level implied by the nominal projection.

State and local purchases will continue to rise rapidly in the first half of 1978, as Federal grants for local public works and employment programs in the 1977-78 stimulus package increase to their peak levels. Some slowing in the rate of expenditure growth may occur in the second half of 1978; but State and local operating surpluses are large, and these governmental units are therefore likely either to increase purchases or reduce taxes.

PERSONAL CONSUMPTION

Real disposable income will rise more than 5 percent during 1978, after allowing for the impact in the last quarter of the proposed reductions in personal taxes. However, since personal consumption does not fully reflect the impact of tax reductions for several quarters, the saving rate is likely to increase considerably in the fourth quarter. Consumption during the year should therefore grow somewhat more slowly than disposable income—increasing about 4½ percent in real terms; but a strong upswing at year-end

will continue into the first half of 1979. Real growth of demand for durable goods in 1978 will slow somewhat from the 7¾-percent rate of last year, and then strengthen again after the tax cuts.

Smaller projected food price increases in this year, together with generous worldwide supplies of natural and manmade fibers, suggest that price increases for nondurable goods will be modest in 1978. These developments will help stimulate an increase in demand for nondurable goods above the 3½ percent of last year. The demand for heating services is expected to return to more normal levels this winter, a change that could also contribute to the growth of sales of both durable and nondurable goods.

HOUSING

Residential investment is expected to be relatively flat during the year at a level about 5 percent higher in real terms than the average of 1977. New housing units are currently being started at an annual rate of 2¼ million, including a record 1.6 million single-family units. Housing starts should remain at relatively high levels early in the year, but some reduction in single-family starts is expected by year-end. However, favorable demographic factors and relatively moderate changes in the availability of mortgage credit should limit the extent of any decline. Multifamily starts are expected to continue growing throughout the year, as the problems that have recently plagued this sector—low profitability caused in part by rent controls in some areas of the Northeast, and the legacy of overbuilding in other areas, particularly the South—are gradually overcome.

Two other components of residential investment are likely to rise significantly this year: additions and alterations to existing structures, and sales of mobile homes. Additions and alterations represent 14 percent of total residential investment and are responsive to sales of new and existing homes, which have risen about 50 percent since 1975. Mobile home shipments, which peaked at 575,900 in 1972 and declined to 212,700 in 1975, have recently been growing more strongly, reaching a rate of over 300,000 per year at the end of 1977. Further increases above this level are expected in 1978.

INVENTORIES

Production has responded promptly to changes in final sales in this expansion. Hence, except for moderate, unintended increases in nondurable goods inventories in each of the past two summers, the ratio of stocks to final sales in 1976 and 1977 was maintained at a fairly constant level, just under the historical average. Improved inventory monitoring techniques and short delivery lags due to excess capacity will be conducive to stable rates of inventory investment this year. However, accelerated final sales and a downturn in the rate of stockbuilding in the last quarter of 1977 will lead to an upswing of inventory investment in the first half of the year. This will be temporary, and the resulting stimulus is unlikely to be as large as that attributable to the restocking that occurred early in 1977.

The rate of accumulation for all of 1978 is anticipated to average about 1 percent of real gross national product, or just sufficient to expand stocks in line with the growth of sales.

NET EXPORTS

The foreign sector is not expected to contribute significantly to the growth of output in 1978, but neither should it detract from the expansion as it has done in the past 2 years. Since approximately one-third of U.S. exports are capital goods, the generally weak performance of investment in other industrial economies has restrained the demand for U.S. exports. Though real growth in the economies of our major trading partners was disappointing in 1977, it should pick up somewhat this year and improve the prospects for U.S. exports. Growth outside the OECD area is also expected to show some acceleration this year, which should have a beneficial effect on our exports. In addition, there should be a resumption of growth in demand from countries such as Brazil and Mexico, where restrictive actions were taken in the last 2 years to reduce large trade deficits caused by the recession and oil price increases. Given these modest improvements in the world economy, U.S. merchandise exports, after adjustment for inflation, are expected to rise 4 to 5 percent in 1978.

Growth of imports should slow in 1978. Imports other than fuel rose more in 1977 than would have been forecast on the basis of historical relationships between imports and GNP, but this phenomenon is not expected to continue in 1978. The volume of U.S. oil imports should be unchanged this year, compared with a rise of 20 percent last year. Cold weather in the early months of 1977 and a buildup of petroleum inventories last summer contributed to the sharp rise of fuel imports in 1977, but these developments are unlikely to recur this year. Production of North Slope oil averaging about 1 million barrels a day, four times the output available last year, will also restrain the growth of petroleum imports in 1978. The decision of the oil-exporting countries to freeze prices will mean that the value of oil imports will show little change this year. The high level of oil imports will nevertheless continue to be an important factor in the United States' persistent foreign trade deficit.

LABOR FORCE AND EMPLOYMENT

The 4½- to 5-percent expansion of output should increase employment during the year by nearly 3 percent. Given the projected increase in the labor force of 2¼ to 2½ percent, the unemployment rate should fall to a range of 6 to 6¼ percent by year-end. The projections for labor force participation rates of women and teenagers assume continued increases that are above previous historical trends, but somewhat below the unusually large increases of the past 2 years.

It should be noted that projections of labor force growth have not been very reliable in recent years. For example, the 3.1-percent increase in the

labor force in 1977 was substantially larger than most estimates of a year ago. Consequently, unemployment rate forecasts can prove inaccurate even when projections for the growth of output and employment are correct.

INFLATION

Before allowing for the Administration's program for the deceleration of inflation, prices would be expected to rise this year at a rate of 6 percent or somewhat above—the underlying rate for the past 2½ years. The underlying rate is measured by consumer prices excluding food and energy, and it parallels the difference between the rates of increase of productivity and compensation per hour worked. Average hourly earnings and productivity would rise this year by about 7¼ and 2 percent respectively. However, total unit labor costs would rise by more than the 5¼ percent that these figures suggest, partly because privately negotiated fringe benefits are increasing more rapidly than basic wages, and partly because of government-mandated additions to payroll costs. The 15-percent step-up of the minimum wage to \$2.65 an hour, and the \$6 billion in higher payroll taxes for employers in 1978, will add about 1 percent to labor costs of the private sector. Total compensation per hour including fringes and employer payroll taxes would therefore rise about 8½ percent in 1978, and unit labor costs by 6 to 6½ percent.

A number of special factors will also influence the actual rise of prices in 1978. Implementation of the first stage of the crude oil equalization tax will add 0.2 percent to the aggregate price level at year-end. The recent decline in the value of the dollar in foreign exchange markets will also add to pressures on prices. On the other hand, highly competitive markets for many goods, caused by the weakness of economic recovery abroad and by generally low capacity utilization rates at home, will work against any acceleration of inflation. The food price outlook should also lead to moderation in the rate of inflation this year. Retail food prices rose by 7¾ percent last year, but are expected to increase in 1978 by less than the rise in prices of nonfood commodities and services. This deceleration will help to moderate the increase in the general price level, offsetting the effects of the mandated cost and price increases.

Ample grain stocks and depressed crop prices are currently stimulating pork and poultry production and hence will restrain retail price increases for these items. Large harvests of fruits and vegetables in the second half of last year should assure abundant supplies of these commodities through mid-1978. On the other hand, because cattle herds have been cut drastically and the cost of feed grains is extremely low, increased cattle feeding is likely. This should be reflected in reduced marketing of cattle and more rapid increases in retail prices for red meat in the second half of 1978.

The action of the oil-producing countries in not increasing the price of crude oil will provide modest additional restraint on inflation this year. Repeal of the Federal excise tax on telephone service in the last quarter

of 1978 and the 0.2-percentage point reduction in the Federal unemployment insurance tax in January 1979 will also ease the pressure on prices next year.

The President's request to business and labor to cooperate in a voluntary program to decelerate wage and price increases, discussed in Chapter 4, is expected to help moderate the rate of inflation in 1978. With success of the program, the rate of price increase in 1978 could fall below the level of 6 percent or more that would otherwise occur.

INCOME AND SAVING FLOWS

The combination of 4½- to 5-percent real growth and about 6 percent inflation will cause nominal GNP to grow approximately 11 percent in 1978. Both personal income and corporate profits are expected to rise at about the same rate as GNP.

In the year ahead, the household sector will contribute an increased volume of saving to credit markets, while the growth of household credit demands should moderate. Personal saving will expand by approximately one-third as a result of the projected increase in after-tax income and an increase in the saving rate. Though part of this increased saving will be absorbed by home mortgage and consumer credit, growth in these uses of funds will be less than in 1977. Business credit needs will expand in 1978, but an adequate growth of profits should sustain the flow of internal funds. In the past 2 years gross internal funds have amounted to more than 75 percent of capital expenditures of nonfinancial corporate businesses.

Apart from the usual seasonal fluctuations, the Federal Government's net new issues of securities are likely to change very little between the latter half of 1977 and the first half of this year. Toward the end of 1978, however, new funds raised by the Federal Government will increase, since the decline in receipts resulting from the proposed tax reduction will be only partially offset by the growth of revenues that normally occurs in an expanding economy.

A greater volume of funds will flow through credit markets this year, primarily because the higher net household saving must be channeled to the debtor sectors to meet growing financial needs. As noted earlier, these increased credit flows are likely to be accompanied by a somewhat higher level of interest rates than in 1977, particularly on short-term securities. Given current economic prospects, however, there need not be large or unsettling changes in interest rates during 1978.

THE OUTLOOK FOR 1979

Forecasting more than a year ahead is a hazardous exercise, since uncertainties about probable economic developments grow with the passage of time. Nevertheless some general comments can be made about the

likely state of the economy in 1979 and its response to the Administration's tax proposal.

The \$25-billion tax cut effective in October 1978 will provide the necessary impetus to extend the recovery into its fifth successive year. Business investment should be particularly strong in 1979, since capacity utilization rates will have risen further, and the effects of the tax cuts will have been incorporated into plans for plant and equipment expenditures. Consumer spending will be supported by the \$17-billion reduction in personal taxes. And there is likely to be a further reduction of State and local surpluses.

If the recovery proceeds along these lines, and there are no severe unexpected shocks, real output in 1979 should increase at about the same rate as in 1978—that is, by $4\frac{1}{2}$ to 5 percent. Moreover the unemployment rate should continue to decline to a range of $5\frac{1}{2}$ to 6 percent by year-end as a result of another $2\frac{3}{4}$ -million increase in the number of jobs.

Price forecasting beyond a year is even more difficult than projecting output. Before taking into account any effects of the Administration's deceleration program, the underlying rate of inflation would be close to 6 percent or slightly above in 1979. Government-mandated cost and price increases will be smaller than in 1978. The proposed repeal of the telephone excise tax and the reduction in the Federal unemployment insurance tax would also help restrain price increases.

On the negative side, there are other factors that could lead to stronger pressures on wages and prices in 1979. First, labor markets may tighten somewhat as a result of continued economic expansion, and this could increase the upward momentum of wages. Moreover, 1979 will also be a heavier year of collective bargaining: agreements covering $3\frac{1}{2}$ million workers will expire or will be open to negotiation in 1979, compared with agreements covering $1\frac{3}{4}$ million workers in 1978. Second, healthy domestic demand could push the manufacturing capacity utilization rate to higher levels by late 1979 and encourage firms to increase their profit margins by raising prices. The stronger growth of investment projected for late 1978 and 1979 should moderate the rise in utilization rates, however, and the availability of ample capacity abroad for production of most major materials should also act as a restraint on price increases above general cost trends.

Most important to the long-run improvement of inflation will be the cooperation of business and labor in the program of gradual deceleration of prices and wages. There must be a well-coordinated, good-faith effort on the part of both sides if progress is to be made in unwinding the inflationary pressures inherited from the past. Next year will pose a critical test for the new program because of the heavy calendar of collective bargaining and the fact that utilization rates for both labor and capital will have risen substantially.

POLICY REQUIREMENTS FOR THE LONGER TERM

Upon taking office in early 1977, this Administration set out specific objectives for economic growth and the reduction of unemployment. Putting these goals explicitly on the record serves the important purposes of informing the Congress and the public of the Administration's policy objectives and identifying the means by which they will be pursued. Setting explicit goals also disciplines the formulation and execution of policies, and creates a system of early warning signals for midcourse policy adjustments.

The Administration's longer-term goals for the domestic economy can be simply stated: steady progress toward the achievement of a high-employment economy, with the benefits shared widely by all major groups in society; principal reliance on growth in the private sector to promote economic expansion; and a gradual reduction in the rate of inflation. The President's budget for fiscal 1979 sets out annual projections for real gross national product, the unemployment rate, and the rate of inflation through 1983. For 1978 and 1979 these numbers represent the Administration's "best-guess" forecast and are consistent with the tax and spending policies proposed in the budget. Beyond 1979 they are not a forecast, but projections of the path of real output necessary to achieve steady reductions in the unemployment rate of about one-half percentage point per year.

Projections in the budget show real GNP reaching its potential by late 1981 and the unemployment rate dropping below 5 percent. If the economy is to achieve high employment by 1981, a sustained expansion of real output of nearly 5 percent a year will be required.

ACHIEVING THE U.S. ECONOMY'S POTENTIAL

Potential output is an estimate of what the economy could produce at high rates of utilization of the factors of production—labor, capital, and natural resources. The historical series for potential GNP was completely revised in the 1977 *Economic Report* by the previous Council of Economic Advisers, and the level in 1976 was lowered by 4 percent. There were two principal reasons for this downward revision. First, the rate of secular productivity growth implicit in the earlier estimates was substantially reduced. This change reflects the deceleration of productivity since the late 1960s. Second, the high-employment unemployment rate was adjusted for changes in the age-sex composition of the labor force. This benchmark unemployment rate is calculated to be 4.9 percent in 1977, compared with 4.0 percent in 1955 (Table 10). The present Council has reviewed the new estimates and concluded that they are a major improvement. Through additional research, the quality of our potential GNP estimates should continue to improve in the future.

For the next 4 years, real potential GNP is projected to grow at a rate between 3.3 percent and 3.8 percent per year, and to rise to between \$1,610 billion and \$1,640 billion in 1981 (Chart 3). The benchmark unemploy-

TABLE 10.—*Potential gross national product and benchmark unemployment rate, 1952–77*

[Billions of 1972 dollars, except as noted]

Year	Potential GNP	Actual GNP	GNP gap (potential less actual)	Benchmark unemployment rate (percent)
1952.....	584.9	598.5	—13.6	4.0
1953.....	608.2	621.8	—13.6	4.0
1954.....	629.7	613.7	16.0	4.0
1955.....	651.4	654.8	—3.4	4.0
1956.....	673.9	668.8	5.1	4.0
1957.....	697.2	680.9	16.3	4.0
1958.....	721.3	679.5	41.8	4.0
1959.....	746.2	720.4	25.8	4.1
1960.....	771.9	736.8	35.1	4.1
1961.....	798.6	755.3	43.3	4.1
1962.....	826.4	799.1	27.3	4.1
1963.....	857.1	830.7	26.4	4.2
1964.....	890.3	874.4	15.9	4.3
1965.....	925.0	925.9	—0.9	4.4
1966.....	960.8	981.0	—20.2	4.5
1967.....	996.3	1,007.7	—11.4	4.4
1968.....	1,031.7	1,051.8	—20.1	4.4
1969.....	1,068.3	1,078.8	—10.5	4.4
1970.....	1,106.2	1,075.3	30.9	4.5
1971.....	1,145.5	1,107.5	38.0	4.6
1972.....	1,186.1	1,171.1	15.0	4.7
1973.....	1,228.2	1,235.0	—6.8	4.8
1974.....	1,271.7	1,217.8	53.9	4.8
1975.....	1,316.9	1,202.1	114.8	4.8
1976.....	1,363.6	1,274.7	88.9	4.9
1977.....	1,412.0	2 1,337.6	2 74.4	4.9

¹ Shift in benchmark unemployment rate from 1966 to 1967 because of 1967 change in sampling procedure in the Current Population Survey.

² Preliminary.

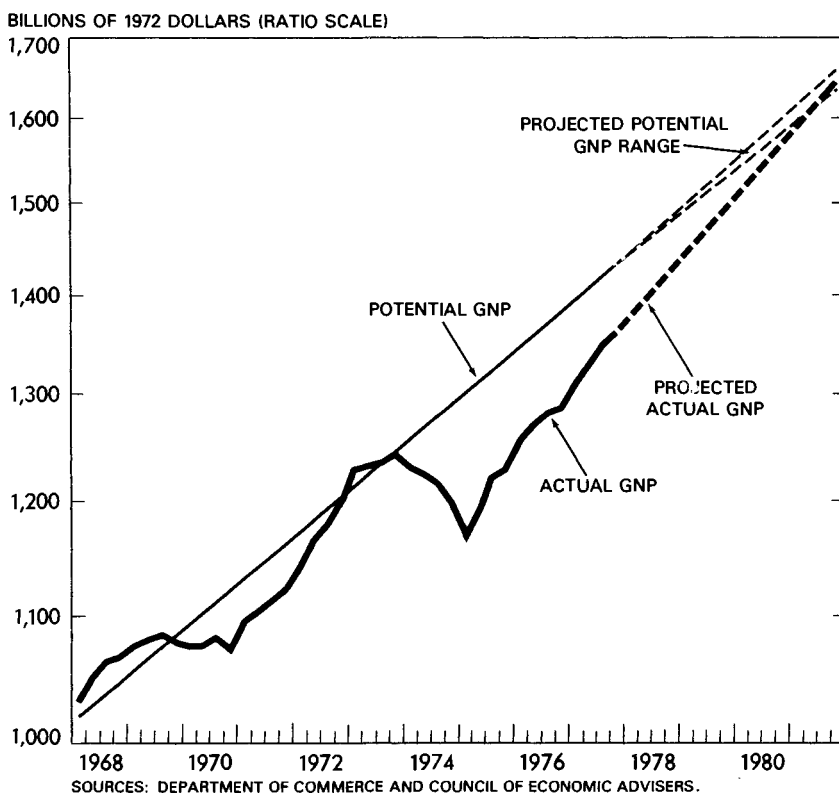
Sources: Department of Commerce (Bureau of Economic Analysis) and Council of Economic Advisers.

ment rate associated with this range of potential GNP estimates would fall slightly from its current level to about 4.8 percent.

In addition to the usual uncertainties about the future, forecasts of potential GNP under current conditions are subject to a wide margin of error. The principal source of uncertainty in projecting potential output lies in estimates of productivity. The abrupt decline in the level of productivity in 1973–74, which is much larger than can be explained by cyclical factors, has not been reversed. Improvements in productivity since the recovery began early in 1975 have followed normal cyclical patterns: gains have exceeded long-term trend rates of growth, but have not been large enough to close the gap opened up by the 1973–74 recession. Future productivity growth will be strongly influenced by additions to the capital stock. Unless investment shows a marked acceleration in the next few years, the trend rate of productivity growth is unlikely to regain the pace of the 1950s and 1960s. If the recent modest increases in output per hour persist over the next 4 years, potential GNP growth will probably be nearer the low end of the projected range. On the other hand, if labor force participation should continue to rise at unusually rapid rates, as it did in 1977, or if productivity growth should resume its earlier pace, the rate of potential GNP growth would be closer to the upper end of the range.

Chart 3

Actual and Potential Gross National Product



LONG-RUN BUDGETARY STRATEGY

The Administration has frequently indicated its determination to maintain control over the growth of Federal expenditures, and to rely principally upon growth in the private sector as the major source of economic expansion in the years ahead. The share of Federal outlays in GNP during the past 3 years has been between 22 and 23 percent—well above the 18- to 21-percent share that characterized the previous two decades. In part, the higher share in recent years reflects the fact that GNP is still well below its potential level. But the increase is also a result of rapid growth in Federal transfer payments and grants to State and local governments during the last 10 years.

Decisions about the level and composition of Federal expenditures are particularly difficult. Many essential national goals—such as national defense, equal opportunities, a fair distribution of income, support for basic research, and preservation of natural resources—can only be reached

through Federal programs. Government expenditures, however, are not subject to the discipline of the market place. Private markets are imperfect, but they do tend to encourage efficiency in the use of resources by rewarding firms that are most efficient and eventually weeding out those that cannot perform effectively. These market functions must be accomplished in government by budgetary planning that stresses careful choice of priorities and efficiency in the use of our Nation's scarce resources. Placing limits on the overall growth of Federal expenditures is an effective tool for maintaining such control.

This Administration, after careful review of national priorities, has concluded that the Federal Government can respond effectively and compassionately to the needs of the country within a carefully managed and closely controlled budget. The path of expenditures projected in the fiscal 1979 budget reflects this judgment. Budget outlays are projected to increase by less than 2 percent in real terms between fiscal 1978 and 1979. This restraint on expenditures is also carried into the future; over time, outlays will be steadily reduced to about 21 percent of GNP.

Managing the Federal budget to meet national needs, while gradually reducing the share of Federal outlays in GNP, has important implications for economic policy. If the course of Federal spending is determined by these principles, tax reductions then become an important device for maintaining a stable rate of growth in the private sector. Tax reductions work quickly to stimulate spending, and the effects tend to spread quite broadly over the various sectors of the economy. Moreover, they can be designed to emphasize either stimulus to consumer spending or growth of business investment, depending on the particular circumstances that prevail. Tax reductions are thus a powerful and flexible instrument of economic stabilization policy.

Over the course of the next several years, the amount of reduction in income taxes needed to keep the economy moving ahead steadily will depend on a variety of factors, including the course of monetary policy, the degree of drag from the foreign and State and local sectors, and the willingness of consumers and business to spend. It will also depend on other aspects of the Federal budget. Higher payroll taxes for social security and unemployment insurance are scheduled to take effect in 1978 and 1979, as shown in Table 11. In addition, inflation and economic growth will push individual taxpayers into higher tax brackets, raising the effective tax rate on personal income. The Administration's proposed reduction in personal income taxes would approximately offset the effects of these increases on individual tax payments. In 1977 the share of personal income absorbed by Federal personal taxes and the contributions of employees and the self-employed to the social security system was 14.3 percent. This share will show a small decline by 1979 if the Administration's tax proposals are enacted. Total Federal revenues as a percentage of GNP, on the other hand, will rise slightly over this period. The size of the new tax package, however, was not

TABLE 11.—*Projected effects on Federal receipts of selected tax changes, national income and product accounts, calendar years 1978–81*¹

[Billions of dollars]				
Tax increases or reductions ²	1978	1979	1980	1981
Payroll tax increases.....	7.0	14.9	15.0	29.6
Social security and unemployment insurance ³	6.9	7.5	5.0	8.9
Social Security Amendments of 1977.....	.1	7.4	10.0	20.7
Proposed tax reductions.....	6.9	27.4	27.9	29.2
Individuals ⁴	4.1	19.7	18.9	21.0
Business ⁵	2.4	5.7	7.2	6.7
Unemployment insurance.....	0	.8	.9	1.0
Telephone excise.....	.4	1.2	.9	.5

¹ All projections based on the path of GNP, incomes, and unemployment assumed in the Budget of the United States Government, Fiscal Year 1979.

² Entries are cumulative differences in tax levels above those that would prevail under 1977 tax rates.

³ Social security rate increases of 0.4 percent in 1978 and 0.5 percent in 1981. Increases due to automatic social security base changes are not included. Changes in unemployment insurance (UI) taxes are due to 1978 increase in the Federal taxable wage base, expanded coverage of the UI system, and estimated adjustments in effective State UI tax rates.

⁴ The amount of tax reduction for individuals shown here differs from the amount estimated by the Treasury on a liability basis. The principal reason for this is that the tax reduction provisions of the proposal would take effect on October 1, 1978, while the reform provisions would not take effect until January 1, 1979. Since withholding schedules would be adjusted in October 1978 to reflect the amount of net tax reduction, refunds would be required in 1979 to compensate for over-withholding in 1978. Refunds are treated in the national income and product accounts on a collections rather than a liability basis.

⁵ Includes tax reductions for individuals due to changes in the investment tax credit.

Sources: Department of Health, Education, and Welfare, Department of Labor, Department of the Treasury, Office of Management and Budget, and Council of Economic Advisers.

designed to achieve a particular ratio of tax revenue to income, but to ensure satisfactory progress toward our economic goals. This requires taking into account a number of factors, including developments on the expenditure side of the Federal budget.

As noted in Chapter 1, the simplest measure of the *total* fiscal impact of the Federal sector on the economy is the change in the high-employment budget. As shown by the \$9-billion increase in the high-employment deficit in calendar 1978 (Table 12), the Administration's enacted and proposed tax

TABLE 12.—*Projected high-employment Federal receipts and expenditures, national income and product accounts, calendar years 1977–81*

[Billions of dollars]					
Item	1977	1978	1979	1980	1981
Receipts.....	401.9	447.0	488.5	547.7	619.9
Expenditures.....	419.8	473.9	511.1	557.3	594.8
Surplus or deficit (—).....	—17.9	—26.9	—22.6	—9.6	25.1

Sources: Department of Commerce (Bureau of Economic Analysis), Office of Management and Budget, and Council of Economic Advisers.

reductions, together with the expenditure path projected in the budget, result in a substantial net increase in fiscal stimulus. In 1979 the high-employment deficit declines slightly, indicating a moderately less expansive fiscal stance as the economy improves. Over the 2-year period 1977–79, the Federal budget provides \$5 billion of net fiscal stimulus. Beyond 1979, total

tax revenues would rise more rapidly than expenditures; and in the absence of additional tax reductions or changes in expenditure programs, a high-employment surplus of \$25.1 billion would exist by 1981 (Table 12 and Chart 4). The actual path of the high-employment budget after 1979 will, of course, depend on fiscal policy decisions yet to be made.

THE BUDGET AND THE ECONOMY OVER THE LONGER RUN

Whether the economy can actually achieve high employment in 1981 with a balanced Federal budget depends upon the strength of the non-Federal sectors of the economy. Our ability to forecast economic developments over a period of 4 years is, however, extremely limited. One alternative to developing an explicit economic forecast for 1981 is to examine the distribution of saving and investment by sector in past periods of high employment. For the economy as a whole, the net saving (excess of receipts over expenditures) in one or more sectors must be offset by net investment (excess of expenditures over receipts) in the remaining sectors. What one economic unit saves, another unit must invest. An analysis of how saving and investment might be distributed at high employment provides some insights about the prospects for balancing the budget over the next several years.

Chart 4

High-Employment Federal Surplus as Percent of High-Employment GNP

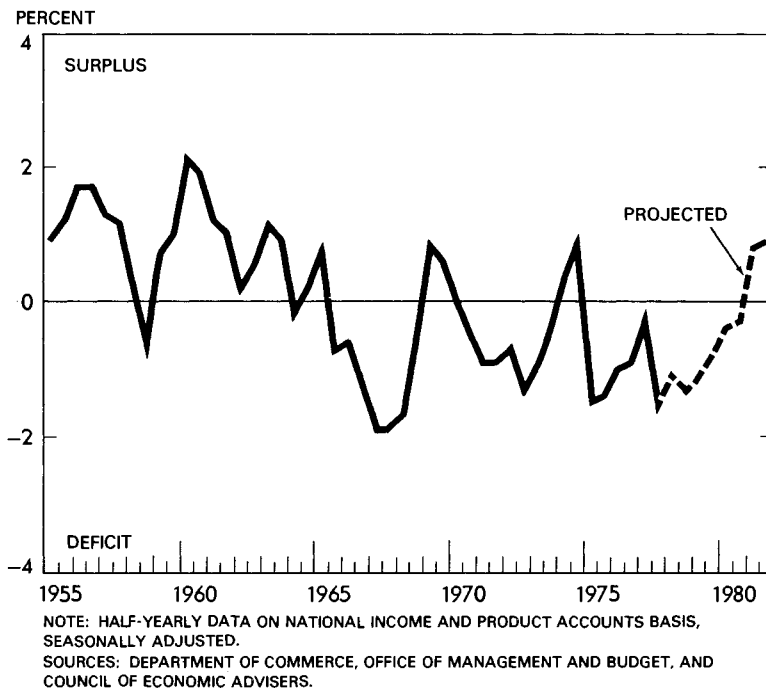


Table 13 shows net saving by major sectors of the economy in three past periods of relatively high employment and in 1977. Some interesting patterns emerge from these data.

First, net private saving in a high-employment economy has typically been rather small. Investment in plant, equipment, and inventories by businesses, together with investment in new residences, is generally about equal to total saving by individuals and business enterprises.

TABLE 13.—*Net saving by sector, national income and product accounts, selected calendar years, 1955–77*

[Billions of dollars]				
Sector	1955–56 average	1965–66 average	1972–73 average	1977 ¹
Non-Federal sectors	–5.2	0.6	12.0	49.6
Private sector	–3.5	3.3	–6.6	1.4
Personal	17.3	31.6	59.8	67.8
Business ²	–20.7	–28.3	–66.4	–66.4
Other sectors	–1.8	–2.7	18.5	48.3
State and local government	–1.1	–.2	13.4	29.2
Foreign ³	–.7	–2.9	5.2	19.1
Federal sector	5.2	–0.6	–12.0	–49.6

¹ Preliminary.

² Corporate and noncorporate business saving, plus the statistical discrepancy, less gross private domestic investment.

³ Net capital grants received by the United States less net foreign investment.

Source: Department of Commerce, (Bureau of Economic Analysis).

Second, in 1955–56 and again in 1965–66, the total net saving attributable to State and local governments and the foreign sector was also near zero. As a result, in these periods a Federal budget that was approximately in balance was consistent with a high-employment economy. Indeed, 1965–66 was a period in which real GNP was above its potential level and pressures on prices were mounting. In this situation a surplus in the Federal budget would have been appropriate.

Third, in recent years the aggregate net saving by State and local governments and the foreign sector has become very large. In 1977, net private saving was again near zero, but a Federal deficit of nearly \$50 billion was required to counterbalance the aggregate surpluses of State and local governments and the excess of receipts over expenditures stemming from our international trade and payments. Since economic activity in 1977 was well below its potential, an even larger Federal deficit would have existed in a high-employment economy last year, given the substantial volume of net saving in the non-Federal sectors.

The trend toward significant positive net saving by State and local governments developed in the early 1970s, when the secularly rising surpluses in their employee retirement accounts began to dominate their aggregate budget positions. In addition, surpluses in their operating accounts (exclusive of the social insurance trust funds) have risen sharply in the last 2

years as a result of rapid increases in Federal grants, growth in tax receipts from economic recovery, and slow growth in expenditures. Economic and demographic factors are such that continued growth of the trust fund surpluses in the foreseeable future may be expected. Moreover, a sudden reversal of the conservative budgetary policies in evidence since the last recession is unlikely, so that operating surpluses of State and local governments will decline slowly. Hence, the restraint on the economy resulting from net saving in this sector will persist, though it will probably diminish somewhat over the next few years.

The excess of receipts over expenditures in the foreign sector stems principally from two sources: the continuing heavy dependence of the United States on foreign sources of energy, and differences in the pace of economic expansion at home and abroad that have resulted in a much more rapid increase in nonfuel imports than exports. The National Energy Plan, discussed in Chapter 5, is designed in part to reduce the outflow of dollars, but the reduction will require a period of years. The growth rate differentials between the United States and its major trading partners have persisted since the last recession, and they became especially pronounced last year. These differentials are expected to narrow in 1978 as recovery abroad improves. Recent alignments of exchange rates and the steps announced by Japan to reduce its current account surplus should also help reduce our deficit. However, while some improvement in our external balance may be forthcoming, the foreign sector is very likely to continue to act as a net drain on U.S. income for some years.

Whether we can reduce the Federal deficit to zero by 1981 and still achieve a high-employment economy will depend on how sectoral saving-investment balances change over the next few years—something that cannot be known with certainty at present. Developments in a variety of areas—including monetary policy, fiscal behavior of State and local governments, oil prices, growth rates of the economies of our major trading partners, and foreign trade policies of other countries—will influence the outcome. As the figures in Table 13 indicate, rather marked shifts in net saving by the non-Federal sectors would be required to reach high employment with a balanced budget in 1981. Recognizing that fact means that we must stand ready to provide additional tax reductions if they are needed to keep the pace of economic activity advancing strongly. Should further cuts of significant size prove necessary, the return to a balanced budget would have to be postponed until after 1981.

These fiscal policy decisions for the longer term should not be made at this time. If developments are favorable—if business capital spending grows fast enough to generate significant net investment in the private sector, if State and local surpluses diminish substantially, if the foreign sector deficit improves materially—the need for further tax reductions to sustain continued economic expansion would be greatly reduced. Developments in these

areas would be difficult to predict. Responsible budgetary policy must retain the flexibility to cope with a range of outcomes.

THE ROLE OF MONEY AND CREDIT IN REACHING HIGH EMPLOYMENT

As noted above, the amount of fiscal stimulus required over the next few years will be significantly influenced by the pace of investment in business plant and equipment and in housing.

Investment in business plant and equipment will only be undertaken if rates of return on these assets are favorable in relation to the cost of financing and the returns from alternative financial investments. Among the determinants of business fixed investment discussed in Chapter 1, the rental price of capital services and the ratio of market valuation to the replacement cost of capital assets are the most directly affected by monetary policy, and they are a principal channel through which monetary developments are linked to the real sector of the economy. Monetary policy directly affects the interest rates on short-term and highly liquid obligations, such as Federal funds, Treasury bills, and commercial paper. The rates of return on longer-term debt instruments and equities vary in relation to each other and to short-term interest rates, depending on cyclical developments, inflation, and expectations about the future. Nevertheless these rates tend to influence each other because of the opportunities for both lenders and borrowers to shift their holdings among different types and maturities of financial instruments (Chart 5). Monetary policy, through its direct impact on interest rates for short-term obligations, can influence, but not determine, the cost of financing business investment and hence affect its growth in the years to come.

Monetary policy is also important for the housing sector. Residential construction is highly sensitive to financial conditions—both on the demand side through the mortgage market and on the supply side through construction loans to builders. For the average buyer of a single-family home, the purchase price is about 2 times income. For such a family, an increase of 1 percentage point in mortgage rates would raise the share of income committed to interest payments by about 1½ percent. Hence the state of financial markets will significantly influence the demand for housing and the pace of residential construction.

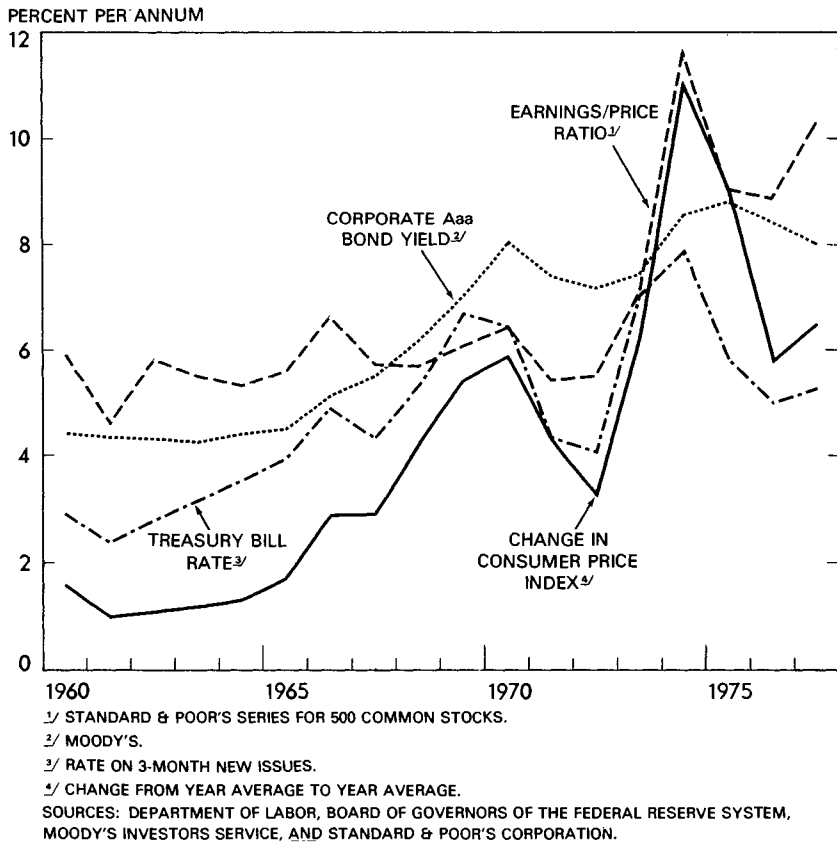
Maintenance of a financial environment conducive to significant increases in investment during a prolonged period of economic expansion is a difficult task, and will require an appropriate balance between monetary and fiscal policy; but it is not without precedent. Between 1960 and 1965, real output grew at a fairly steady rate from a level about 5 percent below potential to a level that was approximately equal to potential. Fiscal policy was stimulative throughout this period, and monetary policy was supportive. The inflation rate was very moderate—1.3 percent per year during the period—and interest rates were quite stable; the short-term Treasury bill

rate rose only 1.02 percentage points during the entire period, while rates on long-term Treasury bonds rose only 0.1 percentage point. This pattern of interest rates was associated with growth in the money supply (M_1) at an average annual rate of 3.5 percent, so that velocity grew about $3\frac{1}{2}$ percent per year, a rate slightly above postwar trends.

Careful management of economic policy will be necessary to reach and maintain high employment in the years ahead. At the present time there are still ample supplies of idle labor and capital resources available. In the period immediately ahead, growth in real output can therefore proceed at a rate above its long-term trend without risking a resurgence of demand-induced inflation. But fiscal and monetary policies should not attempt to close the remaining output gap at an excessively rapid pace, since this could lead to an unbalanced and unsustainable pattern of recovery. And

Chart 5

Rates of Interest or Return and the Rate of Inflation



as the economy approaches its potential, macroeconomic policies must adjust in order to avoid the creation of excess aggregate demand.

The inflation problem for the immediate future does not stem from excess aggregate demand, but from the momentum of inflation inherited from the past. An inflation rate in the 6- to 6½-percent range is a serious problem and it needs to be lowered while slack remains in the economy. When higher rates of inflation become built into the expectations of the public, however, the process of unwinding the inflationary momentum is a slow and arduous task and one that is only partially amenable to the tools of demand management. If the anti-inflation proposal by the President is widely supported and succeeds in lowering inflation rates, gradually slower growth of the monetary aggregates will be consistent with a strong and healthy economic expansion. Efforts to hasten the process of reducing this inherited inflation rate through restrictive fiscal and monetary policies would, however, be unproductive. Such measures would result mainly in a slowing of real growth rather than a reduction in the rate of price increase.

ECONOMIC GOALS BEYOND 1981

The projections in the budget show the unemployment rate continuing to decline to 4 percent in 1983, in line with the targets embodied in the proposed Full Employment and Balanced Growth Act. A primary objective of this legislative proposal (popularly called the Humphrey-Hawkins bill) is to modify and extend the general principles enunciated in the Employment Act of 1946. That act, which also established the Council of Economic Advisers and requires the President to submit an annual *Economic Report*, gave the Federal Government the responsibility for promoting high levels of employment and output. It established broad economic objectives that have served as useful guidelines for the formulation of macroeconomic policy during the past 30 years. However, the economy has changed in many respects since 1946; the task of making economic policy has become more complex; and the standards for acceptable economic performance have been raised. The Administration therefore believes that an updating of the Employment Act of 1946 is appropriate to deal with the changing economic environment and a new set of policy requirements.

The Full Employment and Balanced Growth Act would require the President to enunciate explicit short-term (2-year) goals and to recommend the fiscal policies necessary to achieve them. It would also require the President to set forth intermediate-term (5-year) goals each year and to present projections of Federal receipts and outlays consistent with them. The target for the overall unemployment rate in 1983, assuming the bill is enacted in 1978, would be 4 percent.

The bill would for the first time explicitly establish the goal of reasonable price stability as a high priority objective of national policy. Moreover it

directs the President to pursue this goal by a variety of measures: an early-warning system to detect emerging capacity problems, stockpiling of agricultural commodities and other critical raw materials to dampen price fluctuations, regulatory reform, vigorous enforcement of the antitrust laws, and the promotion of labor-management cooperation in efforts to boost productivity.

Though the bill sets ambitious economic goals, it is designed to achieve a careful balance among various competing objectives. The potential conflict between low rates of unemployment and inflation is implicitly recognized, and flexibility is retained to adjust the economic strategy. In the third *Economic Report* after passage of the bill, and in any subsequent ones, the President may modify the numerical unemployment goal contained in the bill, or the timetable for achieving it, if he finds such changes necessary.

In recognition of the fact that macroeconomic policies alone are not able to reduce unemployment to acceptable levels, the President is directed to develop, as appropriate, supplementary employment programs to help achieve the long-run unemployment target. There is no requirement that any specific programs be introduced, but those recommended to the President for his consideration include the following: countercyclical employment programs, including public works projects, countercyclical public service employment, and countercyclical revenue sharing; regional and structural employment policies designed to reduce unemployment among specific demographic groups and within depressed geographic areas; youth employment programs; job training and counseling programs to prepare persons for employment in the private sector; and finally, establishment of such additional public or private nonprofit employment projects as are needed to meet the long-term target for the unemployment rate. These additional projects may be created only after an official finding by the President that all other means of reducing unemployment are insufficient. Any new programs would require authorization and funding by the Congress.

The bill requires the Congress to evaluate the President's economic strategy and adopt its own set of goals and policies, which may or may not coincide with those of the President. The Federal Reserve would be required to submit its own plan for monetary policy to the Congress and to explain the relationship between its intended policies and the President's short-term goals. These procedures for establishing and reviewing goals and policies are designed to achieve a better coordination of the actions of the President, the Congress, and the Federal Reserve, and to produce a more coherent set of macroeconomic policies.

The procedures established by the Full Employment and Balanced Growth Act are an important advance beyond the Employment Act of 1946. The bill does not authorize massive new Federal programs. Nor does it impose controls on the economy or create additional governmental institutions. On the contrary, it reaffirms the critical importance of a healthy and dynamic private sector in achieving our long-term goals, and it relies on existing institu-

tions to improve the formulation and coordination of economic policy. While this new framework cannot guarantee a return to full employment and price stability, it should help identify the most serious obstacles and point the way toward rational solutions.

A 4-percent rate of unemployment in 1983 is a very ambitious objective, for it would imply that actual GNP would exceed our present estimates of potential GNP. The major unanswered question regarding this target is whether it can be achieved without creating pressures in labor and product markets that would touch off a new round of inflation. Given the present structure of these markets, it is unlikely that a 4-percent unemployment rate could be achieved through aggregate demand policies alone without at the same time causing a significant increase in the rate of inflation. Responsible policy, however, requires not that we abandon efforts to reach the 1983 unemployment goal, but that we work steadily to reduce the conflict between low unemployment and inflation by developing structural measures to improve the functioning of markets. Chapter 4 discusses in some detail the role of such policies in improving the efficiency of labor markets.