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96TH CONGRESS
2d Session
SENATE
REPORT
No. 96-___

THE 1980
JOINT ECONOMIC REPORT

REPORT

OF THE

JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES

ON THE

JANUARY 1980 ECONOMIC REPORT
OF THE PRESIDENT

TOGETHER WITH

ADDITIONAL VIEWS

FEBRUARY 28, 1980

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(Created pursuant to sec. 5(a) of Public Law 304, 79th Cong.)

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REPORT ON THE JANUARY 1980 ECONOMIC REPORT OF THE PRESIDENT

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———————, 1980.—Ordered to be printed

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Mr. BENTSEN, from the Joint Economic Committee, submitted the following

REPORT

together with

ADDITIONAL VIEWS

[Pursuant to sec. 11(b)(3) of Public Law 304 (79th Cong.)]

This report is submitted in accordance with the requirement of the Employment Act of 1946 that the Joint Economic Committee file a report each year with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report. This report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

All statistics appearing in this report were current as of February 18, 1980.

INTRODUCTION
BY
SENATOR LLOYD BENTSEN, CHAIRMAN

The Majority and Minority Members of the Joint Economic Committee have risen above political partisanship in this election year to once again issue a unified annual report. We have done so because we believe that our Committee has developed an innovative and effective strategy to help reverse our country's declining economic fortunes and raise the standard of living for all Americans during the 1980's and beyond.

The 1980 annual report signals the start of a new era of economic thinking. The past has been dominated by economists who focused almost exclusively on the demand side of the economy and who, as a result, were trapped into believing that there is an inevitable trade-off between unemployment and inflation. America does not have to fight inflation during the 1980's by periodically pulling up the drawbridge with recessions that doom millions of Americans to unemployment.

The Committee's 1980 report says that steady economic growth, created by productivity gains and accompanied by a stable fiscal policy and a gradual reduction in the growth of the money supply over a period of years, can reduce inflation significantly during the 1980's without increasing unemployment. To achieve this goal, the Committee recommends a comprehensive set of policies designed to enhance the productive side, the supply side of the economy. The Committee also recommends a targeted approach to the Nation's structural economic problems and de-emphasis of macroeconomic fine tuning.

The Committee recommends that fully one-half of the next tax cut be directed to enhancing saving and investment in the economy. Traditionally, tax cuts have been viewed solely as countercyclical devices designed to shore up the demand side of the economy. The Joint Economic Committee is now on record in support of the view that tax policy can and should be directed toward improving the productivity performance of the economy over the long term and need not be enacted only to counter a recession.

One of the major reasons why policymakers have not viewed tax reductions as an important device to improve the structure of the economy has been the absence of economic models capable of adequately assessing the effects of supply side tax policies. The Joint Economic Committee, working with Dr. Otto Eckstein of Data Resources, Inc., has taken a major step toward remedying that deficiency.

The new model discussed in the 1980 report shows that tax policies, such as depreciation schedule adjustment, can lower the inflation rate substantially over the decade. The model also demonstrates that the only way demand management policies alone can lower the inflation rate substantially is by maintaining unemployment at near depression levels throughout the decade. This new model is an important tool which will help policymakers implement the supply side policies which are being advocated by the JEC.

The Committee's 1980 report recognizes that continuation of the historic adversary relationship among government, business, and labor is a major impediment to implementation of supply side policies to improve

productivity. Therefore, the Committee recommends that the Administration use the National Productivity Council as a vehicle to enlist the active cooperation of business and labor to work on new ideas to improve the productivity performance of the economy. Our country may find it difficult, if not impossible, to solve its major economic problems and remain competitive in world markets as long as government, business, and labor continue to work at cross purposes.

The Committee continues to believe that the Federal Government must put its own financial house in order. That requires a steady reduction of the ratio of government spending to the gross national product and a full accounting of the command over resources now exercised by the Federal Government. The current fiscal budget understates the proportion of the Nation's resources that are used for public purposes. The fiscal budget does not include private, State, and local government spending mandated by Federal regulations.

The Committee recommends the establishment of a process that would ultimately lead to a Federal regulatory budget to be submitted along with its fiscal budget. Development of a regulatory budget would be the most important new budgetary development since the Federal Government began to submit a single budget for all Federal departments and agencies.

Despite the important employment gains which have been made over the last two years, too many blacks, Hispanics, young people, and other disadvantaged minorities have been left out of the mainstream of our economic life. We do not, and we must not, accept the inevitability of structural unemployment.

The Committee recommends that this society undertake a renewed effort to keep youngsters in school and to return to the basic elements of a good education -- reading, writing, and quantitative skills. We also advocate a new approach to job training programs -- one that coordinates job training and actions to increase capital formation in order to avoid a mismatch of job opportunities and the newly trained.

Energy remains a key economic and national security problem. The 1980 report recommends increased domestic production, particularly through enhanced recovery techniques and greater energy conservation. It also recommends a new concept -- an energy security index -- to help alert all Americans to potential dangers to this country's security from possible disruptions in our energy supplies.

The Committee also advocates development of an energy productivity index to assess the effects of our efforts at energy conservation. We also support development of alternative sources of energy and initiatives to diversify oil and gas production through increased exploration in the third world. Taken together, these energy recommendations provide a solid, workable agenda to protect our national security and to reduce our reliance on foreign sources of energy.

As part of the effort to adapt U.S. trade policies to the economic realities of the 1980's, a delegation of JEC Members journeyed to East Asia in January at the request of the U.S. Chamber of Commerce, the American Pacific Council of American Chambers of Commerce, and the U.S. Department of State. That delegation held 10 days of hearings during which it received testimony from

numerous businessmen and women who are on the front lines of America's effort to remain competitive in the world.

The delegation will issue a detailed report in April. But some of what it has learned is discussed in the 1980 annual report. For example, the Committee urges the Administration to undertake a major diplomatic initiative to encourage our trading partners to adhere to an international code of conduct enforced by an international agency. That would improve the conduct of international business transactions and ensure that no business firm operating anywhere in the world can gain a competitive advantage through corruption. The Committee also recommends a comprehensive assessment of Federal tax and regulatory policies which affect American business and individuals living abroad to determine the impact of those policies on our competitive position in world markets.

More than a century ago, Oliver Wendell Holmes suggested that the most important thing in this world is not so much where we stand, but in what direction we are moving. "We must sail," he said, "sometimes with the wind and sometimes against it -- but we must sail and not drift, nor lie at anchor." The Joint Economic Committee's 1980 unified annual report points the Congress, the Administration, and the Nation in the right direction. It is a call to lift anchor and in President Kennedy's words to "get this country moving again."

INTRODUCTION
BY
REPRESENTATIVE CLARENCE J. BROWN,
RANKING MINORITY MEMBER

The Minority Members of the Joint Economic Committee are again pleased to join the Majority Members of the Committee in this consensus annual report. To achieve another consensus report, this time in a national election year, is a remarkable accomplishment, attesting to the soundness of the policy recommendations contained herein.

The 1980 Joint Economic Committee Report is not a vague compromise of mushy logic. It is a clarion call to get this country moving again. And it offers a new, clear set of policies to generate real, sustainable economic growth without inflation. It is forthright, revolutionary, and important.

These are tense times. The United States and the free world are threatened militarily and economically. Americans struggle with each other for a bigger slice of a shrinking pie. It should not be this way. It did not have to be this way.

In 1978 our economy crossed the $2 trillion threshold. It could have been $3 trillion.

If Americans had saved and invested a bit more, if the Nation had grown only 1 1/2 percent faster each year since 1950, the United States would now have more than a $3.5 trillion economy instead of the $2.4 trillion

registered in 1979. Incomes would be 50 percent higher than they are now, and jobs would be plentiful. Federal revenues would have been $250 billion higher in 1980, and there would have been enough to provide for balanced budgets and greatly expanded health and social spending with enough left over to permit lowering income and payroll taxes instead of raising them. The Nation would be enjoying stable prices, millions more jobs and a solvent social security system. America would have an ultramodern productive industrial economy three times the size of the Soviet Union's instead of twice -- and unquestioned military superiority. Russia simply could not have kept up with the United States.

Faster growth, higher real incomes, and plentiful jobs are exactly what the minorities, the unemployed, and the underpriviledged of this country have been seeking for years. It is no accident that the greatest gains in income, jobs and dignity for such workers have come during periods of rapid expansion.

Therefore, growth is critical; and saving, investment, and productivity are critical to growth. They must be encouraged, as the Minority has been saying for years. The hour is very late. It is high time the Nation got started.

We have not gotten started because the Administration has clung to an outdated economic doctrine, forged in other economic circumstances decades ago. The political leadership that has dominated our Nation for more than a generation has not adopted modern solutions to address America's current economic problems. The emptiness of its doctrine is proven by the Administration's

own estimates that one year from now the best it feels our Nation can hope for under its policies is 10.5 percent inflation and 7.5 percent unemployment. The Minority is convinced our Nation can do better and that Americans demand that it do better.

This report provides the needed approach that repudiates the myth perpetuated by the Administration that to fight inflation we must increase unemployment. That is manipulative demand management economics of the old-fashioned variety, and it is outdated by today's circumstances.

Our Nation should have three major goals: price stability, real growth, and full employment.

We cannot hit these diverse economic targets if all our policy options are aimed at slowing the economy to wring out inflation. The proper policy "mix," as outlined in this report, is:

1. To fight inflation by a gradual (but sustained) reduction in the growth of the money supply and a gradual reduction of the ratio of Federal direct and regulatory spending to GNP.

2. To fight general unemployment by increasing real economic growth through tax reductions designed, not to pump money into the economy, but to restructure the tax code to increase the after-tax reward to additional saving, investment, production, and employment. The tax structure must direct more of our annual economic effort into modernization for competitiveness

and growth rather than immediate consumption.

3. To fight hard-core unemployment by a targeted program emphasizing productive, private sector, on-the-job training to increase the skills of the unemployed. Structural unemployment is not a problem which can or should be solved by pumping money into "make-work" jobs to inflate the whole economy.

These policies -- spelled out in this report -- are consistent and mutually reinforcing. The tax cuts to stimulate saving, investment, and competitiveness will put more goods on the shelves and lower prices, thus reinforcing the anti-inflation monetary policy. The anti-inflation monetary policy will reduce the biases against saving and investment (now in the tax code) which occur as inflation destroys the depreciation allowances and savings returns and pushes people into higher tax brackets. The lowering of inflation will thus reinforce the tax changes in generating more production, real growth, and profits to operate government programs at lower tax rates. Both policies will raise labor productivity, increase the demand for labor, and reinforce the incentives to hire and train the unemployed.

All these policies mean a healthier and more efficient domestic economy better able to compete in the world, to improve the U.S. balance of payments and strengthen the dollar without sacrificing U.S. freedoms. The stronger dollar addresses the cost of imported oil, raw materials and other products, thus helping to fight inflation.

The comprehensive Joint Economic Committee approach to the many problems confronting the economy herein addressed is a workable and acceptable answer for a better future for America and the world.

The Minority is pleased to have participated in pointing the way, refining the ideas and presenting them for consideration.

II. REVIEW AND OUTLOOK

Review of 1979

The economy continued its expansion in 1979 though at a much reduced pace from that experienced during the earlier years of the recovery from the 1973-75 recession, and inflation accelerated. This was contrary to widespread predictions by many economic forecasters.

Measured year over year, real gross national product (GNP) grew by 2.3 percent in 1979, down from the 4.4 percent rate of growth posted in 1978 and the 5.3 percent rate of growth registered in 1977. The consumer price index (CPI) rose by 13.3 percent in 1979 compared to 11.8 percent in 1978.

A more accurate portrayal of the rate of economic activity over the course of any single year is obtained by measuring growth fourth quarter over fourth quarter. Using this criterion, it is clear that the pace of economic activity slowed dramatically in 1979. From the fourth quarter of 1978 to the fourth quarter of 1979, real GNP advanced at the sluggish rate of 0.8 percent, down sharply from 4.8 percent in 1978 and 5.7 percent in 1977.

Most forecasters did not predict the accelerated pace of inflation. There were signs of growing economic slack as evidenced by a reduction in the Federal Reserve Board index of capacity utilization from 86.8 percent in December 1978, to a value of 84.4 percent in December 1979, and a slowdown in order backlogs. Nevertheless, inflation, as measured by the CPI, zoomed up from a 9.0

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percent rate of increase in 1978 to 13.3 percent in 1979. Food and energy prices in the first half of the year, and energy prices and home-related financing costs in the second half, accounted for much of the sharp increase in the CPI during 1979. However, the accelerating rate of inflation was not due to these special factors alone. On the contrary, during 1979 there was a marked increase in the underlying rate of inflation -- the rate determined by the long-run pace of unit labor and unit capital costs -- of 2.5 percent or more, bringing it to a high of about 9 percent. This rapid increase in the underlying rate of inflation is what poses the most serious challenge for U.S. policymakers. Even if the special factors were to disappear in future months, we would still be stuck with a very high rate of inflation that, on the basis of past experience, exhibits considerable inertia.

Although the slowdown in real GNP growth was substantial in 1979, the reduction in the growth of real final sales was much less so, advancing fourth quarter to fourth quarter at a rate of nearly 1.7 percent in 1979. The sharp reduction in the rate of inventory investment in 1979 accounts for the difference in these growth rates.

The slowed rate of inventory investment has two implications. First, from the point of view of final sales, the economy was stronger in 1979 than real GNP statistics indicate. Second, because business inventories have already been substantially adjusted in response to a reduced rate of economic activity, inventory reduction will be less severe if there is a further decline in real economic activity in 1980, an outcome that will limit the magnitude of the decline itself.

The real story in 1979, however, was not the fact of the economic slowdown itself. This was widely anticipated -- indeed, it was planned -- as a consequence of the restrictive demand management policies put into place late in 1978 and early in 1979. Moreover, after imported oil prices rose by 46 percent from February to July, the slow growth outcome for 1979 was all but guaranteed. Most forecasters did not predict the resilience of the American economy in the second half of the year in the face of these domestic and external policy actions. Coming off an annualized 2.3 percent decline in real GNP in the second quarter of 1979, real GNP increased sharply in the third quarter by 3.1 percent at an annual rate and continued to advance in the fourth quarter at an unexpectedly high annual rate of increase of 1.4 percent. The economy simply refused to turn down at the point most forecasters had led us to expect it would.

There were a number of other developments in 1979 that were not predicted by most forecasters. Despite the slowdown in the economy, the unemployment rate moved only slightly, varying by almost imperceptible amounts over the course of the year around an average rate of 5.8 percent. True, labor force growth slowed in 1979 to an average annual rate of increase of 2.1 percent, down from the 2.42 percent average annual rate of increase experienced over the course of the past five years. But the fact that our economy, experiencing less than 1 percent real growth, was capable of translating a labor force increase of 2.2 million into employment gains of 2.1 million, thereby leaving the unemployment rate unchanged, astounded even the most optimistic forecasters.

Most forecasters also did not predict the continued remarkable strength of consumer spending during 1979. Although rapid price increases left real disposable personal income virtually unchanged, real consumption expenditures, measured from the fourth quarter of 1978 to the fourth quarter of 1979, actually increased by 2.6 percent. As a consequence, personal savings as a percent of personal disposable income fell from 4.7 percent in the fourth quarter of 1978 to 3.3 percent in the fourth quarter of 1979, the lowest level in more than three decades, a development that we view with concern. This low savings rate helps to explain the recent strength in the economy, but living off our savings could be a bad sign for the future.

Several explanations have been offered for these developments. Some have suggested that the decline in saving is a natural reaction to the inflation-induced drop in the after-tax reward to saving. Others have mentioned the effect of heightened inflationary expectations on the desire to buy before prices rise further.

The investment picture in 1979 was mixed. Measured year over year, real gross private domestic investment increased by $0.5 billion in 1979, an increase of two-tenths of 1 percent. Real nonresidential fixed investment performed quite strongly, rising by 5.8 percent in real terms. By comparison, residential fixed investment declined by 6 percent in real terms.

When the rate of investment spending is calculated using fourth quarter to fourth quarter comparisons, it is apparent that investment activity slowed sharply in 1979. From the fourth quarter of 1978 to the fourth quarter of 1979, real gross private domestic

investment declined by over 5 percent; real nonresidential fixed investment increased by only 1.7 percent compared with about a 5 percent average annual increase over the past decade; and residential fixed investment declined by 8.33 percent. The slowdown in the growth of real nonresidential fixed investment in 1979, down from a fourth quarter to fourth quarter rate of increase of 10.48 percent in 1978, is a source of considerable concern to the Committee.

Particularly noteworthy was the magnitude of the improvement in our net export position during 1979. Measured in billions of current dollars, net exports improved by almost $7 billion in 1979, rising from an average annual rate of $-10.3 billion in 1978 to an average annual rate of $-3.5 billion in 1979, an improvement that occurred despite a near $18 billion increase in our oil import bill in 1979. In billions of 1972 dollars, net exports rose from $11.0 billion in 1978 to $17.7 billion in 1979.

Several factors account for the improvement in our net export position, the most notable being the more rapid growth of nonagricultural exports, the slower growth of nonoil imports, and the surge in growth of our services exports. The trade deficit declined from a value of $33.7 billion in 1978 to $29.1 billion in 1979 due in large part to the sharp turnaround in our trade balance in manufactured goods from a deficit of $5.8 billion in 1978 to an estimated surplus of $4 billion in 1979. Our surplus on the services account swelled by an estimated $8.3 billion, the result mainly of strong gains in net direct investment income which rose from $21.7 billion in 1978 to $30.6 billion in 1979. Both of these developments were sufficient to bring our

current account into near balance in 1979. This represents an improvement over the 1978 current account deficit of $13.4 billion. Table II-1 shows a breakdown of the sources of economic growth during the recovery period.

TABLE II-1

SOURCES OF ECONOMIC GROWTH*
(Percent Change, Annual Rates)

	1976	1977	1978	1979
Consumer	4.5	4.1	2.9	0.7
Business	1.4	1.5	1.1	-0.4
Foreign Trade	-0.7	-0.6	0.5	0.5
Government	-0.3	0.7	0.3	0
Total	4.9	5.7	4.8	0.8

*Comparisons are fourth quarter to fourth quarter

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

As noted earlier, the United States reached near balance in its current account despite dramatic developments on the international oil price front. Twice during the year, in response to turmoil in Iran and resulting tight world oil markets, oil exporters responded to surging spot market prices with massive contract price increases. The Organization of Petroleum Exporting Countries (OPEC) crude prices averaged about $27 per barrel in January 1980, up from $13.66 per barrel a year earlier. The price increase occurred despite a worldwide surplus of oil production over consumption which approached one million barrels daily (mbd) by the end of the year.

Evaluating Economic Forecasts

Before making our assessment of the outlook for 1980, it is worthwhile going back a year or so to examine the outlook for 1979 formed on the basis of economic forecasts that were then receiving a lot of attention. How accurate were the model forecasts? Did the performance of the economy in 1979 parallel the performance projected by forecasters or were they way off the mark? Did the forecasters predict a continued expansion of the economy in 1979 or did they project a downturn? Did they accurately predict a near constant unemployment rate? Did they accurately foresee the sharply accelerated rate of inflation?

These are not easy questions to answer. The various forecasters were not always in agreement with one another in terms of their outlook for 1979. And their outlook varied depending on when it was that they made their forecasts.

The discrepancies in model forecasts for 1979 and the variations in those forecasts as we approached 1979 are presented in Table II-2. The table shows the 1979 forecasts made by Data Resources, Inc. (DRI), Wharton Econometric Forecasting Associates, Inc. (WEFA), and Chase Econometrics Associates, Inc. (Chase), over the period from the third quarter of 1977 to the fourth quarter of 1978.

TABLE II-2

QUARTERLY FORECASTS FOR YEAR 1979

	Forecasts Made In:						Actual*
	1977:3	1977:4	1978:1	1978:2	1978:3	1978:4	
Real GNP (% Change)							
DRI	3.0	4.0	3.9	3.9	3.2	2.0	2.27
Chase	3.9	3.9	4.2	4.3	2.5	1.3	2.27
WEFA	4.1	3.9	3.9	4.3	3.9	2.4	2.27
Implicit Price Deflator for GNP (% Change)							
DRI	5.5	5.7	5.8	6.2	6.6	7.3	8.84
Chase	5.2	5.5	5.8	6.5	6.8	7.7	8.84
WEFA	6.1	5.7	6.5	7.0	7.0	7.1	8.84
Unemployment Rate (Percent)							
DRI	6.4	6.3	6.4	6.0	6.3	6.6	5.8
Chase	8.5	7.3	5.6	6.0	6.5	6.8	5.8
WEFA	5.6	6.3	6.0	5.5	5.7	6.2	5.8
Employment (Millions of Persons)							
DRI	94.9	95.0	95.3	95.6	96.0	96.0	96.9
Chase	92.5	94.1	96.1	96.4	96.0	95.5	96.9
WEFA	96.6	94.9	95.7	97.1	97.7	96.4	96.9

*preliminary

Source: Statistics compiled by the Library of Congress

The 1979 real GNP forecasts made in 1977 and early 1978 were all in the neighborhood of 4 percent. During the last half of 1978 the GNP forecasts were lowered and by the end of the year two of the three forecasts shown were acceptably close in terms of the growth actually observed. Looking at the price predictions, most forecasts showed an increase of 5 to 6 percent in the early part of the forecasting period. By the end of 1978, the forecasts had been raised to the 7 to 8 percent range, but they still fell short of actual performance. The unemployment rate projections were consistently too high and showed a mixed picture with no significant improvement or deterioration as time passed. The employment projections show a pattern which parallels the growth forecast.

Although not shown in Table II-2, the model forecasts for 1979, made in 1979, were much closer to the mark in terms of real GNP growth, inflation, unemployment, and employment. However, virtually all forecasters in the spring of 1979 predicted that the economy would be turning down by the end of 1979, that the unemployment rate would be rising, and that inflation would be somewhat less rapid. All of these predictions turned out to be incorrect.

The record for the four-year period, 1975 to 1978, shows a different but in some ways more disturbing pattern in the forecasts. In general, the inflation forecasts were poor, the unemployment forecasts were mixed, and the growth forecasts were good. In this period, the 1973-75 recession ended and was followed by three years of steady growth, and there were no unusual inflation shocks to the economy. The consistent underestimates of prices by all the forecasters were therefore disappointing. Two of the three forecasters

underestimated unemployment at the beginning of the period and, in the last three years, they were increasingly too high. These inaccuracies reduced the value of the forecasts and demonstrate the dangers of excessive reliance on forecasts as guides to policy.

It is, of course, dangerous to make sweeping conclusions based on this very limited analysis of the forecasting record of the model builders. Nevertheless, one conclusion seems apparent. In assessing the outlook for the coming year, the model forecasts need to be used very cautiously.

The forecasters themselves would tell you the same thing. Forecasting is not an exact science; it is partly, and maybe largely, an art. And all forecasts are "conditional" -- dependent on the assumptions employed by the forecasters in making their projections.

There are three principal sources of error in model forecasts. First, the models used to generate the forecasts could be in error to the extent that they fail to reflect accurately the underlying structure of the economy, including assumed behavioral responses, during the forecast period. Second, they could be inaccurate because of the assumptions employed about the nature of economic policy during the forecast period. And third, they could be wrong because they fail to reflect the influence of a whole host of events that no one could reasonably have anticipated at the time of the forecast.

The second source of error is that frequently policymakers adjust their policies in ways that differ from those assumed in making forecasts precisely because the forecasts portend outcomes that are found to

be inconsistent with stated policy objectives. In other words, the private forecasts with their assumed policy scenarios are often used for the purpose of making policy adjustments in an effort to achieve outcomes that differ from those originally forecast.

If the economic policies assumed by the model builders constituted the only serious source of forecast error, it would be highly appropriate to use those model forecasts as one important basis for the design of our economic policies. However, it is becoming clear that the other two sources of error are more important, as a consequence of which it might be injudicious to alter policies when confronted with forecasts implying outcomes that are at variance with our economic objectives.

The inability of the forecasters to accurately predict employment, unemployment, and inflation in the face of reasonably accurate real GNP forecasts suggests that there are problems with either the structures of the models themselves or their assumptions respecting the behavioral responses of consumers and businesses. The failure of the model builders to foresee the huge jump in OPEC prices in June, and the heightening of world tensions and their economic consequences at year end, should make us doubly cautious in accepting current economic forecasts for, if anything, political uncertainty is much greater now than it has been in the recent past.

None of this discussion is intended to deny the usefulness of economic forecasting. On the contrary, economic forecasting is a very useful planning tool for both the government and the private sector. Economic

forecasts can alert us to developments that might occur in the future. Without forecasts, public and private policymakers would be confined to walking into the future while constantly looking at the immediate past.

We have been strong advocates of economic forecasts as useful inputs to the policymaking process. Indeed, we have pushed both the Executive Branch and the Congress to look further into the future in trying to formulate our economic policies. We continue to believe that this is important to the process of policy design. Nevertheless, we need to exercise extreme caution, particularly now. Indeed, some forecasters who had initially predicted a recession for 1979, saying later that it would not come until 1980, are saying now that we may not have a recession at all. In a period with as much uncertainty as this one, policymakers would be well advised to approach any forecast with a good deal of caution.

The Outlook for 1980

To be blunt, we do not know for sure, nor does anyone else, whether the economy will enter a recession in 1980. We do not know whether inflationary pressures will abate significantly or whether the unemployment rate will rise significantly. If the OPEC producers escalate their oil prices once again or curtail their shipments of oil to the United States, there could result a serious recession and a sharply increased rate of inflation. There are a number of reasons why the now widely expected recession forecast may not materalize. For example, a steep rise in military outlays coupled with continued strong consumer spending could

provide a short-run stimulus. Barring a wartime mobilization effort and assuming, optimistically, that OPEC petroleum production remains at or above 30 mbd, and that spot prices decline converging toward an assumed average contract price of $30 per barrel, it is possible to formulate a less uncertain outlook for 1980. For the most part, these are the conditions assumed by most model forecasters in their "baseline" predictions for 1980. The present uncertainties add to the reasons that policymakers should focus on the long term.

The Council of Economic Advisers has forecast that in 1980, the economy will experience a mild recession. They have predicted that real GNP will decline 1 percent during 1980 then grow at a 2.8 percent annual rate during 1981. At the same time, they foresee inflation slowing moderately. Looking at changes in the CPI from December to December, the Council sees the rate of inflation declining from 13.2 percent in 1979 to 10.4 percent in 1980 and 8.6 percent in 1981. The decline in real GNP is expected to be accompanied by an increase in the unemployment rate to about 7-1/2 percent in late 1980. With the resumption of economic growth, the unemployment rate is expected to fall slightly to 7-1/4 percent by the end of 1981. In the Council's view, the recession is likely to be brief, mild, and largely over by midyear.

Private forecasters are largely in agreement with the Council. They are almost unanimous in telling us that we should expect economic contraction to occur in the first half of 1980 and a resumption of moderate growth in the latter part of the year. Although there are differences in the exact quarterly pattern, the depth of the decline,

and the length of the recession, there is widespread agreement that the economy will experience at least a mild recession in 1980 and move into 1981 on a positive growth track.

The forecast of a mild recession seems reasonable, but it is not certain. When we examine the potential sources of economic growth, the consumer sector is one area where caution needs to be exercised. Although it is widely anticipated that consumers will retrench and try to bring spending patterns more closely in line with disposable income, it is possible they will continue to borrow or to dip further into their savings. The unused lines of credit available to consumers remain substantial, and it is clear that people's attitudes toward the use of debt have changed dramatically in recent times. If consumers continue to behave as they did in 1979 and other parts of the economy do not deteriorate, a recession could be avoided. Although we do not consider this the most likely prospect for 1980, there is a strong possibility that it might occur.

Caution also needs to be exercised in terms of the outlook for Federal Government outlays. Defense and cold war factors could cause sharp increases in defense outlays, a factor that will contribute to growth directly, in addition to the private sector spending increases occasioned by increased contracts and military purchases. How large the military buildup will be and how rapidly it will be translated into military contracts and payments is unknown at present.

Looking at other potential sources of growth, we believe that there are likely to be some shifts between the government sector and the foreign trade sector. The embargo on

grain sales to the Soviet Union means that our exports will be reduced and government purchases will be increased. Since these changes are largely offsetting, they will have little impact on next year's economic growth. However, a general slowdown in the world economy, in the wake of 1979 OPEC price increases, would mean that the growth contributed by the foreign trade sector in 1979 would not be repeated in 1980.

There is good reason to expect the business sector to be virtually flat in 1980 as it was in 1979. The slowdown in inventory accumulation observed in the last half of 1979 indicates that inventory levels will probably be kept tight next year. Surveys of investment plans also show a flat year for 1980. And finally, investment has traditionally lagged behind other sectors of the economy in turning up after a slowdown.

This brings us back to the consumer. While it is possible for consumers to maintain their spending levels by increasing their debt burden, it seems more likely that they will cut back. The weakness in housing and automobiles that showed up in the latter part of 1979 is likely to spread to other parts of the economy, and another year of stagnant or falling real disposable income will create mounting pressure on consumers' budgets.

In view of these considerations, we think the rate of real GNP growth for 1980 could lie in the range of from +0.5 to -1.5 percent measured fourth quarter to fourth quarter. The range is a narrow one encompassing the possibility of continued sluggish growth with no recession, and a mild recession. The consensus forecast estimates growth at from -0.5 percent to -2.0 percent, and some

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forecasters have suggested that the situation could be much worse. However, the following factors could contribute to a more optimistic outcome: (1) The behavior of businessmen in maintaining lean inventories makes the probability of a classic inventory cycle much less likely. (2) Much of the employment growth of the past few years has been in the service industries. This part of our economy is less sensitive to cyclical fluctuations, and therefore the prospect of large layoffs during a slowdown are somewhat reduced. More stable employment patterns will be translated into more stable consumer income. (3) Just as the new financial instruments provided more credit to the housing market than had been available in past periods of high interest rates, thereby delaying the slowdown in housing starts, those same sources of funds can be expected to cushion the fall in 1980.

On the price front, we see little prospect for relief from inflation in 1980. The recent petroleum price increases mean that even with moderate wage increases and no unfortunate surprises in other areas, we are virtually locked into a rate of inflation of 10 percent or more. The only way our Nation can absorb external price shocks is through productivity growth. Unfortunately, policies have not been put in place to strengthen productivity and therefore the prospects are dim for a much improved productivity performance during 1980.

Of course, if consumers cut back on their expenditures by more than we now anticipate, and if investment does not increase to pick up the slack, and if net exports deteriorate by more than we now foresee, the economic outlook could be worse.

The caution we express with respect to our net export position in 1980 is well grounded. As a result of the 1979 rise in world oil prices, OPEC revenues are estimated to jump to around $280 billion in 1980 compared to $138 billion in 1977, $130 billion in 1978, and an estimated $196 billion in 1979. Even assuming no dramatic changes in OPEC policies in 1980, the magnitude of this increase in revenues virtually guarantees that the OPEC nations will run a current account surplus of $100 billion or more in 1980.

The consequences of the 1979 OPEC price increases for the world economy in 1980 seem clear. There will be slower growth, higher inflation, and enlarged balance-of-payments deficits for the non-OPEC nations of the world. And it is likely that the nonoil developing nations will be hit the hardest, all the more so because it is almost certain that the OPEC surpluses will not be recycled as quickly or as easily as they were following the 1973-74 OPEC price hikes. Depending on the outcomes that result from OPEC's 1979 price increases, the net export position of the United States could deteriorate dramatically.

In our estimation, it is not now possible to judge which of the many prospective outcomes is most likely for 1980. We do expect 1980 to be a year characterized by sluggish growth, at least. But even this prospect is not unconditional.

In view of this uncertainty, we do not feel that it is appropriate to rush forward with new macroeconomic policy initiatives designed explicitly on the basis of current economic forecasts. We will make a number of macroeconomic policy recommendations later on in this report, but the rationale for their

implementation is based on considerations other than those implied by the now popular economic forecasts.

Recommendation No. 1

Because the outlook for 1980 is so uncertain, and because actual economic developments may not unfold in the manner predicted by many forecasters, we urge Congress and the Administration not to rush forward with new program initiatives specifically aimed at countering prospective short-run developments implied in those forecasts.

Long-Term Focus

In formulating our recommendations for this report, we have given careful consideration to the short-term forecasts provided by the Council of Economic Advisers and numerous private economists. However, we continue to find that looking at both the past and the future from a longer term perspective yields insights which are more valuable for policymaking.

As we turn to the longer term outlook for the U.S. economy, we cannot be unmindful of current developments. The history of the 1973-75 recession demonstrates that the economy can deteriorate more rapidly than was believed reasonable, and certainly if this situation were to recur, short-term countercyclical measures would be necessary. Contingency plans to deal with such unanticipated situations must be a permanent part of our policy formulating process. Nevertheless, it would be inappropriate to

implement such countercyclical measures as long as we feel that the economy will recover from any temporary setbacks within a reasonably short period of time.

The fundamental elements which underlie the economy's long-term growth were discussed at length in the report we published last August. To briefly review the outlook for these fundamentals, consider estimates for the growth of potential GNP. The easiest way to arrive at such an estimate is to sum the growth rates of (a) the labor force, (b) productivity, and (c) hours worked.

Since the population supplying new workers to the labor force during the next five to ten years is largely fixed, the major factors which influence the number who actually enter the work force are changes in female and teenage participation rates. This, in turn, is influenced by such factors as the need for additional family members to enter the work force in order to maintain a certain level of real earnings in the face of rising prices, the desire of women to participate in the work force, the number of women who are occupied by childbearing and childrearing, the average length of time people remain in school, etc. Immigration also has an impact on both the population and the labor force. After reviewing all of these factors, we conclude that the labor force is likely to grow 2 to 2.3 percent per year over the next five years.

The second major factor determining longer term economic growth is, of course, productivity. We discuss this at length elsewhere, but briefly, we believe that the U.S. productivity performance must and will improve significantly during the next few years. An older, more experienced work force

will be a positive factor. If combined with policies which encourage the growth of capital relative to labor, 1.5 to 2 percent average annual growth is quite reasonable. Negative factors which could reduce productivity growth such as an erratic growth pattern which would reduce capital formation or dramatic changes in the relative price of energy must be carefully managed.

Combining the projections for productivity and labor force growth with an average decline in hours worked of about 0.5 percent per year yields an estimate of 3 to 3.5 percent per year for the growth of potential GNP. Many economists will call this estimate optimistic, and we have already stated that policies designed to increase the capital to labor ratio will be necessary to achieve it. Nevertheless, if the economy is moving forward in the range of its potential growth rate by 1981, as many forecasters now expect, we believe that by implementing now the policies which are laid out in the remainder of this report, Congress can lay the foundation for economic growth and prosperity for the remainder of the decade.

III. THE DESIGN OF MACROECONOMIC POLICY FOR 1980 AND BEYOND

The failure of the economy to register as sharp a slowdown in 1979 as many forecasters earlier predicted has had one very unfortunate side effect. It has all but stalled efforts to design new fiscal and monetary policy initiatives to deal with both our current and prospective growth and inflation problems. Many policymakers are unwilling to commit themselves to any kind of tax cut proposal until presented with incontrovertible evidence that the economy is in the midst of a serious recession and that there will be no adverse inflationary effect from the tax cut. The Administration, for example, has made it clear in its fiscal 1981 budget message that it will stand firm against tax reductions until events deteriorate more than is now anticipated.

The Need for Consistent and Steady Long-Term Economic Policies

In our estimation, there is need for a shift in the focus of monetary and fiscal policies away from short-run crisis containment toward steady long-term economic growth. In the past two decades, there has been too much emphasis placed on "fine tuning" the economy. In the future, monetary and fiscal policy should be conducted in a stable manner. Long-term policies should have a two-fold aim. First, they should promote growth at rates that are in line with the economy's actual potential for noninflationary real growth. Second, they should be structured to encourage an increase in these potential growth rates for the future.

We can use as our guide to the establishment of our steady growth target the growth rate of our Nation's productive potential, technically, the growth rate of potential real GNP. Given current and expected rates of productivity and labor force growth, this guide implies, at present, a long-term growth potential of approximately 3 percent annually. If this is correct, monetary and fiscal policies should be designed now to accommodate 3 percent average real growth per year; as well, consideration needs to be given to the structure of these policies in ways conducive to an increase in our growth potential over the long term.

From the perspective of long-term economic growth, monetary and fiscal policy should be adjusted only in accordance with changes in the long-run growth potential of the U.S. economy. Since the growth of potential real GNP only changes very gradually over time, no abrupt long-term policy changes would be anticipated.

From a short-run point of view, we do not feel that it is appropriate to try to "fine tune" the economy by attempting to adjust policy in response to all, or even most, cyclical departures from our targeted long-run growth path. However, we do feel that it is appropriate -- indeed, mandatory -- to adjust our macroeconomic policies if actual real growth registers a sustained departure from our long-run targeted growth path and if a change in policy is judged necessary in order to put us back on target toward the realization of our long-term growth goal. This does not mean, of course, that real economic growth must proceed at the same rate year in and year out, or that macroeconomic policies should be adjusted in ways to attempt to bring such a precise result about.

It does mean that macroeconomic policies should be adjusted when, in the absence of policy changes, a realistic long-run average rate of growth would be otherwise unattainable.

And finally, since any realistic program must have a beginning and an end against which our actual performance can be assessed, we need to avoid attaching undue significance to the promised performance at the terminal date the closer we get to it. It would be wrongheaded policy, for example, to rush forward with programs to either dramatically pump up or slow down the economy in the interests of attaining a goal as though that were a desirable end in itself. Too many unexpected events can take place to render the goal unreachable, not the least of which is the fact that as we move forward in time we may witness changes in the growth of our real GNP potential as a result of both unanticipated developments and policy actions initiated in the interim. In short, there is no specific terminal goal other than that of attaining the highest possible long-run rate of real economic growth consistent with the satisfaction of our myraid other goals.

Recommendation No. 2

U.S. monetary and fiscal policies need to be designed for the purpose of achieving an average annual real growth rate equal to that of our long-run potential real GNP; we need to hold those policies steady over the long term; and we need to avoid adjusting those policies cyclically except in those instances when actual real output growth registers a sustained departure, up or down, making the attainment of

our long-term growth target unattainable in the absence of policy changes.

The policy implications of this recommendation are profound. It implies the setting of monetary and fiscal policies and sticking with them, changing them only under the most extraordinary circumstances. It implies abandonment of the "fine tuning" approach to policy, an approach that is impractical because, among other reasons, the state of the art of economic forecasting is much too imprecise to permit us to make the required policy adjustments when they are needed. It implies the very close coordination of monetary and fiscal policies. And finally, it implies that conventional macroeconomic policies can no longer be used as the primary means to reduce unemployment below the 5.5 to 6.0 percent range, because the labor markets for skilled workers are tight in that range.

The latter point requires explanation. We are not abandoning the 4 percent unemployment target mandated by the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978. However, we have learned from past experience that it is inappropriate to attempt to reach that 4 percent target solely through demand stimulation. Conventional macroeconomic policies are constrained by the fact that, once the overall unemployment rate reaches the 5.5 to 6.0 range, further increases in demand add significantly to inflationary pressures. The reason for this is now clear: Although shortages of low-skilled workers are rare when the overall unemployment rate is in the neighborhood of 5.5 to 6.0 percent, at that overall rate, shortages begin to appear in many high-skilled labor markets. Demand expansion to further reduce the overall

unemployment rate causes little wage inflation among low-skilled workers but highly inflationary wage increases among high-skilled workers. In order to avoid exacerbating labor shortages in high-skilled markets while attempting to reduce unemployment among low-skilled workers, it is necessary to adopt targeted structural microeconomic policies tailored to meet the specific needs of the low skilled. We also need targeted structural policies to fight inflation by generating investment in modern plant and equipment and to shift the composition of our output toward industries with high potential for productivity growth. These matters are discussed more fully elsewhere in this report.

We view the adoption of this recommendation, in conjunction with the other recommendations in this report, as essential to the ultimate attainment of the inflation and unemployment goals mandated by the Humphrey-Hawkins Act. In our estimation, an environment characterized by the application of steady, consistently applied policies is itself conducive to the establishment of an economy characterized by steady, rapid growth.

We have had enough of policy-induced economic fits and starts, enough of roller coaster policies that have left us at the end of each recovery and downturn with more inflation, higher unemployment, and a smaller growth potential than the one earlier. Steady real growth is essential to the encouragement of major new investments in factories and skills, to expand the supply side of our economy, and to enhance productivity growth and reduce inflation. The uncertainties created in the wake of economic fits and starts serve to diminish

such investment incentives, the consequence of which is a slower rate of growth of potential real GNP. In other words, steady real growth, by encouraging a higher rate of capital formation than otherwise, is itself conducive to a higher rate of growth of our Nation's productive potential. According to one study by Data Resources, Inc., steady growth could add 0.2 percent to the growth of our Nation's potential real GNP each year. Additionally, appropriately structured monetary and fiscal policies aimed at enhancing productivity and capital growth could result in an even faster rate of growth of our real potential output.

In order to achieve these goals, however, it is mandatory, as noted before, that monetary and fiscal policies be closely coordinated. They must not be permitted to work at cross purposes in terms of our national goals. And the Federal Reserve Board needs to send Congress more than broad-brush assurances that their monetary growth targets are "reasonably consistent" with the economic goals of the President, as was done last year in the Board's first report to Congress under the Humphrey-Hawkins Act. We are convinced that there exists an effective anti-inflationary pro-growth mix of monetary and fiscal policies. And we know that they can be carefully coordinated with the cooperation of the Federal Reserve, the President, and Congress.

The Design of Fiscal Policy for 1980 and Beyond

What is required in order to maintain fiscal policy on a steady course is reasonably straightforward. Once Congress and the Administration reach agreement on the levels of government spending, they must set tax policies in such a way as to accommodate a rate of growth of real private spending consistent with the targeted long-run average rate of growth for the economy, and consistent with the monetary policy then in place. However, because both real and nominal income increases are taxed at progressively higher rates, real tax receipts will rise more than in proportion to the increase in real income. This extra rise, if not offset, will lower the future growth of real private spending, making the long-run average real growth target for the economy unattainable. Insofar as private sector incentives are reduced, the real growth potential of the economy is reduced as well. In order for fiscal policy to continue to have a steady, not contractionary, influence on the economy, it would be necessary either to periodically increase real Federal Government spending or to lower tax rates, or both, to offset the real growth and inflation-induced increases in tax receipts. Which method of offset should be used -- whether it should take the form of an increase in real Federal Government spending or a reduction in taxes -- depends upon the goal we set for the share of Federal Government outlays in the gross national product.

The question that now arises is: what course should fiscal policy follow in 1980 and 1981? The answer given by the Administration is that there should be no

bold new fiscal policy initiatives at this time. The policy initiatives that have been proposed relate mainly to defense and energy. Proposals have not been put forward to deal with the economic slowdown.

As far as taxes are concerned, the Administration remains adamantly opposed to a tax cut at this point. The economic outlook is highly uncertain. The recession failed to materialize in 1979, and there is no guarantee that it will emerge in 1980. According to the Administration, there is no need for a tax cut because such fiscal stimulus could worsen an already disturbing rate of inflation.

We fail to see why the question of a tax cut should be so intimately tied to whether or not a recession actually materializes. That there will be continued sluggish growth and that the United States will fall farther below its real GNP potential in 1980 are not in dispute. The Administration is concerned that a tax cut will contribute to inflation. A properly designed tax cut can be targeted so that it will not add to inflation and, over the long term, help slow it down. The conscious adoption of policies designed to throw the economy into recession or the failure to offset the drift of the economy into recession caused by external forces such as OPEC price increases, is not a responsible way to conduct policy. The costs of such a policy option in terms of lengthened unemployment lines, idled productive capacity, and reduced real output are both obvious and huge, serving neither the short-term nor the long-term interests of the American people. The anti-inflation gains from pursuing a sluggish growth strategy are disappointingly small.

A severe economic slowdown will result in a sharp and immediate reduction of investment spending. This is something our economy can ill afford. Not only would such a reduction of capital spending severely limit our future growth potential and our long-term rate of productivity growth, it would virtually guarantee yet another sharp increase in prices once the restrictive policy spigots are reversed. One of the first requirements for a healthy rate of capital formation is a healthy high employment economy, an outcome that we have a greater chance of fostering through the use of consistent and steady monetary and fiscal policies.

It is not the worsened outlook itself that forms the basis for our consideration of a tax cut, but the fact that fiscal policy, far from remaining steady, has become contractionary in the course of the past year, a factor that has contributed to the worsened economic outlook.

Last March, in our annual report to Congress, we endorsed the Administration's policy of overall demand restraint. We knew then that such a policy would result in a slower rate of growth for the economy in both 1979 and 1980. In the Committee's view, such an outcome was deemed appropriate in order to prevent demand (which at the end of 1978 was pressing up against our productive potential) from contributing to the then accelerating rate of inflation. Importantly, when making our recommendations we did not call for a policy of severe demand restriction. We recommended only a policy of moderate restriction aimed at slowing the rate of growth of aggregate demand to bring it into closer alignment with the growth of potential real GNP. We believe that the policy recommendations we made last March with

respect to fiscal policy were correct, and on the basis of the evidence we have at our disposal concerning the current state of the economy and the long-term growth of our productive potential, we feel that fiscal policy design should continue to be guided by these same principles. However, the additional fiscal drag exerted by a higher than expected inflation rate means we are not pursuing the same fiscal policy we recommended last March. Fiscal policy has tightened considerably since then and will continue to tighten further throughout 1980 in the absence of tax or expenditure changes. Therefore, it is necessary to put fiscal policy back on its earlier recommended steady course.

The move toward fiscal restraint is most clearly evidenced in the sharp decline of the high employment budget deficit between 1978 and 1979 and its expected further decline during 1980. Between the fourth quarter of 1978 and the fourth quarter of 1979, the high employment budget shifted from an annualized deficit of $6.6 billion to a surplus of $13.8 billion, a swing of over $20 billion in the direction of fiscal restraint. This additional margin of fiscal restraint was largely the result of legislated increases in social security taxes and the effects of inflation on Federal Government tax receipts. Moreover, given a near double digit rate of inflation projected for 1980, fiscal policy will automatically tighten further this year causing yet another $10 billion increase in the high employment surplus. In order to maintain a steady fiscal policy, this additional fiscal restraint, occurring as it does in automatic response to real income increases and inflation, should be offset if it can be accomplished without worsening inflation.

We are convinced that we need to consider a modest tax cut on the order of $25 billion to take effect no later than the summer of 1981, even though there is considerable uncertainty surrounding the economic outlook.

The tax cut we propose here is not the conventional kind which mostly benefits consumers. On the contrary, at least half of the tax reduction should be targeted to enhance productivity through savings and investment with the remainder going to help relieve taxpayers of the pressure of increased taxes and higher energy costs.

It is important to recognize why a conventional tax cut is not in order. We do not need another boom in consumer spending. Savings and investment must command a larger percentage of our GNP or we will fail to reverse our dismal productivity performance with the result that we will make little headway in our efforts to slow inflation and raise real incomes. Moreover, it is important that whatever tax relief is given to the business community it be given on the basis of its performance in expanding plant and equipment expenditures. We leave it to the tax-writing committees to work out the precise details of the tax cut proposed here.

If there is a downturn in the economy over the next 18 months and a sharp increase in the unemployment rate, Congress is likely to enact a tax cut. If there is no downturn and the unemployment rate remains in the neighborhood of 6 percent, according to the Administration, substantial budget surpluses will begin to accrue in fiscal year 1981 and Congress is also likely to enact a tax cut. In either case, Congress must make sure that the tax cut does not result in exacerbating the rate of inflation.

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Recommendation No. 3

Should either of these events occur, the Joint Economic Committee recommends a targeted tax cut of approximately $25 billion to take effect no later than the summer of 1981, designed to improve productivity and partially offset the tax increase on individuals caused by inflation. At least half of the tax cut should be directed toward enhancing savings and investment. 1/

1/ Mr. Reuss states: "To the extent that the economy needs an infusion of resources to reduce fiscal drag, this should come in the form of targeted spending on structural unemployment, on our cities and transportation networks, and as carefully targeted subsidies or incentives to business investment."

There are a variety of approaches and methods to achieve an enhancement of savings and investment. For example, adjustments to depreciation schedules could increase business savings and investment. It would also be appropriate to consider a rollback in social security taxes and other forms of personal and corporate tax reductions.

A caveat is in order here: If in response to heightened world tensions Congress and the Administration deem it appropriate to step up sharply the rate of Federal Government outlays for defense purposes, the tax cut will need to be pared or deferred accordingly, or some other spending restrained in order to keep fiscal policy on a steady course.

The President's fiscal 1981 budget implies some increase in the Federal Government share of GNP over the course of the next year. Projected future increases in government spending imply a somewhat reduced Federal Government share of GNP in future years, an outcome that meets with our approval because, with the improved economic outlook for future years, our social program objectives need not be encumbered. More rapid growth in the private economy is the appropriate means for achieving a reduced Federal share.

The Employment Act, as amended, requires that the President's Economic Report include interim numerical goals for reducing the share of the Nation's gross national product accounted for by Federal outlays to 21 percent or less by 1981 and to 20 percent or less by 1983, or the lowest level consistent with national needs and priorities. It was the intent of Congress when this requirement was enacted that the President's report discuss the goal of reducing Federal outlays

as a share of GNP and demonstrate how policies and programs can be designed to achieve this goal without impeding the achievement of the goal of reducing unemployment. The President's Economic Report does not contain the interim numerical goals or the policy discussion called for, with respect to the share of GNP accounted for by Federal outlays. This lapse is unfortunate and we are hopeful it will be corrected in next year's report.

Recommendation No. 4

The Committee supports the basic trend of Federal Government spending proposed by the President, for fiscal year 1981 and projected into future years, toward a gradually reduced share of Federal outlays in the gross national product.

It should be recognized that the Government's command over national resources is not accurately measured by the share of Federal outlays in GNP alone. Government regulatory activity also represents command over resources as it often requires State, local and private spending. It is conceivable that the Federal share of GNP measured by Federal spending could increase while at the same time total federally mandated spending is reduced because of a reduction in regulatory burdens.

The Design of Monetary Policy for 1980 and Beyond

In the overall design of macroeconomic policy, it is equally, or perhaps more, important that the monetary authorities pursue a steady course. Unfortunately, the

gyrating rates of change of money growth over the past several years provide convincing evidence that the Federal Reserve's charted course has been anything but steady.

It is not difficult to discover why past Federal Reserve efforts to control the money supply proved largely unsuccessful. It was mainly a by-product of the methods used by the Federal Reserve to control money growth, methods which in practice caused short-run movements in the money supply, and perhaps long-run movements as well, to be determined largely by changes in the demand for money. The problem of monetary control arose because the Federal Reserve believed that by controlling movements of short-term interest rates -- in particular, the Federal funds rate, the interest rate at which commercial banks lend to each other -- it could effectively control movements in the demand for money. Using the policy instruments at its disposal to bring about changes in the Federal funds rate, the Federal Reserve believed that it could bring money demand growth into alignment with its targeted rate of money expansion.

As long as the demand for money is a stable function of the interest rate, and as long as the Federal funds rate targeted by the Board is consistent with the Board's targeted rate of money growth, such a policy approach should work. Unfortunately, neither condition was met.

The demand for money was not effectively controlled by controlling interest rates. When the demand for money rose for reasons other than movements in interest rates, the Federal funds rate would rise above its target, causing the Federal Reserve to inject new reserves into the banking system raising

the supply of money. When the demand for money declined, the reverse sequence of events would occur and the money supply would fall. The absence of a stable and predictable relationship between the demand for money and the Federal funds rate meant that volatile movements in the demand for money would be mirrored in corresponding volatile movements in the money supply.

Additionally, if the Federal Reserve set its interest rate target "too low" or "too high," even assuming that there existed a stable relationship between the demand for money and interest rates, there would result a rate of money growth above or below the Federal Reserve's money growth targets. A targeted Federal funds rate that was too low would cause too rapid an injection of reserves, and conversely.

In an earlier era there may well have existed a more stable and predictable relationship between interest rates and the demand for money. For a variety of reasons, including recent financial reforms and rapid inflation, that relationship today is much less stable and predictable. Moreover, in a period of inflation, and particularly accelerating inflation, it is extremely difficult to interpret the significance of any given level of interest rates, in particular, what a given level of interest rates implies about the actual rate of money growth.

It is possible that the Federal Reserve's past monetary growth problems were compounded by its practice of making only small and relatively predictable policy and interest rate adjustments. This can prove particularly troublesome in a period of accelerating inflation because it means only

marginal upwards adjustments in the targeted Federal funds rate when, in retrospect, much more dramatic increases would have been called for. The consequence, in the minds of many monetary experts, was a Federal funds rate that was consistently too low; too low in the sense of being inconsistent with the Federal Reserve's own targeted rate of money growth. The result was an inordinately rapid increase in the secular growth of money.

In a dramatic departure from its previous operational practices, the Federal Reserve announced on October 6, 1979, new operating procedures designed to enable it to gain more effective control over the supply of money. Instead of tying its policies to movements in the Federal funds rates, the Federal Reserve will henceforth peg its operations largely to bank reserves. That is, the Federal Reserve will supply reserves to banks at rates it believes are consistent with its money growth targets.

We applaud the Federal Reserve for having the courage to change its operating methods as it did on October 6. By exercising firm control over the growth of reserves, the Federal Reserve should now be able to gain much more effective control over the money supply growth process than was true in the past, a laudatory goal for which there is near universal agreement. The control might not be as precise as some would like, but it should be effective enough to ensure money growth at rates that fall within the ranges of the prescribed growth targets.

We come now to the really thorny issue. Just how fast should the money supply be permitted to grow in the months and years ahead? Unfortunately, there are no clear-cut answers to this question. It depends on

one's definition of money and the relationship between it and the rate of nominal spending.

Settling on an appropriate definition of money is not as easy as one might imagine. Some argue that money should be defined narrowly as checking account (or checking account type) balances plus currency and coin only, since these constitute the only universally acceptable "means of payment" for virtually all economic transactions. True, but the relationship between this narrowly defined aggregate and the rate of nominal spending is not particularly close or reliable.

The reason why this is so is clear. The dollar amount of spending that can be financed depends not only on the stock of the "means of payment" but also on its velocity of circulation -- the rate at which it changes hands and is used to make purchases. If the velocity of circulation increases, the dollar amount of purchase that can be financed rises even if the stock of the "means of payment" does not, and conversely.

The difficulty with focusing on the "means of payment" is that its velocity of circulation fluctuates sharply over time. These fluctuations are the result of the decisions people make with respect to their holdings of the "means of payment." If a large enough number of people decide to economize on their "means of payment" by temporarily putting those funds into interest bearing assets until needed for their purchases, they will thereby have put them into the hands of those who will use them to make purchases in the interim, the result of which will be a noticeable increase in the velocity of circulation. But the fact that

different people behave differently at times in response to all sorts of developments, including changing laws and regulations, financial innovations and the rate of inflation, among other reasons, it is not surprising that we should discover volatile movements in the velocity of circulation of the "means of payment."

Because the velocity of circulation of the "means of payment" is so volatile and unpredictable, the Federal Reserve was not able to accomplish its objective of controlling movements in nominal spending by controlling movements in the "means of payment." This fact caused the Federal Reserve years ago to search out some more broadly defined aggregate to be used along with the "means of payment," one that included one or more financial assets that was more or less readily substitutable for the "means of payment," an aggregate that was more reliably and predictably related to nominal spending. The results of that search process led ultimately to the development of not one, but several, alternative monetary aggregate measures, no single one of which was unambiguously better than any other in all circumstances. Thus, the Federal Reserve attempted to subject to its control the growth of all of these many monetary aggregates.

As a result of continued changes in the financial and regulatory environment and changes in the behavioral responses of individuals and businesses to interest rates and inflation, even these monetary aggregates proved to be inadequate, a matter that we discussed in detail in our annual report last year. The problem, in short, is that none of them behaved as reliably and as predictably in terms of nominal spending as they once

did; the velocity of circulation associated with each had increased in volatility over time. The Federal Reserve has recently introduced new aggregate measures which it hopes will prove more meaningful.

Under the circumstances, it is difficult to recommend a precise growth target for the new aggregates because their relationships to the ultimate targets of monetary control at present are unknown and ill defined. We are forced, therefore, to discuss the issue of monetary control in terms of the general principles that should govern the conduct of monetary policy now and in the future.

We find ourselves in broad agreement with Federal Reserve Board Chairman Paul Volcker who, on January 2, 1980, made the following statement before the National Press Club in Washington:

> Our policy, taken in a longer perspective, rests on a simple premise -- one documented by centuries of experience -- that the inflationary process is ultimately related to excessive growth in money and credit. I do not mean to suggest that the relationship is so close, or that economic reality is so simple, that we can simply set a monetary dial and relax. Changes in spending and saving habits, the shifting characteristics of different financial instruments having some of the characteristics of money, and the inflationary process itself, all affect the observed relationship between money and economic activity. The increased openness of our economy in general, and the growth of international financial markets in particular, has long since ended illusions of autonomy in policy. Spending and tax policy, a whole range of government regulatory policies, and the behavioral patterns of business and labor all affect the performance of the economy, and the relationship between money, inflation and economic activity. But, with all the complications, I do believe that moderate, noninflationary growth in money and credit, sustained over a period of time, is an absolute prerequisite for dealing with the inflation that has ravaged the dollar, undermined our economic performance and prospects, and disturbed our society itself. We are learning that money

creation cannot substitute for the productivity, savings and resources we need to support economic growth but rather, in excess, will only impair prospects for sustained growth.

The central question is, how can we attain "noninflationary growth in money and credit"? Should it be accomplished rapidly or only gradually over a period of several years? In our view, the rate of money and credit expansion should be slowed gradually. To do otherwise, risks pushing the economy into a prolonged and deep recession. Since wage and price inflation show considerable momentum, at least on the downside, the burden of any very abrupt slowing in the growth of money and credit would fall on production and employment, virtually guaranteeing a deep and protracted recession. As we said earlier in our discussion of fiscal policy, attempts to wring inflation out of the economy by adopting the recession route makes no sense. The emphasis should be on the attainment of a gradual reduction in money and credit growth in order to permit the economy to make the production, investment, and other real adjustments that can and do occur only gradually.

Recommendation No. 5

The Committee strongly recommends that the Federal Reserve accomplish a gradual reduction in the rate of money and credit expansion (relative to the very high rates posted in years past) over a period of years toward money and credit growth rates that are consistent with the noninflationary real growth rate of the economy.

We believe that this recommendation, coupled with our other recommendations concerning productivity, energy, savings and investment, is essential to solving inflation while maintaining real economic growth and full employment.

Turning briefly to the rates of money expansion experienced since October 6, there exists a possibility that the Federal Reserve has moved too abruptly, that it is aiming for a rate of reduction of money growth that is too rapid from the point of view of the short-term and long-term interests of the economy. If this is so, it should ease up somewhat over the next few months in order to accomplish its ultimate long-run objectives in a more gradual and more certain manner. We say "more certain" because if the economy is thrown into a serious recession, made all the more serious by an overly restrictive monetary policy, the Federal Reserve may feel compelled to reverse itself sharply bringing us back to yet another era of monetary instability.

More explicitly, if the Federal Reserve were to maintain a rate of money expansion that was too low <u>for a period of several years</u>, there is little doubt that our inflation rate would be reduced. But unless there has been an unusual increase in the velocity of circulation, the economy would be forced to suffer through a moderate to severe recession. We find it hard to believe that the Federal Reserve would be willing to maintain such a policy in the face of such heavy costs.

But if the Federal Reserve, in the face of such an eventuality, did reverse itself sharply, we would have to ask ourselves what it was that we accomplished by such a tight

money policy. Will the deflationary effect of slower money growth and higher interest rates do much to slow inflation this year and next? Probably not. The burden of the deflationary adjustment will fall almost exclusively on employment and output in the short run. And if the deflationary effects of the policy will not make a significant dent in inflation in the short run, a quick policy reversal will return us to current or higher rates of inflation, thus incurring the costs of the recession without any permanent gains against inflation.

In fairness to the Federal Reserve, there is a possibility that the relationship between the aggregates and GNP may be somewhat more flexible than in the past. If velocity, for one reason or another, has increased significantly, then any given reduction in the growth of the supply of dollars may have less of a restraining influence on GNP than formerly. This is not entirely inconceivable since high inflation, rapid financial innovation, ever-changing laws and regulations and changing behavioral responses on the part of individuals and businesses to interest rates could change the relationship between the aggregates and GNP dramatically.

We do not know, for example, how much significance to attach to the sharp rise in interest rates since high levels of interest rates are, in part, a by-product of the inflationary process. Thus, although nominal interest rates are high, real interest rates are much lower; and real interest rates after taxes are lower still.

Interest earned is taxable. Interest paid is tax deductible. For savers and borrowers in the 50 percent bracket, a 2 percent real

interest rate at zero inflation implies a real after-tax reward to savers and a real after-tax cost to borrowers of 1 percent. At a 12 percent interest rate and 10 percent inflation, the after-tax rate for both lenders and borrowers will be 6 percent in nominal terms, but a negative 4 percent in real terms, even if the real pretax interest rate remains at 2 percent. The reduction in real after-tax interest rates induces borrowers to demand larger quantities of money and credit, an outcome that could account for the continued strong demand for credit at record nominal interest rates and help to explain the problems the Federal Reserve had in controlling the monetary aggregates in earlier months.

Our final assessment on the matter of the appropriate rate of money expansion will have to await the announcement by the Federal Reserve of its new money growth targets and the meaning of those targets in the context of the relationship between the old and the new monetary aggregates and between the aggregates and GNP.

Conventional macroeconomic policies are incapable of working a quick fix on our inflation problem. We can lick the inflation problem only gradually -- through the use of steady policies and through a very gradual reduction in the growth of the money supply from the high rates registered in years past. Monetary policy, in general, should be neither overly expansionary nor overly contractionary, nor should it be erratic. In the past, we pursued policies that were too expansionary at first; when accelerating inflation reared its ugly head, we slammed on the brakes hard; inflation didn't decline much but output and employment did, so we pumped up the economy again for yet another

repeat performance. As noted before, this roller coaster approach has caused a secular upward ratcheting of our rate of inflation. It is time we learned from our past mistakes.

One final problem area concerns the conduct of monetary policy in the face of downward pressures on the foreign exchange value of the dollar.

We should not sacrifice our long-term economic objectives for the purpose of attempting to maintain the value of the dollar in the short run. Indeed, it was precisely to avoid the need to sacrifice domestic economic objectives that made the abandonment of fixed rates of exchange an attractive option years ago.

Recommendation No. 6

The Committee sees no need to divert monetary policy from domestic goals to secure international objectives other than in truly exceptional circumstances. We are firmly convinced that the Committee's recommendations for monetary and fiscal policy will work to raise productivity and lower inflation in the United States, outcomes that will ultimately result in greater stability for the dollar internationally.

We fully recognize that the key currency role of the dollar imposes on the United States an obligation to ensure its stability. But that obligation is not ours alone; it is an obligation that must be shared by all the major industrialized countries. The key requirement that needs to be met to bring about a more stable dollar is the effective

synchronization of macroeconomic policies and performances. Absent the required degree of coordination, there can be little hope of greater long-run exchange rate stability.

We are often told that it is unrealistic to expect the major industrialized countries to coordinate their economic policies in the manner required to ensure exchange rate stability, that to insist upon highly coordinated economic policies would necessitate that they each sacrifice the realization of their domestic goals, an outcome they would all find unacceptable. The alternative these critics suggest is a return to some more stable system of exchange rates, one that is more heavily managed than the current system. We disagree. In our estimation floating is required precisely because the industrialized economies have failed to achieve the necessary degree of coordination. Indeed, in the absence of synchronized macroeconomic policies and performances, a fixed or near-fixed exchange rate system would foster the development of growing payments imbalances, the correction of which would necessitate the use of trade and capital restrictions or the use of restrictive macroeconomic policies, or both.

We do <u>not</u> view floating as a panacea for the world's economic problems. But floating is important because it can facilitate the process of balance-of-payments adjustment by providing time for governments to correct domestic imbalances without resort to trade and capital restrictions or inappropriate macroeconomic policies.

Recommendation No. 7

The system of floating exchange rates, with periodic intervention to counter disorderly markets, should be retained. Under present world conditions, floating appears to be the only viable approach. In order to achieve greater exchange stability, we urge the Administration to continue to press for greater international coordination of macroeconomic policies.

Macroeconomic Policy Objectives: An Overview

The American people have every right to be thoroughly dissatisfied with the performance of our economy -- both past and prospective. We have not been successful in our efforts to contain inflation. On the contrary, our inflation problem has worsened. We have not solved our unemployment problem. Indeed, for huge segments of the American population -- most notably blacks, Hispanics, and teenagers generally -- the American dream of steady, meaningful employment at high wages is nothing more than a hopeless myth. To be sure, the employment gains registered in the past several years have been truly impressive. But these employment increases have not been matched by a rising standard of living for the average American worker. The reason is the fall-off in the growth of labor productivity.

In our view, the American people are not unreasonable in demanding a reduction in the unemployment rate to 4 percent or less, a decline in the rate of inflation to something on the order of 3 percent annually and an increase in their living standards.

It would be irresponsible in the extreme to seek solutions to our problems by forcing the American people to suffer through yet another period of vicious "stagflation" characterized by continued rapid inflation, lengthened unemployment lines, and reduced levels of real production. Macroeconomic policy must be directed more toward the supply side of the economy, toward an expansion of our Nation's productive potential in a manner that raises dramatically the growth of American labor productivity. To accomplish this we need to step up sharply our Nation's rate of capital formation. Specific policies targeted at enhancing investment constitute only part of the answer, and not necessarily the most important part. Steady real growth and a lower rate of inflation are essential components of this process.

The emphasis that we accord to the supply side of the economy is important for yet another reason. The capacity of our economic system to absorb the huge costs imposed on us by the OPEC oil producers is severely limited when our capacity for growth is limited. It is undoubtedly easier to absorb the required adjustment costs when real production -- and real production per worker -- is advancing at a rapid rate. Under those circumstances, the economy could adjust without the need to suffer actual declines in consumable output. In the absence of rapid real growth, purchasing power must decline for some or all citizens. The strain this puts on our economic, social, and political fabric is all too clear. The need for a growth buffer is apparent.

Finally, as a further means of bolstering the supply side of the economy, we need to go beyond the macroeconomic policy

recommendations set forth above, so as to deal with the real structural maladies that plague our economy. We need better programs that address specifically the problems of the structurally unemployed, programs forged on the basis of a close partnership between the public and private sectors. We need to develop an effective long-term energy strategy aimed at reducing our vulnerability to the price and production policies of OPEC. We must do more to enhance the development and construction of high productivity technologies in America's businesses. We need to develop more efficient methods for achieving the reallocation of our Nation's resources away from declining low-productivity industries to those high technology consumer and capital goods industries at the leading edge of the product cycle. We need to provide more adequate transportation networks and public utilities in order to make our industrial centers more efficient locations for industry. And we need to shift out of, not protect, those industries that cannot successfully compete with foreign firms. One alternative to protectionism is to invite foreign companies to open their high-productivity plants here.

IV. INFLATION, PRODUCTIVITY, AND REGULATORY REFORM

Inflation, charged by the slowdown in productivity growth and energy price shocks, continues to be the paramount economic problem. In 1979 we posted our worst inflation record in over 30 years, and productivity actually declined by 2 percent.

The Committee is more convinced than ever that solutions to the inflation and productivity problems must be found on the supply side of the economy. A new study prepared for the Committee by Dr. Otto Eckstein reinforces our belief that changes in tax policies, if properly designed and implemented over a period of several years, would significantly reduce inflation and increase the growth rate of productivity and GNP.

The study shows that a combination of enlarged investment tax credits and liberalized depreciation allowances could result in a 4 percent reduction in inflation as measured by the Consumer Price Index and a 3.3 percent increase in productivity by the end of the present decade. To achieve a similar reduction of inflation through demand management policies would require a prolonged period of above 9 percent unemployment, nearly depression levels, and such policies would further slow down productivity growth.

Although we recognize that any analysis based on econometric model simulations should

be approached cautiously, the Eckstein study contains one of the first formal models of the supply side of the economy, and we consider this initial application very encouraging.

The remainder of this chapter discusses inflation and productivity from the perspective of supply side economic analysis. Comparisons are made of our record with those of other major industrial nations in order to place the issue in an international context. Two factors, the slowdown in the growth of capital formation and the proliferation of government regulations and paperwork, are singled out for detailed treatment. The wage-price guidelines and the need for greater cooperation between government, business, and labor in order to improve productivity are also discussed.

International Comparisons of Inflation and Productivity

The U.S. productivity record contrasts sharply with the records of the other major industrialized countries. Our growth in productivity since World War II has lagged behind the rates posted by every one of our major trading partners. True, the United States still maintains the lead in terms of the overall level of productivity, but if our relatively poor productivity growth performance persists, that gap will soon be closed. Indeed, evidence suggests that we have fallen behind some of our trading partners in a few key industries.

One recent study by Dale W. Jorgenson of Harvard University and Mieko Mishimizu of Princeton University shows that by 1972 Japanese industries had eliminated the

technological gap with their U.S. counterparts in 13 out of 28 industries compared. Japanese industry has been ahead of the United States in primary iron and steel and in primary nonferrous metals since 1967 and in chemicals since 1963 and has been steadily increasing their advantages in those industries. According to the study, which covers the period 1955 to 1972, Japan has been catching up with the United States in other heavy manufacturing industries and is ahead of the United States technologically in a number of light manufacturing and service industries including construction, paper and allied products, printing and publishing, and transportation and communication.

In Table IV-1 we compare the productivity and inflation records of the United States, Japan, France, West Germany, and the United Kingdom for the period of 1974 to 1979. In view of our relatively poor productivity performance, it is no mere coincidence that our record on inflation has been one of the worst among the countries compared in the table.

TABLE IV-1

INFLATION AND PRODUCTIVITY FOR VARIOUS COUNTRIES
1974 to 1979
(Rates of Increase Over Same Period of Previous Year)

	U.S.		Japan		France		W. Germany		U.K.	
	CPI	Prod.	CPI	Prod.	CPI	Prod.	CPI	Prod.	CPI	Prod.
1974	11.0	-2.9	23.2	0.1	13.7	2.4	7.0	2.4	16.0	-1.7
1975	9.1	0.3	11.7	1.7	11.8	2.2	6.0	1.3	24.2	-1.0
1976	5.8	2.5	9.4	5.4	9.6	4.0	4.5	6.1	16.5	3.3
1977	6.5	1.8	8.1	3.8	9.4	2.4	3.9	2.9	15.8	1.1
1978	7.7	0.3	4.2	4.5	9.1	2.9	2.6	3.1	8.3	3.1
1979:1	9.8	---	3.0	---	10.1	---	3.0	---	9.6	---
1979:2	10.7	---	3.3	---	10.1	---	3.7	---	10.6	---
1979:3	11.7	---	3.5	---	10.7	---	4.9	---	16.0	---
1979:4	12.7	---	---	---	11.5	---	5.7	---	17.3	---

Source: Bureau of Labor Statistics. Productivity measured by Gross Domestic Product per employed person.

Not all of the relative improvements for Germany and Japan on the inflation front can be attributed to their more rapid rates of productivity growth, however. One needs to acknowledge the importance of the sharp appreciation of their currencies relative to the dollar over this time period, exchange rate movements that are particularly important to those two countries because of the enormous size of their foreign sectors in relation to their domestic levels of production. Nevertheless, higher productivity growth rates brought them more inflation relief than was possible in the United States.

In Table IV-2 we present the productivity growth rates for the United States and for each of our six major trading partners over the period 1950 to 1978. Besides the fact that the United States is on the bottom of the list as far as productivity growth is concerned, one other important fact also needs to be acknowledged: all seven countries registered precipitous declines in their rates of productivity growth after 1973.

TABLE IV-2

PRODUCTIVITY MEASURES FOR VARIOUS COUNTRIES

	Relative Productivity* 1978	Average Annual Percentage Change in Productivity**			
		1950-65	1965-73	1973-78	1950-78
Japan	63.0	7.2	9.1	3.1	7.0
W. Germany	85.1	5.2	4.3	3.2	4.6
Italy	57.3	5.1	5.6	1.3	4.5
France	85.6	4.7	4.5	2.8	4.3
Canada	96.1	2.7	2.3	0.8	2.3
United Kingdom	58.4	2.2	3.3	0.9	2.3
United States	100.0	2.4	1.6	0.4	1.8

*Measured by real gross domestic product per employed person, using international price weights, relative to the United States.

**Measured by growth in real domestic product per employed person, using own country's price weights.

SOURCE: Bureau of Labor Statistics

Recession, Inflation, and Productivity

It is clear that recession is a very inefficient and inhumane means of fighting inflation. In order to have a significant influence on inflation, a recession would have to affect labor markets to a sufficient degree that the rate of growth in hourly compensation falls by an appreciable amount. The extent has to be enough to more than offset the usually harmful effect of a recession on productivity so as to reduce the rate of increase in unit labor cost.

The Eckstein study referred to above illustrates this problem. To lower the core inflation rate 1 percent to 7.9 percent by 1985, demand management policies would have to aim at 7.5 percent unemployment following a 1980-81 recession. To achieve a 2 percentage point reduction in the core inflation rate, unemployment would have to be held above 9 percent from now to 1985. This would pull one family in 16 into severe distress and make progress for disadvantaged groups virtually impossible. Moreoever, the effects on the utilization rate of industry and thus on production under this approach continue to be damaging and limit the benefits of holding down aggregate demand.

Even if a recession were effective in reducing inflation, it would not be worth the resulting higher unemployment and economic distress. This is particularly true for black and other minority workers. Because the black unemployment rate is approximately twice the white unemployment rate at all stages of the business cycle, in a recession the percentage of black workers losing their jobs is approximately twice the percentage of white workers who are thrown out of work.

Capital Formation and the Productivity Slowdown

Analysts are virtually united in their call for more capital formation, despite differences of opinion on the relative importance of various causes of the productivity slowdown. In a recent study, productivity analysts at the Bureau of Labor Statistics stated "the 1973-78 slowdown is dominated by the effects of reduced capital formation."

There are several methods of measuring the adequacy of capital formation. One can look at the ratio of real nonresidential fixed investment (spending for plant and equipment) to real GNP. This was 10.7 percent for 1973 to 1974, averaged 9.5 percent for 1975 to 1977, but recovered to 10.0 percent for 1978 and 10.4 percent for 1979. However, these data are somewhat misleading because a share of this investment was for the installation of pollution abatement equipment. This yields benefits of reduced pollution, but it does not contribute directly to measured output. In 1978 these expenditures amounted to $6.9 billion, more than 4.5 percent of total investment in the surveyed industries, with a projected increase to $7.3 billion for 1979. For certain industries the share in 1978 was higher: primary metals (12.6 percent); electric utilities (10.1 percent); petroleum (8.3 percent); and chemicals (7.8 percent). And these data omit the annual operating costs of complying with pollution abatement regulations.

A better measure of the adequacy of capital formation is the capital-labor ratio because it accounts for the growth in the labor force as well as the change in the capital stock. This ratio increased at an

average annual rate of 2.2 percent for the 1955-75 period. But with continued labor force growth and inadequate investment, it fell after 1975 and still has not regained its 1975 peak. Due to our energy situation, past rates of increase in the capital-labor ratio may be inadequate to restore past rates of labor productivity growth.

A recession would have an adverse short-run effect on productivity and inflation due to the cyclical performance of productivity. In the long run the effects are equally adverse. In a recession the rate of utilization of existing capacity falls, reducing the incentive for new plant and equipment spending, thus hurting productivity growth.

Inflation, Productivity, and Tax Policy

In order to understand the role that tax policy can play in addressing our severe inflation and productivity problems, we need to develop a conceptual framework of the inflation process and the forces that influence the supply side of the economy.

The actual rate of inflation can be divided into three separate inflation sources: the demand rate of inflation, the shock rate, and the core rate.

The Demand Rate of Inflation

The demand rate is determined by the state of aggregate demand in relation to our potential GNP. High rates of resource utilization, reflected in low overall rates of unemployment and high operating rates of physical capital, cause demand inflation to rise. An easing of demand pressures through

restrictive demand management policies can alleviate this source of inflation. Severely restrictive policies that push aggregate demand far below our Nation's productive potential can bring about an actual reduction in the overall rate of inflation. A number of studies have suggested that, in our present economy, the demand rate of inflation is approximately zero when the overall unemployment rate is in the neighborhood of 6.0 percent and the overall capacity utilization rate (as measured by the Federal Reserve) is around 88 percent. At lower rates of unemployment and higher rates of capacity utilization, demand contributes to higher inflation. At rates of unemployment above 6.0 percent and at capacity utilization rates below 88 percent, demand helps control inflation.

The Shock Rate of Inflation

The shock rate is determined by all those forces that cause sudden changes in particular costs: OPEC decisions affecting energy prices; weather and crop conditions, both here and abroad, affecting food prices; and shocks by government actions in the form of changes in payroll taxes, regulations, tariffs, and exchange rates that affect production costs and output prices.

The Core Rate of Inflation

The demand and shock rates of inflation primarily determine short-term price behavior. The core rate of inflation, on the other hand, determines the long-run price behavior of the economy.

The core rate of inflation is described by Eckstein in the following way:

> The core rate of inflation can be viewed as the rate that would occur on the economy's long-term growth path, provided the path were free of shocks and the state of demand were neutral.... The core rate reflects those price increases made necessary by increases in the trend costs of the inputs to production. The cost increases in turn are largely a function of underlying price expectations. These expectations are the result of previous experience, which, in turn, is created by the history of demand, shock inflation, and changes in the tax code.

What is notable about the core rate of inflation is its "great propensity to persist." It changes only very gradually and does not respond quickly to policies or other particular events.

The inertia exhibited by the core rate is extremely important as far as the design of economic policies is concerned. This can easily be illustrated. There is little doubt that shocks will continue to be an important source of inflation in the future. The current round of OPEC price increases and the impending increases in social security tax rates will raise the shock rate of inflation significantly, according to Dr. Eckstein. Additionally, even if we assume that future OPEC real price increases amount to only 4 percent a year, this in combination with domestic oil price deregulation will add to the shock rate of inflation. During the next three years these factors will raise the shock rate of inflation by about 2 percent,

and they will add at least 1 percent a year over the course of the next decade. Of course, these increases in the shock rate of inflation will eventually drive up the core rate as well.

If we were to use conventional macroeconomic policies to stabilize the core rate at its present near-9-percent plateau, the demand rate of inflation would have to become sufficiently negative to offset the increasing shock rate. As mentioned earlier, this could be accomplished only by holding the unemployment rate above 6.5 percent for several years. Moreover, if monetary and fiscal policies were to be used for the purpose of dramatically lowering the core rate below 9 percent, according to the Eckstein study, it "would require a prolonged period of deep recession, bordering on depression, with the average unemployment rate held above 9 percent."

The answer to our inflation problem, then, does not lie in the exclusive use of demand management policies. We must go beyond demand management to deal with the supply side of the economy -- to expand our Nation's productive potential through an increase in the quantity and quality of our labor and capital resources.

The productive potential of our Nation's economy is determined by a vast array of complex factors of which we have at present only an imperfect understanding. Labor, capital, energy, and the state of technology are all important determinants. How they interact and how policy can be used to change effectively both the quantity and quality of those resources are not clearly understood. We know that education, training programs, health policies, and the tax system all

affect the quantity and quality of our labor resources, but the precise relationships are not known. We know that research and development (R&D) expenditures can influence all of the factors cited above, but there exists a dearth of information on the relative and absolute importance of such expenditures on the quantity and quality of our resources.

The Eckstein study is a first step in the direction of a supply-side model of the U.S. economy. The econometric tests performed by Dr. Eckstein indicate that further developments focusing on the supply side will ultimately yield us a huge payoff in terms of new policy approaches aimed at both raising productivity and lowering inflation.

The results that emerge from Eckstein's aggregate-demand/aggregate-supply model based on two relatively simple tax policy changes are most significant: the study assumes that we raise the investment tax credit by 2.7 percentage points beginning in 1980 and that we also reduce the average tax lifetime of producers durable equipment by four years beginning in 1980; finally, it assumes that we hold monetary and fiscal policies neutral so that the demand rate of inflation is zero on average over the decade of the 1980s.

By comparison with the outcomes that would emerge in the absence of these tax policy changes, real business fixed investment would be up 5.7 percent by 1981 and 15.5 percent by 1990, raising the capital stock by 3.5 percent by 1985 and 7.2 percent by 1990. The increased stock of capital would raise potential GNP by 1.1 percent by 1985 (0.2 percent annually in the first half of the decade). The improved capital to labor ratio would add 1.2 percent to the level of

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productivity by 1985 (0.5 percent annually). It would raise real wages by 0.9 percent by 1985 and would help to produce a 0.7 percent increase in real consumption. It would reduce the core inflation rate by 1.3 percent by the end of the decade.

A 1.0 percent reduction in the core rate might not seem like much, but in the absence of these policy changes, the core rate would tend to rise because of the assumed secular increase in the shock rate of inflation.

It is also worth emphasizing one other important finding from the Eckstein study. A question that often arises in the consideration of policies to stimulate investment is whether expanding the investment tax credit would be the most efficient method or whether we should liberalize business depreciation schedules. Opinions have been very mixed on this score, but recent evidence leans toward liberalized depreciation. The Eckstein study concludes that liberalizing depreciation produces a long-run effect on supply which is modestly greater than the investment tax credit. In addition, McGraw-Hill, at our request, asked this question of the companies they include in their capital spending survey. The response to this survey varied across industries, but on the whole businessmen stated that in the intermediate and long run, faster depreciation would have a larger effect on their capital spending than a larger investment credit. These and other survey results will be presented in a report which we expect to publish soon.

Recommendation No. 8

In accordance with our general recommendations on fiscal policy and the timing of the tax cut, the composition of our next tax reduction should be as follows: one half of the tax reduction should be designed to provide greater incentives for capital investment. This should be accomplished primarily by increasing allowances for business depreciation.

Other Measures to Reduce the Core Rate of Inflation

To further reduce the core rate, other supply-side policy approaches could be explored. As Eckstein notes:

> They include a renewed effort to build up the stock of technical and scientific knowledge through investment in research and development, changes in the personal tax burden which may augment the supply of labor at least to a small degree and encourage productivity, and measures to enlarge the total supply of capital to the economy through increased personal saving. Measures that would reduce the unemployment rate of disadvantaged groups also would help in the struggle against inflation both by adding to the effective labor supply and by making it acceptable to manage aggregate demand in a more cautious manner.

In the remainder of this chapter we focus our attention on three promising ways of increasing investment efficiency -- increased

research, development, and innovation; increased Government-labor-management cooperation; and reduced regulatory costs.

Research and Development

In 1978 total expenditures for research and development in the United States amounted to $47.3 billion, or 2.2 percent of GNP, down from approximately 3 percent in the mid and late 1960s. Some economists have questioned the link between this decline and the falling rate of productivity growth because much of the drop was in military and space-related R&D and because the specific payoffs to R&D are uncertain and difficult to measure.

We believe that even though the precise effects are difficult to trace, it would be unwise to wait until definitive analyses are concluded before acting to improve the effectiveness of Federal R&D programs. Thus, we favor increasing R&D relative to GNP. This has happened abroad. Our overall R&D to GNP ratio still exceeds that in Japan, but theirs has been rising while ours has been falling. Civilian R&D relative to GNP is greater in Japan than in the United States. The aggregate West German ratio is about the same as ours, but their civilian R&D ratio is much higher.

Concentrating strictly on research and development is too narrow a focus when analyzing the effects on productivity of policies in this field. In our 1979 Midyear Review, we used the term "Advances of Knowledge" to include R&D, innovation, and the rate of diffusion of new knowledge. The latter two factors were as important as R&D in explaining the productivity slowdown, and studies have repeatedly shown that research

is a small fraction of the total cost of innovation. Our national policies toward innovation should be viewed in this broader framework.

Last year we urged consideration of additional tax and other incentives to promote industrial R&D. We realize that there may be some difficulty in defining R&D sufficiently narrowly to distinguish it from other costs. But we believe that this problem is not beyond solution, and appropriate tax incentives might be designed.

In the past many Federal R&D programs have not been aimed at the most promising areas. In some cases this arises from the lack of oversight. For example, under the Pentagon's independent R&D program, defense contractors receive grants for civilian R&D which in practice are used for a wide variety of expenditures with tenuous relation to R&D. Also, under the Comprehensive Employment and Training Act (CETA) program many research grants are made to local governments with virtually no review. In other cases, such as certain National Science Foundation (NSF) projects, funds are allocated by rigid percentage formulae, rather than by careful overall program review. Of course, it is often difficult to predict in advance exactly what activities will lead to the greatest economic benefits. But we believe that more can be done in this area.

Recommendation No. 9

We believe that the Federal Government should more closely target its R&D programs toward areas of prospective growth.

Wage-Price Guidelines

On October 24, 1978, President Carter announced his anti-inflation voluntary wage-price guidelines. The original provisions were discussed in some detail in The 1979 Joint Economic Report. Since that time there have been several major developments in the guidelines.

The legality of the guidelines and possible sanctions for violators were upheld on July 2 when the Supreme Court refused to review a lower court decision.

A Pay Advisory Committee of 18 members (six representing labor, six representing management, and six "public" members) was established. A Price Advisory Committee of six "public" members was also established.

The Pay Advisory Committee recommended new pay guidelines to the President on January 22, 1980. The new standards would replace the former percent wage guidelines with a 7.5 percent to 9.5 percent range, and establish criteria for determining where within this range a specific agreement might fall. The rate of inflation assumed in judging compliance of contracts with escalator clauses would be raised from 6 percent to 7.5 percent. New price guidelines were established in October. These involved some tightening of the profit margin standard.

The Council on Wage and Price Stability was directed to take into consideration the need to stimulate productivity in monitoring wages and prices to determine compliance with the standards. The Council was also directed to submit a report to Congress in July

reviewing its policies with respect to promoting greater productivity growth.

It is difficult to assess the effects of the guidelines program. The 13.3 percent rate of increase in the Consumer Price Index in 1979 might suggest that the standards have been a "failure," but this conclusion does not necessarily follow for several reasons.

(1) Ideally, the relevant comparison is not between inflation before and after the guidelines, but inflation since 1978 with and without the guidelines.

(2) The wage guidelines might have been more successful than the price guidelines, thus it is necessary to look at the performance of wages as well as prices.

(3) Changes in the growth rates of productivity and nonlabor cost affect the differences between growth in compensation, unit labor cost, and prices.

(4) The Consumer Price Index has recently overstated the "true" rate of inflation.

(5) Many items are excluded from the guidelines.

(6) A detailed review of the program would require a comparison of price and wage data for the thousands of companies and labor contracts covered with the specific standards applicable to each.

The CPI rose 3.7 percentage points faster in FY 1979 than in FY 1978, but the accelerations in the personal consumption expenditure (PCE) price index and nonfinancial corporate implicit price deflators were 2.0 percent and 2.6 percent.

The worsening of inflation in FY 1979 in the nonfinancial corporate sector was due neither to more rapid gains in total hourly compensation (which accelerated by only 0.6 percent to 8.9 percent, as compared with the target of 7.5 percent), nor to higher unit profits (which showed a turnaround, from a gain of 1.4 percent in FY 1978 to a loss of 3.9 percent in FY 1979). Rather, it arose from the large jump in the rate of increase in unit nonlabor cost (especially energy), and the fall in productivity in FY 1979 after a modest gain in FY 1978. While not conclusive, these data suggest that the guidelines may have been successful in restraining both wage and profit growth; the worsening of inflation arose from the increase in nonlabor costs and the turnaround in productivity.

Recommendation No. 10

Voluntary wage and price guidelines can be an effective policy for winding down persistent long-term inflation when they are part of an overall anti-inflation program that includes fiscal and monetary restraint and other anti-inflation policies. We urge Congress and the President to conduct economic policy during 1980 in a manner that will contribute to the success of the guidelines. 1/

1/ Congressmen Clarence J. Brown and John H. Rousselot, and Senators William V. Roth, James A. McClure, and Roger W. Jepsen feel that the "voluntary" wage-price guidelines are improper (if not illegal) because of the compliance provisions making them involuntary for certain segments of the economy, and, thus, highly unfair in their applicability. Federal employees and members of large industrial unions have been hurt more than others. In addition, the Administration has mocked its own "voluntary" program in certain politic circumstances by pragmatically endorsing settlements which are obviously in excess of the guidelines. Thus, unfairness is implicit in the whimsical compliance required by these nonvoluntary guidelines -- the same unfairness that history establishes is rampant in mandatory uniform wage-price controls. Free market adjustments may not result in equal impacts, but they are much more effective, balanced, and desirable. It is time the Administration admits that the guidelines are not working and move to an anti-inflation policy that will work -- the one described in this report.

National Productivity Council and Labor-Management Cooperation

It is unfortunate that the efforts of the Federal Government to stimulate productivity growth appear to have diminished at the very time that the need for such efforts has grown. Ironically, 30 years ago we knew what was necessary when we required that countries participating in the Marshall Plan set up national productivity centers. These centers have made major contributions in Europe and Japan. But we have not followed our own advice.

The National Center for Productivity and Quality of Worklife, with a staff of approximately 50 employees, was created as the catalyst and focal point for national efforts in November 1975, but it terminated operations as of September 30, 1978. The Center was superseded by the National Productivity Council (NPC), created by Executive Order on October 23, 1978. The Director of the Office of Management and Budget is the Chairman of the Council, and the heads of a number of key agencies are members. To date the main function of the NPC is the undertaking of several studies: the improvement of productivity statistics; determining the proper Federal role in supporting State and local government productivity improvement efforts; improving Federal employee productivity through the Civil Service Reform Act; and analyzing Federal initiatives to encourage labor-management cooperation.

Critics have charged that the NPC is inadequate to meet our needs, with only two professional staff persons (though some work is carried out by staff from other agencies). The Comptroller General has stated that the

size of the staff is "mighty inadequate." Other criticisms have been that in an interagency task force responsibility is too diffuse and, as stated by the Comptroller General, "We must move from rhetoric to action in improving national productivity."

A center serving as the focal point for Federal productivity efforts need not be a large new bureaucracy, imposing added paperwork on businessmen. Rather a small but effective group could work with the private sector. As outlined by the Comptroller General in a letter to the Chairman of this Committee, such a center should:

--Identify Federal Government targets of opportunity to improve private sector productivity.

--Work to have adequate funds allocated to match these targets of opportunities.

--Ensure the coordination of all Federal efforts to improve productivity.

--Represent the perspective of productivity improvement at the top policymaking level.

The direct Federal efforts to improve national productivity should remain within existing agencies. The productivity focal point should, however, provide the needed leadership and direction to Federal departments and agencies.

One of the best examples of the type of success such a center might achieve is provided by the cooperative efforts of the Agriculture Department and American farmers. These efforts have given us by far the most productive agricultural sector in the world.

We strongly support Federal policies which encourage greater cooperation between industry, labor, and government in order to identify opportunities for productivity gains and improvement of worker morale. It is part of our general view that steps should be taken to modify the often strong adversary nature of relations between labor, management, and government.

Recommendation No. 11

The efforts of the National Productivity Council should be expanded. One specific area which should be addressed is the need to promote higher productivity through the cooperative efforts of labor, management, and government. In general the NPC should give more stress to specific policy actions.

Regulation and Paperwork

It is difficult to quantify the effect of Federal Government policies on inflation and productivity. There can be little doubt, however, that government regulations and paperwork requirements impose substantial compliance costs on American businesses, which contributes to rising prices. We believe that a comprehensive program to reduce inflation and improve the productivity of the American economy should include measures to reduce the unnecessary costs of redundant, ineffective, wasteful and conflicting regulations and paperwork requirements. A number of measures have been proposed for reforming Federal regulations. The test of their effectiveness should be whether or not they reduce regulatory costs

without reducing the ability of regulatory agencies to carry out their congressional mandates.

During the past decade and a half, the Federal Government has increasingly relied on regulation of the private sector to channel resources toward such public goals as a cleaner environment, safer workplaces, less hazardous consumer products, and equal employment opportunities. More than 20 new regulatory agencies were established during the 1970s with regulatory responsibilities in such areas as environmental protection, highway safety, consumer product safety, and energy production, to name only a few. Although many pre-existing programs were incorporated in those agencies this was the largest number of regulatory agencies created during any decade in the Nation's history.

These important programs usually require that businesses incur significant compliance costs which are then passed on to consumers through higher prices. While many government regulations, particularly those affecting health, safety and the environment, have contributed significantly to the overall well-being of the vast majority of American consumers and workers -- and we would not roll back the clock because many regulatory policies have produced substantial benefits for the public -- the cost of regulatory programs must be brought under control.

The Federal Register, where all new regulations are printed, provides evidence that the burdens imposed by regulation are growing substantially. In 1955, the Federal Register contained only about 10,000 pages. By 1970, 15 years later, the number of pages had doubled to 20,000. In 1979, however, the number of pages was over 77,000, almost four

times the 1970 level. Much of this growth was the result of new regulatory programs.

This regulatory growth has imposed a substantial, and rising, cost on the American economy. Although the measurement of the private sector costs of compliance with government regulations is still at the development stage, a number of studies have recently been performed which give an indication of their magnitude. According to a study prepared for the Joint Economic Committee by Murray Weidenbaum of Washington University, businesses and individuals are currently spending perhaps as much as $100 billion annually, or even more, to comply with government regulations. This represents a 63 percent increase just since 1976. While the results of this study have been challenged, some believe they provide useful estimate of regulatory compliance costs. Spending by State and local government is also heavily influenced by Federal regulations. In addition, there have been numerous studies of the costs of individual regulations or regulatory programs, including a study by the Business Roundtable which found that 48 member firms incurred costs of $2.6 billion during 1977 to comply with the regulations of just six Federal agencies.

The growth of Federal regulation continued during 1979. According to the second edition of the Calendar of Federal Regulations, which was published by the Regulatory Council in the November 28, 1979, Federal Register, Federal agencies are in the process of developing 129 major new regulations that will significantly affect the economy during 1980 and in the years to come. Among the criteria used for listing a regulation in the Calendar is that it have an economic effect of $100 million or more or have some other

significant impact on an industry or sector of the economy. Of the 129 regulations in the Calendar, 31 affect energy, 24 affect State and local governments, 21 affect autos, trucks, and buses, 21 affect agriculture, 18 affect the coal industry, and 13 affect the chemical industry. These regulations will very likely increase costs and prices in these industries and sectors of the economy.

As with many new and rapidly growing government programs, problems have developed with regulations that have to be dealt with in order to improve their efficiency and effectiveness. One major problem involves the measurement of benefits and costs. Most economists would agree that the costs of regulatory programs should be balanced against the benefits. But this is very difficult in practice, as the current techniques for measuring benefits and costs are still crude and need further development. There are other significant problems which we will discuss later. Partly as a result, the benefit goals of many regulations are set with little regard to cost. Some of the fault for this lies with Congress, as some laws allow regulations without requiring that costs or benefits be weighed, while other laws prohibit the consideration of costs.

In addition, the recent proliferation of regulations and lack of coordination among regulatory agencies often results in regulations which are duplicative, conflicting, and excessive. Recently, the Congressional Research Service prepared for the Joint Economic Committee a background study of conflicting and duplicative regulations in eight major industries or sectors of the American economy, including iron and steel, automobiles, chemicals, pharmaceuticals, health care, farming,

housing and energy. The study will be published by the Committee later this year. The study, which relies on published sources and industry spokespersons, concludes that:

> The areas of Federal regulation cited most frequently as being in conflict with one another included energy, environmental, and health and safety regulations. In a number of instances, our inquiries found that conflict may not only be among regulations themselves but with broader national economic objectives as well, such as the goals of increasing productivity, promoting economic growth, reducing inflation, conserving and allocating scarce resources, and providing affordable housing for low and moderate income families....
>
> On the question of duplicative regulatory requirements, industry spokesmen consulted in our informal inquiries cited examples of redundancies or overlap in reporting requirements, inspections, and Federal, State and local regulations....
>
> Finally, though the focus of this study was not on the cost of regulation or the problem of regulatory delay, several examples of conflicting and/or duplicative regulations were identified by industry spokesmen as causing costly and unnecessary delays in production and as placing heavy cost burdens on their businesses.

The growing cost of Federal regulations and their contribution to inflation has led to efforts within the Administration and Congress to reform the way in which agencies

develop and issue regulations. President Carter has recently taken certain actions to improve the regulatory process -- including formation of the Regulatory Council to coordinate agency regulations, creation of the Regulatory Analysis Review Group to evaluate agency regulatory analyses, and promulgation of an Executive Order requiring all executive agencies to prepare an economic analysis of major regulations. The effectiveness of these actions, however, is still uncertain. In addition, the President and various Members of Congress have introduced numerous bills during the 96th Congress to improve the regulatory process or cut the cost of regulations. Numerous efforts have also been made to cut the burden of government paperwork.

These actions will reduce inflation and improve the productivity of the American economy only if they help cut the unnecessary and wasteful costs of Federal regulatory programs without hampering the ability of agencies to achieve their statutory goals. Unfortunately, many measures now before Congress are unabashedly antiregulation and aim explicitly at hamstringing the ability of regulatory agencies to protect consumers, workers, and the environment.

There is no limitation on the costs that regulatory agencies can impose on the private sector in their attempts to achieve their regulatory goals. The President cannot set limits, because most of the regulatory agencies are independent commissions or administrations. Congress does not set limits because we have not yet established a systematic way of doing it. The result is entirely predictable. The agencies have no incentive to consider private sector costs when they develop regulations, and so they

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have no incentive to minimize those costs. Regulations can turn out to be ineffective, unnecessary, wasteful, in conflict with other regulations, or duplicative of other regulations.

The Joint Economic Committee supports the major goals of most of our regulatory programs, but we are concerned at the way those regulatory programs are sometimes administered. We have no intention, however, of recommending measures that will reduce the protection now afforded consumers, workers, and the environment while we try to discipline the regulatory agencies. Instead, we believe measures adopted by Congress and the President must require that the regulatory agencies behave in a responsible manner and minimize the unnecessary costs that regulations impose on the American economy.

There are a number of measures Congress and the President could take to reduce the costs of duplicative, conflicting, and unnecessary regulations and to cut the burden of Federal paperwork on American businesses.

Regulatory Budget

During the past year, the Joint Economic Committee held hearings to examine how enactment of a regulatory budget could improve the regulatory process and cut unnecessary regulatory costs. Administration and private witnesses testified on the potential uses of a regulatory budget and the problems that will have to be solved before such a budget could be implemented for the Federal Government. Their findings indicate that a regulatory budget could, in the long run, fill a number of important gaps that

have been omitted from other efforts to improve the regulatory process, without posing any insurmountable problems.

The current regulatory process fails to recognize that the goals of regulatory programs must be balanced rationally with other national objectives. The achievement of any objective, public or private, involves resources that could be used for several purposes. The more resources that are devoted to one purpose, the less available for others. George Eads, member of the Council of Economic Advisers, testified that only the regulatory budget proposal would "provide a control mechanism capable of keeping the level of private sector expenditures resulting from Federal regulatory requirements in line with alternative uses of the same resources to attain other national objectives."

The impact of this omission was discussed by James C. Miller III, Codirector of the Center for the Study of Government Regulation at the American Enterprise Institute for Public Policy Research:

> Government can obtain resources in three ways: Taxing and using those proceeds to buy things in the private sector; printing money and using the money to pay for such resources; and conscripting resources outright. In essence, regulation to accomplish social ends is not unlike conscription, and I think we need to have a handle on the size of that bundle of goods and services that we're conscripting, to know what size it is and to know to whom those resources are being allocated and from whom they're being taken.

And it seems to me the regulatory budget would accomplish that in great measure.

The fiscal budget no longer provides Congress and the President with the information needed to make these decisions. Prior to the rapid growth of regulatory programs, the present fiscal budget was generally adequate to show the impact of government on the economy. Almost all the activities of the Federal Government involved direct spending, in the form of purchases or transfers or direct taxation, and these showed up in the budget. There were very few regulatory programs.

By showing the level of total spending and the amounts to be spent by each agency, the Federal budget has been a powerful tool for limiting the Government's command over public resources and facilitating their allocation among competing uses. One could have a fairly clear picture of the Government's influence in the economy by reading the budget. But with the rapid growth of the new regulatory agencies -- the Occupational Safety and Health Administration, the Environmental Protection Agency, the National Highway Traffic Safety Administration, and many others -- the Federal budget no longer conveys a complete picture of the Government's economic impact.

The annual budget understates the proportion of the Nation's resources that are used for public purposes. Government spending for national defense, welfare, job training, revenue sharing, and other programs, as well as revenues lost through tax incentives, do appear in the budget. Spending in the private sector for auto safety, mine safety, pollution control, and

consumer protection, plus the attendant government-required paperwork do not appear in the budget. Nor do the possible higher prices paid by consumers because of economic regulation by such agencies as the Interstate Commerce Commission, the Civil Aeronautics Board, and the Federal Communications Commission. The costs and benefits of both social and economic regulations should be more clearly available to policymakers.

If these costs were minor, their omission from the budget would not be a problem. But they are not minor. The costs are significant and growing. On the other side of the ledger, benefits are also significant but do not appear anywhere.

Enactment of a regulatory budget would make it possible for Congress and the Federal agencies to establish better priorities over the use of the Nation's resources. Currently, the fiscal budget establishes a ceiling on the amount agencies can spend for social goals out of tax receipts. This forces Congress and the agencies to determine how we can obtain the greatest benefits for the Nation from the resources available in each year's budget. But the regulatory agencies currently operate under no constraints on how they force the private sector to spend funds for social purposes. As Robert Crandall of the Brookings Institution testified:

> In the absence of a regulatory budget, regulators may proceed as if the resources they command have no other social value.... In virtually every major institution which controls a share of our society's resources, the use of these resources is limited by a budget. Households, firms, most

> government agencies, and even the military services are operated with a budget limitation. Only regulatory agencies -- such as EPA, OSHA, CPSC, or FDA -- are not limited by such a device in their discretion to command our society's resources to protect the public. Regulatory standards or rules, may have to be "reasonable" or "feasible", but there is no mechanism which forces the decisionmakers in these agencies to trade off expenditures on one goal for outlays on another.

Enactment of a regulatory budget would significantly improve the process by which regulatory agencies channel private resources toward important public uses.

Although some regulatory costs cannot be to measured with current techniques, many costs are measurable, including the costs of required investment, paperwork, and changes in product quality. While much progress remains to be made in regulatory analysis, witnesses argued that significant improvements have occurred just in the last year in the ability of agencies to measure the costs of regulations. As Christopher DeMuth, Director of the Faculty Project on Regulation at Harvard University, testified:

> I would like to note that the executive branch regulatory agencies are already preparing fairly exhaustive cost estimates of their major regulatory proposals at present, under President Carter's regulatory review program.
>
> So the first step toward a regulatory budget, presumably, would be for some group at OMB or COWPS to collect these

cost analyses and consolidate them as part of a special analysis of the budget.

James Miller III was also optimistic about the ability of agencies to develop the cost figures needed to implement a regulatory budget:

> While the performance of many agencies in measuring costs has been less than exemplary, over time agencies have gained a great deal of experience -- at least in estimating the costs of individual regulatory initiatives. The bottom line seems to be that while many would disagree over the precise estimates, in most cases fairly good approximations can be developed if the agencies go about the task with determination and employ competent analysts.

Recommendation No. 12

The Committee urges Congress and the Executive Branch to study and develop a regulatory budget during the next three years, with emphasis on developing the methodology necessary to make a regulatory budget for the Federal Government a reality in the future. A regulatory budget would encourage government agencies to reduce the costs of regulation and improve the efficiency of regulatory programs. In addition, a regulatory budget would supplement the annual fiscal budget to give the public, Congress, and the President a more comprehensive view of the Federal Government's command over resources for public purposes.

Cost-Effective Regulation

In our 1979 Joint Economic Report, the Committee recommended that all government regulations should be cost effective. When there are alternative ways of achieving the goals of a regulation, the least costly way should be adopted unless there is some overriding national objective that requires the adoption of a less cost-effective alternative.

We argued that a cost-effectiveness requirement would be the simplest way of assuring that regulatory goals are achieved at the lowest possible cost and with the least waste of resources. The American public would still receive the benefits of regulations designed to protect consumers, workers, and the environment, but without the inflationary impact of regulations which pay little attention to the costs they impose on the private sector. We believe a cost-effectiveness rule would be a more effective way of controlling regulatory costs without reducing benefits than would a cost-benefit test, as some have proposed, because benefits would not have to be measured and because regulators would simply have to choose the least costly of alternative ways of achieving their regulatory objectives.

President Carter included this requirement in his proposed Regulation Reform Act of 1979 which was introduced in March of last year. Under the bill, the regulatory analysis accompanying each major Federal regulation would have to demonstrate that the method chosen to accomplish the goal of the regulation is the least costly of the possible alternatives or it would have to explain why a more costly alternative was chosen.

Recommendation No. 13

All government regulations should accomplish the statutory objective in the most cost effective manner. When alternatives exist, each of which clearly would achieve a particular regulatory goal, the least costly way should be adopted unless an overriding statutory goal requires the adoption of a less cost-effective alternative.

Federal Paperwork

Among the most unproductive uses of the Nation's resources are the time and energy wasted by American businesses and individuals in responding to excessive, repetitive, duplicative or unnecessary Federal, State and local recordkeeping and reporting requirements. Much of government's collection of information from the private sector is legitimate and is useful for administering programs or advancing our knowledge of the Nation's problems. But in too many instances, Federal agencies demand information that is already being collected by other agencies or that is in excess of their needs to satisfy their statutory responsibilities. The resources used to comply with these requirements could be much better employed, without impairing the Government's ability to carry out programs effectively.

Last year, the Joint Economic Committee requested a General Accounting Office (GAO) study of the burden imposed by Federal paperwork on American businesses. In response, the GAO thoroughly surveyed agency paperwork requirements affecting business

that had been approved by either the Office of Management and Budget (OMB) or by the GAO.

According to the General Accounting Office, American businesses take about 69 million hours annually at an estimated cost of over $1 billion to respond to the more than 2,100 reporting and recordkeeping requirements that have been approved by OMB or GAO. The average approved requirement involves ten separate forms, although one requirement was discovered which created 90 forms. In addition, many Federal reporting requirements are repetitious and occur throughout the year, thus vastly increasing the burden. For example, one Department of Commerce requirement generates 5.8 million responses yearly, while 22 of the Government's paperwork requirements each involve more than 1 million annual responses. The General Accounting Office found in its study that:

> The requirements analyzed represent only the tip of the burden iceberg. About 78 percent of all Federal reporting requirements are exempt from either GAO or OMB clearance. Thus, the most pervasive, burdensome, and probably most irritating requirements were not addressed.

When the exempted forms -- primarily the tax forms of the Internal Revenue Service -- are added, along with paperwork affecting individuals, farms, and State and local governments, the Office of Management and Budget has found that "the Government's paperwork requirements translated at the beginning of 1979 into 786 million hours of the public's time spent filling out forms." This is the equivalent of over 390,000 full-

time workers -- the number of people who work for the fourth largest American corporation.

Federal paperwork is particularly burdensome for smaller businesses. A study recently prepared by the Chief Counsel for Advocacy of the U.S. Small Business Administration found that small businesses file over 305 million Federal forms a year, totaling over 850 million pages and containing over 7.3 billion questions. The SBA's survey showed that the average annual cost per small business firm to comply with government reporting requirements comes to about $1,270, about 80 percent of which is attributable to Federal requirements and the balance to State and local requirements.

In its report to the Joint Economic Committee, the GAO found a number of serious problems with the management of paperwork by the Federal Government.

First, when an agency submits a request to the Office of Management and Budget or the General Accounting Office for approval of a new reporting or recordkeeping requirement, the request must be accompanied by an estimate of the burden-hours to be imposed on each respondent plus an estimate of the total burden to be imposed on all respondents. This burden estimate is designed to help compare the cost of supplying the information to the government with its benefit or usefulness. If the burden estimates are inaccurate, they provide little information for making these comparisons. The General Accounting Office found that:

> The accuracy of burden estimates provided by the various Federal agencies is unknown. Because these estimates are currently the only

available measurement of the burden of reporting requirements, they should be as accurate as possible. If the estimates are poor, their usefulness is limited. Before these estimates can be relied upon, questions regarding their accuracy need to be resolved.

It is highly likely that the agencies underestimate the actual burden of their reporting and recordkeeping requirements. Many agencies only compute the time needed to fill out required forms, but in fact there are 17 different kinds of costs involved with Federal paperwork as shown in Chart IV-1.

CHART IV-1

EXAMPLES OF PAPERWORK BURDENS
(Time and Money)

* First-time costs to design, develop, install information systems needed to furnish information requests by the government
* Repetitive direct and indirect costs of data collection, processing, and analysis
* Costs of filling out forms
* Costs to hire consultants, lawyers, accountants, actuaries, computer services, or other professional services to prepare report
* Costs of time required to take part in the program, including salaries and benefits
* Costs of program delays resulting from paperwork and red tape
* Costs of keeping informed, including publications and seminars on regulations
* Costs to transmit or mail data
* Costs of correcting reporting errors on complex forms
* Costs of stationery, reproduction, postage, and telephone
* Personnel training costs
* Costs of time to understand what the government's requirements mean
* Costs of travel to government offices to discuss requirements
* Records/data storage costs
* Computer costs
* Overhead costs
* Costs of on-site government audits for data submitted

Source: U.S. Small Business Administration. Government Paperwork and Small Business: Problems and Solutions. December 1979. P. 24.

The General Accounting Office is currently evaluating the accuracy of burden estimates, and the processes used by agencies to develop these estimates, in a series of in-depth studies for the Joint Economic Committee. The first of these studies examines Federal recordkeeping and reporting requirements under the Packers and Stockyards Act of 1921, as administered by the U.S. Department of Agriculture. The following is an informal summary of the findings.

1. The Office of Management and Budget has specified four ways in which agencies can determine the burden imposed by their various reporting and recordkeeping requirements -- including interviews with experts, preliminary tests, etc. The General Accounting Office found that the Department of Agriculture ignored these guidelines and relied almost entirely on staff judgment to create burden estimates. Of 82 clearances examined, the burden estimate on 73 was undocumented. When the Department of Agriculture clearance officer sensed that the estimate made by the agency was unreasonable, the clearance officer and the program officer would negotiate a more reasonable estimate.

According to the General Accounting Office report, the use of staff judgment for burden estimates means that the Department of Agriculture has been able to reduce its paperwork burden figures under the President's Burden Reduction Program without making any substantive changes in its paperwork requirements, simply by reducing the burden estimate on selected clearances based on "better" staff judgments. For example, in 1977, the Food Safety and Quality Service used a new staff estimate to cut the burden estimate of its meat inspection reporting requirement from 833,000 hours

annually to 407,500 hours, even though no change had been made in the requirement.

2. Although the Office of Management and Budget requires that data collected be useful, the General Accounting Office found that the Department of Agriculture has no formal criteria for determining utility. Of six Department of Agriculture agencies examined, the General Accounting Office found that the utility review consisted of no more than an informal discussion between the paperwork clearance officer and program officer. Often the clearance officer simply accepted the program officer's desire to collect data.

3. The four major reporting and recordkeeping requirements the General Accounting Office decided to look at under the meat inspection program are part of a paperwork clearance package that actually includes 24 separate reporting and recordkeeping requirements, 20 of which are minor. While looking at this clearance, the General Accounting Office found eight more requirements that had never been submitted to the Office of Management and Budget for approval, and which were thus being imposed on packers and stockyards illegally. In addition, the General Accounting Office found almost 1,100 "bootleg" forms being used by State and local offices of Department of Agriculture agencies that had not been submitted to the Office of Management and Budget for approval.

4. One of the most serious findings involves the labeling requirement. Each time a packer wants to change a label on one of its products, such as canned hams, it must submit the label to the Department of Agriculture for approval before it can be

used. The Department of Agriculture requires a separate application for each size and each packaging plant so that a firm producing five sizes at different plants must submit 25 different applications even though the only difference in labels may be in weight designation. The burden estimate for each application is 15 minutes. At $15 per hour for labor costs, the General Accounting Office found that this example would cost a packer $94. If all the labels could be submitted together, the cost could be cut to $4. Even worse is the fact that packers have been forced to hire private expediters to cut through the Department of Agriculture red tape to get their labels approved. Approval currently takes 2-3 weeks. Private expediters will speed up the process and usher applications through the bureaucracy for $8-15 per application, at a cost of $200-375 in the above example. A Food Safety and Quality Service officer interviewed by the General Accounting Office admitted that this greatly speeds the process, at the cost of delaying applications not having an expediter.

The General Accounting Office also found much duplication in the collection of data from the business sector, even within the same department or agency. For example, the indepth report on the Packers and Stockyards Act discovered that the same financial data was being collected from companies in the meat industry by four different Department of Agriculture agencies, as well as by the Department of Commerce. Only the format and coverage of the data differed. This duplication imposes an unnecessary and costly burden on businesses, but the General Accounting Office believes that current government efforts to eliminate such duplication are inadequate.

Much of the blame falls on the Office of Management and Budget. Rather than set and enforce overall standards and procedures to be followed by Federal agencies, OMB instead reviews all agency requests for paperwork clearances. Since OMB does not have the personnel or experience needed to judge each request for information adequately, it approves an overwhelming proportion of such agency clearance requests. In addition, pursuant to a congressional mandate clearance requests from the independent regulatory agencies are processed through the General Accounting Office, not the OMB.

Recommendation No. 14

Congress should enact legislation consolidating all paperwork management responsibilities under the Office of Management and Budget, provided there is sufficient protection of the sensitive functions of the independent regulatory agencies. The paperwork management activities of the Federal departments and agencies should be upgraded and monitored by OMB, with the goal of reducing the burden of Federal paperwork on the American public to the level necessary for the effective management of government programs.

V. EMPLOYMENT, SMALL BUSINESS, AND HOUSING

The medium- and long-run goals for employment and inflation established in the Full Employment and Balanced Growth Act of 1978 (The Humphrey-Hawkins Act) can only be achieved if our economic policies pursue the twin goals of long-term economic growth and improved productivity.

The best way to create new jobs is through economic growth. Economic growth is particularly important to black workers, women, youths, and other groups of workers who suffer from high rates of unemployment in good times and bad. Many of the unemployed in these groups are jobless for structural reasons -- inadequate basic educations, poor or nonexistent job skills, job attachment to declining industries or decaying central cities, and discrimination based on race, sex, age or other characteristics unrelated to their ability to work and produce. They are the last hired and the first fired.

During the past decade and a half, Congress has created a number of programs to provide the structurally unemployed with the job training, skill development, work experience and other support many of them need to enter the mainstream of the American labor force. These are important programs but they are not a complete answer to the problem because they don't create jobs. Only strong economic growth will create the jobs needed over the long run to provide

employment opportunities for all Americans willing and able to work.

The biggest obstacle to growth today is inflation. Our inflation problem is partially the result of rising oil prices and our declining terms of trade. Traditional policies of economic restraint will not help check this source of inflation, because energy cost increases will still be passed along to consumers through higher prices. These increases could be absorbed, however, through improvements in productivity, with reduced labor and capital costs offsetting rising energy costs, thus allowing for price moderation. The policies we recommended in Chapter IV to stimulate productivity and expand the supply side of our economy go hand in hand with many of the recommendations in this chapter. Poor productivity and high inflation rates and their harmful effects on economic growth are the major obstacles to the full employment policies that are the best hope for millions of Americans who desperately want to work and share in the American dream but who are currently unemployed for reasons beyond their control.

Overview of the Employment Situation in 1979

Employment growth during 1979 was considerably below the job growth of the three previous years, marking the first significant slowdown since the economy began its recovery from the severe recession of 1974-75. Between December 1978 and December 1979, the economy created 2.1 million new jobs. By comparison, 3.2 million jobs were created during 1978, 4.1 million during 1977, and 3.0 million during 1976, as Table V-1

shows. The proportion of the working age population holding jobs rose last year to a record level of 59.3 percent, but the year's increase of 0.7 percentage points in the employment/population ratio fell significantly below the gains registered during the previous three years, as seen in Table V-2. This downturn in job growth reflected the overall slowing of the economy discussed in Chapter II.

TABLE V-1

EMPLOYMENT

December of Year	Civilian Employment (Thousands of Persons) 16 years of age and over, seasonally adjusted)	Change From Previous Year	Percent Change From Previous Year
1975	85,534	-	-
1976	88,486	2,952	3.45
1977	92,589	4,103	4.64
1978	95,831	3,242	3.50
1979	97,912	2,081	2.17

Source: Department of Labor, Bureau of Labor Statistics

TABLE V-2

UNEMPLOYMENT AND EMPLOYMENT --
POPULATION RATIO

Year	Unemployment Rate (Percent of Civilian Labor Force)	Employment/ Population Ratio, Percent	Change in Employment/ Population Ratio From Previous Year, Percentage Points
1975	8.5	55.3	-
1976	7.7	56.1	.8
1977	7.0	57.1	1.0
1978	6.0	58.6	1.5
1979	5.8	59.3	.7

Source: Department of Labor, Bureau of Labor Statistics

Last year was the first year since the bottom of the recession in which unemployment failed to show a noticeable decline (see Table V-2). The unemployment rate fluctuated between 5.7 and 5.9 percent throughout the year, while the December 1979 jobless rate of 5.9 percent was identical to the rate registered during December 1978. Total unemployment during 1979 averaged 6.0 million persons. This was only 1.9 million below the record unemployment level set in 1975. While the job gains made during 1979 were welcome, the increase in employment barely kept pace with the growth of the labor force and was thus inadequate to make further progress in reducing unemployment.

Of the 2.1 million jobs added to the economy during 1979, over two-thirds were filled by adult women. Virtually all of the net additions came in white collar occupations, while blue collar employment remained about constant.

Among the industries, most of the employment gains came in the service-producing industries, led by "services" and "wholesale and retail trade." Although the goods-producing industries posted some modest gains, most of this employment growth came in the construction industry, while manufacturing employment remained about constant. However, toward the close of the year, even these gains were beginning to erode as the housing market tightened and auto industry layoffs rose.

The Problem of Structural Unemployment

The Nature of Structural Unemployment

Unemployment is traditionally divided into three categories -- cyclical, frictional and structural. The real source of concern today is structural unemployment. The expansionary policies pursued since 1975 have proven successful in dealing with the high level of cyclical unemployment which occurred following the 1974-75 recession. Frictional unemployment is not a major source of concern since it represents the natural movement of readily employable workers who are in the process of changing jobs and whose unemployment is usually voluntary.

The structurally unemployed are all those workers who are jobless for other than standard frictional reasons and who would be involuntarily unemployed even when the economy has reached its full output potential. Any attempt to provide jobs for the structurally unemployed through conventional expansionary policies would open few new employment opportunities but, instead, would result in an acceleration in the current inflation rate.

It is difficult to identify specific individuals who could be considered as structurally unemployed since the term encompasses a wide variety of job-related problems. As a group, however, the structurally unemployed face one common malady -- their characteristics as workers generally fail to mesh with the needs of private and public employers. Even when the economy is operating at or close to full capacity and job opportunities are numerous,

many workers still have difficulty finding employment -- because they have an inadequate basic education, poor or nonexistent job skills or obsolete job skills; because they live in a depressed geographic location; or because they face discrimination by employers on account of race, age, sex, or other personal characteristics that are unrelated to how well they would perform on the job. These problems are concentrated in particular population groups which suffer more heavily than others from structural unemployment. For example, new entrants or reentrants into the labor force -- mostly women and teenagers -- suffer from much higher unemployment rates than do experienced workers because they have few job skills. Blacks and other minority workers also have high unemployment rates, largely because of the continuing impact of racial discrimination.

The severity of the problem can be demonstrated by comparing the unemployment rates for various groups of workers.

In December 1979, the unemployment rate for adult men was 4.2 percent on a seasonally adjusted basis. By comparison, the unemployment rate was 5.7 percent for adult women and 16.0 percent for teenagers. The unemployment rate for blacks and other minorities was 11.3 percent, more than double the 5.1 percent unemployment rate for whites. These figures are shown in Table V-3.

TABLE V-3

SELECTED UNEMPLOYMENT RATES
(Percent of Civilian Labor Force)
(Seasonally Adjusted)

Category	1975	December, 1979
Total	8.5	5.9
Men, 20 years and over	6.7	4.2
Women, 20 years and over	8.0	5.7
Both sexes, 16-19	19.9	16.0
White, Total	7.8	5.1
Men, 20 years and over	6.2	3.7
Women, 20 years and over	7.5	5.0
Both sexes, 16-19	17.9	13.9
Black and Other, Total	13.9	11.3
Men, 20 years and over	11.7	8.6
Women, 20 years and over	11.5	10.0
Both sexes, 16-19	36.9	34.3
Married men, spouse present	5.1	2.8
Married women, spouse present	7.9	5.0
Women who head families	10.0	8.4
Whites		4.9*
Blacks		11.3*
Hispanics		9.1*

*Not seasonally adjusted

Source: Department of Labor, Bureau of Labor Statistics

Using an even more detailed breakdown of the unemployment statistics, the discrepancies between different groups become even more glaring. The December unemployment rate for white adult males -- considered prime workers by most employers -- was 3.7 percent. By comparison, the rate for white adult women was 5.0 percent, while the rate for white teenagers was 13.9 percent. For blacks and other minorities in all three groups it was much higher -- in fact, more than double. Black adult males experienced an unemployment rate of 8.6 percent, for black adult women it was 10.0 percent, and for black teenagers it was 34.3 percent.

For Hispanics, the December unemployment rate (not seasonally adjusted) was 9.1 percent, compared to an unadjusted rate of 4.9 percent for whites and 11.3 percent for blacks.

For male heads of households, the unemployment rate was a mere 2.8 percent, while female heads of households faced joblessness of 8.4 percent.

To compound the problems faced by these groups from structural unemployment, they also face much greater joblessness during an economic downturn, as the figures from 1975 in Table V-3 show, indicating that a recession during 1980 would likely have its greatest impact on those who suffer from high unemployment even in the best of times.

The Economic and Social Costs of Structural Unemployment

In addition to the economic and psychological costs suffered by those who are jobless, structural unemployment imposes immense economic and social costs on the Nation as a whole. During October 1979, the Joint Economic Committee held a series of hearings to examine the economic and social costs of structural unemployment affecting minority workers, women, and youths. The witnesses testified that the economic costs of unemployment are much greater than just the sum of transfer payments to the unemployed and their lost incomes. In the long run, economic costs also include the resulting misallocation of human resources and the loss of their productive output. When the incidence of structural unemployment falls more heavily on one societal group than on others, the Nation also suffers pervasive and long-term maldistribution of income that offends our sense of economic justice.

The costs to the Federal budget are one aspect of the economic costs of unemployment. Based on estimates made by the Congressional Budget Office, each percentage point in the unemployment rate costs the Federal Government about $16-$20 billion in direct and indirect transfer payments and lost tax revenues. Although these figures could vary widely depending upon the rate of GNP growth, there are substantial budgetary costs associated with increases in unemployment.

Structural unemployment also has a significant effect on the economy's potential output and productivity. According to the Congressional Research Service of the Library of Congress, in 1978 we lost $93.5 billion in

potential gross national product because of the effects of racial discrimination in the labor market. This discrimination takes three forms -- higher unemployment rates for blacks, Hispanics, and other minorities; a higher concentration of blacks in less-skilled occupations and higher educational requirements for blacks; and lower pay for blacks than whites in the same occupation. If these differentials did not exist, our 1978 gross national product would have been 4.4 percent higher, according to the Congressional Research Service study.

Lost opportunities for employment, lower earnings, and depressed household incomes are tangible evidence of gaps in the economic health of minority groups. For example, between 1970 and 1977, black median family income declined from 61.3 to 57.1 percent of the median family income of whites. Black families also lost ground in absolute terms as their median real income declined 2.4 percent, while that of white families gained by 4.8 percent. In 1978, Hispanics had the lowest median weekly earnings of any group, $174, compared to $232 for white workers and $181 for black workers. The median annual income of Hispanics in 1977 was $11,400, as compared to $16,700 for the general population. Twenty-one percent of Hispanic families have incomes below the poverty level, compared to 9 percent of all U.S. families.

Comparisons made by the Equal Employment Opportunity Commission of relative advancement rates among occupations show that minority workers are still not receiving a fair share of higher wage occupations even though a large number of qualified and qualifiable minority workers exist. Although

wage discrimination is decreasing for equivalent work between minority and white workers, hiring discrimination is still evident. In addition, inequality exists in job assignments and promotional opportunities for minorities. Workers in low-wage occupations usually have fewer sources of nonsalary income such as interest and dividends, another factor in the income differentials between minority and white households.

The high rates of unemployment for minority youths reflect discrimination and deficiencies in training, education and job experience, as well as structural shifts in the economy. In the next decade, minority youth will continue to have difficulties in the labor market. Although the relative importance of youth in the labor market will decline in the 1980s, minorities will become an increasing proportion of the youth population and the youth labor force. In order to keep pace with the expected growth in the labor market and to reduce the differential in unemployment rates between minority and other youths by 1983, many more jobs have to be created for minority youths to fill.

In addition to the economic costs of structural unemployment, there are also important social costs.

One study performed for the Committee indicates that a stable and predictable relationship exists between unemployment and such social indicators as health problems and crime rates. During the past three decades, health problems of workers and crime rates have increased with the national unemployment rate. When unemployment rose, so did crime,

suicides, heart attacks and commitments to mental institutions. These relationships are statistically significant, although the changes in a social indicator can lag the change in the unemployment rate by as much as three years. For example, heart attacks and other circulatory problems show up, particularly among nonwhites, within two or three years after an increase in the unemployment rate. These relationships were found primarily among adults.

For youths, a different relationship holds. Youths seem to be less influenced by the overall unemployment rate than by their relative unemployment rate. Thus, an adverse change in the ratio of youth unemployment to the general unemployment rate seems to trigger increases in crime and aggressive behavior. If youths consider themselves relatively worse off in economic terms, this perceived disparity plays a significant role in the increase of youth suicides, automobile accident mortalities and personal crimes, including assault, homicide and rape. Nonwhite youths respond to unemployment differentials at a rate almost three times as great as white youths both in terms of crime and other sources of pathology unrelated to crime -- infant mortality, cardiovascular mortality, and mental hospitalization.

Another study presented to the Committee discovered that jobs alone do not encourage individuals to commit less crime, particularly property offenses. Rather, it was discovered that only good jobs with high wages and more job satisfaction (less turnover) are a significant factor in reducing crime rates. Because many juvenile offenders alternate between legitimate and illegitimate work, the better the legal job,

the greater the probability that they will stay away from crime.

There may also be a link between unemployment and early childbearing for teenage women. Low expectations coupled with poor educational preparation leads to low-wage jobs and intermittent employment. Many young women in this situation choose parenthood, which often means continued poverty and early welfare dependency. The social costs of this vicious cycle are clear.

There are a number of reasons for the lack of availability of better jobs. The cyclical waves of economic activity have encouraged firms to create secondary rather than primary jobs in order to preserve their flexibility in changing business conditions. The workers in these secondary jobs, primarily youths, minorities and women, are laid off easily. Since the jobs are not career-oriented, workers feel little job attachment to them.

Youths have also experienced increased competition for entry-level type jobs from the large influx of women entering the labor force, and from the greater number of their own peers. In addition, structural shifts, such as the exodus of workers from the agricultural sector, have resulted in fewer jobs requiring a lower level of skills.

As the size of the population aged 15 to 24 years shrinks in the next decade, analysts believe a decrease in crime and mortality statistics will occur. However, the relationship of youth unemployment to total unemployment should continue to influence crime and mortality rates.

As youths grow older, they typically commit less crime. But if they become unemployed or low-income adults, they will remain vulnerable to economic fluctuations. In the longer term, these persons are picked up in the statistics on mental hospitalization, morbidity and mortality data. This phenomenon holds true particularly among lower socioeconomic groups which have had traditionally higher mortality rates than the general population.

Long-Term Demographic Trends and Structural Unemployment

During the 1970s, the problem of structural unemployment was magnified by the unusually high rates of growth of those segments of the labor force which suffer the most serious employment problems. For example, the number of females in the labor force increased by 42 percent during the decade, more than twice the male increase of 18.5 percent. Blacks and other minorities increased 37 percent, while whites increased 26 percent. The teenage labor force (16 to 19 years old) increased 36 percent over the decade, and the young adult labor force (20 to 24 years old) grew 55 percent, compared to a growth rate of only 22 percent for workers 25 years old and over.

Population growth explains some of this pattern. The number of youths in the population rose rapidly as the baby boom generation came of working age. Blacks and other minorities also increased as a percentage of the population. Much of this pattern, however, resulted from significant increases in labor force participation rates, particularly for women and white teenagers.

More than half of all women work today, compared to only 43 percent at the start of the 1970s. Among these groups, the characteristics of structural unemployment -- poor skills, lower levels of formal education, reduced attachment to the labor force, and the effects of discrimination because of race, sex or age -- occur more frequently, and so their relative growth in the labor force has helped make structural unemployment a significant problem today for economic policy.

In this section, we will examine the demographic changes which occurred in the labor force during the 1970s and look at the implications of these changes for economic policy during 1980 and beyond.

The past decade has been marked by dramatic changes in the size and composition of the labor force. During the 1970s, the labor force expanded by over 25 percent with the massive influx of youths and women. Employment also experienced extraordinary growth, registering some of the sharpest gains in the 38-year history of modern day employment statistics. The result was a much larger and substantially younger work force, one in which women played an increasingly primary role, and one which found most of its new employment among the ranks of white collar jobs in the expanding service and trade industries.

About ten years ago teenagers and young persons born during the postwar baby boom became a significant force in the labor market. In the early 1970s the rate of women's participation in the labor force, which had been rising slowly since the end of World War II, began accelerating

unexpectedly. As young adults started postponing marriage and fertility rates dropped, more and more women began to enter the "primary" labor force. In more recent years, as the baby boom generation matured, the households formed were frequently characterized by two-income families. Reflecting these demographic and social changes, the labor force increased at an annual rate of 2.5 percent during the 1970s. This rate of growth was the largest since the last great wave of immigration during the 1880s.

This massive labor supply increase was accompanied by a large increase in the demand for labor. During the 1970s, employment grew by about 2.2 percent per year. This represents a very rapid absorption of the supply surge of youth and women into gainful employment, raising the ratio of employment to working age population to an all time high of nearly 60 percent. While this growth in demand was large relative to earlier periods of growth, it was not sufficient to employ the entire labor supply increase. As Table V-4 shows, unemployment in 1978 fell much more heavily on the shoulders of women and blacks than it did in 1970. The unemployment burden on teenagers and young workers is masked by the fact that the labor force participation rate for black teenagers declined considerably over the decade, as many simply gave up looking for work in the face of a hopeless situation.

TABLE V-4

UNEMPLOYMENT EXPERIENCE OF
SELECTED POPULATION GROUPS
(Thousands of Persons)

	Number of Persons Unemployed		Percent of Number Unemployed	
	1970	1978	1970	1978
Total	4,088	6,047	100.0	100.0
Male	2,235	3,051	54.7	50.5
Female	1,853	2,996	45.3	49.5
White	3,337	4,620	81.6	76.4
Black	752	1,427	18.4	23.6
Aged 16-24	1,969	2,984	48.2	49.3
16-19	1,105	1,559	27.0	25.8
20-24	864	1,426	21.1	23.6
25 & Over	2,119	3,063	51.8	50.7

Source: Bureau of Labor Statistics

On the whole, the changing structure of industry and employment growth during this period tended to coincide with the large increase in the supply of labor. All industries now employ higher proportions of women and young workers. However, those industries that increased their share of total employment, such as retail trade, insurance and real estate and professional services, generally have had historically higher proportions of women and younger workers.

Occupational changes largely paralleled those in industries, with the shift being away from manufacturing and blue collar jobs toward service industries and white collar occupations. Nearly two-thirds of the ten-year employment growth came in white collar jobs, while blue collar occupations accounted for only about one-fifth of the employment growth. Here, too, women and young adult workers made substantial gains in the expanding white collar professional and technical positions, and women appear to have broken many of the barriers to managerial and administrative jobs.

Despite the upward trend in aggregate labor force participation rates, the participation of racial minorities dropped off during the past decade. The nonwhite male participation rate declined much more rapidly than that of white males. And while nonwhite women increased their participation, they did so at a much slower pace than white women. The civilian labor force participation rates of whites and nonwhites are summarized by age and sex in Table V-5.

TABLE V-5

CIVILIAN LABOR FORCE PARTICIPATION RATES

	Age							
	White				Nonwhite			
	16 and over	16 to 19	Under 35	35 and over	16 and over	16 to 19	Under 35	35 and over
Total:								
1968:2.....	59.5	50.5	62.8	57.6	63.0	42.7	64.3	62.0
1973:2.....	60.9	56.9	68.1	55.9	60.0	40.9	62.7	57.5
1978:2.....	63.3	61.8	74.1	55.4	61.7	41.6	66.1	57.3
Male:								
1968:2.....	80.8	58.6	82.8	79.7	78.6	50.7	79.2	78.2
1973:2.....	79.7	63.3	84.7	75.9	73.9	47.2	75.5	72.4
1978:2.....	78.8	66.4	86.5	72.8	72.2	45.2	74.3	70.1
Female:								
1968:2.....	40.7	42.8	45.0	38.1	49.9	35.2	51.8	48.4
1973:2.....	44.4	50.3	52.2	38.5	48.4	35.0	51.8	45.4
1978:2.....	49.2	57.2	62.0	40.3	53.0	38.1	59.8	47.0

Source: Bureau of Labor Statistics

The participation rates of white and nonwhite men were fairly comparable at the start of the decade, measuring 80.8 and 78.6 percent respectively. But by 1978 the gap between the two had widened considerably, with white male participation at 78.8 percent and nonwhite male participation at 72.2 percent. Most of this gap was due to trends among white and nonwhite men under 35 years of age. White males in this group increased their participation while the participation of their nonwhite cohorts declined. This divergence of trends was most pronounced among teenagers; in 1978 the participation rate for white male teenagers was 66.4 percent compared to 45.2 percent for nonwhites. This disparity in labor force participation is an indication of the hopelessness with which many minority teenagers view their job prospects.

Participation rates among nonwhite women have historically been higher than those of white women, but the gap narrowed appreciably in the past decade. Minority women increased their participation rate by only about 3 percentage points during the 1968-78 period, while white women registered a sharp increase of nearly 9 percentage points. These developments brought the labor force participation of white and nonwhite women closer together.

Among women under 35 years of age, white women increased their participation rate by 17 percentage points between 1968 and 1978, while nonwhite women upped their rate by less than half that amount. As a result of these changes, for the first time, white women now participate at higher rates than minority women in the under 35 age group.

Thus, while employment among the working age population rose to an all time high during recent years, the employment situation of racial minorities with respect to their working age population deteriorated during the 1970s. In contrast to the employment-to-working-age-population ratio for whites, which rose from 56 to over 60 percent, this ratio for nonwhites declined from 56 to 53 percent. This means that racial minorities have enjoyed less than their proportional share of the employment and economic growth of recent years.

The excessively high youth unemployment rates among the baby boom generation, the rising participation rates of women, and the continued lack of satisfactory employment opportunities for blacks and other minorities will make structural unemployment an important policy issue for 1980 and beyond. During the upcoming decade, however, certain likely demographic changes will alter the nature of some of the most pressing problems.

First, as the baby boom generation ages and the number of teenagers declines, the unemployment rate among youths will probably fall from the levels set during the 1970s. Between 1980 and 1990, demographers expect the number of teenagers 15 to 19 years old to decline by almost 20 percent and the number of youths 20 to 24 years old to fall almost 15 percent. Although the impact of this decline in supply on the teenage unemployment rate will also depend on what happens to the demand for their labor, it is likely that their unemployment problem will ease during the decade.

The improvement, however, will probably be concentrated among white teenagers, with

black teenagers continuing to suffer from the high unemployment rates they suffered during the 1970s unless targeted programs are geared to their specific needs. According to demographers, there will be a continued growth in the number of black teenagers during the 1980s. As a result, youth unemployment will increasingly become concentrated among black teenagers and young adults. This was one issue emphasized by Dr. Bernard Anderson in testimony October 9, 1979, before the Joint Economic Committee:

> From 1977 through 1990, for example, there is expected to be very little change in the numbers of blacks between the ages of 16 and 24, while the number of whites in that age category is expected to decline. And so those who look at demographic changes as the potential source of solution to the problem of minority youth employment, I think, are barking up the wrong tree.

In addition, Anderson argued, black teenagers continue to live predominantly in areas that suffer from limited employment opportunities in the private sector, particularly in declining central cities and poor rural areas.

The percentage of women in the labor force will also continue to grow during the 1980s, although the trend in female participation rates has always been difficult to predict. An article in the January 1980 issue of American Demographics states:

> Bureau of Labor Statistics projections in the 1970s consistently underestimated the growth in the labor force participation rate for women. The bureau's projected participation rates for women by 1990 vary from 53.8 percent to 60.4 percent. Since more than 50 percent are already in the labor force, the figure should be closer to the high projection than the low by the end of the decade.

According to the American Demographics article, demographic trends among blacks and other minorities indicate that jobs will continue to be a major problem for these groups:

> By 1990 nearly one out of every five Americans will be black or Hispanic. In younger age brackets the proportion will be higher. Blacks will number nearly 30 million, 12.2 percent of Americans, according to the Census Bureau projections which assume a 2.1 fertility rate. While the population as a whole increases by only 10 percent, the black population will grow by about 14 percent because of the higher fertility black women are expected to have during the 1980s.
>
> Hispanics are the fastest growing minority group in the United States. Although the Census Bureau does not issue projections of the Hispanic population, we predict based on current growth rates that it will increase to about 17 million by 1990. Hispanics, who represented only about 4 percent of the population 10 years ago, will account for 7 percent by 1990.

Several witnesses appearing before the Joint Economic Committee testified that blacks, Hispanics, and other minority groups will continue to face many of the labor market difficulties experienced during the 1970s.

Solving the Structural Unemployment Problem

A Policy Framework

In this section, we intend to consider two important questions. First, can targeted programs reduce joblessness among those segments of the labor force which have special difficulties in obtaining employment even when the economy is operating at full capacity? Second, can targeted programs achieve and sustain a decrease in the national unemployment rate without exacerbating inflation?

Our answer is yes to both questions, but with certain qualifications. First, the programs must be carefully designed and targeted to reach the structurally unemployed. Second, measures must also be taken to increase the rate of capital formation. These measures must be coordinated with the special unemployment programs. Third, we must pursue policies designed to achieve strong economic growth and expanded employment opportunities for the economy as a whole.

There are several reasons why targeted policies are needed to significantly reduce structural unemployment without adding to inflationary pressures. In the first place, unskilled workers constitute a

disproportinate share of the pool of job seekers when the economy is operating at or near full capacity. Skilled workers, on the other hand, tend to be in relatively short supply. An overall expansion of the economy through macroeconomic policies would raise the demand for both skilled and unskilled workers. While the increased demand for unskilled workers would cause little or no increase in inflation, the increased demand for skilled workers would impart an upward, and perhaps substantial, inflationary impact on the economy because it would tend to raise their wages. As former Deputy Assistant Secretary of Labor Donald A. Nichols testified before the Joint Economic Committee:

> The ability to reduce the overall unemployment rate through economic growth is limited by inflation. When the lowest unemployment rate consistent with the inflation barrier is reached, the unemployment rate for low-skilled workers will still be high and will be substantially higher than that of high-skilled workers. Shortages of low-skilled workers will be rare and a reduction in the unemployment rate of this group by itself would not cause inflation to increase. The high-skilled group, on the other hand, will have shortages and an attempt to reduce their unemployment rate further would tend to lead to wage increases rather than employment increases. Therefore, an attempt to reduce unemployment among the low-skilled by increasing economic activity is stymied by the fact that it will lead to shortages in the high-skilled market and therefore to inflation.

There seems to be little question that labor markets for skilled workers are generally tighter than for unskilled workers. The unemployment figures for 1979 illustrate this. The unemployment rates for several skilled occupations -- including white collar workers, craft workers and transport operatives -- are significantly lower than those for less-skilled occupations -- operatives, nonfarm laborers and many service workers. These figures are presented in Table V-6. Since the unemployment rates in Table V-6 only include workers who have previously held jobs and do not include new entrants into the labor force -- mostly women and teenagers with low skills -- even these figures understate the unemployment disparity between skilled and unskilled workers. Furthermore, the unemployment rates for less-skilled occupations have recently turned up in response to the economic slowdown, while unemployment rates among skilled workers have remained relatively low.

TABLE V-6

UNEMPLOYMENT RATES BY OCCUPATION, 1979

OCCUPATION	UNEMPLOYMENT RATE (Percent)
White-Collar Workers	3.3
Professional and Technical	2.4
Managers and Administrations (except farm)	2.1
Sales Workers	3.9
Clerical Workers	4.6
Blue-Collar Workers	6.9
Craft and Kindred Workers	4.5
Operatives (except transport)	8.4
Transport Equipment Operatives	5.4
Nonfarm Laborers	10.8
Service Workers	7.1
Farm Workers	3.8

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

If targeted structural employment and training programs are to be used to reduce the national unemployment rate without exacerbating inflation, they need to be aimed at low-skilled workers, where there is an excess supply and where additional employment gains could be achieved with little or no upward pressure on costs. Such programs could also help to alleviate cost pressures in high-skilled markets if they provide an increased supply of trained workers to these markets. Supplying additional workers to such "tight" labor markets can help alleviate bottlenecks among skilled workers that push up costs.

The second reason why conventional macroeconomic policies would be ineffective in reducing unemployment has to do with the fact that the tightness and looseness of labor markets varies dramatically from one region of the country to another. Since it is difficult, if not impossible, to target aggregate monetary and fiscal policies by region, any attempt to reduce unemployment through aggregate policies in areas where the unemployment rate is excessive will generally also end up adding to inflationary pressures in regions where there is very little labor market slack. In addition, much structural unemployment occurs in older urban areas where job opportunities are scarce, particularly for black teenagers and other minority youths. These areas have experienced an economic decline in good times and bad and are hard to help with aggregate economic policies. Ending the deterioration of business and employment opportunities in our Nation's central cities of the North and South should be a central goal of our program to reduce structural unemployment.

The third reason why conventional macroeconomic policies should not be relied upon to reduce structural unemployment when the economy is at or near full capacity is because further increases in overall supply would be severely constrained by productive capacity limits. Capacity utilization rates are still quite high, even though the economy has slowed. According to the Federal Reserve Board's index, capacity utilization was 84.4 percent in manufacturing in December 1979; in materials, the capacity utilization rate was 85.7 percent. Since an index value in the range of 88 to 90 percent is widely viewed as constituting full capacity, the margin of unused capacity is currently still quite small. Thus, independent of any inflationary wage pressures that might arise as a result of further increases in demand, additional inflationary pressures would mount because of the continuing unavailability of capital. The point that needs emphasis is this: if the availability of capital and rates of return on investment were not restraining factors today, further increases in demand and further reductions in unemployment could be brought about without adding to our inflationary pressures. The difficulty is that, under present market conditions, further expansions of output and employment would necessitate the use of older, less efficient capital which in turn would lower productivity, raise unit costs and accelerate inflation. This means that the approach to reducing unemployment should include targeted structural employment and training programs as well as measures aimed at raising the rate of capital formation.

If the restraints on productive capacity were eliminated, conventional macroeconomic policies might not need to be as restrained

as they now are. In that event, it might be possible to use conventional demand management tools to reduce the margin of idle labor resources without risking further inflation. Even under such circumstances conventional policies alone probably could not be relied upon to reach the 4 percent unemployment rate goal.

Recommendation No. 15

Structural training and employment programs should be accompanied by measures to increase capital formation. It would be necessary to coordinate targeted training and employment programs and actions to increase capital formation so as to avoid a mismatch of job opportunities and the newly trained.

It should be emphasized, however, that targeted structural employment and training programs constitute only part of the solution to the structural unemployment problem. Another essential element is strong economic growth.

Economic growth has been found to reduce black unemployment even more rapidly than it reduces white unemployment. According to a study recently performed by the National Commission for Employment Policy, a one percentage point reduction in the national unemployment rate will reduce the black unemployment rate by 1.26 percentage points compared to only .99 percentage points for whites. For teenagers, the disparity is even greater, with a one percentage point reduction in the national unemployment rate associated with a 1.66 percentage point reduction in white teenage unemployment and a 2.17 percentage point reduction in the black teenage unemployment rate. The reverse, of course, is also true -- an economic downturn has a greater impact on black unemployment than on white unemployment. This evidence indicates that sustained economic growth can do much to lessen the discrepancies between the different racial groups in this country in their employment opportunities.

A Program for Upgrading Education and Skills Among the Structurally Unemployed

Structural unemployment is a long-term rather than a short-term problem. While a strongly growing economy is needed to create jobs for the structurally unemployed, growth alone is not the answer, as we have pointed out. In order to achieve the unemployment

goals set in the Full Employment and Balanced Growth Act of 1978, we also need targeted training and employment policies to alleviate the education and skill deficiency and other problems of the structurally unemployed.

The Target Population

Most of the recent work on structural unemployment focuses on the problems of youths for several reasons. Unemployment rates are much higher for youths, especially minority youths. Furthermore, the situation for minorities relative to white youths has been deteriorating since the 1950s. Joblessness for out-of-school youths, particularly dropouts, leads to unstable employment patterns and lower earnings as adults. Social and economic costs, such as early childbearing and antisocial behavior, often accompany youth unemployment, as we discussed above. And, finally, lack of basic literacy skills is one of the primary structural deficiencies for youths. Those basic skills can be taught more effectively and at less cost at a younger age.

Not all youth unemployment, including unemployment for minority youths, is undesirable. The time spent in job search often results in new information about the labor market, a higher level of earnings and more realistic job expectations. In-school youths who experience periods of unemployment do not seem to suffer long-term employment consequences as a result. Most youths will voluntarily move from part-time work to full-time school attendance to full-time summer employment to part-time work during school periods. It is a time of experimentation

with the labor market and employees, and the youths themselves perceive it as such.

This orderly movement into the labor market can break down for many youths. This occurs, for example, when a youth, without adequate credentials for anything more than menial work, drops out of high school and then tries to enter the job market. Another problem occurs for the functionally illiterate high school graduate. The "devaluation" of the high school diploma has become a very serious problem. Even employers who are willing to train their young workers need someone who has good literacy and number skills. A third example is the juvenile delinquent, often a dropout, who needs much more than conventional education.

Beyond the achievement of basic skills, youths also need adequate specialized preparation for certain jobs. Poor or nonexistent counseling often results in coursework choices which are irrelevant to future jobs. The increasing number of jobs with a high technology and energy related content mean that adequate course preparation will be more, not less, important in the next decade.

Minority youths, particularly blacks and Hispanics, face additional obstacles to entering the job market. The most serious is discrimination by employers. Hispanic youths also have staggeringly high dropout rates from school, and so their educational background can be very weak. Minorities have far fewer informal entrees into job opportunities from relatives or friends and a less developed "old boy" network to speed up the promotion process after a job is

attained. Minority aspirations tend to be very unrealistic in terms of job content and wage levels because of their poor access to labor market information.

The previous discussion has involved the structural unemployment problems of youths. In addition, there are structurally unemployed adults who have serious problems.

For most structurally unemployed adults, providing jobs appears to be a better approach than upgrading skills. Although there are adults who have educational and basic skill deficiencies, the main problem is usually a mismatch of particular skills with available jobs. Quite often, adults have considerable previous job experience. For many, retraining involves an emotional commitment to an entirely new type of job. This becomes a particular problem for those who are only five to ten years from retirement. Usually there are family expectations, family support responsibilities and a certain living standard from previous jobs which make it difficult for an individual to change employment patterns. Relocational difficulties may occur especially if community and family ties are well developed. Occasionally, job losses are the result of the realignment of international trade patterns -- i.e., shoes, textiles -- over a long period of time. These structural problems must be met quite differently from the structural difficulties experienced by youths.

What Should be Done? The Setting of Goals and Priorities

Extensive research, training experience, and numerous surveys of employers have confirmed that high schools have been graduating youths who cannot read or write. Without basic educational skills, other employment and training efforts are usually wasted. Education and the development of basic literacy skills for school-age youths should be the first priority of policies to help structurally unemployed youths. Eli Ginsberg, Chairman of the National Commission for Employment Policy, summed up the situation: "The best kind of vocational education in a service economy is acquisition of the basic skills, meaning the three R's."

Recommentation No. 16

> The Nation's youth employment and training programs should place greater emphasis on basic education and basic skills. A good job requires a good education, but too many young people drop out of school or fail to take school work seriously because they do not understand this connection. Programs for the young should make the connection between basic educational skills and future employment opportunities, and youths should be given strong incentives to remain in school.

The Administration's recently announced youth initiative, drawing heavily on the research of the National Commission for Employment Policy, stresses educational objectives in its proposed employment and

training programs. The proposals are based on the fact that as youths mature from their early teens to young adulthood, their employment and training experiences change in an orderly way. In the earlier years, most time is spent acquiring basic education and some work experience. The latter years are spent in job search or specialized skill training.

The Administration's proposal attempts to complement that natural process. Fundamentally, the proposal calls for better policy coordination between education and employment.

Previous Federal programs in the educational area directed the bulk of funds into elementary institutions. The current proposal channels more funds into secondary institutions for the development of programs in remedial classwork, additional tutoring and incentives for students to remain in school.

Based on hearings before the Committee, we believe there are several important elements which should be included in any training and employment policy.

The programs should target their assistance on those who need help the most, stressing the needs of minorities and youths and the economically disadvantaged, who invariably suffer the greatest employment problems.

Targeting programs to the population of low-income students can be carried out on the basis of various important criteria. The family income level is one such criterion. Dr. Sawhill, Director of the National

Commission for Employment Policy, testified that eligibility standards for youth programs should also include geographic location, since income level alone often includes many white students and others who are not economically disadvantaged or prone to structural unemployment problems. This geographic dimension can be achieved by targeting on census tracts where a certain percentage of the households are poor, a criterion that picks up a much higher percentage of minorities than does a straight income criterion alone.

Recommendation No. 17

> Youth training and employment programs should target their assistance on those who need help the most, particularly economically disadvantaged minority youths and others who suffer from severe structural unemployment. The criteria chosen for eligibility should achieve the necessary targeting of assistance.

A number of witnesses before the Committee stressed that conventional classroom techniques are ineffective for many of those students who are likely to suffer from structural unemployment. For example, most attempts to induce high school dropouts back to the classroom have failed. Many Hispanic students do not respond well to the classroom because of cultural disparities, severe problems with the English language, the low-income status of many Hispanic families, and a low priority set on educational attainment. These factors provide formidable disincentives for Hispanic students to remain in school.

There are a number of alternative ways to deal with these problems, including individual tutoring and remedial work outside of the formal school system, work experience programs tied to classroom participation and intensive counseling, and the use of resources and expertise of community-based organizations to help youths learn the English language.

Recommendation No. 18

> Alternatives to conventional classroom education should be explored for youths who are inadequately prepared for the job market through traditional methods. Particular emphasis should be placed on programs for potential school dropouts and for those who have dropped out. These alternatives should help noncollege-bound students acquire enough basic skills for the job market or for more specialized training.

Educators in the school system should assess the special needs of target students through counseling. Students nearing the end of formal schooling should be taught efficient methods of job search, development of proper work attitudes, nonstereotyped occupational opportunities, and realistic job and salary expectations. Information about the course work needed for job preparation in a variety of occupations should be given to freshman and sophomore students. This would serve two purposes: first, youths would realize that even traditional jobs may require more background than they once thought and second, youths would have enough time to prepare themselves adequately for the job market.

The information provided youths about the labor market should stress the fact that potential employment opportunities differ among occupations. Many occupations, particularly those requiring few skills, are in declining industries where long-term prospects are poor. Guiding young people into these areas does them and the Nation a great disservice. Instead, we should gear our youth employment programs toward those occupations and industries where there are good prospects for long-term growth. This will serve two purposes. First, those who participate in the programs will be well served through increased lifetime employment opportunities and better incomes. Second, the Nation will be well served as the pool of skilled workers expands and labor market bottlenecks become less severe. This will help improve the long-range growth prospects for the economy.

Recommendation No. 19

The Nation's youth training and employment programs should channel minority and economically disadvantaged young people into industries and occupations experiencing long-run growth. This would coordinate the training of youths who would otherwise become structurally unemployed with the skill needs of growth industries, thus helping the economy grow faster than it otherwise could.

For older youths and youths out of school, the primary objective of youth labor market programs should provide training and jobs, with particular emphasis on private sector employment. Youths often are at the end of

the hiring queue due to employer discrimination, poor job search techniques, and fundamental deficiencies in education. Our experience with the Comprehensive Employment and Training Act (CETA) shows that public sector jobs alone will not necessarily lead to an increase in the employability of job recipients, particularly for the target populations of blacks and Hispanics, youths, and economically disadvantaged persons. Because the CETA program's success is measured by the number of persons placed in unsubsidized jobs, persons with the greatest chance of making that transition have often been chosen. This process leaves out many of the hardest-to-employ. In addition, CETA was designed to serve several objectives, and its clients included many more persons unemployed for cyclical reasons than for structural reasons.

Improving the access of minority youths to private sector jobs is a crucial part of a long-term solution to their structural unemployment problems. While public sector jobs such as summer employment programs will be necessary to fill the employment gap, employment policy should be directed toward opening up private sector employment opportunities. This is also important for adults who are structurally unemployed.

Recommendation No. 20

The Nation's employment and training programs should recognize that most jobs are in the private sector. Public sector efforts should be fully coordinated with the needs of and the opportunities provided in the private sector. In addition, the incentives currently provided to the private sector to employ and train those who suffer most from structural unemployment problems should be strengthened and expanded, and the public and private sectors should improve their links between training programs and employment opportunities.

These links can be initiated through more intensive use of the Private Industry Councils (PICs) and community-based organizations (CBOs) which draw on local community expertise and knowledge of local labor requirements. There has been successful experimentation with programs in which a private employer guarantees job placement for a certain number of unemployed youths after prior screening by a community organization. Work experience programs for youths during the summer and after school can familiarize an employer with the youths, and this often results in permanent hiring of youths after their graduation.

Experimentation with different types of employer incentives to hire the structurally unemployed should be pursued. Among incentives that would reduce the cost of hiring the structurally unemployed are a delay of social security costs or limitations of other fringe benefits. Unfortunately, it is too early to judge whether the targeted

tax credit to employers enacted last year is an effective incentive, since its impact was delayed by slow dissemination of information about the program. In addition, the news about the program was sent primarily to large employers rather than small businesses where its effect would be more pronounced. Early reports suggest that the number of participants is increasing monthly at a rapid rate.

Subsidies to the private sector for work by the structurally unemployed can be a valuable mechanism for creating private sector employment opportunities. Work experience programs in the public sector have not fulfilled expectations for long-term benefits accruing to the unemployed. Analysts conclude that temporary jobs with little or no future only depress the work aspirations of the unemployed. A stigma resulting from their participation in such programs hindered some youths' entry into private sector jobs. Work in the public sector is not a realistic substitute for private sector employment.

Recommendation No. 21

Legislation should be enacted to provide targeted incentives to private sector employers -- particularly small business -- to effectively train and hire the structurally unemployed. Training subsidies or other incentives for training should be provided to employers. We emphasize that this support should be paid only for training and not wages.

Expanding Small Business Opportunities

The small business sector of our economy can make an important contribution toward achieving the full employment and inflation goals of the Full Employment and Balanced Growth Act of 1978. A growing small business sector offers a unique opportunity for addressing basic long-term structural problems by improving productivity, lowering inflation, and creating more jobs. However, many small business people believe that their ability to help solve these problems is sharply limited by government policies.

Small business has historically provided the backbone of employment growth and inflation-fighting innovation and competition in our economy. Small business currently accounts for almost half of the Nation's total business output and 55 percent of all private employment. According to a study performed by the Center for Neighborhood and Regional Change at the Massachusetts Institute of Technology, from 1969 to 1976, businesses with 20 or fewer employees generated two-thirds of the private sector's employment growth, while businesses with 500 or more employees created only 13 percent of private sector employment growth.

In the area of innovation and productivity, the National Science Foundation has found that one out of every four of the most significant industrial product and process innovations since World War II was developed by firms of less than 100 employees, while one-half were accounted for by firms with less than 1,000 employees.

The rate of productivity growth depends in part on how rapidly the ideas of inventors

become innovations and how rapidly innovations are diffused throughout the industry. Small firms are often more adventuresome and have a greater propensity for risk-taking. Accordingly, they are able to move faster and use resources more effectively than large companies. However, much of the innovation and diffusion process is dependent on whether the entrepreneurial risk-takers in the economy can raise enough money to convert new ideas into more productive technology.

TABLE V-7

HOUSING STARTS, MEDIAN PRICES
AND MORTGAGE INTEREST RATES

	Annualized Starts (millions)[1]	Median Prices New Homes[2]	Mortgage Interest Rates*[3]
1978	2.0	$ 55,700	9.58%
1979			
Quarter 1	1.6	60,600	10.23%
Quarter 2	1.8	63,200	10.52%
Quarter 3	1.8	64,600	10.96%
Quarter 4	1.6	62,600	11.51%
1980 (Estimated)	1.4	71,900	11.77%
DRI Forecast			

* average interest rate on conventional mortgages by Savings and Loan Associations.

Source: (1) Bureau of the Census
(2) Bureau of the Census
(3) Federal Home Loan Bank Board

Greater access to capital for small business in both credit and equity markets would also boost employment growth. Given the historical tendency of small business to employ a relatively lower ratio of capital to labor than large business, each additional dollar invested in small business is likely to generate more jobs than if it were invested in large business.

A policy of small business growth would have its greatest effect in decaying central cities where the structurally unemployed have the most difficulty finding good job opportunities. Traditionally, young people in this country use jobs in small businesses to gain the work experience needed for entry into jobs that lead to highly skilled careers. Although the United States has not had an explicit policy of discouraging business growth in central cities, this has been the effect of a wide variety of government programs and activities. As a result, a large number of teenagers, primarily black, who live in declining urban areas do not have the opportunity to develop the skills needed to obtain good jobs. In many urban areas, the unemployment rate among black teenagers can run as high as 50 percent. Although unemployment falls dramatically as youths mature, witnesses have recently testified before the Committee that prolonged teenage unemployment hurts for life by retarding personal growth and skill development in comparison with those who had jobs as teenagers.

Recommendation No. 22

During 1980 and beyond, the attack against structural unemployment should emphasize the development of small business opportunities with particular attention to minority-owned small businesses. These businesses could provide entry-level job opportunities for all teenagers, especially minority teenagers, as well as skilled jobs for older workers.

Public policies to improve capital formation in the small business sector should be targeted to remove the present disparities suffered by small business as a result of inflation and the current structure of government policy. Additional programs are necessary to improve small business' access to credit, particularly during times of excessively restrictive monetary policy.

Targeted tax measures are also needed to improve small business' access to equity. In the past, the tendency of Congress has been to enact tax incentives which on the surface treat all firms equally but fail to acknowledge that most small businesses are unable to take advantage of them for a variety of reasons specifically related to the size of the business. Tax incentives need to be developed that will enable smaller firms to retain a greater proportion of their earnings for reinvestment in capital improvements and plant expansion. These programs should be targeted directly to small businesses.

Recommendation No. 23

When Congress enacts business tax incentives, it should pay particular attention to their effect on the ability of small businesses to obtain capital for growth and innovation. Special small business tax provisions, such as an exemption for capital gains that are reinvested in new small businesses, or accelerated depreciation provisions that are geared to the needs of small businesses, should be considered in order to increase the availability of capital for investment in small businesses.

Currently, if an investor sells an equity interest in a business, he is taxed on any capital gain. Consequently, he has an incentive to retain his investment, dispose of his investment through a nontaxable transaction such as a merger, or conjure offsetting capital losses in an attempt to defray the tax. Allowing the investor to retain the full equity and capital gain provided he reinvest the full sum in a small business would strengthen new business development. Targeted accelerated depreciation would also generate more capital for small business growth. These incentives would be particularly useful if they were aimed at the needs of minority small businesses in economically depressed areas.

Stabilizing Homebuilding: The Impact on Structural Unemployment

The homebuilding and construction industries are sources of the kinds of jobs that can make a significant impact on

structural unemployment. Most jobs in these industries are relatively highly skilled and well paid and offer career opportunities that are not just dead-end jobs. The entry-level jobs in these industries, however, do not require a high skill level, and most skills can be learned on the job.

These industries, unfortunately, are characterized by significant cyclical fluctuations in activity and employment. This seriously hampers the ability of minority workers to obtain good jobs in these industries, since those who are hired last when the industry is undergoing a boom are the first laid off during a downturn. Hiring practices in these industries have yielded a very high proportion of whites in positions with seniority, so that downturns in housing and construction have a much greater impact on minority unemployment in construction jobs.

In addition, the deterioration of central cities and the lack of new construction in these areas, combined with the strong growth of suburban areas, means that most construction jobs are located far from inner-city black youths and others who suffer the most from structural unemployment.

Therefore, policies which stabilize homebuilding and construction and which revitalize declining urban areas will contribute significantly to employment opportunities for minority youths and other workers who are structurally unemployed. Historically, fluctuations in the Nation's business cycles have affected and, in turn, were themselves inversely affected by the rate of housing starts. In inflationary periods, the housing industry is generally

affected sooner and often more sharply than most other sectors. Typically, this is reflected in declines in housing starts as interest rates rise. Likewise, increased housing starts encouraged by low interest rates have generally led the Nation out of economic downturns.

In response to record high interest rates and home prices, housing starts in 1979 fell 14 percent from 1978 to 1.75 million units. While this may be a significant reduction, it is not as steep as might have been expected in light of the fact that the median price of a new home for 1979 increased 13 percent over last year to $62,900. And mortgage interest rates reached a previously unprecedented national average of 10.8 percent in 1979. In December, preliminary estimates indicate mortgage interest rates averaged 11.79 percent nationally.

The high cost of interest and home purchases did not initially have the expected dramatic dampening effect. But as the year progressed and interest rates soared, housing sales came to a virtual standstill in many States where usury laws prevented interest rates from rising to the market level. This situation has been alleviated by P.L. 96-161 which invalidates all State usury ceilings through March 31, 1980.

In November, new home sales declined to an annualized rate of 604,000, 13.5 percent below October sales. This was the largest percentage drop since February 1970, and the lowest number of home sales since June 1976.

Rapid and severe swings in the housing sector are both costly and inefficient during downturns. Idle capacity is created when plant and equipment remain dormant, the capacity for manufacturing materials used in housing construction is underutilized, and construction workers are not employed. Further, the pent-up demand created during the downswing may exert an upward pressure on prices as the economy recovers. According to Herman Smith, Vice President of the National Association of Home Builders, in testimony before the Committee, during periods of high construction activity returns on plant and equipment must be higher to make up for losses during idle periods. The demand for resources used in housing increases sharply, resulting in higher land prices, material prices, interest costs and wage costs. It is important therefore that a precipitous decline in housing starts be averted in 1980.

Housing start projections for 1980, however, anticipate average annual starts well below the 1979 level. At a recent Joint

Economic Committee hearing, projections varied between 1.1 and 1.5 million units. Data Resources, Inc. and Chase Econometrics are both predicting 1980 starts of about 1.4 million units. The Chase forecast projects a drop in single family units from 1.2 million this year to .88 million in 1980, the low point reached during the housing trough of 1974. Both DRI and Chase predict the decline in starts will reach its depth in the second quarter of 1980 at approximately 1.3 million units and recover to about 1.5 million units by the fourth quarter.

The projected sharp decline in starts could have serious implications for our national economy in 1980. The implications of these projections for employment opportunities are significant. If housing starts decline by 300,000 units in 1980, more than 400,000 worker-years of labor could be sacrificed.

The introduction of money market certificates (MMCs) in June 1978 and other institutional and regulatory changes in the past year were responsible for preventing a sharper decline in housing starts in 1979. The MMCs and other instruments provided a continuous source of funds to the thrift institutions and helped to avert disintermediation in most instances. The extraordinarily high rate of interest paid on the MMCs by the lenders, however, particularly in relation to the lower interest rates received from existing, outstanding mortgages, have placed financial strains on many thrift institutions. In recent months, with the elimination of the interest differential on MMCs favoring thrifts, disintermediation has increased for the mutual savings banks, and the flow of

funds to the savings and loan associations has been down sharply from last year.

Structural Unemployment and the Goals of the Full Employment and Balanced Growth Act of 1978

Most of the labor market developments during 1979 were directly related to long-term trends and shifts in the structure of our economy that characterized the 1970s. These trends and shifts and their anticipated turns and developments in the coming decade were most clearly reflected in the Administration's revisions of the timetable for achieving the Humphrey-Hawkins goals. While the necessity of revising these goals is certainly unfortunate, it is equally necessary to preserve the validity of the Humphrey-Hawkins process by making the timetable more realistic, particularly in light of long-term economic problems for which there are no easy short-term solutions.

The 1980 Economic Report of the President contains what the Committee believes are some of the essential policy incentives for achieving the Humphrey-Hawkins goals. Many of our present unemployment and inflation problems stem from long-term demographic developments, structural shifts in the economy, and the disappointing trends in business investment and productivity. In this regard, we are pleased to note the new initiatives for addressing the problems of youth unemployment, although we reserve final judgment until the full details are presented. The new initiatives speak not only to the need to improve the educational preparation of disadvantaged youths, but also to the need to differentiate the job training

and job experience needs of youths that are in different stages of structural unemployment. Targeted jobs programs that are premised on incentives for both public and private involvement in job training are the key to attacking the long-term structural problems that plague our economy, particularly if they are complemented by appropriate incentives for increasing job-creating capital investments in the private sector.

Small business can provide the important linkages between the job training, job experience and job creating aspects of this policy strategy. With their relatively low capital to labor ratio, small business can create more jobs per added investment dollar and at the same time reap relatively larger benefits from such targeted job experience programs as the targeted jobs tax credit program. Furthermore, since small business already tends to provide the lion's share of our present employment growth, closer cooperation of job-training officials with the small business community would help ensure a closer match-up of job opportunities for training program graduates.

A policy strategy that combines job training and job experience programs with programs for small business investment growth would not be inflationary. It would not overstimulate the demand side of our economy, but rather it would improve the productive potential of our work force and expand the productive capacity of the competitive, small business sector of our economy. This supply side strategy will mean not only more jobs, but lower consumer prices as well. Additionally, if the proper incentive framework is built into these programs, the

price of this strategy will be only a small fraction of the social costs of high unemployment and high inflation that we currently pay in high crime rates, high prices, extreme uncertainty, and ever-growing government spending and taxes.

VI. ENERGY AND INTERNATIONAL TRADE

Energy Dependence

The decade of the 1970s witnessed two very important changes in the international economic position of the United States: sharply higher energy prices and growing American dependence on the world economy. America's growing economic ties with the rest of the world have made us starkly vulnerable to economic and political events overseas.

The American economy has become heavily dependent on the political as well as the economic fortunes of our major trading partners. The revolution in Iran, and the short-lived seizure of the Grand Mosque in Saudi Arabia point to the potential for political instability in a region of the world that supplies the United States with 33 percent of its oil imports and accounts for 60 percent of the noncommunist world's oil supply. A growing Soviet presence in the area -- first in South Yemen, then in Ethiopia, and most recently in Afghanistan -- adds to the likelihood of a politically determined interruption in the U.S. oil

supply and a serious disruption of the overall world economy.

American dependence on the rest of the world involves more than imported oil. The old phrase "when America sneezed, Europe caught cold" can now apply to our own health as well. The United States depends on imports for 50 percent or more of its supply of a long list of raw materials. One acre in three is now planted for the export market; one in eight manufacturing jobs is linked to exports. Most of the leading U.S. manufacturing firms, many large banks, and a growing number of service companies are also heavily involved in international commerce as well. Consequently, merchandise exports now account for 6.7 percent of GNP compared to 4.3 percent in 1970, while imports have more than doubled in importance from 4.1 percent of GNP in 1970 to 8.3 percent in 1978.

These growing economic ties with the rest of the world have brought many benefits, but they have also made the United States increasingly vulnerable to economic and political events overseas. And nowhere is this vulnerability more explicit than with petroleum supplies. The supply and prices of critical liquid fuels in the United States and the noncommunist world continued to be subject to manipulation during 1979 by a handful of petroleum-exporting nations.

Members of the Organization of Petroleum Exporting Countries (OPEC) control the decisive margin of tight world oil supplies. Repeatedly since 1973, they have exploited this position to limit production and increase prices, creating a major international income redistribution which will approach $300 billion in 1980 alone. OPEC contract oil prices have risen from $1.80 per barrel in 1970 to an average of $28-$30 per barrel at the end of 1979. Largely in response, the U.S. terms of trade deteriorated by more than 25 percent over this period.

With petroleum imports at 8.2 million barrels per day (mbd) in 1978, the United States relies on foreign nations to meet 24 percent of its demand for all forms of energy. As depicted in Table VI-1, this level of dependence is not unique among noncommunist countries. For example, Japan relied on oil imports for 72 percent of its total energy needs during 1978. More as a consequence of slowed economic growth and rising prices than of government action or increased domestic oil production, these levels of oil dependency have generally stabilized. The United States, for example, has held petroleum imports in the last two years below the 8.8 mbd recorded in 1977. Yet as the occasionally frantic bidding revealed last year, the oil consuming nations

are far from united in efforts to reduce their oil dependence. In fact, most explicitly reject voluntary reductions in imported oil levels, noting the adverse effects on domestic growth and employment associated with such reductions.

TABLE VI-1

NET OIL IMPORTS AS PERCENTAGE OF TOTAL
PRIMARY ENERGY CONSUMPTION

1960 - 1978

	1960	1973	1978
United States	5	16	24
Japan	31	75	72[1]
West Germany	19	54	56
United Kingdom	26	49	19
France	30	71	62[1]
Italy	40	73	66[1]
Austria	5	41	43
Norway	39	34	-28[2]
Turkey	10	36	57
USSR		-12	-14
Eastern Europe		16	18
China		0	- 2
World Oil Price Per Barrel	$1.75	$2.59[3]	$12.70

Sources: Resources for the Future, Energy: The Next Twenty Years. British Petroleum Statistical Review of the World Oil Industry, 1978; U.S. Department of Energy.

[1]Including coal and liquefied natural gas energy imports, Japan imported 88 percent of all energy consumed in 1978, while France imported 76 percent and Italy 81 percent.

[2]Negative numbers signify net energy exporters.

[3]Benchmark light crude petroleum sold by Saudi Arabia. Variations of up to $1 existed due to quality and locational differences. This price was increased to $3.01 per barrel in October upon initiation of the Arab oil embargo.

A number of destabilizing factors exist which may send OPEC prices higher and force import reductions upon the noncommunist world. The Soviet seizure of Afghanistan and the Soviet military presence in Ethiopia and both North and South Yemen have alarmed Persian Gulf oil exporters. Continuing turmoil in Iran, domestic unrest in Saudi Arabia, and the continuing Arab-Israeli conflict jeopardize Middle East petroleum production. And the looming emergence of the Soviet Bloc as a net oil importer of up to 4.5 mbd by 1985 also threatens oil availability and price stability. If the Soviet Union enters the world oil markets it would tax foreign exchange reserves and expose the Soviet economy to the threat of foreign disruption. Soviet acquisition of a client oil exporting state in the Persian Gulf would minimize these problems, but create havoc in the free world.

The United States is developing a multifaceted program of conservation and energy production to reduce oil imports. While some of these investments will promote labor productivity and employment, others will not. The new programs will be costly. For example, to liquefy or gasify significant amounts of coal will require investments in the tens of billions of dollars through the year 2000. The programs will raise serious environmental issues, as well, such as coal-

related acid-rain and atmospheric carbon dioxide accumulation. Other notable problems exist. One is with nuclear energy exemplified by the Three Mile Island nuclear power plant accident, and the de facto moratorium on nuclear plant construction permits and operating licenses. Another is the continuing controversy over low-level radiation standards.

Increased coal utilization, nuclear power, and reversing the declining trend in oil production all carry economic and social costs. Yet the drain abroad of national wealth and the threat of energy embargoes has slowed economic and employment growth and eroded living standards. And these debilitating effects of America's energy dependence will probably persist throughout the 1980s.

It is vitally important that the United States increase domestic energy, and particularly oil production. This is a cornerstone of any American energy policy. In addition to providing necessary incentives for traditional domestic oil production, a major program to increase the yield of existing oil fields must be initiated, utilizing enhanced recovery techniques. 1/

1/ Mr. Reuss states: "A technique exists to reduce our dependence on imported oil rapidly and effectively. We could and should ration gasoline now."

Enhanced Oil Recovery

The United States is witnessing a decline in its proved reserves of domestic petroleum. Consumption stands at close to 6 billion barrels annually, with domestic production at slightly over three billion barrels. For the first time in 25 years, Texas production fell last year to less than one billion barrels. Since the major addition of Prudhoe Bay in 1970, new proved reserve finds have fallen well below production. From 1975 to 1979, consequently, the United States consumed 4.5 barrels of oil for each new barrel of oil discovered despite near-record exploratory drilling activity. New proved additions averaged less than 1.3 billion barrels a year in that period.

To close the present oil import gap of 8.0-8.5 mbd would require the discovery of a new Prudhoe Bay-sized field every two or two and one-half years during the 1980s. Even to maintain present domestic production will be a prodigious achievement, requiring the discovery of two Prudhoe Bays, or a 150 percent rise in discovered proved reserves over that period. Prospects, consequently, are for a notable reduction in domestic oil production over the next decade, a reversal of most predictions made during the 1970s when domestic production was projected to rise by 50 percent or more by 1990.

The decline in domestic oil production cannot be reversed over the next several years. Beyond that, however, one significant option exists to rapidly rebuild domestic oil production, even if oil discovery rates remain at present dismal levels: the enhanced recovery of oil from existing oil fields.

Primary and secondary petroleum recovery techniques extract only some 25-30 percent of petroleum from reservoirs. The remainder (some 300 billion barrels, domestically), remains too closely adhered to surrounding strata for natural field pressures or waterflooding to extract. However, up to 30 billion barrels of this remaining oil is subject to extraction with a variety of enhanced recovery techniques, about half with gas and steam injections and the remainder with more expensive chemical technologies.

Enhanced oil recovery is expensive (from $10-$32/barrel). Many of the technologies are immature and require years following their application in specific wells to yield substantial results. Federal research into enhanced recovery technologies, consequently, should be accelerated now if this promising supply option is to contribute notably to the domestic energy stock during the 1980s.

Recommendation No. 24

The Administration should initiate a major program to accelerate the use of enhanced oil recovery technologies and other steps designed to increase domestic petroleum production.

A Near-Term Energy Security Program

In light of the pessimistic prospects for oil prices and supply stability and the extended period of time required before U.S. energy programs will sharply reduce oil imports, an added dimension is needed for U.S. energy policies. The United States must establish a new, short-term energy program designed to prevent further loss in energy independence during the 1980s. This program should stress emergency energy preparedness, conservation, and energy supply alternatives which will yield results quickly. That is, we need to establish an emergency energy security program that places emphasis on energy conservation, enhanced recovery of oil from existing wells, alcohol fuels production, the filling of the strategic petroleum reserve, and increased energy imports from more secure sources including Canada and Mexico. Additionally, we need to begin now to encourage the search for and development of new fossil fuels in the third

world. We need to develop, as well, statistical measures expressing the magnitude of our vulnerability to energy supply interruptions -- an energy security index -- and our energy requirements -- an energy productivity index.

Energy Indices

Each month the Council of Economic Advisers publishes Economic Indicators for the Joint Economic Committee. This document includes about 45 key economic indicators which measure what we think is important and what should be a focus of public debate. The Departments of Commerce, Energy, and other Federal agencies maintain indices, as well. Yet, there are two key aspects of energy policy for which we have no valid indices -- our level of energy security and the efficiency of U.S. energy use or energy productivity.

Energy Security Index

One of the basic facts of energy life in the 1980s is the possibility that oil imports will be interrupted. The economic importance of these supply interruptions can be very large. For instance, it has been estimated that the 1973-74 Arab oil embargo increased

inflation by 1.8 percent, lowered GNP by 3 percent, and increased unemployment by 1.7 percent.

A national energy security index could be developed to measure our ability to withstand a one mbd to three mbd cutoff of oil imports, an amount roughly equivalent to a complete shutdown of Saudi Arabia or a cutoff of all other Arab OPEC exports. This index could be a combined measure of how the following four factors affect the U.S. ability to withstand an import supply interruption.

1. Spare Capacity: If the United States could temporarily increase its production from Alaska, the Outer Continental Shelf, and the National Naval Petroleum Reserves by 300,000-500,000 barrels per day, it would substantially reduce the economic threat posed by an embargo. OPEC's ability to control world oil supplies really arose when Texas and Canada ceased to be the marginal world oil suppliers in 1971. Thus, the "capacity" section of the index would measure the amount of spare capacity the United States has that could quickly be brought into production in the event of a cutoff.

2. Emergency Curtailment: If the Federal Government developed a series of programs to reduce energy consumption in an emergency and had the legal authority to enforce such

curtailments, our ability to withstand cutoffs would be substantially increased. For instance, a temporary combination of reduced gasoline and fuel oil consumption, the substitution of natural gas for oil, electricity wheeling, and building temperature controls could save over one million barrels per day with no serious economic dislocations. The index would show the amount of reduced consumption that could be realized with such programs.

3. Strategic Petroleum Reserve: A sizeable Strategic Petroleum Reserve of 500 million to one billion barrels would reduce dramatically the security risks of import cutoffs. The present level is about 90 million barrels -- 11 days' supply of imports. Filling the SPR was halted last year to relieve pressure on world oil prices but should be resumed once markets become less tight.

4. "Risky Nation" Import Reduction Program: Finally, we should have as a national policy the lowering of imports from nations that are the most likely to embargo the United States. The security of our imports, not their gross level, is the fundamental national security problem. An undifferentiated policy of "lowering imports" may be ineffective, or even counterproductive, if we reduce imports from

stable suppliers while increasing them from unstable sources.

To illustrate how the energy security index might be used, let us suppose that we choose as our optimum short-run policy the ability to withstand a three million barrel a day cutoff for 100 days. Thus, if all of the supply and conservation alternatives suggested above yielded a 300 million barrel offset to a prospective energy import supply interruption, the index would have a value of 100.

The index would read 33 if the available offset amounted to only 100 million barrels, since a three million barrel per day cutoff would exhaust such a reserve in only 33 days -- one-third of the optimum measured by the index. The index would increase one point for every additional three million barrels stored in the Strategic Petroleum Reserve. The index would also increase as our imports from politically unstable nations were reduced -- a 500,000 barrel per day reduction would add 17 points to the index, since it would increase our security by 17 percent of three million barrels. Similar increases in the index would occur as spare production capacity or emergency curtailment options were put in place.

The development of an energy security index would help the Nation assess its ability to withstand oil cutoffs. As the value of the index steadily improved, the national sense of confidence would gradually increase. Since the United States is the world's largest user of oil and the world's largest oil importer, an international perception that it is steadily increasing its ability to weather oil cutoffs would tend to weaken upward pressure on world oil prices.

Recommendation No. 25

An energy security index and emergency stand-by programs to alleviate oil shortages following a temporary disruption in petroleum imports should be developed. Among the criteria contained in an energy security index should be the amount of oil in the strategic petroleum reserve, our ability to curtail consumption, our ability to increase production on an emergency basis, and the amount of oil obtained from insecure suppliers.

Energy Productivity Index

The 1 percent reduction in American oil use during 1979 was caused in part by renewed uncertainty over oil availability; past investment in energy efficient machinery, autos, and equipment; sharply higher energy prices; and a growing awareness by the American public that oil import dependence must be curtailed. U.S. consumption of energy per GNP dollar continued to decline in 1979, dropping 4 percent below 1978. Since 1975, our real GNP has risen almost 20 percent, while energy consumption has grown by only 11 percent.

This energy efficiency or productivity gain is the result of millions of individual investment and consumption decisions -- ranging from the purchase of more efficient automobiles to the caulking and insulation of drafty homes -- which were aimed at reducing energy use without penalizing economic growth. The overall contribution of this growing energy efficiency to our current energy supply mix has been significant.

In 1973 before the oil embargo, America consumed 74.6 quads of energy, a rate of 60.4 thousand Btu's of energy per constant dollar of GNP (as depicted in Table VI-2). If that rate of energy use had been maintained through 1979, the rise in real GNP since 1973

would have required the use of 86 quads of energy during 1979. In fact, only 79 quads were used due to a reduction in the rate of energy use to 55 thousand Btu's per constant dollar of GNP. This increased efficiency directly reduced U.S. oil import requirements by 7.2 quads per year, or the equivalent of 3.5 million barrels of oil per day. In other words, given a near constant level of domestic energy production over that period, including new Alaskan production, the increased efficiency enabled us to reduce our energy imports by about 3.5 million barrels per day below what they otherwise would have been.

TABLE VI-2

ENERGY CONSUMPTION PER GNP DOLLAR

Annual Rate	Energy Consumption per Constant Dollar of GNP (Thousand BTU's)	Yearly Rate of Energy Consumption (Quadrillion Btus)	Gross National Product	
			Current Dollars	1972 Dollars
			(Trillion Dollars)	
1973 Average	60.4	74.605	1.307	1.235
1974 Average	59.9	72.756	1.413	1.214
1975 Average	59.3	70.706	1.516	1.192
1976 Average	58.6	74.513	1.700	1.271
1977 1st Quarter	64.4	84.108	1.807	1.307
2nd Quarter	53.6	71.047	1.867	1.326
3rd Quarter	53.7	72.222	1.917	1.344
4th Quarter	58.2	78.872	1.958	1.355
Average	57.4	76.536	1.887	1.333
1978 1st Quarter	64.2	86.902	1.992	1.354
2nd Quarter	53.0	73.269	2.088	1.383
3rd Quarter	52.8	73.468	2.136	1.391
4th Quarter	56.8	80.256	2.212	1.413
Average	56.6	78.443	2.107	1.385
1979 1st Quarter	62.3	89.620	2.265	1.416
2nd Quarter	51.3	72.952	2.330	1.422
3rd Quarter	50.0	71.711	2.395	1.434
4th Quarter	54.6	82.013	2.456	1.438
Average	54.5	79.074	2.362	1.427

Source: U.S. Department of Energy

Further increases in energy efficiency can occur in ways that do not jeopardize economic growth. The jump in energy prices during 1979 encouraged conservation but reduced the ability of consumers and businesses to make long-term energy efficiency investments. For example, optimal weatherization of a typical American house costs from $1,500 to $2,500. Yet few families can make such a front-end outlay easily, and investments that are extremely important to reducing our oil import dependence are thereby thwarted. Focusing on this problem, Congress expanded incentives in 1979 for homeowners and commercial building owners to increase the energy efficiency of their structures. It is apparent, however, that much more could be done. Indeed, an analysis by the Energy Project at the Harvard Business School suggests, for example, that an accelerated energy conservation program could save the equivalent of 5 million barrels of oil beyond the savings already projected from existing government programs.

The long-term competitiveness of many domestic industries depends on the rapidity with which they adapt to higher energy prices by improving energy efficiency. Despite significant improvement since 1973, however, many industries remain relatively energy inefficient. The United States uses 40 percent more energy to produce a ton of

steel, for example, and 50 percent more energy to produce a ton of cement than does Japan. Production of aluminum here requires 30 percent more energy than in France. If the adaptation to energy efficiency is slow, these and other industries in which energy is a significant cost element will become less and less competitive, jeopardizing employment and economic growth. Energy efficiency, then, has a direct impact on domestic economic growth and employment.

To focus national attention on the wisdom of improving energy efficiency, an energy productivity index (EPI) should be developed. Such an index, patterned on the labor productivity indices of the Labor Department, would measure output per unit of energy input. An EPI would facilitate establishment of national energy conservation goals, and would provide a mechanism with which to measure progress here and with fellow members of the Organization for Economic Cooperation and Development (OECD).

Recommendation No. 26

An energy productivity index should be developed to measure progress toward improved national energy utilization. Separate energy productivity indices should be developed for each of the

major U.S. industries, for each consuming sector, and for the economy as a whole.

Near-Term Energy Production: Alcohol Fuels

Every gasoline engine in the United States can be fueled with a mixture of alcohol and gasoline -- or gasohol -- which increases the fuel's octane rating and eliminates engine knocking without jeopardizing fuel efficiency or mileage. Usually comprising either 10 or 20 percent of the fuel, alcohol can be produced from coal or a variety of biomass sources, including wood (methanol) or grains and sugars (ethanol). The traditional beverage technology presently utilized for alcohol production, reflecting the necessity to meet strict human consumption standards, is fuel inefficient. Newer equipment, however, holds the prospect for a favorable energy balance. This beverage technology yields alcohol which, at $1.60 or more per gallon, is substantially higher than the tankwagon price of gasoline. This cost disadvantage will diminish as newer technology evolves and as markets develop for the protein-rich alcohol by-product called Distillers Wet Grain (DWG). DWG is presently selling for 35 cents to 45 cents per gallon in limited quantities as livestock feed. Existing and proposed Federal and State tax

incentives will reduce this cost disadvantage further.

The development of DWG as a by-product may resolve the fuel versus food trade-off which surrounds gasohol debates. If so, a significant diversion of feed grains to alcohol production could occur without jeopardizing livestock feed supplies or price. Present alcohol for gasohol production is a miniscule 6,000 barrels daily. Evolving Administration plans include expansion of ethanol production to meet 10 percent of unleaded gasoline demand with gasohol by late 1981 which would require production of 28,000 barrels daily of alcohol.

Blending all gasoline with a 10 percent alcohol mix would reduce oil imports by 5 percent to 10 percent, would require production from some 45 million acres (10 percent of U.S. planting), and would require an investment of approximately $10 billion to $15 billion in new alcohol production facilities.

Expansion of production even on the modest scale envisaged by the Administration faces several hurdles, however. Technology for the small scale production of alcohol suitable for blending with gasoline must be developed if the rural economy, including farmers and

farm co-ops, are to participate directly in gasohol production. Research must be conducted on the use of vehicles, including farm machinery, run largely or entirely on alcohol in the Brazilian pattern. And further research is needed, as well, on the technology of producing alcohol from coal and from wood and urban waste.

Increased Diversity of Supply

In 1979, just three countries, Saudi Arabia, Iran, and Iraq, produced over 25 percent of the total world oil supply. (See Table VI-3.) And as presented in Table VI-4, five OPEC countries, Saudi Arabia, Nigeria, Venezuela, Libya, and Algeria, accounted for over half of all U.S. imports. This extreme dependence on the stability and production policies of a handful of governments is a constant threat to U.S. economic stability.

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TABLE VI-3

CRUDE OIL PRODUCTION BY MAJOR PETROLEUM EXPORTING COUNTRIES
September, 1979

Country	Production (Thousand b/d)	
Algeria	1,000	
Iraq	3,500	
Kuwait	2,374	
Libya	2,028	
Qatar	454	
Saudi Arabia	9,774	
United Arab Emirates	1,837	
Subtotal: Arab OPEC		20,967
Ecuador	220	
Gabon	199	
Indonesia	1,578	
Iran	3,500	
Nigeria	2,116	
Venezuela	2,365	
Subtotal: Non-Arab OPEC		9,978
TOTAL OPEC		30,945
Canada	1,474	
Mexico	1,460	
North Sea	2,157	
TOTAL OPEC, Canada, Mexico, North Sea		36,036
TOTAL WORLD		63,124

Source: U.S. Department of Energy

TABLE VI-4

U.S. PETROLEUM IMPORTS BY COUNTRY
1979 Average[1/]

Country	Imports (Thousand b/d)	
Algeria	614.9	
Indonesia	387.0	
Iran	230.4	
Libya	667.5	
Nigeria	1,068.8	
Saudi Arabia	1,351.5	
United Arab Emirates	288.5	
Venezuela	657.8	
Other OPEC	202.8	
Subtotal: OPEC		5,469.2
Canada	513.5	
Mexico	409.4	
Caribbean [2/]	1,013.9	
Other	691.3	
Subtotal: Non-OPEC		2,628.0
TOTAL IMPORTS		8,097.2

1/ January through September.
2/ Includes Bahamas, Netherland Antilles, Puerto Rico, Virgin Islands, Trinidad and Tobago. Virtually all of these imports are petroleum products transhipped from OPEC nations.

Source: U.S. Department of Energy

Developing new international sources of imported petroleum supplies is a key component of any strategy for reducing overall U.S. dependence on foreign supplies. Federal policy should recognize that there is "safety in numbers" -- the greater the number of oil producers worldwide, the less is the risk of economic disruption from the temporary loss of any single nation's productive capacity or an embargo. Every barrel of new oil discovered potentially places downward pressure on OPEC prices and contributes to stabilizing world oil supply. Such stabilization of world oil markets is at least as important for developing countries in the Third World as it is for its contribution to the economic security of the United States. Third World nations face severe hardship as a result of what they will be required to pay in 1981 for OPEC oil. This currency drain means substantial setbacks for development programs and portends additional years of hardship for citizens of oil-importing developing countries.

The International Bank for Reconstruction and Development recently embarked on an expanded five-year program to spend $1.2 billion annually on oil and gas projects in non-OPEC, less-developed countries (LDCs). Sixty percent of these funds will be for production facilities to develop known but

previously unexploited reserves. This is an important and necessary program. Yet only a relatively small $500 million will be devoted to an increase in exploratory drilling designed to identify new commercial reserves. Although non-OPEC LDCs account for approximately 50 percent of the world's prospective area of oil reserves, less than 5 percent of the exploratory wells ever drilled have been located in Africa, Southeast Asia, Latin America, and China, as summarized in Table VI-5, from a study prepared for the Joint Economic Committee. Yet the results of such exploratory drilling have been favorable, as noted in Table VI-6.

TABLE VI-5

EXPLORATORY WELLS DRILLED [1/]

Developed Countries:		
U.S.S.R	100,000	
United States	482,000	
Canada	20,000	
Australia and New Zealand	500	
Western Europe	12,500	
Japan	1,000	
Total:	616,000	95.4 percent
Developing Countries:		
Africa and Madagascar	6,500	
Latin America	14,000	
South and Southeast Asia	5,000	
Peoples Republic of China	2,000	
Total:	27,500	4.3 percent
WORLD TOTAL	643,500	

1/ Figures are approximate in some instances.

Source: A Strategy of Oil Proliferation. Arnold E. Safer. Joint Economic Committee, forthcoming.

TABLE VI-6

BARRELS OF OIL PER FOOT OF TOTAL DRILLING,
U.S., WESTERN EUROPE, LATIN AMERICA, AFRICA
(1945-1974)

Time Interval	United States	Western Europe	Latin America	Africa
1970-74	15.0	1,134.0	208.6	1,062.4
1965-69	30.3	322.6	158.4	1,189.4
1960-64	13.9	35.7	117.5	813.6
1955-59	13.7	26.9	160.6	996.2
1950-54	16.1	84.8	167.5	77.8
1945-49	25.5	49.9	191.2	109.8

Source: Grossling, B., "A Critical Survey of World Petroleum Opportunities," Project Independence: U.S. and World Energy Outlook Through 1990, Congressional Research Service, Library of Congress, Washington, D.C., November, 1977.

North American Energy Policy

As the world's largest energy importer, the United States is fortunate to have two neighbors who are among the handful of nations both capable and willing to export energy. Development of a North American energy policy, designed to replace insecure OPEC petroleum with energy from Mexico and Canada will reinforce efforts to minimize U.S. energy dependence.

Mexico envisages expansion of oil production by up to an additional one mbd over the next five years. Domestic energy firms should be encouraged to build on the good will established by the successful conclusion of the American-Mexican natural gas negotiations in December and seek to negotiate long-term guaranteed contracts for petroleum supplies.

Looming natural gas surpluses in Alberta, could be made available to U.S. consumers through prompt U.S./Canadian cooperation on the Alaskan gas pipeline and on a proposed West-to-East Canadian line.

Canadian petroleum exports to the United States could be increased in future decades by U.S. participation in development of the vast Canadian tar sands resources. A memorandum of understanding on tar sands

research and development was signed last summer with Canada and the new Energy Security Corporation will have authority to expand upon that agreement if warranted. In addition, Canada has expressed interest in the development of joint strategic petroleum reserves in her Eastern provinces, convenient to oil-dependent New England. Prospects exist, as well, to back out U.S. oil imports used for electricity generation with hydroelectric exports from Canada. An expansion of seasonal electric power wheeling between the U.S. Midwest, Quebec, and Ontario awaits regulatory approval in the United States. And sizeable untapped hydroelectric sites in Canada could possibly be utilized by U.S. utilities under long-term agreements.

Recommendation No. 27

The Administration should present to Congress a comprehensive plan, including the estimated costs and benefits, proposed for the development of:

(1) a program to stimulate greater energy conservation and to raise energy productivity;

(2) a major, accelerated Alcohol Fuels Program, stressing large and small-

scale production facilities and the use of coal and biomass as feed stocks;

(3) a program to encourage oil exploration in non-OPEC developing countries;

(4) a program to increase the economic security of the Western Hemisphere by increasing and strengthening long-term trade relationships of mutual benefit including energy trade with Mexico and Canada.

International Trade

The difficulty with which America is adapting to its growing interdependence with the world economy emphasizes the urgency to renew its industrial base and export markets. American industrial policy has continued to cling to the economic assumptions characteristic of the post-World War II world. At the close of the war, America stood virtually alone as the world's pre-eminent military, political, and economic power. U.S. technology was the most advanced while the industrial base had grown and become more modern during the war years. But the world economy and America's place in it have undergone considerable change.

The major development of the 1970s and the major factor in growing U.S. dependence on the world economy has been and remains oil. In part, the expansion of American prosperity in the 1950s and 1960s reflected a steady improvement in our terms of trade -- in effect, year after year we had to sell fewer of our own products for each barrel of imported oil. Over the entire period, our terms of trade improved by almost 25 percent.

The oil shock of 1973 has reversed our economic fortunes. The sudden increase in the price of energy not only added to inflationary pressures but it also made a portion of America's plant and equipment economically obsolete. At the time, domestic production of oil and gas started to decline. The jump in our oil import bill -- from roughly $3 billion in 1970 to over $60 billion in 1979 -- is another way of saying that our terms of trade have sharply deteriorated. Instead of continuing to improve, over the last decade our terms of trade have deteriorated by some 25 percent. Among other factors, the shifting terms of trade have forced us to focus on augmenting our stock of capital equipment and the domestic supply of raw materials.

But it is not only the oil bill that concerns American policymakers.

Nearly all other nations recognize the link between international trade and domestic prosperity. The United States has been slow to adjust to the competitive world of trade. We have tended to view foreign trade as a luxury rather than a necessity. In the meantime, the U.S. market has become the target of integrated, well-financed, and highly successful efforts by our competitors.

International Competitiveness

Industry after industry has lost its competitive edge in international commerce. Textiles, shoes, industrial fasteners, ball bearings, specialty steel, and the automotive industries have come under severe pressure from overseas competitors. In recent testimony before the Joint Economic Committee, a spokesman for the semi-conductor industry, a key element in our high technology future, expressed concern about the future ability of his industry to meet current and expected challenges from abroad.

An important part of the answer to restoring international competitiveness lies in raising our rate of investment in plant and equipment. As we emphasize elsewhere in this report, higher rates of investment will boost sagging American productivity and allow us to move toward a lower, more stable price

level. But investment is not the entire answer. During the next decade, we will have to take a hard look at many of our institutions. The relative economic strength and health of Germany and Japan suggest that they might have some lessons for us in terms of policies and institutions. Neither country has adopted the adversary relationship that often exists between the American Government and the private sector. That relationship will surely have to change if we are to continue to be the economic as well as the political leader of the free world. Both Germany and Japan give workers a greater voice in the operation of corporations than we do in the United States. And both Germany and Japan have some form of a national industrial strategy that influences, if it does not determine, government policy and private sector investment plans. It is premature to suggest that the United States should move in any of these particular directions. What is clear is that our national desire for industrial and economic leadership will be severely tested in the decade ahead. Sharply higher energy prices have rendered obsolete or reduced the economic life of a substantial portion of U.S. plant and equipment and have affected the value of many commercial structures, private automobiles and appliances.

At the same time that America faces sharply higher energy prices, there has been a steady increase in competition among industrial and industrializing countries for access to secure supplies of raw materials, in world markets for manufactured goods, and for the American market itself.

U.S. dependence is not just a question of high energy imports. The periodic ability of the OPEC cartel to sharply and suddenly raise prices has forced a much more severe adjustment on the American economy. The sudden rise in prices created a loss in national income and a deterioriation in the American terms of trade with the OPEC cartel; America will have to sell more machines or more grain for each barrel of oil.

Export Incentives

High energy prices and economic interdependence will force major adjustments on the U.S. economy. First, there will have to be an increase in capital investment. By devoting a greater share of national income to investment in plant and equipment, American industry will be able to replace obsolete machines with equipment that incorporates recent innovations and energy saving techniques. A more modern industrial plant would boost U.S. productivity, a key to

bringing inflation under control, and help maintain the international competitiveness of U.S. goods. In addition, a reasonable rate of economic growth and higher levels of capital investment will facilitate the shift of the U.S. economy toward a greater export orientation and away from relatively inefficient industries that can no longer compete for international markets.

Second, the rising import bill for energy and other raw materials and the growing competition for foreign and domestic markets should force the United States to become a more effective international competitor. The recommendations in this report concerning the conduct of macroeconomic policy and targeted programs aimed at raising productivity if adopted, will tend to increase the competitiveness of U.S. exports. There are also a wide range of specific policies that the United States could adopt to improve its export performance. For example, there are hundreds of thousands of U.S. firms that have yet to test the export market. The relatively limited budget for export promotion may be part of the problem. In addition, there are few governmental incentives to help firms penetrate new foreign markets.

Although the new international code on the use of subsidies has circumscribed the use of

direct subsidies to stimulate the export of manufactured goods, permissible techniques could be used to aid the kind of structural shift toward exports that is already indicated by long-term market forces.

Recommendation No. 28

To help improve the U.S. export performance, the Government should actively promote the interest and participation of American business in foreign trade; evaluate and eliminate the disincentives and the statutory and regulatory requirements which unnecessarily impede U.S. exports and investment; and explore the need for new incentives.

Foreign Corrupt Practices Act

We are also concerned about adherence to principles contained in the provisions of the Foreign Corrupt Practices Act by foreign producers. The Act, passed in 1977, is designed to discourage the use of bribery and other illegal business practices by American firms. It was hoped that this law would provide a guideline, and a behavioral framework for U.S. trading partners and competitors, as well. This hope has not yet

been fully realized despite a draft convention of this issue. The Justice Department has developed a business review procedure to help U.S. business firms who have questions about the law. It is hoped that this will assist in resolving such questions.

Some American businessmen abroad argue that their ability to gain new markets and maintain existing ones is jeopardized by the disproportionate responsibility they have for maintaining ethical business practices overseas to the extent that competitors ignore the spirit of that law. In our view, the answer to this problem is not to relax the standards of conduct of U.S. businesses in foreign trade, but to insist upon the elimination of any corrupt practices on the part of foreign nationals.

Recommendation No. 29

The President should initiate an effort to encourage adherence to the principles contained in the Foreign Corrupt Practices Act by our competitors and customers abroad, utilizing international forums and other appropriate multilateral channels.

American Trading Companies

A number of America's trading partners, in particular Japan and several of the newly industrialized countries, have had considerable success in increasing exports through large trading companies. Although trading companies do exist in the United States, most of their trading activity is on the import side and there has been little success in forming the large, export-oriented trading companies through which a high percentage of Japanese exports are traded.

There is no clear reason why the trading company concept has failed to become a major force in U.S. foreign trade. The rapid post-World War II spread of the U.S. based multinational firm, the extensive American use of antitrust laws and limited availability of adequate bank financing have all been suggested as possible impediments to the formation of U.S. trading companies.

Recommendation No. 30

The Administration should provide Congress with a study assessing the existing barriers to the formation of U.S. trading companies and the feasibility of significantly increasing exports through trading companies.

Federal Trade Bureaucracy

In the past, the United States Government has not been sufficiently well organized to deal with overall trade policy. Export policy, in particular, has been given a relatively low priority. Alone among the major industrial or the principal industrializing countries, the United States does not have a full-fledged Department of International Trade.

The President has recently moved to reorganize the international trade bureaucracy. Under the President's plan (Reorganization Plan #3) responsibility for trade policy will be consolidated in the White House-based Office of the Special Trade Representative (now renamed the Office of the U.S. Trade Representative) and the execution of trade policy will be centralized in the Department of Commerce. Under the President's trade reorganization plan, both export policy and export promotion will be given considerably more emphasis.

The President's recent reorganization of the international trade bureaucracy was a definite step in the right direction. The consolidation of policy and operations, the establishment of a foreign commercial service, and the new emphasis on export policy are all welcome innovations. There is

concern, however, about the institutional split between policy and operations and the danger that the U.S. Department of Commerce will find its dedication to trade matters diluted by its multiple responsibilities.

Recommendation No. 31

Congress and the President are urged to monitor the effectiveness of the new trade reorganization. At the same time, the Congress and the President should continue to study the feasibility of establishing a full-fledged Department of Trade.

International Finance: Adjustment and Recycling

International economic developments during 1979 provide us with further evidence that the international adjustment process does work under floating exchange rates. We note first the substantial improvement in the U.S. current account position during 1979, from a deficit of $13.9 billion in 1978, to near balance in 1979, and this improvement despite an increase in our oil import bill of nearly $18 billion. More rapid growth of nonagricultural exports, slower growth of non-oil imports, and a surge in the growth of

our surplus on service transactions are the most notable factors responsible for our improved current account position. Both our export and our import-competing industries have made major gains in their market shares. The lagged effects of gains from past reductions in the foreign exchange value of the dollar, in combination with slower growth in the U.S. and more rapid growth abroad, have produced a substantial improvement in the current account position of the United States

In addition to the U.S. improvement, we also witnessed a change in the current account positions of the other industrialized countries. The huge Japanese surplus has been sharply reversed -- from a surplus of $16.5 billion in 1978 to a deficit of $8.6 billion in 1979; the German surplus -- which amounted to $8.8 billion in 1978 -- fell to a $4.9 billion deficit in 1979. Again, the lagged effects of past exchange rate changes and shifts in relative growth rates largely explain the reversal of these current account balances.

Of course, we need to emphasize what we have known for a long time: changes in exchange rates and growth rates exert their influence on trade flows only with a considerable lag. Nevertheless, the results of past exchange rate and growth rate changes

can be seen clearly in the current account swings of the major industrialized countries in 1979. A similar shift occurred after the exchange rate realignments of the early 1970s.

The shifts of the current account positions of the major industrialized countries during 1979 were largely responsible for another important development -- a more stable dollar on the world's currency exchanges. The dollar was subjected to intermittent downward pressures over the course of 1979, but it did not register a sustained decline. Indeed, despite the pressures, the dollar now stands above the levels reached in October 1978. On a trade-weighted basis, the dollar on January 31, 1980, stood about 4.9 percent above the rate registered during October 1978.

However, balanced current account positions are by themselves not sufficient to ensure continued stability in the value of the dollar. There needs to be confidence as well in the adequacy of the economic policies of the major countries to combat inflation and sluggish growth. If the policies recommended in this report are adopted, we believe that the world economy will express much greater confidence in U.S. economic policies.

The fact that the dollar continues to play a role in world currency markets that is out of line with the economic position of the United States in the world economy is another possible source of instability. In our annual report last year, we urged the Administration to look with favor on the establishment of a Substitution Account in the International Monetary Fund whereby foreign central banks who wish to diversify their reserve portfolios can do so by exchanging some limited portion of their disproportionately large holdings of dollars for Special Drawing Rights (SDRs) or some other currency composite. We continue to press for this reform.

Recommendation No. 32

In our view, the United States must continue to express a willingness to give serious consideration to proposals designed to facilitate a changed role for the dollar in world currency markets. We endorse the initiatives taken by the Administration to work toward the establishment of a Substitution Account within the International Monetary Fund in the near future. We recognize that other steps may be necessary.

One final issue that needs to be addressed concerns the question of whether recycling is going to work this time around for the nonoil developing countries. As a result of the sharp increase in energy prices in 1979, the oil import bill of the developing nations will swell, absorbing, according to some estimates, one-third of their export receipts. This, of course, will reduce the funds available to them for debt service or for payment of other imports.

The aggregate debts of the non-oil developing nations almost tripled between 1973 and 1978. As a proportion of GNP, average gross debt rose from 17 to 23 precent between 1973 and 1978; gross debt net of reserves rose from 11 to 17 percent. And debt service requirements relative to exports rose from 14 to 17 percent.

The last few rounds of oil price increases raised nonoil developing country debt by an estimated additional $25 billion in 1979; even without another round of OPEC price increases, their debt could rise by another $25 billion in 1980.

Two questions are raised in the wake of these mounting debt problems. The first, and most difficult, concerns the degree of adjustment the nonoil developing nations are prepared to make in their own economies in

response to their growing payments problems. Many adjustments need to be made. Several nations including Brazil, Chile, and Korea have devalued their currencies in an effort to boost their export earnings to help pay for their enlarged oil import bills.

The second question concerns the extent to which banks are willing and able to handle the additional borrowing requirements of the developing nations. U.S. banks have slowed sharply their rate of lending to developing countries. And recently, Japanese banks abruptly curtailed their foreign loan activity. However, in view of the fact that most large non-U.S. and non-Japanese banks have a relatively low ratio of foreign assets to total assets in their portfolios, it is possible that the Eurocurrency markets may be able to accommodate a fairly sizeable increase in loan demand on the part of the developing nations. Of course, in view of the worsened debt position of many developing nations, there are no guarantees that the required financing will necessarily be accommodated, and those loans that are granted are likely to be more expensive.

Under the circumstances, it is becoming increasingly clear that the International Monetary Fund (IMF) will have to play a larger role this time around in recycling funds from the OPEC surplus countries to the

nonoil developing nations. Fortunately, the IMF is in a good position to assume this role. The Fund now has about $30 billion for lending to member countries, and given the 50 percent increase in quotas expected this year, that amount will be augmented substantially. Additionally, since Fund assistance is now available in larger amounts and for longer periods than was true in the early 1970s, it is possible for the nonoil developing nations to make more orderly and gradual adjustments to the now higher oil prices.

At the moment we are mildly optimistic that the banks and the IMF, in combination, can effect the required financing to accommodate the borrowing needs of the nonoil developing nations. However, we believe that the situation needs to be monitored carefully. If existing financial institutional relationships prove to be inadequate, it will be necessary to search for effective alternatives.

APPENDIX

The Current Services Budget

Section 605 of the Congressional Budget Act of 1974 requires the Office of Management and Budget (OMB) to submit "the estimated outlays and proposed budget authority which would be included in the budget ... for the ensuring fiscal year if all programs and activities were carried on during such ... year at the same level ... and without policy changes." It further requires that the Joint Economic Committee "shall review the estimated outlays and proposed budget authorities so submitted, and shall submit to the Committee on the Budget of both Houses an economic evaluation thereof."

We are pleased to report that this year, for the first time, the Current Services estimates are as useful as they were orginally envisioned. The economic assumptions underlying these estimates are the same as those used in other parts of the President's budget. Further, in accordance with a recommendation we made for several years, the Administration has treated all programs equally with respect to inflation. Although there are always further improvements to be made, we believe that the Administration has taken a significant step forward and we applaud them for it.

ADDITIONAL VIEWS

REPRESENTATIVE HENRY S. REUSS

I congratulate Chairman Bentsen and the Committee for having once again produced a unified report. The Committee has worked very hard to achieve consensus and, remarkably, it has fashioned a substantive policy document. As the Joint Economic Committee has in the past taken the lead in pointing out new directions for economic policy, it is now doing so again. What follows is therefore not a dissent, but a synopsis of the most important themes of the Committee's analysis, and an attempt to impart a clear focus to the direction that policy must take.

On macroeconomic policy, the Committee has made two points of transcendent importance.

First, the Committee states that macroeconomic policy should adopt a target for long-run economic growth, and stick to it. This would mean an end to the destructive cycles of stop and go that have characterized policy in the last decade, and which have, at each turn of the screw, made our structural inflation and our structural unemployment worse.

Second, the Committee states that macroeconomic policy alone cannot do the job. We must have comprehensive structural policies, on energy, on incomes, and above all to promote our efficiency and competitiveness that we now lack.

In taking these two positions, the Committee has placed itself in the vanguard far ahead of the Administration. The testimony of Chairman Schultze before this Committee established, had there been any doubt, that the Administration continues to base policy on the macroeconomic will-of-the-wisp. This is an abdication of responsibility that the Committee wisely rejects. 1/

1/ Following is an excerpt from Chairman Schultze's testimony:

Representative Reuss. Welcome, Chairman Schultze. I have a lot of problems with the Administration's anti-inflation policy. I think most members of this Committee believe that the Federal Reserve is doing its part, and has the monetary aggregates at last under control. But when you look at the other gamut of policies, those which the Administration controls, I really don't see an anti-inflation policy in place adequate to deal with the 13 percent inflation that now plagues us.

The budget is not in balance. There's still a deficit at this late stage; and, indeed, military expenditures hint that the deficit will be increased.

The wage-price incomes policy is weakened. The description of that (in the President's report) ends up on page 82 with the statement that "As this Report went to press, the Pay Committee has just recommended a basic pay standard that would establish a range of allowable pay increases." Those allowable pay increases are, of course, greater in many

Footnote 1/ continued

instances than what we had. So that's weaker.

There is no attempt, by gasoline rationing or by a sharp increase in the excise tax, to limit the discretionary nonessential element in American transportation, and thus strengthen the dollar and fight inflation by enabling us to cut down on the real cost of our imports.

Finally, I find that the section on the structure of the economy, on page 104 and 105, "Improving the Structural Performance of the Economy," has just two very short paragraphs in it. Nothing, as far as I can see, is said about the problems of steel, of automobiles, of semiconductors, of railroads, of mass transit, and the half hundred other American industries which, in my judgment, really need a sectoral approach such as the Germans and Japanese have been giving their problems.

So I am disappointed with the anti-inflationary program; but if I am unnecessarily dour, I wish you would cheer me up.

Mr. Schultze. I will try. Let me start with a brief note, that "Improving the Structural Performance of the Economy," which as you note has two paragraphs, was meant to be a two-paragraph introduction to a 51-page exercise. You may disagree with the subjects we picked out that are important. We didn't think we were smart enough to pick out exactly which industries ought to be pushed but we did talk about, importantly, investment, labor markets, agriculture,

Footnote 1/ continued

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energy and the key big sectors of the economy.

Representative Reuss. If I may, let's stop there. Who is smart enough? There really ought to be somebody in the government who is putting his mind on avoiding future Rock Island-Milwaukee Roads, avoiding future Chryslers and Fords, avoiding the disappearance of our steel industry.

Mr. Schultze. I thought we had something called the market. That doesn't mean the government should never intervene. My own judgment is that we are probably better off intervening very occasionally and on an ad hoc basis... Quite frankly, I don't think this is a major area the Federal Government can do anything but harm when it mucks around in....

Representative Reuss. At least you, with your characteristic honesty, have stated the issue.

In the heyday of the macroeconomic fixation, from the passage of the Employment Act of 1946 until the early part of the last decade, the Joint Economic Committee was at the forefront of innovation in economic policy. In recent years, with the passage of the Humphrey-Hawkins and Budget Reform Acts, macroeconomic policy has found an institutional home in other parts of the Congress. Legislative review of fiscal policy is lodged in the Budget Committees, and that of monetary policy in the Banking Committees. Now there is a new emphasis for the Joint Economic Committee -- the design and implementation of structural policies and their integration with fiscal and monetary policy.

In Chapters IV, V, and VI the Committee has defined some of the elements of structural policy on which bipartisan consensus already exists. This is an admirable first step. The Committee should now turn its concentrated energies to the task of designing and winning agreement to the full range of policies that are needed. Broadly speaking, these fall into two categories: long-range policies to which we must make a permanent commitment, and temporary policies that are needed to manage the present crisis.

Our long-run goal must be to restore the competitiveness of U.S. manufacturing and other major economic sectors in domestic and world markets. For the first time in our history, the stability and prosperity of the American economy has become contingent on events outside our borders and beyond our control. This is partly a matter of our dependence on foreign oil, which can and must be reduced. But even more threatening is our growing addiction to superior foreign

manufactured goods. From 1965 through 1978, our imports of manufactures grew at an average annual rate of 9.4 percent, compared to a growth in our exports of manufactures of only 6.1 percent per year. This trend poses a threat to American employment, to American prosperity, and to the quality of American life that even the greatest success in reducing energy consumption and in promoting agricultural exports cannot offset.

To rebuild American industry we must end the adversary relationship that now exists between government and business. This point was emphasized by the Committee, but in my view, we need to go farther -- to adopt the cooperative approach that has been tried and proven by several of our major allies and rivals, notably Germany and Japan. Conventional measures, such as regulatory reform and revision of tax and depreciation schedules, are also necessary, but they are not enough. We need a government role in the planning and coordination of investment, in coordination of industrial location decisions, and to assure adequate and efficient support services (such as transportation, housing, and waste disposal) to major new enterprises. This is particularly necessary to facilitate the relocation of foreign manufacturing enterprise to our shores. Perhaps the best single way to overcome foreign domination of our automotive, television, consumer electronics and motorcycle markets, to name only a few, is to persuade Toyota, Honda, Sony, Yamaha and dozens of others to build their next factories in this country. At present, official efforts to do so are weak and spasmodic.

Such a government role would be indicative, not coercive. Ideally,

independent teams from government, business and labor should be constituted to look into the problems of each of our major sectors. Such teams should come from outside the sector to which they are attached, and should be drawn from our best and brightest public servants and public-spirited private men and women. Their objective should be to devise sectoral policies and development plans, covering corporate restructuring, new investment and its location, remedial regulatory legislation, and public financial assistance where required.

Such teams are needed in many places. Four high-priority examples:

In steel, we need massive new investment in continuous casting technology to overcome our technological lag and recover ground lost in recent years to foreign producers.

In autos, we need to persuade foreign manufacturers to follow Volkswagen, Honda and Renault in establishing manufacturing plants in this country. We need, if possible, to assure the transformation of Chrysler Corporation into a viable energy-efficient producer and to reverse the North American decline of Ford.

In transportation generally, we need to rationalize and rebuild our railroads before they (quite literally) crumble away. The once-great mid-western roads are in imminent danger of complete collapse. So long as the rights-of-way exist, there is hope for a comprehensive rescue operation -- but if government inaction allows the rights-of-way to disappear, our transportation base will be irreplaceably lost.

We also need a coordinated effort to resurrect urban mass transit. The Federal Government should create a market for a mass-produced, made-in-USA light rail transit car, and should greatly step up development of light-rail transit systems around the country. In many cities, existing freight rail track is available and suitable for light-rail, given only the will and the money to fix it up and electrify it. We also need a decent bus.

In energy, we need a major commitment of resources to the production of ethanol for gasohol. We need to promote the use of solar power. We need to end the bungling that has surrounded the construction of a natural gas pipeline from Alaska. We also need to promote the use of insulation, and energy efficient construction techniques.

I will shortly propose legislation to establish a new Cabinet department to pursue the development of long-run structural policies for American industry. To be called the Department of Industry and Trade, this department would replace the amorphous Department of Commerce, adopt the ill-coordinated export promotion functions now scattered through the Departments of State and Treasury, and add such new import-substitution and reindustrialization functions as are needed to get the job done.

Reconstruction of our cities and of our rail networks can be done without adding a new bureaucratic entity to the Federal Government. The task at hand is unavoidably expensive. But the cost of doing nothing is immeasurably greater.

Under the best conditions, it would take a year or more to get the development of

sectoral policies underway, and substantially longer before there were visible results. Immediate action is needed to bridge the gap. I propose a four point program:

1) Ration gasoline, providing enough for essential business, agriculture, and get-to-work use, but cutting back heavily on discretionary driving. The Administration acknowledges that a major saving in our imported oil bill could be achieved at once by such a measure. 2/ Unfortunately, the Administration thinks of imported oil only in terms of shortages of which there are currently none -- and not in terms of its real danger: a deteriorating U.S. trade

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2/ Following is an excerpt from Secretary Duncan's testimony:

Representative Reuss. Secretary Duncan, if we did impose tomorrow a well-administered gasoline rationing system which guaranteed to all industrial and agricultural users what they needed, and enough so that people could get to and from work, but cut out all nonessential pleasure purposes, what percentage of our gasoline consumption would be saved?

Secretary Duncan. Forty percent of gasoline consumption is considered to be discretionary consumption. Now, we're consuming gasoline at a rate of approximately -- in 1979 it was 7.05 million barrels per day, on the average. So assuming that number, about 2.8 million barrels per day of gasoline was in the form of discretionary consumption.

balance, a weakened international dollar, higher real costs of chrome, manganese and what not, and worse inflation!3/

3/ Following is an excerpt from the testimony of Drs. Walt Whitman Rostow, Alan Greenspan, and Lester Thurow:

Representative Reuss. Let me ask each member of the panel a question, which I hope can be answered yes or no. The question: Do you find the anti-inflationary economic program of the Administration adequate? Mr. Rostow.

Mr. Rostow. No.

Representative Reuss. Mr. Greenspan.

Mr. Greenspan. No.

Representative Reuss. Mr. Thurow.

Mr. Thurow. No.

Over the next years, gasoline supplies could be stretched by up to at least 10 percent with the accelerated production of ethanol, which could be pump-blended for pleasure-driving motorists at market prices, high enough to compensate America's corn producers. Our oil-import situation is critical, and we need immediate action before it is too late.

2) Balance the budget. This can be done by such means as cutting back general revenue sharing to the states, by selling a small amount of our gold at current inflated prices from the Fort Knox stockpile, and by using moderation in the military budget. A balanced budget would be an important symbol of our determination, and it would strengthen the fiscal position of the government for the tasks ahead.

3) Increase Federal job programs for the structurally unemployed. The Committee's report makes many useful suggestions on how programs for the structurally unemployed can be improved. The single greatest improvement would be to provide more jobs. A whole generation is going to waste -- we must act.

4) Strengthen incomes policies. In the absence of a thorough-going program to reform our economic structure, mandatory wage-price controls are not useful. In the presence of such a program, controls can play a useful bridging role. In the long run, structural reform can liquidate the need for controls altogether, as high rates of productivity increase permit the payment of high wages without inflation.

Summary

This report of the Joint Economic Committee has made a first step toward the development of sectoral and structural policies to replace the sole reliance on macroeconomic measures that we have all come to reject. Now, we must face the future fearlessly, and work to persuade the Administration and the American public of what is required.

SENATOR WILLIAM PROXMIRE

Inflation is still our number one problem. While I favor a tax cut I believe it must be earned. A tax cut which merely added to the deficit would itself be inflationary.

The tax cut must be earned by cutting spending and balancing the budget. This is the single most important step we could take to fight inflation. Spending should be cut in virtually every program, military and civilian. The Government is too big, too intrusive, and an excessive part of our lives. If cuts are made intelligently we can have a leaner, more efficient, more humane government than at the present.

Further, if we cut spending sufficiently we can provide a budget surplus. When we achieve a surplus we will have earned a tax cut. However, any tax cut should be an anti-inflation tax cut, designed to help hold down wage increases, encourage savings and investment and enhance productivity.

I believe we should require the President to propose a budget each year which would be in surplus if the economy grew at 3 percent or more. Such a requirement would have provided a balanced budget that would have been in surplus in 12 of the last 17 years instead of 16 deficits in 17 years. It would provide for a deficit in years when there is slow growth and a balanced budget or a

surplus in those years when the economy grows at the historical rate of 3 percent or more.

Essentially, it would require a balanced budget over the business cycle, with good years off-setting bad years and providing either stimulus or restraint as were needed. The proposal also removes forecasting and guesswork from the President's proposals. As economists have been routinely wrong in their forecasts, a proposal that would require the budget to be in surplus if growth were 3 percent, removes guesswork and estimates from the calculations of what fiscal policy should be.

Until inflation is brought under control, we must follow both a tight fiscal and a tight monetary policy with any tax cut based on returning to the public the funds saved through budget restraints.

I am in general agreement with the recommendations in the report and the accompanying excellent analysis and discussion. As I have indicated, I would go several steps further than my colleagues in several respects.

SENATOR EDWARD KENNEDY

I commend the Joint Economic Committee for once again issuing a unified annual report, and I am pleased to support it.

I also commend Chairman Bentsen for his leadership over the past two years. He has maintained the Joint Economic Committee as a cohesive unit whose penetrating inquiries and sophisticated analyses have done much to advance the economic interests of all Americans.

I am particularly supportive of the theme of this year's report which debunks the myth that our Nation can only reduce inflation by wringing it out of the system through the adoption of monetary and fiscal policies which produce recession. That is the approach taken by the Carter Administration, yet this report correctly points out that these kinds of policies simply will not work to reduce inflation. Moreover, they will result in unacceptable hardships for the working people of America and our disadvantaged minorities.

The report also places proper emphasis on the need to increase our country's productivity to help fight inflation and to make America competitive once again in the markets of the world. This is a theme I have stressed over the last several years.

Over the last several months, I have spelled out my economic views in great detail. Although I agree with most of the major conclusions of the report, I additionally believe that the only way to stop the present inflationary spiral is through a temporary program of across-the-board controls on prices, wages, profits, dividends, and rent. I have also urged the adoption of an equitable system of gasoline rationing. And finally, I have proposed additional Federal programs of public service and other jobs, and of youth employment and training, to combat a recession, with most of the funding to be spent on a triggered basis as unemployment rises. I have described these views more fully in two policy papers.

I do believe, however, that this report makes an important contribution to developing a strategy to deal with our complex economic problems, and that is why I support it.

REPRESENTATIVE PARREN J. MITCHELL

I am in agreement with the Committee's efforts to attack the long-run structural problems of the economy with a comprehensive economic growth policy and a targeted structural employment effort. I, however, do not agree with the Committee's assessment of the short-run solution to the economic ills that currently confront this Nation, nor do I agree with the Committee's endorsement of Administrative policies which delay full implementation of the Humphrey-Hawkins Act.

Consensus among economists, including the Economic Report of the President, predicts a downturn in the economy which will certainly add to the problems of unemployment in the black and Hispanic communities of America. The Administration's budget, which initiates no stand-by countercylical mechanism, essentially sanctions increased unemployment in already depressed economic areas. The Committee's reluctance to suggest a stand-by countercyclical program, based on uncertainty and variance in the economic forecasts, has the same effect. In either case there seems to be an insensitivity to the cyclical victims of recessionary trends.

Black adult unemployment is currently over 13 percent, while Hispanic adult unemployment has reached nearly 10 percent. Black youth unemployment, which has not been recorded below 30 percent in a decade, is currently 35 percent. Any downturn in the economy will have a disproportionate impact on the already existing depression in the Black and Hispanic

communities of America. Any suggestion to remain silent while the last-hired and first-fired bear the burden of recession is unconscionable.

Sustained economic growth is clearly the solution to the adverse impact that cyclical variations impose on specific sectors of the economy. Because of such external factors as random oil price increases, our economic growth has been significantly reduced. As acknowledged by the Committee report, sustained economic growth addresses both structural economic deficiencies and the economic ills caused by recessionary trends. In the absence of economic growth, however, we must stand ready to assist victims of downturn.

The Council of Economic Advisors has forecast that in 1980, the economy will experience a mild recession. They predict that real GNP will decline by 1 percent during 1980, then grow at a 2.8 percent annual rate during 1981. According to the CEA, accompanying this decline in inflation will be an increase in the unemployment rate to 7.5 percent in the beginning of FY '81. The CEA further predicts that the unemployment rate will experience only a slight decline to 7.3 percent by the beginning of FY '82. The Joint Economic Committee's Annual Report is slightly more optimistic, referring to a continued consumer spending pattern and Federal outlays, associated with escalated military spending, as potential sources of economic growth which may prevent an economic downturn. A caveat should be noted with respect to military spending as a potential source of economic growth. Any steep rise in military spending for FY '81 will have the effect of locking us into military production for five to seven

years. Long-term production contracts, for military weapons, are large uncontrollable budget outlays. The growth of uncontrollable outlays runs counter to the recommendations of both the Council of Economic Advisors and this Committee that Federal spending as a share of gross national product be gradually reduced. Uncontrollable outlays, caused by military spending decisions today, reduce our budget options in the out-years and are certain to limit our ability to maximize the impact of Federal outlays at some future time. I suggest we apply a great deal of consideration to the long-term economic impact of military spending.

I simply cannot endorse a policy of spending limitations in the midst of projections of high unemployment, little economic growth, international chaos and random pricing from international oil cartels. A policy of spending limitations, coupled with additional locked-in outlays for military spending, will render the discretionary human resource programs for education, training and skill development vulnerable for reduction. Currently 77 percent of the Federal budget is uncontrollable by law or prior year contract. Any additions to the uncontrollable portion of the budget complemented with the imposition of a spending limitation will impose constraints that will provide a budget rationale for our reducing the discretionary programs.

In hearings held before the Joint Economic Committee, we had witnesses who discussed the problems of the economy. It was revealed that the problem of unemployment must be addressed with a Federal commitment to train and encourage the employment of the structurally unemployed. This commitment is

met with Federal outlays targeted to the structurally unemployed regardless of a proviso that incorporates some relationship of Federal outlays with gross national product.

During periods of high sustained real growth the uncontrollable portion of the budget as unemployment compensation, veterans' entitlements, social security, and public assistance decrease as a proportion of the gross national product. However, during low growth and economic instability, we need flexibility in Federal spending which will afford options that may be employed to reduce the impact and stimulate growth in the economy.

As Chairman of the Domestic Monetary Policy Subcommittee of the House Banking, Currency and Housing Committee, I have long promoted a policy of controlling the growth of monetary aggregates thus limiting the effect that an oscillating money supply has on investment in the economy. Also, a targeted growth in the money supply is congruent with the Committee objective of a reduced rate of inflation. This recommendation is essential to the viability of the American economy.

Despite considerable economic uncertainty, the Committee is convinced that a $25 billion tax cut is in order. I agree that we must make immediate plans. I, however, disagree with an additional $25 billion tax expenditure. Perhaps as a sound economic alternative, the $25 billion deficit increase could be allocated between a modest tax cut and a stand-by countercyclical program targeted to areas of high unemployment. The Committee's efforts to enhance productivity and bolster consumer disposable income are

admirable. However, of equal importance is the economic well-being of those marginal workers who are victimized by unemployment as well as inflation.

The Annual Report focuses on a point that merits my underscore. Recessions are not an economic vehicle used to control inflation. As reported, "in order to lower the inflation rate by one percentage point, using fiscal and restrictive monetary policy alone, we have to throw a million people out of work for two years." I emphasize this to be the most important economic policy statement of the report. This section emphasizes that Black unemployment is approximately twice the White unemployment rate and hence Black workers are fired at twice the rate as White workers during downturn. In the traditional Philips Curve argument, the trade-off depicts Black workers as victims in an effort to control inflation. I support the Committee's endorsement that this is an unbearable burden for the Black communities of America.

Any tax expenditures designed to encourage capital investment should be targeted to small businesses, the employment generating sector of the economy. In recent hearings before the Joint Economic Committee, we heard testimony that small businesses with less than 20 employees created 66 percent of the private sector new jobs, and establishments with 21 to 50 employees created 11 percent of the private sector new jobs. Thus, 77 percent of new employment generation from 1969 to 1976 was created in the small business sector. Medium and large businesses (those with 500 employees or more) generated only 13 percent of the new private sector jobs in the same period. To stimulate growth and development of the small business sector, I recommend that the accelerated depreciation

tax expenditure be limited to the approved definition of a small business.

I agree with efforts to target expenditure for research and development, thus insuring that efforts are maximized to create technological advances, increase productivity and serve as the vanguard for product development which will upgrade the quality of life. However, I also deem it necessary to reevaluate the tax provision which provides for $1.7 billion loss in tax revenue because large manufacturing corporations abuse the provision which allows them to deduct costs (expense costs) for research and development. Evidence suggests that, of the total amount claimed as research and experimental costs, about 10 percent is basic research and 90 percent is product development. This tax abuse reduces the potential impact of research and development and provides no appreciable productivity increase to the economy.

I commend the Committee's assessment of the problems of structural unemployment. I cannot over-emphasize the need for commitment necessary to institute a shift in the structural unemployment problem. The Federal Government in cooperation with the private sector must be willing to educate, train, and hire the lowest skilled workers in the economy. Without a committed Federal training program and a willingness of the private sector to hire the designated structurally unemployed, the problem is destined to escalate into an insurmountable task. The concentration of the structurally unemployed, who are characteristically Black and Hispanic, in urban areas heightens the potential for tension if the problem is not adequately addressed. I commend Committee

emphasis of the problem and underscore as a recommendation:

> A Federal policy which encourages the use of small and minority owned business in urban areas where the structurally unemployed are concentrated.

The interaction of the small business employment generating sector with the unskilled labor force is a solution which merits extensive economic investigation and consideration as a solution to the problem of structural unemployment. This recommendation is consistent with the goals of the Humphrey-Hawkins Full Employment and Balanced Growth Act. A growing small and minority owned business sector offers a unique opportunity for addressing basic long-term structural problems by improving productivity, lowering inflation, and creating more jobs.

The Committee Report, in responding to the provisions of the Humphrey-Hawkins Act, has the statutory responsibility "to include findings, recommendations, and any appropriate analyses with respect and in direct comparison to each of the short-term and medium-term goals set forth in the Economic Report." In recognition of the fact that the 4 percent unemployment goal by 1983 has been drastically deterred because of Administration budget reductions in skill development and training programs as well as reductions in temporary employment programs in the public sector, it will be more difficult to meet the stated timetable.

The President's budget which reflects a low figure of 450,000 job slots for CETA Titles II-D and VI is a major factor for the delay in meeting the stated unemployment

goals of the Humphrey-Hawkins Act. This lack of commitment to the problem of unemployment clearly violates the last-resort provisions of the Act. I must stand firm on my commitment tht the goals and timetables of the Full Employment and Balanced Growth Act are attainable. I, therefore, cannot support a policy that continues to procrastinate a national commitment to reducing unemployment.

In meeting the goals of inflation as set forth in the Humphrey-Hawkins Act, I suggest that it is time to apply the mandatory constraints of wage, price and profit control on the economy. We must be prepared to take action against the possibility of rampant inflation destroying any gains we might make this year. In recognition of our vulnerability to international oil suppliers, it is obvious that the voluntary controls of the Administration are ineffective in controlling the reported annual profits in Exxon at 111 percent, Mobil's 131 percent, and Texaco's 158 percent. They also are ineffective with respect to housing when considering that the median price of a house increased 13 percent last year. I commend the Committee report for its strong statement that induced recession should not be an economic tool to counter inflation. However, without adequate commitment to temper inflation through mandatory controls, economic history will prevail and an induced recession will result. Before we are overtaken by the experience of recession and double-digit inflation, let us move now to impose a mandatory control of wages, profits, prices and rents and make every effort to meet the inflation goals as defined in the Humphrey-Hawkins Act.

In conclusion, I must applaud the efforts of the Chairman to address the long-term

problems of the structurally unemployed. I, however, have reserved my right to endorse this report because of its policy of spending limitations, inadequate response to the problems of the cyclically unemployed, and the lack of commitment to meeting the stated goals of the Full Employment and Balanced Growth Act.

SENATOR JACOB K. JAVITS

It is especially gratifying, in these times of grave economic and political instability, that bipartisanship has prevailed and allowed a unified Committee in this year's Joint Economic Committee Annual Report to deliver what I believe to be the right prescription that will change the economic direction of our country; diminish our vulnerability to international economic dislocations; buttress our national security; improve productivity; and advance noninflationary growth.

The dampening of inflation must be our country's principal domestic concern, and so, I approve of the Report's comprehensive analysis of the devastating havoc that inflation has wreaked on our economy.

While I share many of the concerns contained in the Report, and especially support the Committee's effort to bring to national attention the urgency and decisiveness with which we must act to adopt a long-run strategy of increased savings and investment to increase productivity, some additional comment is necessary, in my view, with respect to workers' productivity, energy, and the international economy. Also, I set forth here my reservations with respect to the Annual Report's recommendation for a tax cut in 1981.

We must avoid the policy pitfalls of the 1974-75 recession and be particularly wary of tax reductions that increase consumer demand

but accomplish very little in terms of stimulating investment for modernization of machinery, equipment and processes. We cannot ignore that the economy simply does not now have the means to regain for the American people recent losses in their standard of living.

In my view, we can break the economic vise in which we now find ourselves only if we devote a much greater share of the gross national product to investment. Hence, only a tax cut targeted toward generating large-scale increases in savings and investment will serve this objective. I recognize, however, the political realities are such that to implement such a strategy, Congress may be likely to seek to enact personal tax cuts as well but these should be held to readjusting tax brackets for inflation only.

The State of the Economy

It is a tragedy that recommendations of past JEC Reports to address the "triple threat" of double-digit inflation, rising unemployment, and stagnant productivity continue to go unheeded.

Instead of bold action, the Administration offers us an exceedingly grim economic forecast for the near term and for much of the decade. A recession with unemployment reaching 7 1/2 percent is expected -- indeed, counted upon -- to deal with the worst annual inflation since 1944.

The Administration's stated anti-inflationary fight consists only of a promise for a nearly balanced budget and a timorous energy plan, while rejecting the notion that a concerted effort to increase real economic

growth will achieve the real standard of living gains that have evaded us for the past two years.

This is an unacceptable strategy. The hard truth is that double-digit inflation is not abating, nor is a meaningful reduction in energy consumption realistic with the policies we now have in place.

We have neglected to maintain adequately the traditional energizers of our economic process -- our industrial plant and equipment, our research and development facilities, our transportation system and our business enterprises -- and, therefore, at least part of our industrial base is lapsing into obsolescence. If we fail to galvanize our energies and tailor our strategies now so as to achieve the maximum efficiency from our economy in the coming years, we risk an even lower standard of living at home and an increasingly vulnerable competitive stance abroad.

In order to achieve these goals, the American people may very well have to undertake considerable sacrifices in the short term. I believe that they are prepared to do so if presented at the outset with a detailed action program which has a real chance, once and for all, of bringing inflation down to manageable proportions and setting the basis for sustainable long-term economic growth.

Productivity and Inflation

The major potential source for reductions during the 1980s in the core rate of inflation which has severely undermined our built-in incentives to savings and investment

must be improved productivity. Only by correcting our productivity problems will we be able to develop solutions to the inflation and unemployment that dominate the economic outlook in the next few years. To achieve this end, we must begin now to put in place policies that will produce incentives for saving, for working, and for investing. I am particularly pleased that efforts, such as the exclusion on interest income for savings and the accelerated depreciation proposal, are now underway in the Congress. As this year's Annual Report will confirm, the downward readjustment of time limits in depreciation schedules is the most efficient way we can address the core inflation rate while spurring new business investment.

Productivity will also be spurred by the institution of additional incentives for youth employment, targeted training programs (particularly those that encourage greater linkages between the school and the workplace), and labor management committees, which will improve the climate at the industry level and reduce tensions between labor and management in noncollective bargaining.

Energy

The United States cannot feel economically or politically secure nor free in the conduct of our foreign policy until our increasing dependence on foreign oil is significantly lessened. We are confronted with an immediate threat, not a gradual one. Demand for oil must be cut directly and by switching to other more secure fuels where possible. The free market mechanism is not sufficient to achieve these reductions on a timely basis. Furthermore, rationing solely by

price is unfair to the poor who would bear a disproportionate share of the economic impact. The answer is therefore conservation through a mandatory program.

Gasoline, made from premium oils, is the fuel used most wastefully in the United States and which offers the most opportunity for such mandatory conservation.

Also, reduction of our import levels should be achieved by strict, mandatory demand reductions through conservation and not by a quota as proposed by the President. A quota system will create shortages which will require a full-scale allocations and entitlements system with all the predictable red tape and injustices which accompany such regulation.

In addition, our mid-term energy development priorities must be, first, to make our economy significantly more energy efficient; second, to accelerate coal utilization, with the necessary investments to protect air quality; third, advance the use of solar and nuclear energy; and, finally, to develop a series on a cost-benefit basis of our other domestic energy resources including all renewables, heavy oil, shale oil, tar sands and oil recoverable by reworking of existing fields.

The International Economy

The crises in Iran and Afghanistan have only added to the erosion of confidence we are suffering in U.S. leadership of the international monetary system. The problems of a dollar subject to periodic sell-offs, a continued large deficit in our trade balance, a still weak export performance, and

overreliance on energy imports from the OPEC countries must be resolved before confidence can once again be restored adequately to the world economy.

Once again, many of the oil consuming developing countries are facing severe balance-of-payments deficits; and how the OPEC surpluses, which were $40-50 billion in 1979 and in 1980 may be as high as $80 billion, will be recycled may very well be the major dilemma facing the international monetary system today.

It is estimated that, at the end of 1978, medium and long-term indebtedness of nonoil developing countries reached $270 billion, up almost four-fold since 1973 ($74 billion), with U.S. commercial bank credit to these countries totaling $52 billion in 1978. Furthermore, the nonoil developing countries will have to finance current account deficits of around $20 billion in 1979 and about $40 billion in 1980; and even the deficit of the Soviet bloc and Communist China may rise to $12 billion.

Many of the commercial bankers who, as late as early 1979, argued that the LDC debt situation was manageable and that the banking system would be able to provide the necessary LDC credit, today are expressing alarm that the situation may be deteriorating. Innovative approaches to meeting the recycling problem are thus needed to ensure that the system will be able to deal adequately with the most recent OPEC oil price shock.

We must insist that the IMF, which has only contributed 3 percent of LDC financing since 1974, play a greater role in setting the proper conditions for this recycling.

Given the increased perception of risk among the commercial lenders, submission by the deficit countries to IMF "conditionality" before the banks will extend any further commercial credit is a probable objective. To ensure that these countries make use of this IMF conditional financing at an early stage of their payments difficulties, we must lessen the amount of liquidity in world financial markets.

The U.S. and other major central banks must develop new, creative approaches, possibly through the establishment of new off-market techniques, both to dry up partially this excess liquidity and also to meet the desire of both official and private holders of dollars to diversify into other currencies.

A Substitution Account, which is now under discussion in the International Monetary Fund (IMF), and other mechanisms for stemming the "diversification" tide, would also help.

Also, we must begin to consider seriously some form of institutionalized relationship between the IMF and the commercial banks; for example, with respect to exchange of information and coordinated lending to these deficit-ridden LDC's.

In the final analysis, the fragility of the monetary recycling system through the Eurocurrency market will be reduced if and when the OPEC surplus countries begin to undertake a greater share of the risk in recycling their funds directly to these oil importing developing countries through direct placements and investments.

To encourage and facilitate this move by the OPEC surplus countries, commercial banks

could provide the required technical assistance and, thus, take on a new role of "arrangers" rather than "underwriters" of these loans. By assuming part of the actual risk, the OPEC surplus countries would have a greater incentive to assure that their oil pricing policies should not wreck the international monetary system than if the returns on their investments were in effect guaranteed because they are made by commercial banks of deposit.

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