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REPORT
No. 97-5

THE 1981
JOINT ECONOMIC REPORT

R E P O R T
OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
ON THE
JANUARY 1981 ECONOMIC REPORT
OF THE PRESIDENT
TOGETHER WITH
ADDITIONAL VIEWS



MARCH 2, 1981.—Committed to the Committee of the Whole House on
the State of the Union and ordered to be printed

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

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LETTER OF TRANSMITTAL

CONGRESS OF THE UNITED STATES,
JOINT ECONOMIC COMMITTEE,
Washington, D.C., March 2, 1981.

Hon. THOMAS P. O'NEILL, JR.,
Speaker, U.S. House of Representatives,
Washington, D.C.

DEAR MR. SPEAKER: Pursuant to the requirements of the Employment Act of 1946, I hereby transmit the Report of the Joint Economic Committee containing its findings and recommendations with respect to each of the main recommendations made by the President of the United States in his January 1981 Economic Report. This report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

Sincerely yours,

HENRY S. REUSS,
Chairman, Joint Economic Committee.

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97TH CONGRESS } HOUSE OF REPRESENTATIVES { REPORT
1st Session } { No. 97-5

REPORT ON THE JANUARY 1981 ECONOMIC REPORT OF THE PRESIDENT

MARCH 2, 1981.—Committed to the Committee of the Whole House on the State
of the Union and ordered to be printed

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

R E P O R T

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.

INTRODUCTION BY REPRESENTATIVE HENRY S. REUSS, CHAIRMAN

In his state-of-the-economy address last week, President Reagan asked:

May I direct a question to those who have indicated unwillingness to accept this plan for a new beginning: an economic recovery? Have they an alternative which offers a greater chance of balancing the budget, reducing and eliminating inflation, stimulating the creation of jobs, and reducing the tax burden?

In this Report, the Joint Economic Committee Democrats present such an alternative.

This program addresses the full range of our Nation's economic difficulties. We begin, as does the Administration, with the problems of government policy: taxation, spending, regulation, and monetary policy. But we go beyond the partial answers to be found in an exclusive and narrow focus on government's role. In this Report, we address the need for fundamental structural reform throughout our economy, in the operation of government policy and in areas—such as industrial productivity, foreign energy dependence, and the wage-price spiral—which lie beyond the immediate reach of public power. We recognize that our problems are complex and deeply rooted, and that solutions require a comprehensive, cooperative approach which mobilizes the concerted efforts of labor, management, and government alike. This recognition distinguishes our program from that of the Administration. For this reason, we believe that the program we present stands the greater chance of success.

Our goal is simple: to reach full employment without inflation, as mandated by our basic Charter. We do not shrink from this responsibility. We do not consider the task to be impossible. But we recognize that there is no Aladdin's Lamp that will make our problems vanish by wishing alone. Our program will work because its components are proven and sound: investment, employment, sector-by-sector structural reform, and direct action to break the insidious spiral of inflation.

The hallmark of our program is moderation in monetary and fiscal policies, and heavy emphasis on structural reform. Structural reform is the way to escape from the macroeconomic policy trap—an unsatisfactory trade-off between intolerable inflation and intolerable unemployment—and, so to get on with economic growth, job creation, and urban and industrial revitalization. Specifically, we advocate:

(1) A monetary policy which combines continued close control over the growth of money and credit with a concerted program to bring today's high and destructive interest rates down.

(2) A tax policy of immediate relief for the lower and middle-income class groups who paid the payroll tax increases on January 1, 1981, and of liberalized business depreciation for new

investment, but with a "look-before-you-leap" approach to further income tax cuts, avoiding unwise commitments to make huge tax reductions irrespective of conditions in future years.

(3) An expenditure policy which will bring control over spending and the budget, and that will do so fairly, equitably, and without destroying those programs which fight inflation and unemployment by supporting investment and creating jobs.

(4) Structural reform comprising a comprehensive strategy for investment and jobs and a program to stabilize prices, so that sensible monetary and fiscal policies will not founder or structural rigidities or wrong-headed disincentives.

(5) A firm commitment that government tax and spending actions should not increase poverty or reduce the share of income received by the middle classes.

The Administration's "Program for Economic Recovery" deserves prompt, thorough, and fair-minded consideration by the Congress. Much of it—such as to call for liberalized depreciation, for regulatory reform, for budgetary control—is exemplary. But there are important differences between the Administration's program and our own:

(1) The Administration believes that the Federal Reserve should continue to lower its monetary targets in this critical year of 1981, while we oppose such action. Interest rates are too high now, and will remain too high if the Federal Reserve continues to tighten its monetary targets even though control over inflation has not been achieved. Excessively high interest rates will retard investment, growth, and control over Federal expenditure.

(2) The destructive fiscal facet of the Administration's program is the proposed huge individual income tax cut, amounting to more than \$140 billion per year when fully effective. The tax cut favors the affluent (\$30,000 for a family earning \$200,000, \$385 for a family earning \$15,000). The assertion that this radical tax cut will, by some trickle-down magic, produce full employment without inflation is simply not proved. Instead, we urge a moderate, cost-effective tax reduction to offset the payroll tax increase, and a depreciation tax cut, followed by watchful waiting. When the budget and inflation are brought under control, the benefits should be promptly distributed to the taxpayer—but in a fair and equitable way.

(3) The Administration's program does not sufficiently recognize the structural nature of our problem of investment, jobs, and prices. Investment and job-making programs, including employment, training, economic development, and infrastructure investment programs, are repealed or drastically slashed. On the price side, there is nothing at all. The Administration utterly rejects any policy to stabilize prices, and relies instead on a wholly unproven theory that revised expectations, by themselves, will conquer inflation. We urge a comprehensive strategy to stimulate investment and jobs, based solidly on the supply-side recommendations developed in this Committee over the past two years. We urge that the President be given, if he requests it, standby authority to control wages and prices, to attack the momentum of inflation directly.

So there *is* a difference between the Administration's views and those presented in this Report. But we view this not as a stalemate, but as an opportunity for reconciliation.

The Administration says the budget must be cut. So do we, provided that the cuts are sensible and fair.

The Administration says that the growth of money and credit must be controlled. So do we, but we recommend specific action for bringing interest rates down now.

The Administration wants a vast personal income tax cut, mostly effective in the future, and we are told that, for some reason, it must be enacted now. We favor more modest tax cuts, less oriented toward the wealthy, right now, and, for the future, we favor a long, hard look before we leap.

These are not irreconcilable differences. We approach the Administration in a spirit of compromise, and we look forward to working toward a common ground.

INTRODUCTION BY SENATOR ROGER W. JEPSEN, VICE CHAIRMAN

In the past two years, the Joint Economic Committee issued consensus reports. The Republicans on the JEC were proud to have helped forge these bipartisan reports because we believed then and believe now that their "supply-side" approach represented the best method for stopping inflation and getting our economy moving again.

This "supply-side" view was eloquently stated by the Committee Chairman, Senator Lloyd Bentsen, in his introduction to the 1980 JEC Report:

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 deemphasis of macro-economic 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.

In its past Reports, the Joint Economic Committee blazed a new trail in economic thought by showing how the old economics has failed to solve our economic problems, that these outdated demand-side policies actually were a major cause of our economic problems and how a new supply-side approach aimed at stimulating economic growth could whip stagflation.

In this year's Report, the primary goal of the Republicans was to *build* on those consensus Reports; to improve the state of the art of supply-side economics. To accomplish this goal and to contribute substance rather than rhetoric to the national debate, the Republicans specifically addressed two major criticisms of a supply-side solution to our economic problems. To wit, that gradual reductions in the money supply will increase interest rates and, across-the-board personal marginal tax rates cuts are inflationary.

This 1981 JEC Republican Report shows that these criticisms are part myth, part ignorance and part political confusion.

We believe that the Democrats on the Joint Economic Committee have abandoned the supply-side approach which formed the basis for consensus in the past. The Democrats have chosen instead to endorse thoroughly discredited monetary policies of fine-tuning and easy money, fiscal policies to redistribute income and stimulate aggregate demand, and government allocation of credit and other scarce resources. Stagflation has been the inevitable result of these policies in the past. We cannot endorse them now.

The ten Republican members of the Joint Economic Committee have decided unanimously to issue our own Report. We cannot sign the Democrats Report. It largely affirms tried and false approaches and does not build on the 1979 and 1980 consensus Reports of this Committee. We recognize that it contains some constructive suggestions. However, on the whole, its recommendations are counter-productive, and its underlying logic is flawed.

Instead, the Republican members of the Committee have in our report built on the Committee's past consensus emphasizing saving, capital formation, slower money growth, and supply-side tax cuts. We believe that our views are right for America at this critical juncture. Let the reader judge.

**Democratic Views
on the
January 1981 Economic Report
of the President**

LIST OF RECOMMENDATIONS

I. MONETARY POLICY

Recommendation No. 1: Long-Term Monetary Restraint

Monetary policy should be moderately restrained to reduce inflation while sustaining steady economic growth. The long-run rate of growth of money and credit is of primary importance, rather than temporary deviations from the long-run growth trajectory.

Recommendation No. 2: The Federal Reserve Should Explain Its Targets

The Federal Reserve should set forth publicly each year a careful explanation of how its monetary targets have been selected. Such an explanation should relate the target to potential growth of real gross national product (GNP), to unavoidable (core) inflation, and to expected changes in the growth of velocity.

Recommendation No. 3: Bring Interest Rates Down

Consistent with control over the growth of money and credit, the Administration, the Federal Reserve, and the Congress should concert their actions, through the methods set forth in Recommendations 4-6, to lower interest rates.

Recommendation No. 4: Do Not Tighten Targets

The Federal Reserve should refrain from tightening its 1981 monetary targets from those in effect in 1980.

Recommendation No. 5: Avoid Interest Rate Wars

The Administration and the Federal Reserve should work to avoid further international "interest rate wars," in which certain countries rely excessively on monetary rather than fiscal policy to fight inflation, thus raising interest rates and forcing other countries to follow suit to protect their currencies. This "beggar-thy-neighbor" high interest rate competition should be replaced by much closer international coordination of economic policy, both at and between summit meetings.

Recommendation No. 6: Encourage Banks To Fight Inflation

The Administration and the Federal Reserve should encourage the banking system to develop effective methods to prevent destabilizing bursts of bank-financed lending for speculative and purely financial purposes, which make less credit available to enhance productivity and thus fight inflation.

II. FISCAL POLICY

Recommendation No. 7: Fiscal Policy: Coordination With Monetary Policy

Fiscal policy should be closely coordinated with monetary policy. To achieve better coordination, the Administration should make public

the monetary policy assumptions it employs in reaching its budget and economic forecasts.

Recommendation No. 8: Fiscal Policy: Fight Inflation and Recession

Fiscal policy should be steady and moderately restrained. This policy is necessary to reinforce the Federal Reserve's efforts to reduce inflation while supporting growth. All proposed tax and expenditure actions should be examined closely for their effects on productivity and costs. Those which combat both inflation and recession should get priority over all other measures. Recommendations 9-11 deal with taxes, 12-13 with spending.

Recommendation No. 9: Liberalize Business Depreciation

Once again, we urge Congress to enact promptly a liberalization of the business depreciation allowance for new investment, to increase incentives to invest and to ensure that tax treatment does not distort business investment decisions. Prompt enactment is justified to capital because it is the most efficient incentive to investment, which is especially important now in view of the entry of vast numbers of new workers into the labor pool.

Recommendation No. 10: Offset 1981 Payroll Tax Increases

An individual tax reduction designed to offset the January 1, 1981, increase in the social security payroll tax, and thus undo substantially all of the hardship imposed on the low- and middle-income groups who pay the payroll tax, should be enacted immediately.

Recommendation No. 11: Beyond These: Beware

Other proposed immediate tax reductions, particularly if they imply a commitment to large fiscal stimulus in future years, present the risk of reigniting inflation. Congress should consider a further tax cut when we can be sure that we have made progress against inflation, that the budget is under control, and that the investment incentive measures urged here have improved the Nation's stock of plant and equipment and their productivity so that they can accommodate the new surge of demand. We should avoid commitments now to long-term proposals whose consequences are unpredictable.

Recommendation No. 12: Control Spending

Federal spending must be reduced promptly. No government spending program should be exempt from scrutiny.

Recommendation No. 13: Cut Spending Equitably

It is essential that spending reductions be made in a fair and equitable manner. Middle- and lower-income groups should not be required to carry a disproportionately great burden of budget cutbacks. Proposals to terminate or to make major reductions in Federal programs should be accompanied by economic analyses showing the effects on the living standards of different income groups and on different regions.

III. INCOME DISTRIBUTION

Recommendation No. 14: Do Not Worsen the Distribution of Income

The poor are threatened by proposed cutbacks in transfer programs, and the middle class has suffered a significant decline in its real income

in recent years. Government tax and expenditure actions should not increase poverty or reduce the share of income going to the middle class.

IV. STRUCTURAL REFORM

Recommendation No. 15: Long-Term Structural Improvement Must Start Now

Even sensible monetary and fiscal policies cannot achieve full employment without inflation unless we reform our economic structure to rid it of rigidities and disincentives.

IV. A. INVESTMENT AND JOBS

Recommendation No. 16: Needed: Investment and Jobs

We support the goal set out in the 1981 Economic Report of the President and by the new Administration of increasing the share of investment in GNP over the next several years. This goal is necessary to reconcile moderately restrained macroeconomic policy with a sustained push toward full employment, full production, and higher productivity growth. Components of a comprehensive investment and jobs strategy should be developed, including the actions outlined in Recommendations 17-24.

Recommendation No. 17: Tax Incentives for Investment

Tax reduction incentives should stress the enhancement of existing and new industrial capacity and the reduction of costs of production.

Recommendation No. 18: Basic Research

Funding for basic research should be maintained and private research further encouraged.

Recommendation No. 19: Infrastructure

Investment in infrastructure—roads, water systems, rails, ports, utilities, and other physical support systems—should be maintained at adequate levels. Federal economic development programs which can help State and local governments provide necessary infrastructure should be examined to improve their effectiveness and reduce the risk of waste.

Recommendation No. 20: Targeted Jobs Tax Credit

Better use should be made of the Targeted Jobs Tax Credit. Specifically:

- (1) The revision of eligibility criteria to cover the main categories of structurally unemployed workers should be examined;
- (2) Eligibility criteria should be simpler and more readily verifiable by employers; and
- (3) There should be effective publicity to increase awareness on the part of the employers.

Recommendation No. 21: Labor Force and Small Business

The Congress should consider ways to facilitate job creation by small businesses and to increase the proportion of Federal procurement and research and development funding that is available to small businesses, and particularly to minority-owned businesses.

Income support programs should be designed to help improve the employability of individuals by emphasizing training, education, and skill development and should utilize small businesses, and particularly minority-owned businesses, whenever possible.

Recommendation No. 22: Labor-Management Cooperation

The Committee supports private efforts to improve productivity through cooperative activities by labor and management.

Recommendation No. 23: Exports

Smaller, innovation-minded firms and agricultural commodities should receive enhanced incentives and assistance for exports.

Recommendation No. 24: Regional Growth

Noninflationary growth is essential to real income growth and central to the resolution of the fiscal problems of many of the Nation's cities. A strategy for investment and jobs should take advantage of the opportunities in and meet the needs of our many diverse regions. Federal policies should not impede growth and development in any region of the country. Federal policies should be examined for unintended, implicit regional, urban, or rural biases.

IV. B. PRICES

Recommendation No. 25: Many Steps Needed for War on Inflation

Inflation is the major obstacle to sustained economic growth, lower unemployment, and increased investment. Past anti-inflation policies, from voluntary guidelines to engineered recessions, have not worked, and we doubt that anything short of a comprehensive program will work now. Inflation is a complex, deep-seated phenomenon and the war on inflation must encompass all of the measures listed in Recommendations 26 to 29.

Recommendation No. 26: Energy

Energy policy should focus on reducing the sensitivity of U.S. energy supply and price to external shocks by continuing to encourage conservation, greater domestic energy production, including the development of improved techniques for enhanced oil and unconventional gas recovery, and establishment of substantial petroleum reserves.

Recommendation No. 27: Regulation

We should reduce unnecessary government regulations and paperwork, and utilize the most cost-effective techniques to meet necessary regulatory objectives.

Recommendation No. 28: Productivity

We must increase our rate of productivity growth, which requires attention to investment, employment, infrastructure, labor force, education and training, research and development, business leadership, and improved labor-management relations.

Recommendation No. 29: Standby Wage-Price Control Authority

The Administration has disbanded the Council on Wage and Price Stability. While COWPS had lost effectiveness, the stubborn nature of the wage-price spiral may require some form of incomes policy. We are willing to support an Administration initiative for standby wage-price control authority. Such authority should only be invoked as part of a comprehensive anti-inflation strategy.

V. INTERNATIONAL ECONOMIC POLICY

Recommendation No. 30: International Financial Institutions

We support an enlarged role for the International Monetary Fund and the World Bank to deal with oil-induced economic adjustment, and we support an enlarged role for oil-exporting nations in programs administered by these institutions.

Recommendation No. 31: Promote Worldwide Growth

The United States must work to foster economic growth and financial stability around the world, and particularly in the non-oil exporting LDC's, which now purchase 27 percent of our manufactured exports. We should support fair and reciprocal efforts to achieve freer and more open trade and capital flows in order to promote growth and adjustment in developed and developing countries.

Recommendation No. 32: Replenish IDA

World Bank lending to lower income developing countries has played a vital role in furthering international development. At the same time, it preserves a Western presence in many parts of the world and helps build the export markets of the next decade. The Congress should act favorably on the sixth replenishment of the International Development Association.

VI. REVIEW OF THE CURRENT SERVICES BUDGET AND THE PRESIDENT'S ECONOMIC GOALS

Recommendation No. 33

The Congressional Budget Reform and Impoundment Control Act of 1974 should be modified to require submission by the President of a Current Services Budget by January 31 of each year, with the Joint Economic Committee evaluation to follow by March 1. This change would make the law consistent with the present satisfactory practice.

VII. REVIEW AND OUTLOOK FOR THE ECONOMY

I. MONETARY POLICY

Recommendation No. 1: Long-Term Monetary Restraint

Monetary policy should be moderately restrained to reduce inflation while sustaining steady economic growth. The long-run rate of growth of money and credit is of primary importance, rather than temporary deviations from the long-run growth trajectory.

The objective of the Federal Reserve should be to bring down the long-run growth of money and credit to rates consistent with the long-run real growth potential of the economy. This means that monetary policy should adopt a posture of moderate restraint, which signals the Federal Reserve's commitment to support a national program to reduce inflation while maintaining steady growth. The Federal Reserve should make clear that noninflationary growth of money and credit must and will be achieved. Short-run deviations of money and credit from the path of long-run noninflationary growth, which are the consequence of fluctuating economic events, must not be allowed to distract either policymakers or the public from the long-run objective. The long-run money and credit targets themselves should only change in response to changes in the economy's long-run growth potential or to permanent shifts in the income velocity of money.

Sudden supply shocks—such as the surge of oil prices in 1979 and 1980—can be a particularly damaging source of short-run deviation from the target rates of growth of money and credit. Such shocks, if not accompanied by an increase in the velocity of money, impose real costs on the economy which cannot and should not be offset completely by monetary expansion. But to err the other way, and to attempt to maintain too rigid a short-run money growth path in the face of an oil shock (for example) could mean sky-high interest rates, lost output, and unemployment. Neither extreme is desirable. The Federal Reserve should partly accommodate supply shocks in the short run, while working toward control over money and credit growth over time.

Recommendation No. 2: The Federal Reserve Should Explain Its Targets

The Federal Reserve should set forth publicly each year a careful explanation of how its monetary targets have been selected. Such an explanation should relate the target to potential growth of real gross national product (GNP), to unavoidable (core) inflation, and to expected changes in the growth of velocity.

Careful description by the Federal Reserve of the procedures it uses to set its annual monetary targets, together with a review of those procedures before the Congress, would strengthen monetary policy by

increasing public confidence in the credibility of the Federal Reserve's long-run policy objectives.

The Federal Reserve should calculate its targets each year on the basis of its long-run noninflationary money growth objective and on the state of the economy. For example, a technique could be to begin by adding to the potential growth rate of real GNP some part of the inflation rate which cannot be avoided in the forthcoming year (taken as the core rate of inflation, the underlying trend of inflation when the effects of excess demand and supply shocks have been taken out). From that value, one could subtract any expected rate of increase of the velocity of money. The benchmark value derived using this option would imply a monetary policy that accommodates the economy's real growth potential and the existing core rate of inflation. If the Federal Reserve believes that a more restrained or a more stimulative policy would be called for, it should so indicate, giving its reasons.

The Federal Reserve should undertake this exercise annually, adjusting its targets to reflect changes in our real growth potential, our core rate of inflation, and in the demand for money—i.e., in the income velocity of money. The Federal Reserve should explain to Congress the influence of changes in each of these factors on the targets which it is presenting. Such careful linking of the annual monetary targets to the real growth potential and to core inflation will increase the credibility of the targets and of the Federal Reserve's anti-inflationary policy, and it will help focus attention on the long-run nature of the Federal Reserve's objectives for money and credit.

In setting its monetary targets, the Federal Reserve should be especially alert for changes in the velocity of money. These alter the relationship between money growth and nominal GNP, and so determine whether a given monetary target is restrictive or expansionary in its effect on the economy. When money velocity increases, it is appropriate to lower the target ranges in order to maintain an equivalent degree of restraint, and conversely when money velocity falls.

Recommendation No. 3: Bring Interest Rates Down

Consistent with control over the growth of money and credit, the Administration, the Federal Reserve, and the Congress should concert their actions, through the methods set forth in Recommendations 4-6, to lower interest rates.

Consistent with the need for moderate restraint, the Federal Reserve, the Congress, and the Administration can and should seek ways to achieve lower interest rates. In our view, interest rates are now higher than necessary to achieve effective long-run restraint on the growth of money and credit, and can be brought down.

Clearly, the general level of interest rates depends partly on the general rate of inflation. Therefore, a complete return of interest rates to historically normal levels will depend on, and must await, success against inflation. Measures to combat inflation are outlined throughout this Report.

Equally clearly, interest rates are influenced by the government's demand for credit. Measures which help to reduce the deficit, therefore, will help lower interest rates. Such measures are outlined in our chapter on fiscal policy.

Recommendation No. 4: Do Not Tighten Targets

The Federal Reserve should refrain from tightening its 1981 monetary targets from those in effect in 1980

Since 1975, the Federal Reserve has adhered to a policy of lowering the target ranges by a small amount each year. As the Council of Economic Advisers has pointed out, the result has been erratic performance of the monetary aggregates with respect to the targets. Only in those years—1976 and 1979—when money demand shifted downward sharply did the growth rate of the aggregates fall within the targets. In other years—1977, 1978, and 1980—money demand was closer to historical levels and the targets were missed.

Table I-1 shows the relationships between predicted and actual M-1 growth in each of the past five years.

TABLE I-1.—MONETARY GROWTH RATES, 1975-80

	Money growth (percent change from 4th quarter a year earlier)		
	Target	Actual	Predicted ¹
4th quarter:			
1976 (M-1).....	4.5-7.5	5.8	10.0
1977 (M-1).....	4.5-6.5	7.9	9.9
1978 (M-1).....	4.0-6.5	7.2	8.8
1979 (M-1).....	3.0-6.0	5.5	7.8
1980 (M-1B).....	4.0-6.5	7.1	7.3

¹ Predicted money growth based on Council of Economic Advisers money demand equation using actual historical data for GNP, interest rates, and prices.

² Above target range.

³ The target range for 1980 based on the newly defined aggregate M-1B was chosen to be consistent with a slowing in monetary growth as compared to 1979.

Sources: Board of Governors of the Federal Reserve System (target ranges and actual money growth) and Council of Economic Advisers (predicted money growth).

Whatever technique the Federal Reserve uses, its annual target-setting exercises should not be a mechanical one merely designed to give the appearance of slower monetary growth if the underlying prerequisite—slower inflation—has not been achieved. If pursued for too long, a policy of mechanical reduction in the monetary targets from one year to the next, leading in the absence of reduced inflation to failure to hit the targets, must end with severe damage to the Federal Reserve's credibility as an inflation-fighting institution.

The monetary targets set by the Federal Reserve for 1980 succumbed to higher than expected inflation, along with surges of credit demand which on two occasions pushed the prime rate to 20 percent, causing great damage to small business, automobile sales, farmers, homebuilders, productive capital investment, and other uses of credit.

The public, which compared the 7.1 percent M-1B growth with the 10 percent rate of inflation, many have gotten the totally false impression that the Federal Reserve was stimulative rather than restrictive. Such an impression does nothing to help the Federal Reserve's credibility or to fight inflation.

The Federal Reserve should reassociate its targets with the long-run growth potential and the core inflation rate, which have not improved since January 1980. It could do so by refraining, this year, from a further tightening of its monetary targets.

Recommendation No. 5: Avoid Interest Rate Wars

The Administration and the Federal Reserve should work to avoid further international "interest rate wars," in which certain countries rely excessively on monetary rather than fiscal policy to fight inflation, thus raising interest rates and forcing other countries to follow suit to protect their currencies. This "beggar-thy-neighbor" high interest rate competition should be replaced by much closer international coordination of economic policy, both at and between summit meetings.

The past several years have seen several episodes of unwarranted and avoidable interest rate competition between major reserve currency countries. During the "locomotive" phase of the European recovery from the 1974-75 recession, Germany in particular relied heavily on an expansionary fiscal policy to stimulate demand, combined with tight money and high interest rates to sustain the level of the mark. The result was capital flight from the United States and a falling dollar, followed by tighter money and higher interest rates at home. The United States was stopped from pursuing growth at home in part by the combination of exchange rate weakness and the monetary actions taken to combat it.

Lately, the shoe has been on the other foot. The United States has been fighting inflation with tight money and high interest rates. As a result, the dollar has climbed and now stands very high compared to most currencies. The Germans and others have wanted to combat their domestic recession by lowering interest rates, but have been delayed in doing so by the weakness of their currency when compared to the dollar.

All sides could benefit from better macroeconomic policy coordination. All should rely more on fiscal policy to fight inflation or recession, and less on monetary policy with its large and undesired short-run impact on capital flows and exchange rates. All should eschew large engineered swings in interest rates designed solely to offset capital flows induced by shifts in fundamentals. In this way, all can enjoy lower interest rates, higher investment, and higher long-run real growth than would otherwise be possible.

Recommendation No. 6: Encourage Banks To Fight Inflation

The Administration and the Federal Reserve should encourage the banking system to develop effective methods to prevent destabilizing bursts of bank-financed lending for speculative and purely financial purposes, which make less credit available to enhance productivity and thus fight inflation.

In October, 1979, the Federal Reserve took steps to discourage bank lending for nonproductive purposes, including commodity speculation and purely financial activities, such as corporate takeovers. At that time, Chairman Volcker acknowledged that such activities compete with small business, productive capital investment, home buyers, and farmers for scarce credit resources, and can have the effect of driving up interest rates to the detriment of these productive and desirable activities.

Subsequent events, including the wave of commodity speculation in January through March, 1980, have confirmed the damage which can be done if banks fail to exercise discretion in their lending practices. Therefore, we urge the Federal Reserve to develop effective methods of persuasion to prevent destabilizing bursts of bank-financed speculative activity in the future.

In carrying out this recommendation, there is no need for the Federal Reserve to attempt a detailed or bureaucratic specification of preferred categories of lending. Such efforts to allocate credit from one sector to another will not long succeed in a country with such highly developed capital markets as ours. But it is possible to discourage banks from certain kinds of inflationary and nonproductive credit-financed activities on the part of individuals and corporations who would not otherwise be able to obtain credit for these purposes. Commodity speculation and some corporate takeover lending are prime examples.

II. FISCAL POLICY

Recommendation No. 7: Fiscal Policy: Coordination With Monetary Policy

Fiscal policy should be closely coordinated with monetary policy. To achieve better coordination, the Administration should make public the monetary policy assumptions it employs in reaching its budget and economic forecasts.

Fiscal and monetary policies must not work at crosspurposes. Nor is it desirable to allow the perception of fundamental policy disagreement between the Administration and the Federal Reserve to emerge. The public would not be well served by an environment in which one side may blame the other for the ill effects of policies for which both are responsible.

It is important, therefore, that the Federal Reserve devote greater attention in its reports to Congress to discussing the relationship of its policies to the Administration's. Broad-brush assurances that its money growth targets are "reasonably consistent" with the goals of the President may create more uncertainty than they resolve. And to emphasize this mutuality of interests, we encourage the Administration to publish the monetary policy assumptions used in formulating its budget and economic forecasts.

Recommendation No. 8: Fiscal Policy: Fight Inflation and Recession

Fiscal policy should be steady and moderately restrained. This policy is necessary to reinforce the Federal Reserve's efforts to reduce inflation while supporting growth. All proposed tax and expenditure actions should be examined closely for their effects on productivity and costs. Those which combat both inflation and recession should get priority over all other measures. Recommendations 9-11 deal with taxes, 12-13 with spending.

A steady fiscal policy is one which is aimed to accommodate a steady real growth rate while reducing inflation, and which is not changed in order to offset short-run shifts in that growth rate. Moderate restraint means that the target growth rate of nominal GNP should be slightly less than the sum of potential real GNP growth and unavoidable (core) inflation—so as to exert a slow braking force on our rate of inflation.

Since in times of growth or inflation tax revenues rise more rapidly than nominal GNP, there is a built-in tendency for fiscal policy to move toward greater restraint, and this has happened in recent years. Thus, the Federal high employment budget surplus rose by \$13.5 billion in 1979 and by \$10 billion in 1980. Absent policy changes, it

will rise still more in 1981. The increased actual Federal and consolidated (Federal, State, and local) deficits in 1980 occurred largely as a consequence of recession, which slowed tax receipts growth while raising Federal outlays for interest charges on the debt and unemployment compensation and other countercyclical programs.

We agree with the Administration that steps to offset the current fiscal posture of strong inflation-induced restraint are needed. But such steps should be consistent with our recommendation of steady, moderately restrained fiscal policy. Therefore, such steps should be more cautious and modest than proposed by the Administration, for two reasons.

First, the Administration is committed to increases in defense spending, over and above the significant increases proposed in the fiscal 1982 budget submitted by President Carter. That increased defense spending, if not offset by other spending cuts or absorbed by current excess capacity, will add to inflation, both by increasing the deficit and, indirectly, through the effects of military demand on the price of materiel.

Second, while Federal spending must be reduced, it is doubtful that large reductions in social spending will be achieved in time to affect expenditures significantly in fiscal 1981. Some of the cutbacks which are immediately possible—in Federal employment, and in grants to States and localities for capital projects, for example—are likely to trigger partly offsetting increases in entitlements spending—for retirement, unemployment compensation, and welfare.

The Nation faces no greater danger than a rekindling of inflation, brought on by a combination of failure to control Federal spending, excessive fiscal stimulus, higher deficits, and higher interest rates. Increased inflation must be avoided. It is, as Alan Greenspan testified, “a time bomb ticking away in the financial system.”

To control the Federal deficit and inflation, the Congress should move only cautiously to reduce taxes in order to reestablish the steady course of moderate fiscal restraint necessary to fight inflation. In view of the need to reduce inflation, we urge that any tax reduction or new expenditure this year be designed specifically to raise productivity or to lower costs. Two such tax measures are described below.

Recommendation No. 9: Liberalize Business Depreciation

Once again, we urge Congress to enact promptly a liberalization of the business depreciation allowance for new investment to increase incentives to invest, and to ensure that tax treatment does not distort business investment decisions. Prompt enactment is justified because it is the most efficient incentive to capital investment, which is especially important now in view of the entry of vast numbers of new workers into the labor pool.

We favor two changes in the tax treatment of depreciation to boost investment and productivity. First, depreciation allowances should be liberalized on new investments. Second, depreciation schedules should be reformed to remove the “non-neutrality,” or bias against longer-lived investments, which affects the current system of depreciation schedules in times of high inflation.

Liberalized depreciation allowances for new business investment are needed because current allowances, which are based on historic cost, understate the real cost of replacing depreciated equipment in times of rapid inflation. Thus, depreciation allowances are smaller in real terms than Congress intended, profits are overstated, and businesses pay higher taxes and receive a lower after-tax return than they otherwise would. Liberalized depreciation allowances, constituting a move toward replacement cost depreciation would directly increase the after-tax profitability of new investment. We acknowledge the support of both the Carter and Reagan Administrations for this measure.

Depreciation schedules should also be reformed to eliminate the bias which they introduce into the composition of investment during periods of high inflation. Investment projects which yield the highest prospective returns before taxes are the most productive projects; they should, therefore, also yield the highest returns *after* taxes. Under current depreciation rules, the tax system is not "neutral" in this respect. Some projects having lower returns before taxes will be selected by companies because they have higher returns after taxes. These tax wrinkles are costly to the economy, since they result in inefficient investment patterns. In times of high inflation, nonneutrality of depreciation allowances works against long-lived investments, such as structures, and in favor of vehicles and equipment.

Liberalized depreciation is the most effective of all supply-side tax measures in stimulating new investment, because the flow of benefits is related directly and explicitly to the decision to invest. Lyle Gramley has estimated that a 40 percent increase in allowable depreciation rates for new plant and equipment would contribute to increasing the long-term growth rate of productivity by as much as 0.4 percent per annum after several years. Over a generation, such a measure alone could increase real potential GNP by 10.5 percent, according to Gramley.

Recommendation No. 10: Offset 1981 Payroll Tax Increases

An individual tax reduction designed to offset the January 1, 1981, increase in the social security payroll tax, and thus undo substantially all of the hardship imposed on the low- and middle-income groups who pay the payroll tax, should be enacted immediately.¹

Social security taxes will rise by \$16.3 billion in 1981 as a result of a financing measure enacted in 1977. This tax falls heavily on middle income wage earners; it will increase costs and depress employment; and it may, in combination with the sizable fiscal restraint associated with income tax bracket creep, slow the economy to the point of recession or worse. There is a clear and compelling case for relief from this tax increase.

There are several different ways to effect an immediate offset of the social security payroll tax increases. One would be to roll back the payroll tax increases themselves. This has the advantage of further fighting inflation by removing the increment to employers' wage costs

¹ Representative Long states: "Before adopting any offset to the January 1, 1981, social security tax increase, Congress must first reduce Federal spending. I commend my colleagues' emphasis on targeting tax relief to low- and middle-income workers and protecting the integrity of the trust fund without unduly adding to the Federal deficit."

which the tax increases imposed, but has the disadvantage of draining revenue from the Social Security System, which might necessitate use of general revenues to maintain the fund until a more permanent solution is devised. One permanent solution which should be examined would be to extend the age of retirement gradually in later years. Another alternative would be an income tax credit to offset the payroll tax increases, which has neither the added advantage or the added disadvantage cited above.

Recommendation No. 11: Beyond These: Beware

Other proposed immediate tax reductions, particularly if they imply a commitment to large fiscal stimulus in future years, present the risk of reigniting inflation. Congress should consider a further tax cut when we can be sure that we have made progress against inflation, that the budget is under control, and that the investment incentive measures urged here have improved the Nation's stock of plant and equipment and their productivity so that they can accommodate the new surge of demand. We should avoid commitments now to long-term proposals whose consequences are unpredictable.

Recommendation No. 12: Control Spending

Federal spending must be reduced promptly. No government spending program should be exempt from scrutiny.

The Nation is correctly concerned with excessive government spending, uncontrolled expenditure growth, mismanagement, waste and fraud, and excessive government influence over the economy and over people's lives. This is not a partisan issue, but one which is shared by citizens of all political persuasions and which touches people in all walks of life.

We share the Administration's willingness to examine all Federal programs, to explore and cut in areas where waste, fraud, and inefficiencies exist. We will work with the Administration, as well, to ensure that the burden of sacrifice is equitably shared. Programs which benefit the poor, the middle classes, the well-to-do, and corporations should be subjected to equal scrutiny.

At the same time, the Administration should not lose sight of the fact that Federal expenditures are linked to the state of the economy. As the proposed 1982 budget of the Carter Administration makes clear, virtually all of the increase in fiscal year 1981 spending above original estimates is due to higher interest rates, inflation, and unemployment than was originally expected. It follows that progress against inflation, unemployment, and high interest rates is another effective way to reduce government spending and the deficit.

In light of this, all proposed government initiatives should be evaluated for their long-term as well as their short-term fiscal effects. The initiatives proposed in this Report are designed to reduce the budget deficit directly by cutting spending and indirectly by attacking successfully the poor inflation/employment performance of the economy. It should be borne in mind that, as this Report's other recommendations for combatting inflation and unemployment bear

fruit and economic growth is restored, spending for interest on the national debt and for unemployment compensation will decline, along with the need for high levels of grants-in-aid. Of course, even the restoration of economic health must not reduce our vigilance in controlling Federal spending and reducing it where warranted.

Recommendation No. 13: Cut Spending Equitably

It is essential that spending reductions be made in a fair and equitable manner. Middle and lower income groups should not be required to carry a disproportionately great burden of budget cutbacks. Proposals to terminate or to make major reductions in Federal programs should be accompanied by economic analyses showing the effects on the living standards of different income groups and on different regions.

III. INCOME DISTRIBUTION

Recommendation No. 14: Do Not Worsen the Distribution of Income

The poor are threatened by proposed cutbacks in transfer programs, and the middle class has suffered a significant decline in its real income in recent years. Government tax and expenditure actions should not increase poverty or reduce the share of income going to the middle class.

According to testimony by Sheldon Danziger, the incidence of poverty among persons has fallen from 12.1 percent in 1965 to 4.1 percent in 1980, when all taxes and transfers are taken into account. Progress has been especially great among the aged, for whom the incidence of poverty has been cut from 11.7 percent to 3.0 percent for whites, and from 35.6 percent to 14.1 percent for nonwhites in the same 15-year period. The Nation can take great pride in this accomplishment.

Nevertheless, poverty remains a very serious problem, especially for female-headed families and for racial minorities. About 23 percent of all persons living in households headed by nonwhite females under the age of 65 are poor; a little more than 9 percent of all persons living in households headed by nonwhite males under the age of 65 are poor.

Most of the progress against poverty was the consequence of sharp increases in cash and in-kind transfers, particularly in social security, and many of those who escaped poverty still rely on these transfer programs to maintain minimally adequate standards of living. Food stamps, medicaid, and low-income energy assistance have made large incremental contributions to reducing poverty even though basic welfare payments, aid to families with dependent children (AFDC), have risen comparatively slowly.

In addition, economic development programs, public service employment, job training, compensatory education, and child care programs have helped many to escape poverty and welfare by their own efforts. While economies can be made, sharp and indiscriminate cutbacks in such programs are likely to throw many thousands back onto the welfare rolls, increasing poverty while achieving small and illusory budget savings. There is no question that we must do more to eliminate the causes of poverty by making it possible for the poor to find and hold decent jobs. There is also no question that we must make a more effective use of scarce fiscal resources in pursuing this objective. This Report presents a comprehensive long-range strategy for investment and jobs in Chapter IV.A. We believe that such a strategy would prove to be an effective and efficient way to continue progress against poverty. An approach which dismantles existing programs for jobs, investment, and economic development wholesale would constitute a step backward.

The second and third quintiles of income receivers—those making between \$5,600 and \$17,000 in 1978—that is, the middle classes—have actually suffered a decline in relative income in recent years. The share of the second quintile declined from 10.82 percent in 1965 to 9.85 percent in 1975; the share of the third quintile fell from 17.65 percent to 16.74 percent. Meanwhile, the share of the fourth quintile stayed approximately the same—24.97 percent in 1965 and 25.17 percent in 1978. The fifth quintile, those earning over \$25,350 in 1978, increased their share from 42.62 percent to 44.38 percent of total income. These data are summarized in Table III-1. This evidence reinforces our belief that government tax and expenditure actions must not further reduce the share of income going to the middle class.

TABLE III-1.—DISTRIBUTION OF INCOME (INCLUDING GOVERNMENT TRANSFER PAYMENTS) FOR FAMILIES AND UNRELATED INDIVIDUALS

Quintile:	Percentage of total income received by each quintile	
	1965	1978
1.....	3.93	3.86
2.....	10.82	9.85
3.....	17.65	16.74
4.....	24.97	25.17
5.....	42.62	44.38

Source: Sheldon Danziger.

In times of budget austerity, it is especially important that income tax reductions be designed to distribute their benefits fairly across the income scale. Table III-2 compares the distributive effect of a social security tax offset similar to that recommended by this Committee with the effect of a 10 percent income tax rate reduction. The table shows that, whereas 59.4 percent of the benefit from a 10 percent rate reduction would flow to taxpayers earning more than \$30,000 per year, only 40.4 percent of a measure offsetting the social security tax increase would go to taxpayers with such high incomes. Conversely, while 30.8 percent of the benefit from a social security tax increase offset would flow to taxpayers earning less than \$20,000 per year, only 19.1 percent of a 10 percent rate reduction would go to moderate income-tax payers. Table III-2 was prepared by the Congressional Budget Office.¹

¹ Senator Bentsen states: "A variety of individual tax cuts will be examined by the Congress this year, and it is premature to endorse a specific one now. This Chapter reflects the rekindling of discussions about the distribution of income whenever the economy is not expanding. Some argue that the Federal Government must redistribute income while others focus on the distribution of tax burdens. These divisive arguments deflect attention from the real issue of how best to generate renewed economic growth without inflation. Rather than arguing over shares of a declining pie, we should be focusing on enlarging the pie itself by stimulating economic growth."

TABLE III-2.—DISTRIBUTION OF TAX REDUCTIONS FROM INDIVIDUAL INCOME TAX CUT PROPOSALS BY INCOME GROUP

[In percent]

	Percent of tax liabilities paid under current law	8-percent social security tax credit (employee portion)	10-percent rate reduction (Kemp-Roth, 1st yr)
Expanded income class (in thousands of dollars):			
Below 5.....	¹ -0.2	1.1	0.2
5 to 10.....	2.4	6.2	3.3
10 to 15.....	5.8	10.4	6.6
15 to 20.....	8.3	13.1	9.0
20 to 30.....	20.8	28.8	21.4
30 to 50.....	29.7	30.6	30.8
50 to 100.....	17.4	8.1	17.5
100 to 200.....	8.2	1.4	6.5
200 plus.....	7.5	.3	4.6
Total.....	100.0	100.0	100.0

¹ Figure is negative because of refundable earned income credit.

Source: Joint Committee on Taxation, 1981 Income Levels.

IV. STRUCTURAL REFORM

Recommendation No. 15: Long-Term Structural Improvement Must Start Now

Even sensible monetary and fiscal policies cannot achieve full employment without inflation unless we reform our economic structure to rid it of rigidities and disincentives.

The structural rigidities and defects have proliferated in our economy as the consequence of misguided, badly designed, or dated government policies. These defects and rigidities sometimes discourage investment and jobs. Sometimes they contribute to inflation. Sometimes they do both.

We urge a comprehensive look at the ways in which government policies impede investment and promote inflation. We urge that the gamut of Federal policies be examined and, where necessary, changed to promote full employment without inflation. These include anti-competitive economic regulation, particularly in transportation and communication; cost-ineffective social regulations; inflationary trade policies; tax incentives which induce households to divert their savings to unproductive pursuits and investors to waste land, energy, credit, and other valuable resources.

We believe that the Humphrey-Hawkins targets of 4 percent unemployment and 3 percent inflation can be achieved in the context of structural reform. Sensible monetary and fiscal policies can bring about full employment and a stable dollar only if we get rid of the rust in the pipes. In Chapter IV.A, we examine how such reform can stimulate investment and jobs. In Chapter IV.B, we see how structural reform can help fight inflation.

IV.A. INVESTMENT AND JOBS

Recommendation No. 16: Needed: Investment and Jobs

We support the goal set out in the 1981 Economic Report of the President and by the new Administration of increasing the share of investment in GNP over the next several years. This goal is necessary to reconcile moderately restrained macroeconomic policy with a sustained push toward full employment, full production, and higher productivity growth. Components of a comprehensive investment and jobs strategy should be developed, including the actions outlined in Recommendations 17-24.

Recommendation No. 17: Tax Incentives for Investment

Tax reduction incentives should stress the enhancement of existing and new industrial capacity and the reduction of costs of production.

Streamlining factories, modernizing equipment, and new plant and equipment investment are critical requirements for restoring economic health. The declining rate of productivity growth that has persisted throughout the 1970's and into the new decade has had a variety of causes—many of which do not readily respond to national economic policies. Whatever the range of causes, however, capital investment, particularly capital equipment that incorporates the latest scientific advances, will contribute greatly to productivity growth in American industry. To the extent American productivity improves relative to that of other industrial powers, it will also make American goods more competitive in international markets.

The current American capital stock is growing old. According to the Council of Economic Advisers, the average age of the capital stock was 7.1 years at the end of 1979. Thus, a substantial percentage of America's plant and equipment was built to take advantage of low and declining real energy prices. Everything from machine tools to factories must be redesigned to reduce the use of energy. These investments will make it possible for economic growth to proceed without sharp increases in our consumption of foreign oil.

According to recent revisions (December 1980) of the National Income and Product Accounts (NIPA), gross business fixed investment accounted for a somewhat higher percentage of GNP in the 1970's than it did in the 1960's. Yet, the diversion of investable funds to meet a faster-growing labor force, to satisfy government regulatory mandates, and to raise energy efficiency has left an inadequate residual for productivity boosting investments.

Despite the recently revised data, the Joint Economic Committee remains convinced that the 1970's was a period of inadequate investment in new plant and equipment.

During the 1970's, investment funds were shifted toward equipment and away from investments in relatively long-lasting structures. As a result, a growing percentage of gross investment amounted to replacement of fully depreciated machinery rather than net additions to capital. When the focus is shifted from gross to net investment in business fixed assets, the 1970's show a decline relative to the previous decade.

The decline in net business fixed investment coincided with the imposition of new social demands for additional capital investment. Federal regulations mandated substantial expenditures for pollution control and worker safety. The sharp rise in energy prices pushed a portion of our capital stock into economic obsolescence and reduced the value of much of the rest. The higher energy and regulatory burdens varied widely across industries. The suddenness and the severity of the economic burdens imposed on certain industries threatened their survival.

The recent decline in long-term capital investment also paralleled a substantial increase in the size of the American work force. The baby boom generation came of working age and millions of American women entered the labor market for the first time. By the end of the decade, more than half of all adult women were in the work force (compared to 63 percent for adult men) and the trend toward greater female participation will probably continue. These contradictory movements in capital and labor markets resulted in a decline in the

capital/labor ratio. In other words, the number of workers grew more rapidly than the amount of plant and equipment in the economy. By the end of the decade, the average American worker had considerably less capital at his disposal than in the 1960's.

Tax policy, particularly the treatment of capital assets, has an important role to play in a policy to stimulate new investment in plant and equipment. Our present tax laws have created an overly complex system that somewhat arbitrarily favors equipment over structures and some types of equipment over other types of equipment.

Inflation has depressed and distorted capital investment at the same time. The combination of inflation and historical cost depreciation has often resulted in largely fictitious corporate profits that are nevertheless subject to the corporate income tax. Depending on the economic durability of the asset, the debt-equity ratio of the firm, and the predictability of price increases, inflation has quite different results on the profitability of particular investments. But the distortions themselves hurt economic efficiency, and overall it is clear that inflation has cut deeply into long-term productive capital formation. The Committee has discussed its major tax recommendations at length in Chapter II.

Recommendation No. 18: Basic Research

Funding for basic research should be maintained and private research further encouraged.

The U.S. position as a world leader in research and development has put us on the moon and raised the living standard in the United States and much of the rest of the world. Working smarter as well as harder has long been the American trademark.

Throughout the 1970's, private sector expenditures on research have more or less kept pace with the GNP growth and remain at about 1.8 percent of GNP. At the same time, many of our principal competitors have steadily increased their budgets for industrial research and development. Germany and Japan now devote a higher percentage of GNP to industrial research than we do, and France and Britain are not far behind.

The Federal Government provides a substantial share of all research funds in the country. Government funding is particularly important for maintaining the research facilities and stimulating the basic research that are often beyond the means of the private sector. Also, because government tax, patent, antitrust, trade, Federal procurement, and regulatory policies have a large influence on privately financed research and development (R&D), the government should adopt a consistent long-range policy of encouraging an adequate level of innovation activity. Key measures in this program include:

Basic research funding levels which take account of inflation and the increasing complexity of conducting such research. Funding growth needs to exceed the rate of inflation because it is in basic research that the knowledge base for future innovation is discovered. Basic research is becoming more complex as sources of major technological advances now require a deeper exploration of scientific principles with specialized facilities, larger research teams, and expensive instruments and equipment.

Continued strong Federal support for academic research. Funding increases in real terms for a number of years will be necessary

to compensate for substantial declines in this funding between 1968 and 1976 and for the soaring costs facing universities.

Federal assistance to universities to modernize their facilities for basic scientific research. A protracted period of low investment for research plant and equipment for universities has caused many installations to become obsolete and inadequate for current research projects. Several years of increased funding will be necessary to update the facilities and equipment for future research needs.

Help for small businesses to participate by increasing the amount of losses within a specified time frame which can be deducted from ordinary income by an individual who invests in a new, high-technology company. Small technology-based firms which are considered risky ventures could be assisted in attracting investors.

If we are to continue to improve our standard of living on this increasingly overburdened planet, many significant programs must be added to those in progress, such as the development of ocean resources and space systems. Such magnitude needs both government/industry and international cooperation.

Congress has taken a significant step toward encouraging a more cooperative atmosphere through the passage of legislation to establish industry technology research centers. These centers are patterned after experimental facilities already under way. Envisioned is a network which brings a cohesiveness to the fragmented elements of society already involved in research and innovation. The centers are viewed as the best hope of bringing to the economy the positive contributions of:

The academic-university environment where basic research flourishes.

The industrial sector where ability and techniques exist to convert an inventive idea into an innovation.

The Federal Government with its capacity to foster a climate which values long-term investments in and commitments to research and development.

The centers will be designed to use funds and personnel from each segment and with a goal to reduce Federal funding as centers become self-sufficient. Such centers would:

Concentrate on underlying technology important to a variety of industries.

Disseminate foreign and domestic technical information.

Provide technical assistance and advisory services, an aid of particular importance to small and medium-size firms.

Most importantly, such centers could serve as an educational and training facility for students. This is proving increasingly important as almost all of the new jobs are being created in the so-called service or information industries. For example, if the computer industry keeps growing at its present rate, by 1990 it would need one million programmers. This far exceeds the number the Nation will produce unless present trends change considerably.

Increased investment in human resources is not just academic jargon. Increasingly, we are learning that America's labor force needs the skills and education to conduct research and development and to operate modern machinery. Investment in the education and training of

United States workers should accompany the investment in R&D and in plant and equipment in order to accommodate technological improvements. Measures that should be examined to assure an adequately educated and skilled labor force include:

Internship programs at the industrial technology research centers described. In return for Federal educational financial aid, interns could be required to work a prescribed period of time at such a research center—contributing both to the education of the intern and the research output of the center.

Increases in the share of student financial assistance programs devoted to studies for the advancement of science and technology. Such programs could be targeted for study of specific areas under agencies like the National Science Foundation. Greater assistance may need to be directed toward academic areas in which future personnel shortages are anticipated.

Programs to provide retaining and reemployment in adjustment assistance for workers displaced because of technological change. The emphasis could be on programs which direct workers to growth areas rather than exclusively on supplementary unemployment insurance.

Over the coming years, the American economy will become more labor intensive as the service industries continue to grow. At the beginning of the decade, services accounted for 67 percent of all jobs, compared to 60 percent 10 years before and nearly 55 percent 20 years ago. Obviously, it will become increasingly important to derive top performance from this work force, for failure to do so will lead to productivity loss.

Recommendation No. 19: Infrastructure

Investment in infrastructure—roads, water systems, rails, ports, utilities, and other physical support systems—should be maintained at adequate levels. Federal economic development programs which can help State and local governments provide necessary infrastructure should be maintained at adequate levels. Federal economic development should be examined to improve their effectiveness and reduce the risk of waste.

Private sector investment thrives best in the context of an adequate and well maintained infrastructure. The proper macroeconomic policies or a well designed capital depreciation program will not have a maximum effect without proper highways, ports, railroads, bridges, satisfactory water systems, utilities, and the like. Throughout the 1970's, however, State and local governments put relatively few investment dollars into building or maintaining the Nation's industrial infrastructure.

The steady shift of population from the Northeast and Midwest to the South and West increased the demand for new roads, sewers, and water works. High and rising energy prices have spawned boom towns in many parts of the West that have seen little or no development in past decades. Inadequate infrastructure has also become a problem in many of the older cities of the Nation where existing facilities are rapidly deteriorating. Recent Federal Highway Administration studies have found that one in five American bridges should be replaced and more than half the Nation's roads require major

repairs. A 1976 Environmental Protection Agency study has estimated that local government requirements for water and sewage treatment to comply with Federal regulations amount to some \$150 billion. The figure would be considerably higher today.

Despite the evident demands for infrastructure investments, real capital expenditures by State and local governments fell during the past decade. While public works investment in constant dollars by the Federal Government has remained near its 1968 peak, such investment by State and local governments declined by 40 percent and 25 percent, respectively.

In part, the decline represents the aging of the baby boom generation and the resulting reduction in demand for schools and other local services. In some cases, responsibility for extending sewer and water lines has been transferred to private developers. But the decline in public spending on infrastructure also reflects real disinvestment by State and local governments in existing capital facilities. Particularly in cities suffering from a fiscal squeeze, the deferral of new construction or maintenance of existing facilities can be an attractive, seemingly painless way to bring the local budget into balance. However, over the long haul, the accumulated effects of deferred maintenance can deter the private sector investment that assures the community of continuing economic strength.

The present Federal system of categorical grants emanating from various agencies and departments may limit the ability of State and local entities to respond effectively to their infrastructure needs. Some revision or consolidation of existing programs may stimulate a more effective use of public funds and diminish the risks of waste and fraud occurring in these programs.

To some extent, the decline in infrastructure investment may also reflect the lack of adequate targeting in the tax code. The problem is believed particularly acute in the field of tax exempt industrial bonds.

Jobs

Cost-effective investments in human resources that upgrade skills, provide relevant training, and lead to jobs at reasonable wages must be an integral part of the investment strategy outlined in this chapter. Millions of potential workers have employment handicaps that prevent them from competing effectively for jobs. Others are the victims of race, sex, and other forms of discrimination. Even when the economy is operating at close to full capacity, these individuals encounter long periods of idleness or underutilization and, in periods of slack, their chronic difficulties become worse.

The 1980 recession reduced total employment by more than one million jobs. Beyond recovering these losses, well over two million new jobs must be created by the private sector to bring a goal of 4 percent unemployment within reach. But the problem is not simply a shortage of jobs: even in the midst of high overall employment, certain kinds of jobs go unfilled. Some require special skills that may be in short supply, at least in the local labor market. For workers without much experience, however, the jobs that become available are too often temporary, low paying, and dead-end—choices that may not be viewed as economically superior to welfare or other nonmarket income alternatives.

Improvements in human capital will not occur solely as a consequence of improving conditions for business and economic growth, although that is the single most effective step our Nation can take to improve employment opportunities. What is needed is a combination of measures that encourage the employment and training of hard-to-employ groups and promote the movement of labor to more productive uses.

If properly designed, policies to reduce structural unemployment need not be inflationary or wasteful. Because of excess supplies of labor in the lower skill ranges, stimulating demand for such workers is unlikely to cause an increase in wages. Where bottlenecks exist, generally in higher skill labor markets, the retraining of workers can, in fact, relieve sources of inflationary pressures. Other steps should be examined to lower unit labor costs through targeted training subsidies or tax incentives for employment and training, thereby reducing inflation.

In previous reports, this Committee had advocated the use of carefully targeted policies to address the problems of specific labor force groups. We still do. Blacks and other minorities bear a disproportionate share of the burden of unemployment at all stages of the business cycle. Youth unemployment rates have been excessively high for two decades, reflecting a substantial deterioration of opportunities for minority and disadvantaged youth. Special difficulties are also encountered by persons reentering the labor force after long absences, older workers, and workers displaced from long-term jobs by technological and other industrial changes.

This does not mean a proliferation of new government programs, nor are we wedded to continuation of all existing ones. Rather, it suggests that different methods of encouraging employment and training should be operated in tandem, to learn what works best. Such a system could reduce the amount of Federal spending devoted to labor training while upgrading program results.

Whether through private- or necessary public-sector programs, an effective human investment strategy should make maximum use of the resources of private industry. Employment and training opportunities for the structurally unemployed could be significantly expanded through the use of financial incentives to employers. Such alternatives appear to offer several advantages: the value of the output produced is likely to be higher, and the experience acquired more relevant to permanent employment. While experience remains limited, the Committee believes effective incentives, perhaps tax credits, can be developed.

Recommendation No. 20: Targeted Jobs Tax Credit

Better use should be made of the Targeted Jobs Tax Credit. Specifically:

(1) The revision of eligibility criteria to cover the main categories of structurally unemployed workers should be examined;

(2) Eligibility criteria should be simpler and more readily verifiable by employers; and

(3) There should be effective publicity to increase awareness on the part of the employers.

The United States has experimented with two types of employment tax credits. The New Jobs Tax Credit, which applied in 1977 and 1978, provided a credit of up to \$2,100 for workers added by firms whose payrolls grew by more than a specified amount from the previous year. According to the Treasury Department, about one million firms—nearly half of those eligible—utilized the credit. There is also evidence that firms which knew of the program experienced more rapid growth—on the order of 3 to 3.5 percent a year—than similar firms which were unaware of it.

The Targeted Jobs Tax Credit, begun in 1979, is targeted on particular categories of workers, providing tax credits of up to \$3,000 in the first and \$1,500 in the second year of an eligible person's employment. To date, participation by employers has been disappointingly low: in a recent survey conducted for the Department of Labor, 21 percent of employers had heard of the Targeted Jobs Tax Credit and only 3 percent reported using it. The single largest group of workers served by the program has been cooperative education students, who account for nearly one-half of the 300,000 persons hired in the first 18 months. Other eligible categories include more obviously disadvantaged individuals such as youth; Vietnam-era veterans from low-income families; handicapped individuals; ex-convicts; and recipients of public assistance.

Perhaps the most fundamental problem is that the certification process by which eligibility is determined does not recognize realities of the hiring process. Many prospective employers are small businesses with considerable turnover, who try to keep hiring costs low: jobs are filled quickly with the first suitable applicant. Requiring contacts with government agencies like the Employment Service or the local CETA program introduces delays, paperwork, and otherwise impedes a reasonably efficient selection procedure.

At present, the credit is benefiting only a small fraction of those it was designed to help. In addition, those with the subsidy may have displaced similarly disadvantaged workers who did not meet the stated criteria or go through all the steps in the certification process.

The Democrats nevertheless believe that tax incentives for private employment can be designed to remove cumbersome features and still retain desirable targeting on hard-to-employ workers. Alternative structures for credits should be examined, including relevant aspects of the New Jobs Tax Credit that would provide a subsidy for additional employment above a threshold level.

Other concepts that could be examined include targeting on entry-level workers rather than on more specific categories of the structurally unemployed. A close look should be given to a flat credit for each additional hour worked as a way to target on entry-level workers, because the relative value of the subsidy would be greater at lower wage levels. Similarly, a credit for new workers with less than one year (or a specified amount) of earnings covered by social security can be reviewed to determine if it would encourage employers to hire the young, the unskilled, and others without much job experience.

Additional tax incentives for the hard to employ can be examined as well to ensure that a cost-effective job tax credit program is available.

Recommendation No. 21: Labor Force and Small Business

The Congress should consider ways to facilitate job creation by small businesses and to increase the proportion of Federal procurement and research and development funding that is available to small businesses, and particularly to minority-owned businesses.

Income support programs should be designed to help improve the employability of individuals by emphasizing training, education, and skill development, and should utilize small businesses, and particularly minority-owned businesses, whenever possible.

The Democrats strongly support the revitalization of small business. The share of output being produced by small businesses has been declining. Small businesses generated 43 percent of the aggregate output in 1963, 40 percent in 1972, and approximately 39 percent in 1976. This represents a decline in the share of GNP produced by small business of approximately 0.3 percent annually. During the same period, large businesses increased their share of output by 2.4 percent. In the manufacturing sector where this trend is even more pronounced, the largest 100 firms increased their share of total assets from 39.7 percent to 47.6 percent from 1950 to 1976, while the largest 200 increased their asset share from 47.7 percent to 60.0 percent during the same period.

Still, more than 98 percent of commercial establishments are small businesses. While they are currently generating a decreasing share of output, they are providing an increased share of the employment growth. In the period between 1969 and 1976 small businesses accounted for approximately 87 percent of all newly generated private sector employment in the country. The largest 100 firms contributed less than 2 percent of the growth during the same period. A study conducted by 2 percent of the growth during the same period. A study conducted by Data Resources, Inc., on the growth of small, extremely competitive, high-technology businesses—mainly electronic—concluded that these businesses increased their output nearly three times as fast, and generated nearly twice the employment growth as all other industrial sectors from 1969 to 1976, while their prices increased only one-sixth as fast.

The decline in productivity in the American economy is directly related to the decline in the small business sector. A National Science Foundation study reveals that small firms produced nearly four times as many innovations per research and development dollar as medium sized firms and more than 24 times as many as the largest firms during the period from 1953 to 1973. Yet, throughout the 1970's, small businesses received less than 5 percent of Federal research and development funds, while the largest firms received more than 50 percent.

The main Federal response to high unemployment has come from the income maintenance system. While spending on CETA jobs programs fell during the 1980 recession, income transfer payments escalated sharply. Unemployment insurance benefits rose to \$18 billion in 1980 from \$10.7 billion in 1979, reflecting both larger numbers of claimants and the activation of an extended benefits program which adds an extra 13 weeks to the regular 26 weeks of benefits.

While these benefits clearly fill a vital need for temporarily unemployed workers, income support programs are an inadequate response

to the problems of longer term joblessness and dislocation. By consisting almost entirely of cash benefits, the programs do not foster rapid reemployment and are subject to abuse when not administered well.

A number of special programs have evolved, apart from regular unemployment insurance, to deal with dislocations in certain industries. The largest is the Trade Adjustment Assistance Program (TAA), under which workers who lose their jobs because of import competition may qualify for up to 52 weeks of benefits. Largely due to the special problems of the auto industry, Trade Adjustment Assistance Program caseloads have increased rapidly. In 1980, these benefits exceeded \$1.6 billion—more than double the total paid out since the program began in 1975. The Labor Department anticipates spending \$2.5 billion to \$4 billion in fiscal 1981, with costs tapering off the following year as the surge of laid-off auto workers subsides.

To date, relatively little adjustment appears to have resulted from the trade adjustment program. According to a 1979 study conducted for the Labor Department by Mathematica, fewer than one-fourth of adjustment assistance recipients are permanently displaced from their jobs. Most, instead, return to their previous employers after a temporary layoff or period of reduced hours.

Unlike the temporarily displaced workers, whose characteristics and labor market experiences differed little from other temporarily unemployed persons on unemployment compensation, adjustment assistance recipients on permanent layoff tended to be older and have considerably longer spells of unemployment than a comparable group of unemployment insurance recipients. Also, in the case of adjustment assistance recipients, taking a new job was more likely to entail a significant cut in real wages—on the order of \$50 a week.

The Mathematica study documented extensive processing delays, which meant that most recipients collected payments in a lump sum—often after they were back on the job. While the department believes that administrative efficiency has improved, the program is still characterized by vague and arbitrary standards.

Less than 4 percent of adjustment assistance beneficiaries have received either training, counseling or relocation assistance which the program is authorized to provide. Although lack of separate funding may have hampered these functions of the program, there is little evidence that participating workers gained anything from such services.

The TAA programs must be rigorously examined to determine where outlays can be reduced by a more careful targeting of benefits to achieve the original objectives of the Act.

Recommendation No. 22: Labor-Management Cooperation

The Committee supports private efforts to improve productivity through cooperative activities by labor and management.

Cooperative activities by labor and management may significantly enhance government efforts to smooth adjustment problems and promote more effective uses of human resources. In hundreds of individual plants as well as several dozen industries and local

communities, committees composed of worker and employer representatives have been formed to find acceptable solutions to issues of common concern.

At the plant level, for example, labor-management committees have arranged for training programs to meet changing skill requirements of employers and to alleviate labor bottlenecks. In other cases, labor and management have worked together to redesign production processes or deal with special workplace problems such as absenteeism. Community-wide committees have sought to encourage cooperative activities in local plants and create conditions that foster economic development. Labor-management committees in the retail food and steel industries have dealt with regulatory problems; in the railroad industry, cooperative projects have experimented with manpower and other changes to increase the efficiency of certain routes. While the scale, mix of activities, and success has varied from committee to committee, the initiatives have helped to improve productivity and strengthen labor-management relations in a variety of industrial settings.

Recommendation No. 23: Exports

Smaller, innovation-minded firms and agricultural commodities should receive enhanced incentives and assistance for exports.

The adoption of a comprehensive investment strategy will strengthen the ability of American industry to compete for foreign as well as domestic markets.

For much of the past decade, meeting the foreign competition has been anything but easy for the domestic economy. An overvalued currency in the 1960's, high rates of domestic inflation, and relatively low rates of growth in productivity all contributed to the emergence of the U.S. trade deficits in the 1970's. Since 1977, however, the total volume of U.S. exports has grown by 40 percent and the U.S. share of the industrial world's total exports has grown by more than a full percentage point.

In the last two years, the overall performance of the United States in the international economy has also been strengthened. The United States experienced a slight (less than \$1 billion) current account deficit in 1979 and is expected to record a 1980 current account surplus over \$5 billion. A considerably larger surplus (almost \$20 billion) is expected for 1981.

This success, however, is more apparent than real. The movement toward current account surplus includes a large surplus on the service account, much of which reflects the profits of U.S. based multinationals. These surpluses mask the weakness of our manufactured exports.

Throughout the period of current account recovery, the merchandise trade deficit has remained large. In 1979, imports exceeded exports by almost \$30 billion and are expected to top exports by an additional \$26 billion in 1980. In addition, the recent appreciation of the dollar, coupled with relatively high rates of domestic inflation, will erode some of the competitive strength of U.S. goods.

The economic strategies of our major trading partners also promise more competition for the United States. Europe and Japan are both attempting to move aggressively into high-technology fields where the United States currently has a definite comparative advantage. At the same time, the newly industrialized countries will supply a larger share of the world market for traditional manufactured goods.

The coming decade will be a period in which the United States will have to become a more effective exporter. In terms of the world market, the United States has been a major exporting power since the close of the second world war. Until recently, however, exports have not been vital to the overall performance of the American economy. Over the past 10 years, exports as a share of GNP have doubled and now amount to a substantial share of profits and production for a number of American industries.

The U.S. export performance has long relied on the better mousetrap to attract worldwide customers. As world competition and our export dependence grow in tandem, we will have to adopt a more aggressive policy.

Many industrial countries have continued to protect their domestic markets—particularly in agriculture and high technology goods. We must adopt an international negotiating strategy to reduce these barriers and to help create new markets for American business and attract small- and medium-sized firms to opportunities abroad. We remain skeptical that the current division of authority between the Commerce Department and the U.S. Special Trade Representative and other bodies will prove to be effective in articulating and implementing the Nation's foreign trade policies.

Recommendation No. 24: Regional Growth

Noninflationary growth is essential to real income growth and central to the resolution of the fiscal problems of many of the Nation's cities. A strategy for investment and jobs should take advantage of the opportunities and to meet the needs of our many diverse regions. Federal policies should not impede growth and development in any region of the country. Federal policies should be examined for unintended, implicit regional, urban, or rural biases.¹

The single most important thing the Federal Government can do to help meet the needs of State and local governments and to foster growth in all regions of the country is to adopt policies which return the economy to a path of stable growth. If the coming decade is characterized by slow GNP growth, growing and economically stagnant States alike will suffer.

Indicators of regional shifts are by now familiar. While the population of the United States increased by 50 percent between 1950 and

¹ Senator Bentsen states: "While Federal policies must be continually examined for cost-effectiveness, fraud and waste, there is a danger that the reviews or studies will become vehicles for regional conflict. Such studies are too often self-serving, designed to favor one region or group over another. They are costly, as well, and frequently rely on inaccurate or suspect data. Analyses of proposed spending cuts frequently suffer from the same faults. To restore a balanced economy, the Nation's regions need to work together, rather than apart, to generate renewed economic growth and full employment with price stability."

1980, the population of the Northeast grew by 24 percent, the North Central States by 32 percent, the South by 60 percent, and the West by 113 percent. Between 1970 and 1980, Chicago's population declined by 11.9 percent, Pittsburgh's by 18.5 percent, Cleveland's by 23.8 percent, and Detroit's by 21.3 percent. Concurrently, the population of San Diego, Phoenix, Houston, San Jose increased by 24.7 percent, 33.7 percent, 26.1 percent, and 36.1 percent, respectively. Although part of the increase in some of these cities can be attributed to the annexation of suburban areas by central cities and to natural population growth, from 1970 to 1977, migration accounted for almost 50 percent of the South's growth. In this same period, two and one-half million more people moved from the North than to it—a reversal of the migratory patterns of the Forties and Fifties.

Since 1950, there has also been a steady shift of employment opportunities from the Northeast-Midwest regions to the South and West. Between 1950 and 1977, total nonagricultural employment increased by 45 percent in New England, 53 percent in the Great Lakes region, and 28 percent in the Mid-Atlantic States, all significantly below the national average of 70 percent. In the South Central, Pacific, and Mountain States, on the other hand, employment grew by 133 percent, 155 percent, and 186 percent, respectively.

The trend in central cities parallels the regional trends. Between 1965 and 1977, employment in Baltimore declined by approximately 15 percent and New York City's employment fell by 12 percent, while Jacksonville's increased by 53 percent and Nashville's by 55 percent.

The loss of large numbers of manufacturing jobs in the Northeast and Midwest in part explains these employment trends. Between 1960 and 1970, the South and West gained 1.9 million manufacturing jobs. From 1970 to 1977, there was a further gain of 880,000. In the same two periods, the Northeast-Midwest gained 847,000 jobs and then lost 673,000. Although the manufacturing losses in the older regions, in the Northeast in particular, were offset by increases in non-manufacturing employment, overall employment growth largely stopped. Between 1970 and 1977, approximately three out of four new jobs created were in the South and West and imposed major new demands on resources and public revenues there. (See Table IV-1.)

TABLE IV-1.—TOTAL EMPLOYMENT BY REGION (000's)

(In thousands of jobs)

Region	1970	1977	Change in number of jobs	Percent change
Northeast.....	18,655	19,148	493	3
North Central.....	19,920	22,513	2,593	13
South.....	20,282	25,511	5,230	26
West.....	11,827	15,048	3,221	27
U.S. total.....	70,684	82,220	11,536	16

Source: BLS: Employment and Earnings for States and Areas.

Another measure of economic activity is per capita personal income. By this measure, too, a shift from the Northeast-Midwest to the South and West is evident. In the past, per capita income in absolute terms had been highest in the Northeast. However, per capita income in the

West presently leads the Nation. Although per capita income in the South has been and remains the lowest, between 1965 and 1979, the South registered the greatest gain. Nationally, between 1965 and 1979, per capita income increased by 215 percent. In this period, per capita income in the Northeast rose by 193 percent, in the North Central States by 216 percent, in the West by 236 percent, and in the South by 260 percent. Although, in 1965, the difference between per capita income in the Northeast and South was 27 percent (\$3,077 and \$2,225 respectively), by 1979 the differential had narrowed to 11 percent (\$9,021 in the Northeast and \$8,017 in the South). The convergence in income which is occurring is more dramatic when individual States are considered. In 1965, Mississippi had the lowest per capita income, \$1,682, which was 60 percent of the national average. By 1979, per capita income in Mississippi had increased to \$6,178, 70 percent of the national average. Conversely, Connecticut's per capita income relative to the national average fell from 124 percent in 1965 to 115 percent in 1979. While the convergence in income provides further evidence of the regional economic shifts which have occurred, it may also be the precursor of the slowing of these trends, as the attraction of lower wages and living costs in the South is diminished.

Although regional migration is not a new phenomenon, the strength of the recent movement of people and jobs from the older Northeast-Midwest regions to the growing South and West has caused concern over the future of both regions. The Northeast and Midwest are confronted by slowing growth in tax bases as the number of business and residential taxpayers has declined and an increasing proportion of their population is composed of the aged, minorities, and others who are relatively dependent upon government assistance for survival. The growth areas are confronting the same rising demand for public services that led to higher government costs in the North, but with significantly smaller income bases than exist there.

Thus, there are reasons to believe regional convergence is likely to occur in the years to come. Income differentials are narrowing and labor costs may now be growing as fast in the South as in the North. There is also evidence that the overall cost of living is rising faster in the South. Similarly, land costs there are likely to rise as available land becomes scarce. And increased demands for public services and infrastructure are placing pressure on public officials to raise State and local taxes, whose relatively low levels until recently were cited as an inducement to growth. Further, low density development may lose some of its appeal if higher gasoline prices continue to raise the cost of automobile commuting. All of these factors could result in a slowing of the growth in the South and West.

Given these trends, it makes sense to address the future development problems of all regions in a balanced way. The Federal Government should not attempt to reverse fundamental trends. Rather, we believe the Federal Government should review ways to cushion the effects of the transition for both the Frostbelt and the Sunbelt, and particularly the effects of transition on employment, on poverty, on infrastructure requirements, and on the fiscal condition of State and local governments. This review should give careful attention to the different needs of different regions, and include evaluations of steps to foster economic growth in all regions commensurate with the opportunities

available in each. Any resulting comprehensive investment strategy should be tailored to take advantage of these opportunities.

In the older industrial regions, public and private infrastructure is in place. There are large numbers of good or rehabilitatable houses, and there is an established work force. These are resources which should be maintained and developed, so as to make a revival of industrial investment profitable in the older regions. The surest way to ensure international competitiveness of basic industries is to boost the levels of private investment flowing to these major employment centers. The review called for by this Committee could include options to ensure that this rebuilding is done in a way which uses the complementary physical and human resources currently available in the older regions, and which validates existing investment in the maintenance and upgrading of those resources.

Large manufacturing industries are not the only hope for the economic revival of older cities and regions. Economic diversification is also possible, and Federal, State, and local policies should encourage it.

In the South and West, the benefits of growth have become the burdens of growth as well. Sunbelt cities are experiencing an increased demand for services, for infrastructure development, and for mass transit—demands which are often made difficult to meet by the low-density nature of much Sunbelt development. Federal policies should be alert to ways to support Sunbelt cities in their efforts to develop inefficient patterns, and to preserve the natural beauty of the region while growth proceeds.

State legislators and local officials should be aware of the benefits of structural reform in the delineation of local government boundaries which provide opportunities to increase the tax base, share adjacent resources, and attain increased self-sufficiency.

One area in which certain Sunbelt cities excel is in the geographic organization of municipal jurisdictions, which allows the Sunbelt regions to equip themselves better to deal with their problems and opportunities than most long-industrialized States. Older cities have long-frozen boundaries which State governments have not been prone to change. These boundaries allow the suburbs to be largely immune to the central city problems of decline, even as suburbs grow. In the South and West, however, many cities have succeeded in repeatedly shifting borders outward since 1945, thus combining the strengths and weaknesses of inner-city and suburban city and matching urban resources with urban needs. The Frostbelt could learn from this experience.

IV.B. PRICES

Recommendation No. 25: Many Steps Needed for War on Inflation

Inflation is the major obstacle to sustained economic growth, lower unemployment, and increased investment. Past anti-inflation policies, from voluntary guidelines to engineered recessions, have not worked, and we doubt that anything short of a comprehensive program will work now. Inflation is a complex, deep-seated phenomenon and the war on inflation must encompass all of the measures listed in Recommendations 26 to 29.

The severe inflation of the 1970's has weakened our economy and caused major dislocations, while imposing hardships on American workers and consumers, particularly the elderly and the unskilled.

In part as a result of inflation, business investment has become inadequate to meet the growing needs of the economy. Inflation creates unnecessary uncertainty for business expectations concerning the risks and profits of potential investments. It discourages investment in long-term projects and research and development efforts needed to spur economic growth, in favor of spending that promises short-term pay-offs. It understates the true cost of production and thus overstates taxable profit by playing havoc with depreciation allowances that are based on historical rather than current replacement costs. Inflation also discourages saving by individuals because of income tax bracket creep and because it reduces the real value of interest, dividends, and capital gains. In addition, the high inflation of the past few years has caused interest rates to rise to record heights and this contributes directly to more inflation as businesses raise prices to compensate for increased costs.

In many other ways, the current inflation has been undermining the strength of the American economy. During the 1970's, we have had three major recessions, all related to problems and policies caused by inflation. High home mortgage interest rates have twice this decade knocked the bottom out of the housing market, contributing to inadequate housing supply and rising home prices. Inadequate investment and savings have helped bring productivity growth in the American economy to a virtual standstill, the balance of merchandise trade has been in chronic deficit, and less expensive foreign imports have been capturing the domestic markets of important basic American industries.

The Reagan Administration's economic policies will be judged in good measure by their success or failure in addressing the persistent and accelerating inflation that has plagued our economy for the past decade and more.

The current inflation is of long duration, and the vast majority of American businesses and consumers have come to expect that it will continue. Each sector of the economy has developed structural mechanisms that have helped it adapt to a climate of rising prices, but these structures in turn contribute to the momentum of inflation. Many major labor contracts now include cost-of-living adjustment clauses that compensate for all or part of the inflation-induced loss of real income. To the extent that these increases are not offset by productivity improvements, they raise business costs and thus prices. When consumers purchase on credit in anticipation of even higher prices, the added pressures on interest rates raise business costs and prices. Many government programs have been indexed to the Consumer Price Index (CPI), so that spending automatically increases as the cost of living rises. This increased spending, to the extent that it is not offset by higher taxes, contributes to inflation.

In addition, there are those who have a financial stake in rising prices. During the past few years, millions of American families have begun treating housing as a financial investment, spending more for a home in the anticipation that housing prices will continue to rise. By committing a large part of current income to mortgage payments,

these homeowners are betting that inflation will gradually reduce the burden of payments as their wages grow, while the rising price of homes will increase their equity and thus their financial worth.

The efforts of workers and businesses to adjust to continued inflationary expectations, and to stay even with or ahead of rising prices, contribute to the inflationary process and make it more difficult to slow the pace of inflation. Each round of wage increases in turn raises unit labor costs. These higher costs then result in higher prices, which form the basis for the next round of wage demands. This generates a momentum in the inflation rate which tends to be very persistent and very difficult to reduce.

When considering proposed anti-inflation measures, it is useful to divide the inflation rate into three separate inflation sources: the demand rate, the shock rate, and the core rate.

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. 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, but the price in human terms is very high.

Currently, demand factors are contributing to reduced inflationary pressures. The unemployment rate is 7.4 percent, as of December 1980, and unemployment has been well above the neutral level for most of the year. There is also plenty of slack in industrial capacity, with businesses at about 80 percent of capacity.

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

It is difficult to predict the kinds or severity of shocks that might occur in the year ahead. It is likely, however, that shocks will contribute to inflationary pressures during 1981. First, both the social security tax base and tax rate increased on January 1 of this year, as did the minimum wage. These actions will contribute to higher unit labor costs. Second, at the end of 1980, OPEC raised the price of oil by an average of \$3 per barrel, equal to about seven cents per gallon. Third, President Reagan has ended petroleum and gasoline price controls in advance of the October target. Fourth, food prices will continue to rise at an 11 percent annual rate, slightly faster than they

rose during 1980, according to economist Jason Benderly in recent testimony before the Committee.

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. It changes only very gradually and does not respond quickly to policies or other particular events.

Currently, the core rate of inflation is about 10 percent. No anti-inflation program stands a chance of success unless it deals with this long-term part of our inflation problem. Our recommendations respond to this need; no simple approach will work. In particular, those who argue that our inflation problem can be cured through monetary and fiscal restraint alone perform a disservice to those who must make policy decisions.

Although monetary and fiscal restraint are a necessary part of an anti-inflation program, there are a number of reasons why it would be a mistake to rely solely on this traditional approach to inflation. As Barry Bosworth testified, to reduce inflation by one percentage point would require an increase in unemployment of one million for two years. Clearly, significant reductions in inflation should not be achieved by these means.

Second, the American people have come to realize that the anti-inflationary effects of recessions disappear when the economy begins to expand again. The last three recessions did reduce inflation, but the recovery phases that followed brought renewed price increases in each case that were as bad or worse than before. There is no reason to believe that future recessions or periods of slow growth would be any different.

Third, monetary and fiscal restraint generate an important side effect that can impair long-run control over inflation. A long-run program for reducing inflation must depend heavily on improving the growth rate of productivity. This requires an increase in new investment, embodying new technology or improved production processes. But during a period of slow growth or recession, there is little incentive for investment as businesses face slack demand and excess capacity. The longer the period of restraint, the more aged and inefficient the capital stock becomes. During the ensuing recovery and growth period, productivity would respond inadequately and additional upward pressures would be placed on prices.

Finally, a policy of fiscal restraint in the context of higher defense spending must not result in counterproductive cuts in programs that help control inflation by contributing to private sector productivity. Cutting Federal outlays by eliminating waste and fraud will improve, rather than harm, our long-run economic performance. But deep and wholesale cuts in job training programs, for example, could jeopardize the Nation's long-run economic performance.

Inflation can be conquered by a program which attacks its causes, and which combines long-run structural reform throughout the economy with immediate measures to break the pressure of inflationary expectations.

The keystone of a long-run program of anti-inflationary structural reform must be to eliminate the inflationary bias built into the determination of wages and prices.

At present, no program to address this fundamental aspect of inflationary momentum exists. The Carter Administration relied, unsuccessfully, on voluntary guidelines and proposals for a Tax-based Incentive Plan (TIP). Congress did not act on TIP, and the Reagan Administration has abandoned the guideline approach.

Other nations, such as Germany and Austria, control inflation by coordinating wage settlements very carefully across collective bargaining units, by keeping prices under heavy international competitive pressure through a high exchange rate, and by trading high levels of public services and social security for wage restraint as part of a "social contract" between workers and their government. These and other approaches should be evaluated to determine the role they could play as a part of a comprehensive strategy against inflation.

Recommendation No. 26: Energy

Energy policy should focus on reducing the sensitivity of U.S. energy supply and price to external shocks by continuing to encourage conservation, greater domestic energy production, including the development of improved techniques for enhanced oil and unconventional gas recovery, and establishment of substantial petroleum reserves.

In the United States, during the first half of 1980, about one-fifth of the increase in the rate of inflation was caused by the direct and indirect impact of energy price increases. This year, increasing prices will raise the U.S. oil bill by about \$50 billion over 1980.

The continuing exposure of U.S. energy costs to OPEC pricing behavior can be reduced by policies to increase the elasticity of U.S. demand for foreign oil. Significantly larger investments in conservation, domestic energy production capacity, expanded production of abundant coal, and conventional and unconventional oil and gas will create a strong incentive for the stabilization of world oil prices.

Federal energy spending is only slowly being reoriented to reflect the energy realities of the 1980's. During most of its short history, the Department of Energy acted on the assumption that electricity usage would increase at very high rates, while conventional oil supplies would remain abundant. Now, domestic oil is in short supply and electricity demand is growing much more slowly. Our continued excessive reliance on foreign oil imports requires that priority be given to Federal programs and policies which increase the efficiency of oil use and increase the supply of domestic oil and of synthetic fuels that are able to meet end-use needs now met by oil. These end uses are principally transportation and space heating.

The conservation impact of increased energy efficiency in these areas is already substantial. More fuel-efficient automobiles, improved mass transit, and better organized residential patterns have yielded large reductions in gasoline use. Dramatic further improvements—some of them from sharp departures in automotive design—are yet to come and should be encouraged. One good substitute for foreign oil is domestic oil recovered by enhanced techniques. Good alternatives to oil in transport and heating including alcohol-based fuels and solar heating and cooling.

Each time energy prices rise, billions of dollars in plant and equipment are rendered economically obsolete. It has been estimated that the capital expenditures necessary to adapt the U.S. capital stock to utilize oil efficiently when it was only \$18 a barrel amounted to \$364 billion in 1978 dollars. At \$35 a barrel, the level of needed capital investment will be much higher. Eventually, of course, energy users will adapt to these new high prices, but substantial time lags with serious impacts on productivity have resulted, as this Report addresses in Chapter IV.A. A variety of estimates of the loss in productivity caused by increasing energy prices have indicated that between 15 and 70 percent of the decline in the rate of productivity growth can be accounted for by energy price increases. While a national decision has been made to maximize conservation efforts through the decontrol of energy prices, a complementary program of targeted tax incentives to accelerate the replacement of obsolete equipment with more energy-efficient equipment should be considered, as well.

Finally, the Nation should develop, in concert with our allies, an explicit national policy toward OPEC, including an adequate program of petroleum reserves. A major objective of that policy should be to promote the same price stability in oil that is normally assumed for most goods in international commerce.

Such a policy would require that our own government take serious steps to reduce our vulnerability to price shocks. The most effective step that the United States can take in protecting its economy from the shock of oil price increases is to develop adequate reserves of petroleum and petroleum substitutes. The importance of such reserves can be seen to some degree by comparing the price effects of the shut-down of Iranian oil exports in the 1978-79 winter season with the price effects of the continuing Iran/Iraq war. When the Iranian revolution virtually ended their oil production, world oil stocks were near traditional levels. Furious bidding on spot markets to supplement these reserves sent oil prices soaring. At the outbreak of the Iran/Iraq war, however, oil stocks worldwide were at their highest in history at 4.7 billion barrels. As a result, this cushion has so far prevented a duplication of the earlier run on spot oil supplies, aided in no small measure by slack oil demand.

In the past, decisions on the pace of filling the Strategic Petroleum Reserve were influenced by policy pronouncements within OPEC. The United States should now proceed to build the necessary reserves. A domestic oil reserve can take many forms, including the Strategic Reserve, industrial reserves, and increased reserves of natural gas which can displace substantial amounts of oil.

Recommendation No. 27: Regulation

We should reduce unnecessary government regulations and paperwork, and utilize the most cost-effective techniques to meet necessary regulatory objectives.

While it is difficult to quantify the effect of Federal Government regulations and red tape on inflation, there is no doubt that government regulations impose many billions of dollars of compliance costs on American businesses, which are translated directly into higher

prices. We believe that a comprehensive program to reduce inflation and improve the productivity of the American economy must include measures to improve regulatory cost-effectiveness and to reduce the unnecessary costs of redundant, ineffective, wasteful, and conflicting regulations. Measures to sharply reduce the paperwork burden of Federal rules and regulations must be taken, as well.

During the past decade and a half, the Federal Government has increasingly imposed regulation on 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 1970's with regulatory responsibilities in areas such as environmental protection, highway safety, consumer product safety, and energy production, to name only a few. Although many preexisting programs were incorporated in those agencies, this was the largest number of regulatory agencies created during any decade in the Nation's history.

These new regulatory programs usually require that businesses incur significant compliance costs which are then passed on to consumers through higher prices. While some government regulations, particularly those affecting health, safety, and the environment, have contributed to the overall social well-being of American consumers and workers—and we would not advocate rolling back the clock—the compliance and inflationary cost of regulatory programs can no longer be ignored; they must be reduced.

One approach which merits consideration is the regulatory budget. Such a budget would permit Congress to tabulate the annual cost of government regulations and limit the regulatory burden which each agency can impose on the private sector and consumers.

Enactment of a regulatory budget could make it possible for Congress and the Federal agencies to establish better priorities for the use of the Nation's resources. A regulatory budget could significantly improve the process by which regulatory agencies dictate the allocation of private resources toward important public uses. A regulatory budget would require the development of better techniques for measuring the costs and benefits of many regulatory programs.

Recommendation No. 28: Productivity

We must increase our rate of productivity growth, which requires attention to investment, employment, infrastructure, labor force, education and training, research and development, business leadership, and improved labor-management relations.

Faster productivity growth is the single most important step we can take to reduce inflation. Every increase in productivity growth results in an equal reduction in the rate of inflation compatible with a given rise in wages. Moreover, high productivity growth rates will have a cumulative effect on inflation as our industry becomes more competitive relative to that in the rest of the world. The Committee lays great emphasis on achieving a faster growth rate of productivity. Chapter IV.A, "Structural Reform: Investment and Jobs," discusses how this can be done.

Recommendation No. 29: Standby Wage-Price Control Authority

The Administration has disbanded the Council on Wage and Price Stability. While COWPS had lost effectiveness, the stubborn nature of the wage-price spiral may require some form of incomes policy. We are willing to support an Administration initiative for standby wage-price control authority. Such authority should only be invoked as part of a comprehensive anti-inflation strategy.²

The measures we have recommended so far in this chapter will help stabilize prices in the long run by reducing costs, increasing productivity, and by cutting the momentum of the core rate of inflation. While they should be implemented as soon as possible, we can expect them to have little short-term effect.

President Reagan has correctly recognized the importance of short-term symbolic actions to catch the public's attention as a prelude to a full-fledged assault on inflation. His hiring freeze, regulatory freeze, abolition of the Council on Wage-Price Stability and cuts in government travel and consulting have all contributed to a public expectation that dramatic and effective action against inflation will soon be forthcoming.

We applaud the intent of the President's initial actions and share the Administration's recognition that further steps may be necessary to root out deeply ingrained inflationary expectations. The American people have a long history of unfulfilled government promises to reduce inflation from past Administrations. They base their inflationary expectations much more on the inflation they observe in the supermarket and the department store, than on government pronouncements. The new President has proposed an extensive economic program which will be fully debated by the Congress. Yet, that program, if enacted, will operate on prices indirectly and with a lag at best and, therefore, may not effectively curb inflationary expectations. We believe that the Congress must cooperate with the President in fighting inflation and should not deny the President a full range of policy options for dealing with double digit inflation, including standby wage-price control authority if requested by him. Providing such authority, however, should be contingent upon the introduction of the comprehensive and productivity-enhancing anti-inflation program discussed above.

² Senator Bentsen has provided additional views on this section at the end of this Report.

V. INTERNATIONAL ECONOMIC POLICY

Recommendation No. 30: International Financial Institutions

We support an enlarged role for the International Monetary Fund and the World Bank to deal with oil-induced economic adjustment, and we support an enlarged role for oil-exporting nations in programs administered by these institutions.

The world economy has adjusted in the short term about as well as could be expected to the huge 1979 OPEC price hikes and to the more modest increases that occurred in 1980. However, the extent of the adjustment and accommodation to these oil price increases has been far from uniform. Thus, the non-oil exporting Less Developed Countries (LDC's) have experienced mounting payments problems of disturbing proportions. Ten years ago, the debt service payments of the 12 major non-oil exporting LDC's totaled \$1.1 billion, about 6 percent of export earnings. In 1980, after a decade of sharply mounting oil prices, such payments totaled \$16 billion, fully 16 percent of export earnings. Debt service payments could reach 21 percent of their export earnings in 1981. Since 1973, as much as one-half of the rise in debt has financed oil imports. The implications of these burdensome debt increases for the development programs of the LDC's are disturbing.

In response to the developments, the International Monetary Fund (IMF) and World Bank are expanding their aid and financing programs, and many commercial banks are rescheduling and increasing their loans. Such increased financial assistance is important, not only to the LDC's, but to the world economy generally. Moreover, oil-exporting nations should be encouraged to undertake a greater fraction of recycling in cooperation with the IMF and the World Bank.

Recommendation No. 31: Promote Worldwide Growth

The United States must work to foster economic growth and financial stability around the world, and particularly in the non-oil exporting LDC's, which now purchase 27 percent of our manufactured exports. We should support fair and reciprocal efforts to achieve freer and more open trade and capital flows in order to promote growth and adjustment in developed and developing countries.

Middle-income developing countries have joined Europe and Japan as key targets for American exporters. A substantial portion of total U.S. exports (35 percent in 1979) and an even higher percentage of manufactured exports (40 percent) are now destined for the developing world. The OPEC group has become an important market in itself (some 12 percent of U.S. exports), but the non-oil producing

countries buy more than twice as much. For some industries, the developing country markets are critically important. In 1979, almost half (some \$24 billion) of U.S. capital goods exports were destined for the developing world.

The United States is now so tied to the rest of the world that slow growth in the developing countries has become dangerous to our own domestic economic health. America has long responded to the plight of the world's poor with generosity and determination. The more recent emergence of the developing countries as a critical export market adds to the importance of a successful U.S. international development strategy.

After the first oil price shock in the early 1970's, many of the middle-income countries were able to maintain their growth plans by borrowing heavily in international capital markets. The latest jump in world energy prices, however, has seriously imperiled the economic prospects of non-oil producing members of the middle-income group. The existing debt burden and the growing reluctance of international banks to increase their lending to the developing world will make it more difficult to finance current account deficits.

Most of the middle-income countries are gradually adapting to higher energy prices. There has been an acceleration in the search for new sources of energy and an attempt to meet more of the oil burden through aggressive exporting. A severe cutback in the rate of economic growth could sharply reduce the demand for capital equipment with only modest savings in energy. With some international banks approaching their statutory lending limits and many channeling their funds to different markets, the middle-income countries will have to turn to the multilateral development banks and more importantly to the International Monetary Fund. Both the World Bank and the IMF have sought to adapt themselves to the new problem of long-term structural payments imbalances that have been a by-product of higher energy prices. The World Bank is increasing its emphasis on program rather than project lending and at the same time is moving to aid countries in planning for long-term structural adjustment.

Recommendation No. 32: Replenish IDA

World Bank lending to lower income developing countries has played a vital role in furthering international development. At the same time, it preserves a Western presence in many parts of the world and helps build the export markets of the next decade. The Congress should act favorably on the sixth replenishment of the International Development Association.

For the OPEC or non-oil producing middle-income countries, the economic future depends upon putting new resources to efficient use or obtaining foreign capital to maintain domestic growth rates. The outlook for the lower income developing countries is considerably less bright.

During the 1970's, the per capita growth rates of the lower income countries (1.6 percent per year) lagged well behind the economic performance of the middle-income group. The likelihood of additional

increases in the real price of oil coupled with stagnant world demand for their exports will only compound their difficulties.

For the most part, lower income developing countries do not have ready access to international capital markets and often find even full cost World Bank loans beyond their means. Bilateral foreign assistance programs of the industrial countries and OPEC remain valuable sources of foreign exchange. In many cases, however, bilateral assistance funds have not kept pace with inflation.

Concessional loans from the World Bank and other multilateral development institutions have also become important to many lower income countries. The International Development Association (IDA), the soft loan affiliate of the World Bank, lent some \$1.4 billion in fiscal year 1980.

Without a new infusion of capital, IDA will exhaust its current resources in March of 1981. The World Bank is seeking to augment IDA's lending capacity but cannot act without U.S. concurrence. Legislation authorizing U.S. participation in the sixth IDA replenishment passed the Senate last summer and should receive favorable consideration by Congress this year.

VI. REVIEW OF THE CURRENT SERVICES BUDGET AND THE PRESIDENT'S ECONOMIC GOALS

CURRENT SERVICES BUDGET

Section 300 of the Congressional Budget Reform and Impoundment Control Act requires the President to submit a Current Services Budget to Congress on or before November 10 of each year. This budget is intended to project the estimated budget authority and outlays needed to conduct existing programs under unchanged policies for the next fiscal year. To the extent mandated by law, these current services estimates take into account the impact of anticipated changes in economic conditions, such as unemployment, inflation, beneficiary level changes, pay increases, or benefit changes. Preparation of a Current Services Budget was mandated to provide the Congress with adequate information and a benchmark data base for use in assessing new budget proposals and in preparation of the budget for the next fiscal year.

To ensure availability of this data in a timely fashion, the Act originally required the Joint Economic Committee to report to the Budget Committees by December 31 with a review and evaluation of the estimates and economic assumptions utilized in the Current Services Budget. Compliance with the two dates set forth in the Congressional Budget Reform and Impoundment Control Act would result in current services estimates which do not parallel those utilized in preparation of the Administration's budget, submitted in January of each year. In order, therefore, to comply with the intent of that Act, waivers have been granted frequently since passage of the Act to permit inclusion of current services budget estimates with annual budget submissions. This adjusted timetable has been found to be satisfactory.

Recommendation No. 33

The Congressional Budget Reform and Impoundment Control Act of 1974 should be modified to require submission by the President of a Current Services Budget by January 31 of each year, with the Joint Economic Committee evaluation to follow by March 1. This change would make the law consistent with the present satisfactory practice.

The economic assumptions presented in the Current Services Budget are identical to those presented in the previous Administration's fiscal year 1982 budget documents. For purposes of comparison, we have prepared our own economic assumptions which depict the economic

outlook in the absence of policy changes. The estimates, summarized in Table VI-1, were developed utilizing the program assumptions noted in the recent Administration's Special Analysis of the Budget for Fiscal Year 1982.

TABLE VI-1.—JOINT ECONOMIC COMMITTEE CURRENT SERVICES BUDGET ECONOMIC ASSUMPTIONS
[Calendar years]

Economic assumptions	1981	1982	1983
Gross national product ¹	2,858.2	3,238.0	3,611.9
Constant 1972 dollar GNP ²	0.7	2.8	1.5
Unemployment rate ³	7.9	7.5	7.8
Urban Consumer Price Index ³	11.5	10.0	9.3
GNP implicit price deflator ²	10.2	9.8	9.3

¹ Billions of current dollars.

² Percent change, 4th quarter over 4th quarter.

³ Percent, 4th quarter.

Examination of the Current Services Budget in light of these assumptions reveals that the Federal deficit in calendar 1981 may be slightly larger than projected by the Carter Administration. This is the result of slower growth in tax receipts this year due to a lower level of economic growth than assumed in the Carter Administration's projections.

This increase in the deficit magnifies the concern of the Committee with the explosive growth in Federal outlays. Over the past six years, the growth in such outlays has averaged \$56 billion. Yet, efforts to slow this growth in outlays must confront the reality that the bulk of Federal outlays are mandated by statute or spent to honor contracts and obligations made in past years.

In fiscal year 1981, for example an estimated 75.9 percent of Federal budget outlays are of a relatively uncontrollable nature, as summarized in Table VI-2. Projected defense outlays proposed by the Carter Administration represent an additional 15.3 percent, leaving less than 10 percent of all fiscal year 1981 outlays devoted to controllable civilian programs. These civilian program outlays will total \$65.1 billion in fiscal year 1981, but were projected to decline to \$63.4 billion in fiscal year 1982 by the Carter Administration and to comprise only 8.5 percent of all outlays that year.

Inflation also complicates the problem of reducing Federal outlays. The current services estimates for fiscal year 1982 reveal that over 30 percent or \$230 billion of total outlays are indexed to the Consumer Price Index, including social security and supplemental security payments, and railroad, veterans, and Federal employee retirement benefits. Inflation directly affects a host of prior-year Federal contracts and obligations containing escalator clauses as well. And outlays for both Medicare and Medicaid programs, while not indexed, rise with the increase in service-provider charges. As a result, half or more of all Federal outlays march in step with inflation, either as a consequence of legal mandate or by private convention.

TABLE VI-2.—RELATIVELY UNCONTROLLABLE BUDGET ITEMS,¹ FISCAL YEAR 1981

Budget items	Outlays	
	Percent	Billions
Social security and railroad retirement.....	21.7	\$143.5
Prior-year contracts and obligations.....	15.3	101.3
Net interest.....	10.1	67.0
Medical care (civilian, veterans).....	8.5	56.5
Military and civilian Federal retirement.....	6.2	40.8
Unemployment assistance.....	3.9	26.0
Child nutrition and food assistance.....	2.2	14.9
General revenue sharing.....	0.8	5.2
Housing assistance.....	1.0	6.6
Assistance to students.....	5.6	36.8
Other.....	0.6	4.4
Subtotal.....	75.9	503.0
Controllable outlays:		
Military.....	15.3	101.2
Civilian.....	9.8	65.1
Undistributed employer share, employee retirement.....	-1.0	-6.6
Total.....	100.0	662.7

¹ Fiscal year 1982 budget, table 17.

The effects of inflation and the growth in relatively uncontrollable outlays as a share of Federal spending have severely constrained the flexibility of Congress and the Executive Branch to control such spending. But it has not diminished the importance played by Federal tax and spending policies in attaining mandated economic goals.

THE PRESIDENT'S ECONOMIC GOALS

Under provisions of the Employment Act of 1946 as amended by the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act), the Joint Economic Committee is required to review and analyze the *Economic Report of the President*. That review, in part conducted with hearings, is to include an analysis of progress toward the economic goals set forth in the Report.

The Carter Administration proposed six initiatives to reduce taxes and 17 steps to boost taxes which combine to yield a net proposed tax increase of \$2.5 billion in 1981 and \$5.3 billion in 1982. The major tax reduction occurs from a proposed simplification and acceleration in depreciation tax allowances, while the major proposed tax increase is a 10-cent-per-gallon hike in the motor fuel and highway use tax.

A variety of spending increases and decreases were proposed as well, as summarized in Table VI-3. Suggested increases totaling \$19.1 billion above the current services outlay level for 1982 are concentrated in defense (57 percent) and refundable tax credit payments (22 percent). The latter are largely designed to improve the capability of firms with limited earnings to make substantial investments which boost productivity and employment. Suggested spending decreases are \$15.9 billion below the current services outlay level. The cuts are concentrated in reduced pay-raise proposals (36 percent) for Federal civilian and military employees, and modifications in entitlement formulas for the unemployed (14 percent) and indexation formulas (11 percent) for Federal retirees, food stamps, dairy, and child nutrition programs.

TABLE VI-3.—Differences between administration's 1982 budget request and current services levels

Category	[In billions of dollars]	Outlays
Current services estimates for 1982		736.2
Decreases:		
Defense, pay raise allowance		-3.5
Defense, retired pay proposals		-0.5
Defense, stockpile sales proposal		-0.2
Export-Import Bank		-0.1
Employment and training assistance		-0.1
Payment to the Postal Service		-0.4
Federal impact aid to education		-0.4
Loan guarantees to students and parents		-0.6
Medicare and medicaid proposals		-0.5
Civil service retirement indexation proposal		-0.7
Unemployment compensation proposals		-2.2
Housing assistance		0.1
Food and nutrition assistance		-0.5
Public assistance program reform		-0.5
Civilian agencies, pay raise allowance		-2.3
Other		-2.9
Subtotal decreases		-15.9
Increases:		
Defense—military, program increases		10.0
Atomic energy defense activities		0.8
Foreign economic and financial assistance		0.3
Science and space programs		0.3
Federal Crop Insurance Corporation		0.1
Highway programs		0.1
Rural development business assistance proposals		(¹)
Student financial assistance (grants, etc.)		0.4
Youth education and training proposal		0.1
Economic revitalization—refundable tax credit proposals		4.2
Allowance for contingencies		1.0
Other		1.7
Subtotal, increases		19.1
President's request for 1982		739.3

¹ \$50 million or less.

Source: Fiscal year 1982 budget, special analysis table A-12.

These proposed spending increases and decreases would result in a net increase of \$2.3 billion in estimated 1981 outlays over current service levels, and \$3.1 billion in 1982. The net effect of both the recent Administration's proposed tax and spending changes is a modest (\$200 million) reduction in the estimate (current services) budget deficit in 1981 and a somewhat larger \$2.2 billion reduction in 1982.

The Carter Administration viewed these modifications in existing tax and spending levels as appropriate to slow inflation and boost real growth. Specifically, President Carter projected that these policies would result in little or no growth in the first and second quarters of 1981, followed by a sharp recovery the balance of the year. A real GNP rise of 1.7 percent was projected for 1981, followed by a more robust 3.5 percent rate over 1982. Labor market growth in 1981, combined with only modest real GNP growth, would prevent reduction in the jobless totals during 1981. The higher growth in economic activity

would result in a gradual reduction in unemployment during 1982. Inflation was not projected to slacken noticeably in 1981 from its pace last year, but to abate by a large 3 percentage points in 1982.

As a first step in assessing these economic policies and the Carter Administration's goals, the near-term effect of its suggested tax and spending policies was evaluated by the Joint Economic Committee. This evaluation utilized Current Services Budget assumptions noted in Table VI-1 adjusted for proposed policy changes.

We believe the Carter Administration's forecast of what would occur in 1981 if its proposals were followed is overly optimistic. Our analysis suggests that real growth in 1981 would reach about 1 percent under the recent Administration's policies, while unemployment would rise to an average 7.9 percent by the fourth quarter, slightly higher than the Carter Administration's forecast. The results are summarized in Table VI-4.

TABLE VI-4.—NEAR-TERM FORECASTS, CALENDAR YEAR 1981

	Carter ¹	Joint Economic Committee
Constant dollar GNP ²	1.7	1.0
GNP implicit price deflator ²	10.4	10.5
Urban Consumer Price Index ²	12.6	12.2
Unemployment rate ³	7.7	7.9

¹ Short-Range Economic Forecasts, pt. 2, fiscal year 1982 budget.

² Percent, 4th quarter over 4th quarter.

³ 4th quarter.

The intent of the Humphrey-Hawkins Act is to focus national policy sharply on the rapid attainment of full employment, price stability, and other goals, including reduction in Federal outlays as a share of GNP to 20 percent. Progress toward these goals is to occur according to a timetable of numeric interim- or medium-term goals set forth in the Act. Goals of 3 percent for inflation and 4 percent for unemployment are set by the Act for 1983, and Federal outlays equal to 21 percent of GNP for 1981. Implicit in the attainment of these goals is maintenance of a robust rate of real economic and productivity growth. The Act imposes an obligation on the President to pursue economic policies compatible with these interim goals and to outline those policies in his Annual Economic Report.

The Nation has not succeeded in achieving the goals of the Humphrey-Hawkins Act. Since passage of that Act in October, 1978, unemployment has increased over 2 million to 7.4 percent from 5.7 percent, inflation as measured by the Consumer Price Index has accelerated to an annual rate of over 12 percent from 9 percent, and Federal outlays as a share of GNP reached levels not seen since the war year of 1945. The fact that we face another year of stagflation and double-digit interest rates suggests we could be even further from attainment of our goals a year from now.

The new Administration should comply with requirements of the Full Employment and Balanced Growth Act by establishing an explicit timetable for attaining the Interim Economic Goals specified in that Act.

In addition to mandating the pursuit of policies to promote full employment and price stability, the Humphrey-Hawkins Act requires annual submission to Congress by the President of an Investment Policy Report. The Carter Administration did not submit such a separate report, although it did discuss investment needs in the Economic Report.

The President is further required to:

Provide an assessment of the levels of investment capital available required by, and applied to, small, medium, and large business entities;

Provide an analysis of current and foreseeable trends in the level of investment capital available to such entities; and . . .

Provide and assess Federal policies and programs which directly, or through grants-in-aid to State or local governments, or indirectly through other means, affect the adequacy, composition, and effectiveness of public investments, as a means of achieving the goals of this Act and the Employment Act of 1946.

The new Administration should comply with requirements of the Full Employment and Balanced Growth Act by submitting an Investment Policy Report in conjunction with its Annual Economic Reports.

VII. REVIEW AND OUTLOOK FOR THE ECONOMY

The slump that many economists had been predicting since late 1978 finally arrived in the first half of 1980. Real GNP in the second quarter dropped at an annual rate of 9.9 percent, the most rapid rate of decline since 1946. The unemployment rate rose from 6.2 percent in February to 7.6 percent in May.

The recovery since has been weak and tenuous. The economy did improve in the last half of the year, but not enough to offset the spring slump. Although real output rose by 2.4 percent in the third quarter and 4.0 percent in the fourth quarter, it was still 0.3 percent below the fourth quarter 1979 level at the end of 1980. Unemployment leveled off after May and dipped slightly to 7.4 percent by December. Housing starts and auto sales are both still well below the levels reached in each of the years 1976 through 1979. And another decline in economic activity early this year is a possibility, with a stagnant recovery thereafter.

The spring slump was caused in part by the disastrous inflation in the first quarter of 1980 and the subsequent policy responses. Inflation in the first three months of 1980, as measured by changes in the Consumer Price Index, marked the culmination of a period of two and one-half years during which the annual rate of increase in the CPI ratcheted upward from less than 5 percent to nearly 20 percent.

TABLE VII-1

Period :	CPI ¹
July 1977 to December 1977.....	3.7- 4.9
January 1978 to January 1979.....	7.4-11.4
February 1979 to December 1979.....	12.6-15.4
January 1980 to March 1980.....	18.2

¹ Monthly increase, seasonally adjusted annual rate.

Following the first quarter's increase at an 18.1 percent rate, the CPI rose at an 11.6 percent annual rate in the second quarter, followed by 7.0 percent in the third quarter (including an anomaly of no change in July), and 12.8 percent in the fourth quarter. A breakdown or recent changes in the CPI by component is presented in Table VII-2. The relative importance of each component (share of the typical household's 1972-73 budget, at December 1979 prices, without allowance for any changes in buying patterns since 1972-73) and the contribution to 1980 inflation (based on the 1980 increase in the CPI and on the December 1979 relative importance) are also shown. The CPI has recently exhibited more volatility than other measures of inflation, as shown in Table VII-3.

TABLE VII-2.—SOURCES OF INFLATION IN THE CONSUMER PRICE INDEX (CPI-U), 1976 TO 1980

Item	Rate of increase in the CPI ¹									Relative Importance, December 1979	Contribution to 1980 inflation ³
	Years ²					1980					
	1976	1977	1978	1979	1980	I	II	III	IV		
Food.....	0.6	8.0	11.8	10.2	10.2	3.8	5.6	18.9	12.5	17.7	1.8
Home purchase.....	4.3	8.4	11.2	15.8	11.4	7.0	14.9	14.9	9.0	10.4	1.2
Mortgage interest cost ⁴	-7	10.8	22.0	34.7	27.6	42.8	39.2	-37.7	41.1	8.7	2.4
Energy.....	6.9	7.2	8.0	37.4	18.1	64.8	8.1	2.9	6.1	10.3	1.9
Used cars.....	19.0	-4.1	13.6	2.2	18.3	-2.5	-16.8	40.1	71.9	2.8	.5
Other.....	6.4	6.1	6.3	7.7	9.1	12.1	8.8	9.4	6.6	50.1	4.6
Total.....	4.8	6.8	9.0	13.3	12.4	18.1	11.6	7.0	12.8	100.0	12.4

¹ Quarterly changes at seasonally adjusted annual rate, last month in quarter over last month in previous quarter.

² December to December basis.

³ Product of the 1980 increase and the December 1979 relative importance of each item.

⁴ Changes in mortgage interest cost component reflect changes in home prices as well as changes in mortgage interest rates.

TABLE VII-3.—MEASURES OF INFLATION, 1976 TO 1980

Price index	Years ¹					1980 ²			
	1976	1977	1978	1979	1980	I	II	III	IV
GNP deflator.....	4.7	6.1	8.5	8.1	9.8	9.3	9.8	9.2	10.7
Personal consumption expenditure deflator.....	5.0	5.9	7.8	9.5	10.0	12.0	9.8	8.8	9.6
Producer Price Index ³	3.7	6.9	9.2	12.8	11.7	17.5	8.4	13.5	7.8
Core rate ⁴	7.5	7.5	7.9	8.2	9.0	8.6	8.9	9.1	9.3
Consumer Price Index ⁵	4.8	6.8	9.0	13.3	12.4	18.1	11.6	7.0	12.8
CPI-X1 ⁶	5.1	6.3	7.9	10.8	10.8	14.6	7.8	11.3	9.3

¹ 4th quarter to 4th quarter; 1980 data are preliminary.

² Quarterly change at seasonally adjusted annual rate; 1980: IV data are preliminary.

³ Finished goods, December to December.

⁴ As estimated by Data Resources, Inc.

⁵ December to December.

⁶ Bureau of Labor Statistics alternative to the Consumer Price Index, based on a rental equivalence measure of homeownership costs.

Interest rates rose sharply in response to the inflation in the first quarter. The prime rate jumped from 15.25 percent in December to a then-historic high of 20 percent in early April, and the yield on 3-month Treasury bills increased from 11 percent in December to 16.5 percent at the end of March. Within the space of 5 months, the estimated resulting total paper loss on the bond market exceeded \$500 billion.

Five policy steps were taken on March 14 following the first quarter's inflation and the resulting effects on financial markets and inflationary expectations:

(1) Budget revisions which called for a balanced budget in fiscal year 1981 were submitted to Congress.

(2) Voluntary prenotification of price increases by large firms and an increased staff for the Council on Wage and Price Stability were requested.

(3) Steps to encourage energy conservation, including a gasoline conservation fee of about 10 cents per gallon, were advocated.

(4) Structural changes to encourage productivity growth, savings, and research and development were recommended.

(5) The President authorized the Federal Reserve to institute a system of credit controls. (Details are discussed in the *Economic Report of the President*).

The effort to balance the fiscal year 1981 budget was ultimately unsuccessful; in President Reagan's February 18 message the estimated fiscal year 1981 deficit under current law is \$48.8 billion. This deficit is largely a consequence of the weakness in the economy. The size of the fiscal year 1981 deficit obscures the shift toward fiscal restraint which did occur last year. This restraint can be measured by the increase in the high employment budget surplus (HES). According to the 1981 *Economic Report of the President*, the adjusted HES rose by approximately \$10 billion over the four quarters of 1980.

The last of the March 14 measures had the largest impact. Total consumer installment credit outstanding, which had grown at an annual rate of 11.2 percent over the previous 6 months, fell at an 11.9 percent rate between March and June. Commercial bank loans to business and industry dropped at a 9.4 percent rate over the same period, after rising at a 12.2 percent rate over the previous 6 months. Many consumers apparently thought that they could not use their credit cards at all, and some returned them.

TABLE VII-4.—MEASURES OF REAL ECONOMIC ACTIVITY, 1976 TO 1980

Indicator	Years ¹					Quarters ²				
						1980				
	1976	1977	1978	1979	1980	1979: IV	I	II	III	IV
Real GNP ³	4.4	5.8	5.3	1.7	-0.3	0.6	3.1	-9.9	2.4	4.0
Real final sales ³	4.0	5.4	5.2	2.5	0.1	2.9	3.1	-10.4	4.1	4.3
Unemployment rate.....	7.7	7.0	6.0	5.8	7.1	5.9	6.2	7.3	7.5	7.5
Housing starts ⁴	1.54	1.99	2.02	1.75	1.29	1.58	1.23	1.06	1.39	1.53
Auto sales ⁴	9.9	11.0	11.2	10.6	9.0	9.8	10.8	7.6	8.8	9.1
Import share (percent).....	15.1	18.8	17.9	22.1	26.7	24.4	26.5	27.5	26.0	27.1
Prime rate.....	6.8	6.8	9.1	12.7	15.3	15.1	16.4	16.3	11.6	16.7
Mortgage rate.....	9.0	9.0	9.5	10.8	12.7	11.4	12.1	13.1	12.4	13.0
Federal deficit ⁵	53.6	46.4	29.2	14.8	61.6	24.5	36.3	66.5	74.2	-----
Corporate profits ⁶	166.3	192.6	223.3	255.4	242.7	255.4	277.1	217.9	237.6	-----
Productivity ⁷	2.3	2.2	-0.4	-1.1	-0.1	-0.3	0	-3.0	3.7	-1.1

¹ Yearly changes on 4th quarter to quarter basis.

² Quarterly data at seasonally adjusted annual rate.

³ Percent change; data for 1980 and 1980: IV are preliminary.

⁴ Millions of units.

⁵ Billions of dollars, National Income Accounts basis, calendar years.

⁶ Billions of dollars, before taxes.

⁷ Change in output per hour, nonfarm business sector.

To date, the economic policy steps taken in March appear to have had two results. First, the sharply accelerating inflationary expectations of early 1980 appear to have been reduced. But the underlying core rate of inflation, shown in Table VII-3, appears to have been little affected by the March policy steps.

Second, the slump was undoubtedly exacerbated by the credit controls. Real consumer spending for durables fell at a 43-percent annual rate in the second quarter. Unemployment rose from 6.2-6.3 percent in the first months of the year to the 7.4- to 7.6-percent range for the last eight months. Even in hindsight, it is difficult to judge whether the March policy steps were successful; such a judgment would require

comparing the gain from reduced inflationary expectations against the cost in higher unemployment and lost production. Whatever the verdict, it is clear that today we are faced with unacceptably high rates of both inflation and unemployment.

In 1980, we witnessed some of the most volatile movements in the rate of growth of the monetary aggregates and in interest rates in recent years. The Federal Reserve, consonant with its procedure adopted in October 1979, set targets for money supply growth for the fourth quarter of 1979 through the fourth quarter of 1980. These were:

3.5 to 6 percent for M1-A (currency plus commercial bank demand deposits).

4 to 6.5 percent for M1-B (M1-A plus other demand deposits).

6 to 9 percent for M2 (M1-B plus overnight repurchase agreements (RP's) issued by commercial banks, overnight Eurodollar deposits held by U.S. nonbank residents at Caribbean branches of U.S. banks, money market mutual fund shares, and savings and small time deposits at all depository institutions).

6.5 to 9.5 percent for M3 (M-2 plus large time deposits at all depository institutions and term RP's issued by commercial banks and savings and loan associations).

For the year, M1-A growth (5.0 percent) fell within the target range, but the growth rates of M1-B (7.3 percent), M2 (9.8 percent), and M3 (9.9 percent) were above the upper targets. M1-A, and M2, and M3 grew somewhat faster than in 1979, but the opposite was true for M1-B. The long-run implications of this are uncertain, but the short-run variations from the trend range did lead to volatile interest rates and financial markets.

The 6.4 percent increase in the trade weighted average value of the dollar in 1980 resulted primarily from the large differentials between U.S. interest rates and interest rates in other industrial countries. The U.S. merchandise trade deficit was \$26.7 billion in 1980, down from \$29.4 billion in 1979 and \$33.8 billion in 1978, due to strong exports and a slowdown in nonpetroleum imports. Petroleum imports increased by near \$19 billion, as a 20-percent drop in volume was more than offset by price increases. The overall current account deficit was only \$0.1 billion through the first three quarters.

The ranges in the most recent forecasts for 1981 and 1982 by five leading private economic forecasters are summarized in Table VII-5. In making comparisons, it should be kept in mind that forecasts with econometric models may differ for three distinct reasons:

(1) Differences in assumptions about economic policy and other factors exterior to the models.

(2) Differences in the structures of the models themselves (for example, variations in estimated responsiveness to price and tax rate changes, importance of consumer and business expectations differences in the degree of disaggregation, etc.).

(3) Differences in any judgmental adjustments to the forecasts yielded by the model.

For these reasons, the relative "optimism" or "pessimism" of any given forecast cannot be determined precisely without comparing all these factors with other forecasts. However, several general comments can be made.

TABLE VII-5.—RANGE OF ECONOMIC FORECASTS FOR 1981 TO 1982¹

	DRI		Chase		Wharton		Evans		M. Lynch		
	1980 actual	1981	1982	1981	1982	1981	1982	1981	1982	1981	1982
Real GNP ²	-0.3	0.8	3.9	1.6	3.7	2.2	3.6	3.0	5.7	0.7	6.1
Consumer Price Index ²	12.6	11.5	9.9	11.5	9.1	12.3	10.1	10.9	10.0	8.7	6.6
GNP deflator ²	9.8	10.4	9.5	10.4	8.4	10.0	9.5	9.1	9.0	7.9	6.6
Unemployment rate ³	7.5	7.6	7.0	8.2	7.5	7.6	7.6	7.2	6.1	8.1	7.0
Prime rate ³	16.7	14.5	16.3	16.8	14.2	15.6	12.9	12.6	12.8		
Housing starts ⁴	1.29	1.39	1.83	1.43	1.76	1.48	1.86	1.59	2.01	1.50	1.82
Auto sales ⁴	9.0	9.4	10.4	9.3	10.3	9.4	9.9	9.5	10.9	9.6	11.0
Federal deficit ⁵	61.6	67.8	70.2	71.1	70.1	67.8	80.0	49.2	35.8		
Corporate profits ⁶	243	230	264	244	294	214	243	237	310	252	312
Productivity ⁷	-1	.5	2.5	.6	1.9	.7	2.0	2.1	2.0		

¹ Based on the following 5 forecasts: (A) Data Resources, Inc., Jan. 27, 1981. (B) Chase Econometric Associates, Inc., Jan. 26, 1981. (C) Wharton Economic Forecasting Associates, Inc., Jan. 29, 1981. (D) Evans Economics, Inc., Jan. 30, 1981. (E) Merrill Lynch Economics, Jan. 20, 1981 (forecast through 3d quarter of 1982).

² 4th quarter to 4th quarter percentage change.

³ 4th quarter average.

⁴ Millions of units, annual total.

⁵ Billions of dollars, National Income Accounts calendar year basis.

⁶ Billions of dollars, before taxes.

⁷ Nonfarm business sector, change in output per hour, 4th quarter to 4th quarter.

Forecasters are divided on whether or not we will experience a "W-shaped recession," with another drop in real GNP in early 1981; but this question is not really of major consequence. The important point is that almost all forecasters foresee a very sluggish recovery for the remainder of 1981 and early 1982. Due to this stagnation, unemployment is predicted to be 7.2-8.2 percent in the fourth quarter of 1981 and in the 6.1-7.6 percent range by the end of 1982. In comparison with other postwar recoveries, this would be about the weakest. For example, if the trough of the 1980 recession was in the second quarter, an unemployment rate of 7.6 percent or more six quarters after the trough, as predicted by four of these forecasters and President Reagan's February 18 report, would exceed the trough rate—this would be unprecedented, and the rate would approximately equal that six quarters after the trough of the 1973-75 recession.

There are several reasons why most forecasters foresee such a slow recovery:

(1) Real disposable income is expected to be flat, with gains in nominal income at best continuing to stay even with price increases, and social security and inflation-induced income tax rate increases.

(2) Personal consumption was 94.4 percent of disposable income in 1980 versus an average of 92.9 percent for the 1970's; this consumption ratio is unlikely to rise much higher.

(3) Continuing high interest rates will discourage purchases of homes and consumer durables, especially automobiles.

(4) Inventory investment is unlikely to show strength, although by December the total business and retail inventory-sales ratios had both fallen below the December 1979 levels; also high interest rates encourage lean inventories.

(5) Real defense spending will rise, but real Federal nondefense spending and real State and local government outlays will both decline. Overall, DRI estimates that real government spending for goods and services will decrease by 0.8 percent.

(6) Real net exports in 1980 were \$52.2 billion, 3.5 percent of real GNP, the highest percentage since 1947, though nominal net exports were only 1.0 percent of nominal GNP. Higher OPEC prices and recessions abroad may reduce net exports in 1981.

The main hope for a faster recovery lies with nonresidential fixed investment. This may be helped by tax incentives, but it currently amounts to only 10.5 percent of real GNP, thus even a 20 percent increase would raise real GNP by only 2 percent; further, high interest rates and low capacity utilization will continue to deter capital spending; and there are usually significant lags in the effects to policy changes in this area.

With regard to inflation, the outlook is for continued significant price increases through 1982. Factors behind this continued high inflation include the following:

(1) The momentum built up by past wage and price increases persists in the face of slack demand in labor and product markets. For example, in 1980 average hourly compensation in the nonfarm business sector rose by 10.0 percent (12.1 percent in manufacturing). In 1981, this momentum will continue. The collective bargaining calendar will be relatively light, but more than 10 million workers will receive automatic pay increases from deferred wage increases in contracts negotiated in earlier years or from cost-of-living adjustments.

(2) The recent and prospective poor rates of productivity growth mean that almost all increases in compensation are reflected in unit labor cost and passed through into higher prices. And in the longer run our recent drop in the rate of productivity growth has a multiplier effect on inflation, as the productivity-induced increase in inflation becomes part of the wage-price spiral.

(3) Food prices rose by 10 percent in 1980 and probably will continue rising at least as rapidly in 1981.

(4) Energy prices rose by 18 percent rate in 1980 and could increase nearly as fast in 1981.

(5) Restrictive monetary policy should in the long run reduce the rate of inflation. However, in the short run, the resulting high interest rates are a cost which is usually passed through in prices. In addition, the lags between monetary changes and effects seem unclear; recent and future financial innovations such as NOW accounts have further complicated matters; and the breakdown of the effects of changes in the money supply between price and real output is uncertain.

(6) A variety of government policies such as indexed programs, the increases in the minimum wage and social security tax rates, and oil price decontrol in 1981 will contribute to inflation, at least in the short run.

ADDITIONAL VIEWS OF REPRESENTATIVE LEE H. HAMILTON

INTRODUCTION

The 1981 Annual Report of the Joint Economic Committee builds constructively on the recent supply-side initiatives of the committee and lays the basis for renewed economic growth in the 1980's. Chairman Reuss and the other members of the committee deserve our congratulations and our support.

I am very pleased to see that the members of the Joint Economic Committee have maintained their commitment to restrained monetary and fiscal policy. By keeping a firm hand on government spending and fiscal policy, some of the burden can be taken off the Federal Reserve. Lower interest rates will help stimulate needed capital investment as they contribute to lower inflation. The centerpiece of our report is the development of a comprehensive investment and jobs strategy. It extends our past emphasis on increasing capital investment.

Because our Annual Report has focused on the basic elements of a new economic strategy, we did not explore all of the details of several key programs. I want to take this opportunity to elaborate my own thinking on the future direction of our economic policy.

LONG-TERM POLICY

The United States has just passed through a decade of frustration and disappointment with the performance of the American economy. Although we remain the world's largest and most prosperous major economy, we enter the 1980's with an unsatisfactory rate of economic growth and high rates of inflation and unemployment. Because the economy has been weak, one often encounters a real doubt that the current economic system can weather its problems. It is important for all of us to remember that our free enterprise system has been extraordinarily resilient, creative, and dynamic. Its staying power should never be underestimated. Proposals to improve it should build on its underlying strengths.

Our approach to the economy should be marked by several features: an emphasis on the free market and skepticism about the advantage of government intervention; a simple candor which acknowledges that the system is not working well, that major changes are needed, and that no one can be sure of having all the answers; and a reorientation of policy away from short-term solutions and toward long-term ones.

Our principal economic goal must be to achieve economic growth with reasonable price stability and full employment. Achieving that goal will not be easy, but neither will it be impossible. Our long-term

strategy must deal principally with productivity, inflation, employment, and the links among them. It must also consider the institutional framework in which economic decisions are made.

Productivity

For most of the post-war era, the average American worker produced between 2 percent and 3 percent more each year. During the 1970's, however, the growth of productivity slowed and then stagnated.

Various steps can be taken to raise productivity. Capital investment should be stimulated by cuts in taxes on capital gains and corporate profits. More generous investment tax credits and liberalized depreciation writeoffs could also be useful. Tax incentives to spur research and development by businesses are long overdue. In addition, the Government should consider direct spending to support such efforts when the benefits to society from improved technology would outweigh the costs. Grants for promising research and development should be exempt from the budgets cutter's knife.

Beyond these steps, there are many others to be taken. Problems of morale in the workplace might be corrected by joint labor-management committees. Inexperienced workers should be helped by special programs of on-the-job training. Regulation must be reduced where possible and redtape be held to the very minimum. We must concentrate on balancing the costs and benefits of all regulations, with special attention to cost effectiveness. We must try to even out the impact of regulation, take a case-by-case approach to the issue of deregulation, make regulators more accountable to the public, and speed up the regulatory process. A final regulatory consideration is just as critical as any of these: Congress must make sure that all regulation is guided by well-defined goals of public policy.

Inflation

Throughout the 1970's historically high rates of inflation have discouraged investment, distorted investment decisions, eroded the savings of many Americans, and clouded our future with economic uncertainty. Inflation is the Nation's most serious economic problem.

We should attack inflation across a broad front. We need to adjust gradually the balance between monetary and fiscal policy. A relatively loose fiscal policy has put too much burden on monetary policy. The high interest rates—which come with tight monetary policy—discourage, rather than stimulate, investment in new plant and equipment. The policy of regular and massive deficits in the Federal budget must be ended. Government expenditures should be reduced as a percentage of the gross national product. The total impact of government spending on the economy should be diminished. The growth of the money supply must be carefully monitored to avoid inflation-generating surges of credit. Reduced deficits would ease pressure on the Federal Reserve. Federal borrowing in private-sector money markets would then be lessened as we slowed the growth in the money supply and moved toward a policy of steady monetary growth.

Indexation of taxes and government programs is itself inflationary, so it should be avoided to the extent possible. The Consumer Price

Index should be revised since the current method of calculating it overstates housing costs. Because of indexation, an artificially high CPI itself contributes to inflation.

Competition must be prompted because it forces prices down, and special incentives must be used to stimulate the growth of small business. Trade barriers should be lowered, and protectionism should be resisted because it means less competition and more inflation. Exports should be increased because a loss of exports weakens the dollar, and every depreciation of the dollar is inflationary.

We must shake off our dependence on foreign oil. The astronomical increase to oil prices in recent years, brought on in large measure by the oil cartel, has sent inflationary shocks through the economy. Programs to diminish the use of oil, both by conservation and the development of substitute fuels, are essential.

The Government must do a better job when it considers the narrow demands of many small but powerful constituencies. In responding to such demands, the Government often gives long-term price stability a lesser priority than it should have. The Government should not be an inflationary price setter. It should also encourage labor and business support for voluntary wage and price restraint. As a part of his economic tool kit, the President should have the authority to impose mandatory wage and price controls as a last resort. Finally, a number of specific steps must be considered, such as holding down Federal pay raises and urging State and local governments to cut sales and property taxes.

Employment

For several years, the American economy has grown by fits and starts. Despite considerable expansion, it has not been able to provide enough jobs for a growing work force. As we enter the 1980's, the rate of unemployment still hovers well above the 7 percent mark. Rapid increases in the labor force and the accelerating pace of industrial change have contributed to the discouraging picture.

Getting the country growing again is the single most important way to bring unemployment under control. Growth, however, will not solve all our problems. Several of America's basic industries will have to undergo major retooling before they can return to prosperity. The comprehensive investment strategy in this report is a clear response to such needs.

Because millions of Americans lack the skills of training to make their way in an increasingly specialized industrial economy, government, business, and labor must work together to open up new opportunities for the chronically unemployed. The targeted jobs tax credit is one device that Congress has developed to help cut down on joblessness. We need to develop others. The transition from school to work often leaves many young Americans without jobs. Part of the problem has been vocational training programs that are not geared to the modern marketplace. The general level of technical education has also been a problem. We should make every effort to see that the transition from school to work takes place as smoothly as possible.

Institutions: Consensus Building

In developing a comprehensive, long-term approach to our economic ills, we must begin to think about new ways of governing, doing business, and working. In some instances, we may need to start building new institutions as well. We have somehow lost the underlying American consensus that provided the basis for American leadership overseas and domestic prosperity at home. More than isolated tax changes, government subsidies, or higher rates of investment, it is the underlying consensus that we must forge anew.

We cannot build a successful economic policy without the broad support of the American public. When Federal spending is cut or taxes reduced, for example, the changes must result in as fair a sharing of the burdens and benefits. When incentives for saving are proposed, for example, they should be designed to draw upon the resources of the American middle class as well as the upper income groups. In effect, we cannot rebuild the economy by paying attention to one group alone. Government must join with labor, business, and other groups to put America back on the path to prosperity.

SHORT-TERM INITIATIVES

There are several economic actions which will have the right impact in the short term and still help us achieve our long-term objectives. As the report notes, we should move immediately to stimulate capital formation by allowing firms to write off investments in a shorter period of time. We should also move quickly to get the growth of Federal spending under control. There are many areas of the budget, identified by the Congressional Budget Office and in President Reagan's Program of Economic Recovery, where cuts are desirable and possible. Substantial cuts can and should be made in line with a gradual reduction of the size of the Federal Government relative to the economy.

Personal tax cuts, in conjunction with spending cuts, are also desirable, but they should be initiated with considerable care. They should come only after spending cuts are assured, and they should not exceed the spending cuts. For several years we have stressed the desirability of making personal cuts in a form that will also fight inflation and spur the growth of productivity. In this report we mention a partial offset of the payroll tax as one method that would reduce the tax burden on the average American and that could contribute to the supply side of the economy. There is considerable merit in searching for some way to trim social security taxes for both workers and individual businesses, but the change should come in a manner that neither endangers the integrity of the trust funds nor expands the Federal deficit.

As we gradually decrease the relative size of the Federal Government, there will be more opportunity to reduce individual taxes. In the short run, however, if the spending cuts are ignored, the combination of increases in defense spending, costly investment incentives, and large personal tax cuts could lead to further inflation, high interest rates, or very severe spending reductions in the future.

LEE H. HAMILTON.

ADDITIONAL VIEWS OF SENATOR LLOYD BENTSEN

I have these comments to make on the recommendations and text in the Report on Monetary Policy:

Controlling inflation while stimulating productivity, savings and investment must be our major economic objectives in 1981. In monetary policy, this calls for the steady, gradual tightening of monetary targets by the Federal Reserve system, a policy which must take precedent over the accommodation of core inflation rates. Any deviation from this long term policy to accommodate sudden supply shocks must be very small, temporary and non-inflationary. Congressional review of Federal Reserve actions and monetary targets must recognize the continuing need for an independent Federal Reserve System, free of political pressure.

Interest rates are too high. The quickest way to achieve the reduction in interest rates necessary to our economic health is to reduce Federal spending and deflate inflationary expectations with a consistent moderately restrained monetary policy.

I do not indorse Recommendation No. 4 to the extent it is inconsistent with Recommendation No. 1, which I support. Monetary authorities must pursue a consistent policy of gradual restraint in order to lower inflationary expectations and interest rates. The pursuit of a monetary policy of continued gradual restraint could well require a reduction in monetary targets in 1981.

I have these comments to make on the recommendations and text in the Report on Fiscal Policy:

Large deficits in recent years, along with our poor productivity performance, are major causes of our inflation. An anti-inflationary fiscal policy requires that targeted reductions in Federal spending occur to reduce the deficit. This need to reduce Federal outlays by eliminating waste and fraud is magnified by the need to increase defense spending, increases which should be offset to the maximum extent possible by sizable reductions in Federal outlays for other programs.

The absolute necessity to control Federal deficits and inflation dictate that a moderate package of tax cuts be provided in 1981 to move us onto a path of renewed economic growth. These cuts should be balanced between individuals and businesses. The individual tax cuts should encourage savings, focus on reducing the impact of the recent payroll tax increase, elimination of the marriage tax penalty, and offsetting the effects of income tax bracket creep due to inflation. Neither of the individual tax cut proposals discussed in Chapter II satisfies these three objectives. The business tax reductions should be designed to increase investment and productivity, including a liberalization of depreciation allowances. It is particularly important that the spending and tax cuts be coordinated and that a rigorous effort be carried out to spotlight and eliminate excessive spending in Federal programs.

I have these additional comments to make on the recommendation and text in the Report on the Promotion of U.S. Exports:

While the trade picture for the United States has brightened considerably during the past year, the need for a comprehensive and effective national trade policy has never been more apparent. The 96th Congress did not pass a single significant piece of export-related legislation.

Overdue and needed efforts to reduce government spending and taxes, to provide incentives for investment and savings and to cut the impact of government regulation will increase our national productivity. Our goods will become increasingly competitive on world markets. A stable, dynamic domestic economy is the best possible tonic for American exports and will help us pay our own way in international trade. Setting our own house in order will not, however, dispell our very significant problems with trade. We must continue the effort to eliminate unilateral, self-imposed impediments to U.S. exports such as our unique fascination with taxing the income and allowances earned by our citizens abroad. Sections 911 and 913 of the Tax Code are currently driving American businessmen out of international markets at precisely the time their presence is most urgently required.

We can encourage many more American firms, particularly smaller and medium size business, to partake in export opportunities by passing the Export Trade Company Act. Equally important, we must continue to insist on full implementation of the Multinational Trade Negotiation Codes and demand access to foreign markets on terms no less favorable than we grant to our trading partners. We can no longer tolerate situations, such as we currently see in automobiles, where the United States plays by the rules of free trade while everyone else plays the game of protectionism.

I have these comments to make on the recommendations and text in the Report on Structural Reform:

A series of recommendations in this Report outline some possible components of a comprehensive national investment and job strategy. While it is important that a coordinated national effort be made to restore economic growth, that effort should not become merely an excuse to impose new Federal rules or regulations on the private sector, to create new spending programs or to promote one region over another, or to establish a government mechanism to allocate resources.

There is a need to reduce the scope and improve the effectiveness of government policies toward industries and jobs. Regarding the call for regulatory review, any examination of Federal economic regulations should carefully weigh their benefits and costs to consumers and producers alike, and their contributions to innovation, employment and economic growth. With the cost of Federal regulations exceeding \$100 billion annually, according to one estimate given to the Joint Economic Committee, a thorough review of government regulations is long overdue, and I strongly advocate adoption of a regulatory budget.

Federal support of mature industries must be carefully designed: bailouts for failing firms rarely lead to restored competitiveness and should be resisted. However, Federal support for modernization strategies and the development of new technologies or production processes in mature industries may be justified.

I have these comments to make regarding several recommendations in this Report which address incomes policies or wage and price controls:

As I noted in the 1978 Annual Report of this Committee:

Government dictation of wages and prices has never worked to control inflation in peacetime. Wage and price controls attack the symptoms of the disease, but not the disease itself. They may provide a temporary disguise, they may present a comforting illusion, but sooner or later consumers will confront the harsh reality of shortages, low quality products, and hundreds of devices designed to circumvent the controls. Price and wage controls put the economy in a straight-jacket which invariably results in inequities among both workers and business enterprises.

We should have learned by now that wage and price controls cannot be imposed on our economy without exacting a heavy cost in the form of serious misallocation of resources, inefficient production, and the potential domination of our daily lives by faceless government bureaucrats. We should have learned by now that excessive government regulation of business, which results in waste and inefficient production, is one of the major reasons for our inability to bring down the cost of living. It is, therefore, fundamentally unsound to recommend additional bureaucratic authority to regulate the private enterprise system in the name of fighting inflation.

Most leaders of business and labor strongly oppose the concept of wage and price controls. Businessmen fear that controls will result in less investment, low productivity, and slow growth. Labor leaders know that it is more difficult for workers to circumvent wage controls than it is for business to get around price controls. Both business and labor leaders correctly recognize that there is no easy, simple solution to the problem of inflation. We will bring inflation under control when we reduce excessive government regulation of business, which drives up the cost of doing business; when we develop ways to encourage competition through the entry of new businesses into our Nation's marketplace; and when we provide adequate incentives for business to invest in more productive machinery and equipment.

I have these comments regarding recommendations in Chapter V:

We face a large Federal deficit this year and the need to increase defense outlays while reducing total Federal spending. In light of these factors, I am not yet willing to support funding recommendations in this chapter for the International Monetary Fund, the World Bank, or replenishment of the IDA programs until more specific information on proposed fund use is made available by those agencies.

In addition to the above comments, I want to elaborate on the energy section of this Report:

The Congressional Economic Conference held December 10, 1980, developed a theme which accurately depicts the energy situation confronting our Nation this decade. It evolved from extensive discus-

sions conducted by a cross section of the over 100 business, labor, and environmental leaders attending the conference. The theme was that we live in an increasingly interdependent world where our energy choices, economic health, and national security are closely linked to events beyond our shores. Consequently, we must broaden our perspective in evaluating energy policy options. In particular, progress towards energy independence at home will yield only a false security if our allies and trading partners confront continuing energy security problems abroad.

This theme grew out of the reality that the great world-wide dependence on oil shows no signs of abating. Despite skyrocketing world oil prices since 1973, world demand jumped over 10 percent from 1973 to 1979, before sliding back slightly last year due largely to a slowing of economic growth.

The United States made striking gains in energy efficiency over this period, but experience since 1973 suggests that conservation alone cannot reduce worldwide pressure on oil, and on energy supplies generally. Yet, it is vital that such pressure be reduced to dampen the explosion in energy costs and minimize the risk of economic turmoil from oil supply disruptions.

As the world's largest energy importer and consumer, the United States has the most to gain from world energy price and supply stability. And, as the repository of the free world's greatest untapped energy supplies, it should take the lead in reducing world dependence on imported oil with policies to further promote and stimulate additional energy production at home. With over 20 percent of our domestic energy demand being met with foreign oil, we have a great stake in the success of these policies. Many of our allies have an even greater stake, however. As explored in detail in the 1980 joint Economic Committee Annual Report, the dependence on imported energy of nations such as Japan (88 percent dependence), Italy (81 percent), France (76 percent), West Germany (56 percent), and a host of lesser developed nations like Turkey (57 percent), render them far more vulnerable than the United States to economic and political oil blackmail.

Like the United States, these nations need time to diversify their oil-based economies. And, like the United States, they recognize that the most practical policy for the 1980's is one designed to maximize conventional energy production in order to buy this time while other energy supply and conservation alternatives are developed. U.S. energy policy should be designed both to maximize conservation opportunities and to maximize domestic energy production. It is not achieving the latter objective. In fact, there are significant domestic energy prospects being underutilized as a direct result of Federal energy policy, including the recovery of unconventional and conventional gas and the enhanced recovery of oil. A national and interational energy policy for the 1980's should promote these new energy supply opportunities, rather than discourage them.

The new Administration must not underestimate the benefits of maximizing domestic oil and gas production. It is far easier and more environmentally sound to utilize these resources than to endure the

staggering resource reallocations necessary to produce the equivalent energy in other fashions. President Carter's Commission for a National Agenda for the Eighties evaluated the alternatives to oil production. To quote from their report:

"To replace the amount of energy contained in 1 million barrels a day, which is the yearly equivalent of approximately 2 quads, the following would be needed:

"Construction of up to 100 new nuclear power reactors of 1,000 megawatts each (more reactors than are presently in service); or

"Operation of 20 synthetic fuel plants, each capable of producing 50,000 barrels a day of fuel from coal or shale; or

"Delivery of an *extra* 2 trillion cubic feet a year of natural gas, or more than one-tenth of the current level of this fuel."

The following steps should be taken to focus our national energy production policy more sharply on the realities of the 1980's:

OIL PRODUCTION

Primary and secondary recovery techniques extract only one-third of the oil contained in the typical reservoir. These conventional methods are being only gradually supplemented with expensive enhanced or tertiary recovery techniques designed to loosen the balance which stubbornly remains in reservoirs, and move it to wells for recovery. Enhanced recovery technology utilizes a host of products capable of scouring oil from rocks, including carbon dioxide, detergents, and steam.

These recovery techniques hold the promise of extracting as much as 50 percent more oil than acquired today from reservoirs. Yet, substantial hurdles exist before their widespread adoption can occur. They are expensive and many are barely off the drawing boards. Yet, time is running out. While the number of reservoirs subject to the application of enhanced recovery techniques is enormous, it is continually declining as old oil fields are abandoned. One estimate (by Dr. E. L. Claridge, Director of the Graduate Program in Petroleum Engineering at the University of Houston) is that reservoirs still containing an average 10 billion barrels might be abandoned annually throughout the balance of this decade. These reservoirs originally held 15 billion barrels of oil. And with mature enhanced recovery techniques, some 2.5 billion barrels are still subject to ultimate recovery from the reservoirs projected to be abandoned each year.

That potential annual loss is close to our current annual conventional production and over double the amount of new oil being discovered each year. Other studies confirm this robust assessment. The Library of Congress in a new study, for example, projects that enhanced recovery techniques applied just to heavy oils, primarily in Texas and the far West, could yield 1 million barrels of new oil daily by 1990. And Douglas Martin, writing in the *New York Times*, quotes a nonprofit Scientists' Institute for Public Information estimate that enhanced recovery could ultimately add 75 to 80 billion barrels to U.S. production.

These rosy projections hinge on enormous capital investments occurring in enhanced recovery, investments that will keep U.S. resources at home and produce oil that would otherwise have to be imported. The rapid emergence of these domestic opportunities caught the Carter Administration by surprise. The Reagan Administration should not be similarly caught off guard. It should act promptly to facilitate the flow of investments to enhanced oil recovery and initiate an extensive research program to identify and refine the most cost-effective enhanced recovery techniques.

In conjunction with this program to stimulate enhanced oil production, the Administration should act to selectively spur further investment in conventional oil production.

NATURAL GAS PRODUCTION

The Powerplant and Industrial Fuel Use Act of 1978 is one component of our Nation's effort to trim foreign oil imports. The fuel use act was designed to expedite the transition to coal by utilities and large industrial firms. It required that all new large boilers be fired with coal, and mandated the replacement, as well, by 1990 of oil- and gas-fired boilers presently utilized by these entities with coal-fired facilities.

This replacement phase-out provision does not impose a significant burden on most utilities and businesses presently burning oil. Many of their boilers were originally designed to be fired with coal and came equipped with all the appropriate accessories, including coal handling equipment, coal storage space, stack scrubbers, or other pollution abatement devices, and railroad connections. Many had only been converted to oil for environmental and economic reasons, and their reconversion will not, in most cases, impose a sizable economic burden on owners of the facilities or their customers.

There are a significant number of gas-fired facilities also covered by the Act which were designed solely for gas, however, and cannot economically be converted to coal. These conversions would require the complete replacement of boilers and, in many cases, relocation of the entire facility. It would be no more expensive in many of these cases to simply abandon existing facilities in favor of new coal-fired ones elsewhere. The fuel use act inadequately addressed this eventuality by granting existing facilities up to 10 years to complete the conversion to coal.

This resolved the issue for the handful of present gas-fueled facilities scheduled for normal replacement by 1990. But, it left literally hundreds of other giant gas-fired facilities in limbo—facilities worth tens of billions of dollars which have useful lives stretching in some cases for another 25 to 30 years. Some 250 gas-fired electric generating facilities alone, for example, with in excess of 50,000 megawatt production capacity would have to be written off prematurely to comply with the fuel use act. Their replacement would impose an extraordinary, inefficient, and needless burden on consumers and the Nation's financial markets to fund substitute capacity. Due to inflation, the cost of duplicating these facilities would probably exceed the existing net worth of the firms involved. One study put the cost of duplicating these endangered facilities at more than \$28 billion. The impact on electricity rates,

on prices of individual goods, and on jobs in the private sector would be equally staggering, and would serve no useful purpose.

The conversions to coal from gas were mandated in 1978 when natural gas supplies were thought to be declining. In fact, as I note below, we have bright future prospects for gas supplies. It is even being used now to back-out oil as a residential fuel of preference all across our country. In short, the forced conversion by 1990 of existing gas-fired facilities will not effect our level of oil imports, which was the motivation behind the mandate in the first place.

For these reasons, Congress and the Administration should :

Repeal Section 301 of the Powerplant and Industrial Fuel Use

Act and prevent the forced conversion of gas-fired facilities to coal.

The rise in natural gas prices since 1978 has stabilized supply. Pricing provisions of the Natural Gas Policy Act are responsible, in part, for this reversal in the supply outlook for gas. But the act is far from perfect, and many components serve as much to burden as to stimulate gas exploration. These provisions of the act need revising.

Equally important is the need to explore and define fully all our natural gas resources, unconventional as well as conventional. We may well find that unconventional gas deposits trapped in tight sand, shale, coal, geothermal and geopressure geological areas far exceed our reserves of conventional gas. An exhaustive and soon-to-be-released Library of Congress study, for example, projects that unconventional gas could be providing anywhere from 2.1 to 9.6 trillion cubic feet (tcf) per year by 1990 to our economy. This very large number is comparable to between 10 percent and 50 percent of all the gas being produced today. Even more exciting is the finding in the study that potentially recoverable reserves of unconventional gas range from 782 to 3,140 tcf. This path-breaking study ranked unconventional gas, along with enhanced oil resources, as the most promising and cost-effective energy supply alternative our Nation has today.

The realization of that promise will require hard work, a more realistic price for unconventional gas, some luck, and especially more research. Unconventional gas recovery techniques are immature and costly. These techniques must be refined and our unconventional gas resource base itself defined before substantial private risk capital will flow to this new energy supply opportunity. Consequently, Congress and the Administration should :

Expand the Federal research program to refine unconventional gas recovery technology and to identify promising unconventional gas reserves; and

The Federal Energy Regulatory Commission should review its procedures for pricing unconventional gas to further encourage expanded exploration and production.

FLOYD BENTSEN.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

Inflation remains our single most important economic problem. I commend the new Administration for taking significant steps to bring Federal spending under control because runaway spending and deficits are a major cause of inflation.

The major weakness in the Administration's program is the lack of a comprehensive attack against inflation. The Administration imprudently rejects any form of incomes policy, opposes Presidential jawboning, is lukewarm if not hostile to antitrust activities, and appears to be ambiguous about the elimination of trade barriers and corporate bailouts. While I oppose wage and price controls and would not support a proposal for standby authority to control wages and prices, I believe the Administration has defined the inflation problem too narrowly and that there is a risk that inflation will remain unacceptably high even if all or most of the proposed spending cuts are adopted.

One danger is that fiscal policy could become stimulative, despite the objectives of the Administration. This could result as a consequence of the spending and tax actions taken this year. Such a possibility makes it all the more necessary for monetary policy to be restrained. Whether the Federal Reserve's monetary targets should be tightened or relaxed is a decision that only the Federal Reserve can make in the light of economic conditions. Although I favor a lowering of interest rates, the Federal Reserve has been the only anti-inflation game in town in recent years and it may have to continue playing that role this year.

I seriously question the Administration's assumptions about the likely economic effects of its tax cut proposals. The Administration is probably far too optimistic about the amount of tax reductions that will be put into savings and investment. We should cut business taxes targeted to increase investment. A rollback of the social security tax increase would help reduce inflationary pressures because such an action would lower business costs. The interest income tax exemption should be increased from its present level to \$1,000 per person, to encourage savers. Tax burdens have increased disproportionately with inflation and should be lowered. However, it is critical that any tax reduction be matched by comparable spending cuts.

The danger that tax cuts will add to the deficit underlines the need to balance the budget. Congress should require the President to propose a budget that shows a surplus whenever the economy grows at a rate of 3 percent annually or more.

Government spending programs need to be streamlined, consolidated and improved in any way that increases their effectiveness and achieves our national goals. In doing so, three principles should be followed:

(1) Programs that are targeted to achieve a specific purpose have a better record for achieving their objectives than non-targeted ones.

(2) This is not the time to increase spending or add new subsidies. Worthwhile objectives such as increasing the quality of basic research, improving infrastructure, encouraging exports, and achieving balanced regional growth should be pursued without additional subsidies or increased Federal expenditures.

(3) Improvements in national defense should be undertaken in ways that carefully relate new initiatives to specific military requirements rather than across-the-board percentage spending increases, and in recognition of the inflationary pressures and industrial bottlenecks that can result.

I commend Chairman Reuss for the excellent report he has presented and I am pleased to support it with the qualifications noted above.

Republican Views
on the
January 1981 Economic Report
of the President

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SUMMARY OF RECOMMENDATIONS

The Nation's chief economic goal must be to increase economic growth.

It is through economic growth that we can best assure economic stability and opportunity for all.

The Nation's economic ills have been the result of bad economic policies, not external shocks or defects in our free enterprise system.

We propose the following economic packages to boost employment, productivity and growth and to lower inflation :

Across-the-board reduction in personal marginal income tax rates;

Business tax reductions and accelerated depreciation allowances; Targeted incentives for saving and investment; and

Reduction in Federal Government spending as a percentage of gross national product.

Departures from the target path of money growth to offset credit market fluctuations, supply shocks or changes in velocity simply result in higher interest rates, worse inflation and make it more difficult to implement a rational monetary policy.

A fiscal policy that aims at reducing the tax barriers to saving and production, that causes a shift of many nontaxable assets from tax exempt into taxable venture and is accompanied by reductions in the spending and borrowing burdens of government is not inflationary.

Special incentives for personal saving are absolutely necessary, especially in times of high inflation, in order for the saving rate to at least reach its historic level.

Inflation is basically the result of too great an increase in the money supply relative to the growth of goods in the economy. Beginning immediately, we must gradually reduce the rate of growth in the money supply.

A strong dollar, stability in our balance of payments and a more competitive American economy can best be achieved by stopping inflation and increasing productivity and growth.

In an effort to facilitate world trade, we should expand our Nation's export base, reduce the tax burden on U.S. workers abroad, reconsider the application of extraterritorial anti-trust laws and increase direct investment abroad. In addition, we should strengthen the capabilities of the IMF, including the disciplining of member nations which follow irresponsible domestic policies.

All government regulations should accomplish their statutory objectives in the most cost-effective manner. When there are alternative options for achieving 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.

Congress and the Executive Branch should begin immediately to develop a regulatory budget to encourage government agencies to reduce the costs of regulations and provide additional incentives for agencies to develop cost-effective regulations. 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.

I. THE IMPORTANCE OF ECONOMIC GROWTH AND THE DECLINE OF AMERICAN PRODUCTIVITY

As the 1980's begin, the list of national priorities is lengthening: Inflation and interest rates are too high. They must be reduced. The Nation still is too dependent for its energy upon insecure foreign sources. Energy dependence must be reduced. Unemployment, and particularly minority unemployment, remains high and has debilitating effects on the social and economic condition of the country. Unemployment must be reduced. And while the poverty rate has been cut in half since the mid-1960's, the number of persons actually in poverty has risen. Poverty must be reduced. In addition:

Events in Afghanistan, Iran, Poland, and elsewhere have driven home the need for a renewed commitment to national defense. We must find the resources to meet this commitment.

In spite of vigorous environmental, health and safety initiatives, more remains to be done. We must find the resources for orderly protection and improvement of the environment, and the health and safety of all Americans.

The Nation's infrastructure—its highways, bridges, harbors, and waterways—are in various stages of decay. The process of erosion must be reversed.

Foreign competition is not only increasingly aggressive, it is increasingly effective. This competition must be met.

The answer to these problems is faster economic growth. The economy's growth has slowed in recent years. Continued slow growth will widen the gaps that have opened in recent years between expectations and realizations, particularly for minorities. As a result, a divisive struggle for income shares, which always threatens, could occur. This would be tragic. All Americans have a far greater interest in the size of the economic pie than in any feasible distribution. More rapid economic growth will transform dreams into realities, and national priorities into achievements.

Demands upon the Nation's resources are growing. These demands will tax our ingenuity and our resolve. They will stretch to the limits the Nation's productive capacity. If they are to be satisfied, economic growth must be accelerated, resources cannot be squandered, and the productivity of America's workers must rise.

Herein lies the rub: Productivity is not rising. It is falling. In 1980, output per manhour *fell* by 0.3 percent. In 1979, productivity declined by 0.4 percent. Without increases in productivity, real standards of living cannot be raised, it will be difficult to reduce inflation, interest rates, unemployment and poverty, to become less energy dependent and more competitive internationally, to rebuild the Nation's infrastructure, clean up the environment, improve health and safety, and improve our defense capability.

No nation can tolerate declining productivity growth—let alone absolute declines in productivity—for very long. To the obvious costs of output not produced and wants unsatisfied must be added the potentially more costly effect of increased animosity among the Nation's diverse interest groups. As economic growth slows, struggles for bigger shares of a shrinking economic pie can cause inflation to accelerate, and will cause resource misallocations and still slower growth, more unsatisfied demands, increased animosity across and within income groups, and among labor, business, farmers and Government. In short, declining economic growth feeds on itself: Slow economic growth engenders even slower growth.

During the period from 1948 to 1979, real GNP has grown at a 3.5 percent annual rate. Growth of the Nation's stock of plant and equipment has made the most important contribution to GNP growth, followed by productivity and employment growth. According to testimony before this Committee, 1.6 percentage points of the 3.5 percent growth rate are accounted for by the growth of physical capital; 0.8 percentage points are attributable to the growth of employment, and 1.1 percentage points are explained by productivity enhancing developments.

Since 1974, real GNP growth has fallen to a 2.9 percent annual rate. Given the role in economic growth of productivity increases, and of underlying increases in the amount of capital and labor employed, this should come as no surprise. Since 1974, the growth rate of physical capital has declined in each of the economy's four major sectors relative to the 1948 to 1974 period. In the private domestic business economy—the most broadly defined sector—the annual growth rate of physical capital declined from 2.4 percent during the 1948 to 1974 period to 1.8 percent after 1974.

These changes in the growth rate of capital have played a major part in the decline in the growth of labor productivity noted above. And together, the productivity decline and the decline in the rate of capital accumulation have brought about reductions in the growth rate of output in three of the economy's four major sectors.

The only sector in which the output growth rate increased is farming. Declines in the output growth rate in the other three sectors occurred *in spite of* employment growth. Employment growth accelerated in the private domestic business economy, and in nonfarm, non-manufacturing industries. In the case of manufacturing, employment growth was positive, but slower than the 1948 to 1974 rate.

The proximate cause of the decline in U.S. economic growth is no mystery. Slow growth of the Nation's capital stock is the core problem. If the capital stock had grown faster, productivity growth could have been sustained, and the expanding labor force would have been more easily accommodated. Had the economy grown since 1974 at a 3.5 rather than a 2.9 percent annual rate, real GNP, in 1972 dollars, would be \$52 billion higher than it is today, real per capita income would be 3.5 percent higher, and the trade-offs which we now face among social, defense, and other programs would be less severe and easier to face. Simply stated, we have lost a full year's normal real growth in just six years.

II. MONETARY POLICY

A proper monetary policy is crucial to the achievement of reduced inflation and interest rates, improved living standards, and economic stability. A proper monetary policy is not difficult to define. It is one that is focused on the long run and tailors money growth so that it is "commensurate with the economy's long-run potential to increase production."

This is what Congress asked the Federal Reserve to do in passing House Concurrent Resolution No. 133 in 1975 and again in passing the Federal Reserve Reform Act of 1977 and the Full Employment and Balanced Growth Act of 1978. In adopting this guideline, Congress expressed its sense that this would "promote effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Money growth had accelerated above the guideline in the decade before 1975. Unfortunately, it accelerated further from 1975 to 1980.

The facts, in brief, are these: From 1955 to 1964, average annual money growth, measured by the percentage change in M1B from the prior year, was 1.94 percent. It jumped to 5.55 percent in the 1965 to 1974 period and to 6.62 percent from 1975 to 1980. (In essence M1B equals coin, currency and checking deposits in commercial banks (old M1) plus automated transfer service (ATS) accounts, negotiable order of withdrawal (NOW) accounts, and share drafts in all depository institutions. M1B closely measures the Nation's means of carrying out its transactions.)

In association with these long, high jumps in money growth, we have experienced rising inflation, volatile interest rates around a rising trend, lower real GNP growth, reduced productivity increases, generally higher unemployment and growing use of resources to cope with inflation rather than to improve living standards. These are the legacies of a faltering fiscal policy and overregulation. Our poor economic performance is also the result of allowing the quantity of money to grow faster and faster; not every year but, by and large, during the past 17 years. Pertinent data are set forth below:

TABLE II-1.—MONEY GROWTH AND SELECTED MEASURES OF ECONOMIC PERFORMANCE, 1956 TO 1980

	1955-64	1965-74	1975-80	1977-80
M1B growth (yearly percent change).....	1.94	5.55	6.62	7.40
GNP deflator (yearly percent change).....	1.99	4.80	7.52	7.66
90-day T-bill rate (yearly average).....	2.77	5.50	7.48	8.51
Real GNP growth (yearly percent change).....	3.63	3.40	2.93	3.32
Output per hour, private business sector (yearly percent change).....	3.04	2.07	1.13	0.30
Unemployment rate (yearly average).....	5.36	4.62	7.04	6.51

BEHIND THE PRODUCTIVITY AND GROWTH DECLINE

What explains the recent decline in the accumulation of physical capital? The answer is simple: Private investment and saving have been discouraged, both directly and indirectly, by bad economic policies.

Bad monetary policy has played a role; monetary policy which has not focused systematically on reducing the growth rate of the quantity of money. In their efforts to "fine tune" aggregate demand and restrict interest rate movements, the monetary authorities have underwritten the price explosion that has eroded real incomes, real cash flows, and the real rate of return on saving and investment. We have had the worst of all possible monetary worlds: We have had to live with increasingly volatile procyclical swings both in the growth rates of the monetary aggregates and in interest rates. These swings have greatly increased uncertainty. Moreover, the swings both in money growth and interest rates have been occurring around rising trends in both and, of course, in inflation as well. If nothing else had been wrong, it would be easy to see how both saving and investment would have been discouraged, and how investment and saving decisions would be increasingly biased toward short-term payoffs, and away from the objective of long-term economic growth and security.

But this is not all that was wrong in recent years. If monetary policy has been bad, fiscal policy has been perverse. On the one hand, the tax burden on working people and businesses has become oppressive. Inflation-induced bracket creep has reduced greatly real after-tax returns to personal effort, saving and investment, risktaking and entrepreneurship. For example, a married person, filing a joint return, with \$16,001 taxable income in 1967 and the same real, inflation-adjusted income in 1980 (\$35,920), was taxed at the margin by the Federal Government at 28 percent in 1967, and 43 percent in 1980. This increasing tax burden has transferred real resources to the Federal Government and away from the private sector. In addition, depreciation allowances based upon historical rather than current costs have understated expenses and overstated profits, resulting in a rising corporate tax burden and a further transfer of command over resources to the Government.

The transfer of control over resources has been exacerbated by Federal activity in the credit markets. Total Federal borrowing—the sum of Federal borrowing and federally assisted, off-budget borrowing—rose from \$24.4 billion in 1974 to \$124.4 billion in 1980. This represents a compound annual growth rate of 31.2 percent! Moreover, total Federal and federally assisted borrowing has increased as a percent of the total funds raised by the nonfinancial sector in other ways—through the sale of debt securities, other forms of borrowing, and through the sale of corporate equities. Indeed, the Federal share of funds raised increased from 16 percent during the 1960's to 25 percent during the 1970's and climbed to 28 percent in 1980. In short, the allocation of funds raised in the financial markets is increasingly biased against pure private investment by the double-edged sword of Federal borrowing and federally assisted borrowing.

On- and off-budget Federal borrowing has inexorably increased Federal Government domination over the Nation's resources. The same

is true of Federal off-off-budget or regulatory activity. In just 15 years, the regulated sector of the economy has increased from roughly one-tenth to about one-fourth of GNP. The regulatory mandates which have driven this extraordinary growth of regulatory activity impose both direct or compliance, and indirect costs on the economy. From the evidence available, compliance costs are currently running at more than \$100 billion per year. The indirect costs—while difficult to measure—include higher product prices and reduced output and employment growth because of the necessity of meeting regulatory initiatives. Whatever the magnitude of these costs, they represent a hidden cost of regulatory mandates; a hidden cost whose effects include the displacement of discretionary, private spending.

There is little doubt that regulatory mandates generate benefits. However, the direct and indirect costs of securing these benefits ought to be minimized. This is nothing more than good economics and common sense. To achieve this result will require that design standards be abandoned in favor of performance standards and that, in general, least-cost methods of achieving regulatory goals be sought.

It is clear that the volume and growth rate of Federal on, off, and off-off-budget activity is too high. It also is clear that tax rates are too high. By discouraging work effort, saving and investment, risktaking and entrepreneurship, these expenditures impart a consumption, anti-saving bias to the economy; a bias that cannot be reconciled with faster economic growth.

Federal spending policies have been equally debilitating. As the recipient of inflation-driven tax windfalls—windfalls deriving from tax bracket creep, and from decreases in the purchasing power of the public's holdings of coin and currency and the Federal Government's debt obligations—the Federal Government gains command of resources which the private sector could have used to finance the purchase of new plant and equipment, and other, productivity enhancing investments. The Government does not use its windfall gains in such ways. Rather, it allocates an increasingly large share of its receipts—76 percent in 1981—to so-called "uncontrollable" outlays. The bulk of these outlays are transfer payments intended to enable recipients to maintain consumption patterns in the face of rising prices. Obviously, the poor, the sick, the elderly and the unemployed should be helped. However, a large part of the expenditures which have been made to help them in recent years would not have been necessary if inflation and unemployment had been lower, and economic growth faster. In turn, bad economic policy—monetary, fiscal and regulatory—accounts for a major part of the economy's poor performance.

REVERSING THE DECLINE OF PRODUCTIVITY AND GROWTH

The way to move up to a faster growth track is clear: The monetary and fiscal policy levers must be pushed in the right direction and kept there; specifically, monetary policy should be put on "slow" and fiscal policy on "go." An anti-inflationary, pro-growth strategy must include the following initiatives:

- A steady reduction in the growth rate of the money supply;
- An across-the-board reduction in personal marginal tax rates;

Reduction in business tax rates and depreciation reform;
 Targeted incentives for saving and investment;
 A reduction of Federal Government spending as a percent of
 GNP;

A reduction of off-budget borrowing by the Federal Govern-
 ment; and

A reduction in the regulatory burden on the private sector.

Inflation and interest rates will come down when and only when the Federal Reserve forgets about fine tuning, abandons any vestiges of "accommodation" by an interest rate targeting policy, and focuses instead on steady reductions in the growth rate of the money supply. It is equally imperative that we recognize that both personal and business marginal tax *rate* reductions are in order, and cut them. Business tax rate reductions are necessary to help offset rising energy and other input prices, to increase investment, risktaking and entrepreneurship, and to stimulate current output and employment. Personal marginal tax rate reductions and additional saving incentives are needed to prevent or at least slow bracket creep, to encourage work effort, saving, and a reduction of installment debt. The new personal saving, coupled with a reduction in installment debt will permit financing of additional investment (on top of that financed by new business saving).

The strategy of reduced money growth and personal and business marginal tax rate reductions is fundamentally anti-inflationary and pro-growth. Steady reductions in money growth will reduce inflation and inflationary expectations. Erosion of inflationary expectations will itself help reduce inflation. It will do so by decreasing anticipatory buying in expectation of continued high inflation. In addition, the erosion of inflationary expectations will pull down long-term interest rates relatively quickly. This will stimulate long-term investment and growth. For their part, permanent business tax rate reductions will reduce both current and future production costs, and increase the profitability of investments generally. Production and growth will increase as a result.

Business tax reductions will have desirable effects, both in the short and in the long run. In the short run—where plant and equipment is fixed—business tax reductions either slow the rate of increase, or actually reduce, costs of production. If large enough, business tax reductions can more than offset the upward pressure on costs coming from rising input prices; in particular, rising energy prices. In this event, business tax reductions would reduce costs, increase quantity willingly supplied at any given price, and thereby stimulate both current production and employment. As for the long run—where plant and equipment are not fixed—*permanent* business tax rate reductions can reduce the cost streams associated with investment projects. Given projected revenue streams, it follows that more projects will become economic, and investment will be stimulated. Thus, in both the short and long runs, rate reductions stimulate output, employment, and investment.

While business tax rate reductions will stimulate supply, personal marginal tax rate cuts will stimulate both demand and supply. Demand will rise via the positive effect of tax rate cuts on real disposable incomes. Supply will rise because of the positive effect of marginal tax rate cuts in real after-tax rates of return to personal effort and saving.

There can be no doubt that the absolute amount of saving will rise as a result of a personal marginal tax rate cut. While it has been decreasing, the saving rate is still positive. Therefore, some portion of the increase in real disposable income will be saved. Moreover, because they will increase after-tax return to saving, personal marginal tax rate cuts will impel an increase in the propensity to save out of disposable income. However, in these inflationary times, still greater incentives to save are needed. Inflation has reduced the saving rate in recent years, and there is now urgent need for additional saving to fuel faster economic growth. This need leads us to recommend additional saving incentives. These extra incentives should aim at increasing additionally the after-tax rate of return to saving and should center around steep reductions in the marginal tax rates on interest and dividend income. If these cuts are made, saving will rise to at least its historic level and will provide a major source of the financing needed to get the economy growing at a faster rate.

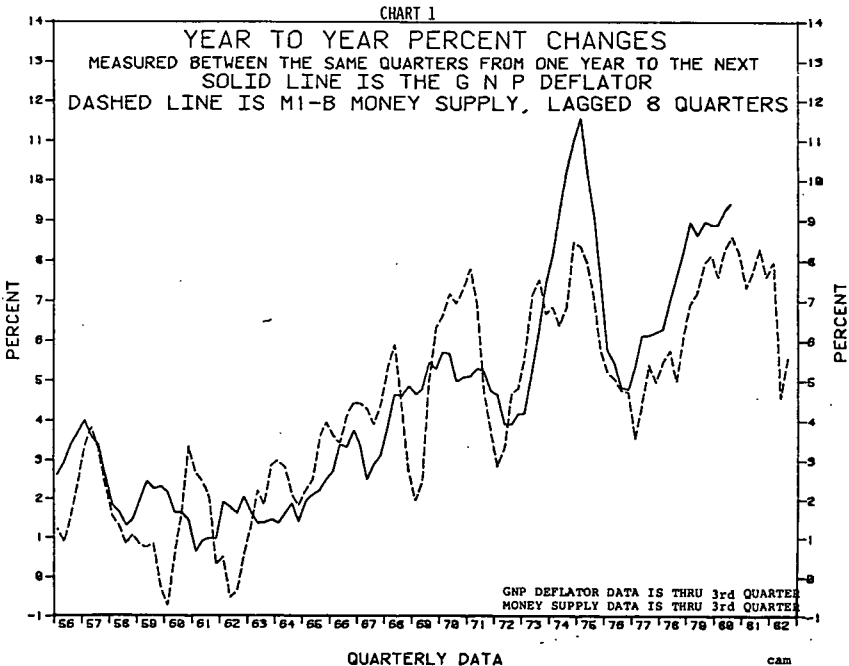
Whether marginal tax rate reductions induce additional work effort depends upon whether increases in real after-tax returns to effort are effective catalysts to additional effort. We believe they are. This reflects our judgment that the work ethic is not dead: Reward work better, and people will work harder, longer and smarter. Tax work, and people will substitute leisure and/or "underground" or untaxed activities.

To complement the strategy of slower money growth and reduced personal and business marginal tax rates, we commend, as absolutely necessary, an accompanying reduction in the burden of the Federal Government on the private sector. When tax rate cuts are combined with reductions in Federal spending, on- and off-budget borrowing, and a rational regulatory policy—one that recognizes that whatever the benefits of regulation, its direct and indirect costs must be minimized—the heavy hand of Government will no longer prevent the economy from moving to a faster growth track.

The result of this monetary-fiscal-regulatory package will be growth in real incomes and jobs, a reduction in inflation and interest rates, an expansion of resources to clean up the environment, an increase in our competitive effectiveness, a greater ability to meet our defense needs, a declining share of GNP being commanded by Government, and the disappearance of the "zero sum society."

Clearly, we must reduce money growth, and we must do it now. We cannot, as some suggest, wait until inflation unwinds before we do so. If we wait, we will underwrite permanent inflation at increasingly intolerable rates. As shown by the data assembled above, over long periods, the rate of inflation tends to match the rate of increase in the quantity of money. More important, the latter tends to lead. Measured over four-quarter periods, the rate of inflation follows in the wake of earlier money growth. In the post-Korean War period, the lag has averaged eight quarters. Reasons for the lag include regulatory delays, contractual rigidities, and rigidities involving advertized and "established" prices. The relationship between current inflation and M1B growth 2 years earlier is mapped in Chart 1.

INFLATION AND LAGGED MONEY GROWTH



COMMENTARY ON CHART

The chart maps percentage increases, measured between the same calendar quarters from one year to the next, in the GNP deflator and M1B. The solid line maps the percentage rise of the deflator; the dashed line maps M1B percentage growth. The GNP deflator data used to compute and chart the rate of inflation are data published by the Department of Commerce before the December 1980 revisions.

To capture the lag between changes in money growth and changes in the rate of inflation, the growth of M1B, which is represented by

the height of any point on the dashed line, refers to the percentage growth that occurred in the four quarters ending 2 years earlier than the date shown directly below that point on the horizontal axis. For example, the height of the dashed line directly above the first quarter of 1956 on the horizontal axis shows the percentage growth of M1B from the first quarter of 1953 to the first quarter of 1954. Unlike this lagged mode of timing, the rate of inflation, which is represented by the height of any point on the solid line, refers to the percentage change in the GNP deflator in the four quarters ending in the quarter indicated by the date directly below this point on the horizontal axis.

Inspection of the solid and dashed lines mapped in Chart 1 shows that, measured over four quarter periods, percentage increases in the GNP price deflator from 1956 to the third quarter of 1980 closely track percentage increases in M1B two years earlier. Moreover, this visual approximation of the relationship of inflation to money growth in the U.S. since 1956 captures only part of the power of changes in M1B growth to change the GNP rate of inflation. Only the part that is centered on price behavior two years after the change in M1B growth is captured.

The evidence warns against waiting until inflation unwinds before reducing money growth. The lesson, in short, is that if we do, it will not. Specifically, money growth must be reduced over a period of time to a level commensurate with our economy's long-run potential to expand production and maintain full employment at zero inflation. These are the goals of the Full Employment and Balanced Growth Act of 1978. They will not be achieved unless money growth is decelerated. Using M1B as our measure of money, and year on year changes as our measurement standard, one sensible guideline is 6 percent growth in 1981, 5½ percent in 1982, and 5 percent in 1983 and 4½ percent in 1984. These guidelines are meant only as an example of the gradual reduction in M1B growth which is required to stop inflation and promote economic stability, growth, and low interest rates.

We urge the Federal Reserve to announce this or some other declining track for M1B growth as soon as possible. The announcement will enable the Congress and, more importantly, financial market participants and the public at large to monitor the Federal Reserve's performance as the record unfolds. By this time next year, assuming the union of promise and performance, monetary uncertainty will be significantly reduced with salutary impact on both the level and volatility of interest rates. Furthermore, current expectations for long-run inflation, averaging 10 to 12 percent per year, also will be reduced as M1B growth is decelerated. In turn, this will produce a major break in long-term interest rates even before inflation breaks. In time, short-term rates will follow.

Given meaningful, yet not drastic, deceleration of money growth, a proper fiscal policy and regulatory reform (as discussed in subsequent chapters), we believe it is not unrealistic to expect the rate of rise of the GNP deflator to fall to 7 to 8 percent next year, to 5 to 7 percent in 1983, to 4 to 6 percent in 1984, and to 3 to 4 percent in 1985.

In setting forth this objective for monetary policy, we reject the contention that there is some "core" or "underlying" rate of inflation

which is independent of money growth. Sustained inflation is not an inertial process which converts unpleasant outside shocks into a wage-price spiral. It is not "one darn thing after the other." It is "the same thing over and over again." The recurring event, as shown by the evidence assembled and mapped in Chart 1, is excessive money growth.

OBJECTIONS CONSIDERED

It will be objected that the world is too complex and full of surprises for the Federal Reserve to adhere to a pre-set decelerating M1B growth track. It will be argued that the Fed will have to deviate from any such path (1) to keep order in credit markets, (2) to accommodate supply shocks, and (3) to compensate for changes in money demand and the velocity at which M1B circulates. We consider these objections below.

Keeping Order in Credit Markets

Many fear that, unless the Federal Reserve keeps order in credit markets, interest rates will rise much higher than even today's historically high rates and bring on another recession. They favor resisting upward pressures on interest rates even at the cost of allowing money to grow faster than desired over the long-run. We reject this counsel. It assumes that increases in money growth will reduce interest rates generally when, in fact, history demonstrates that the opposite is true.

Historically, increases in money growth have operated directly to decrease interest rates. However, this direct effect is both short-lived and trivial. It is followed within three to six months by increases in interest rates which ultimately (in about two years) equal (in percentage terms) the increase in money growth. If the Fed were to increase M1B growth by way of trying to prevent interest rates from rising (as it unfortunately has so often in the past), it would buy at most a few months of so-called order in credit markets. We would then pay for this by living for years in a higher interest rate environment. Although it is tempting to focus on the next few months, rather than upon the long run, it is a mistake to do so.

Throughout the past 4 years, the Federal Reserve was urged repeatedly by the Administration and others to increase the rate of money growth in order to reduce interest rates. Looking backward, it is clear that this advice was wrong. We should have *reduced* M1B growth $\frac{1}{2}$ to 1 percent a year after 1976 (when it grew 5.56 percent) instead of increasing it to 7.53 percent in 1977 and 8.16 percent in 1978. Inflation could not have reaccelerated if we had. By accelerating money growth, the Fed avoided the higher interest rates it was trying to prevent for only a few months, but engineered a subsequent prolonged period of skyrocketing interest rates. The 90-day T-Bill rate averaged 4.93 percent in the second half of 1976 and 4.99 percent in the year as a whole. It fell to an average of 4.72 percent in the first half of 1977 and to a low of 4.54 percent in May. By July, 1977, it averaged 5.15 percent and it has climbed much higher since then.

Supply Shocks

Supply shocks have two macroeconomic impacts. One is a temporary reduction in the growth rate of the Nation's output of goods and services; the other a temporary bulge in the general rate of inflation. Other things equal, the two must balance in the sense that total spending on *all* goods and services will be unaffected, even though spending on the particular goods and services immediately involved may rise or fall depending on the demand elasticities for these goods and services.

For example, consider the devastating supply-side shock that occurred in late 1973 and 1974 when OPEC raised the price of oil and, for a time, the Arab nations embargoed shipments of oil to the United States. We had to make do, during the embargo at least, with less oil and we had to pay higher prices for it both during and after the embargo. The price rise made a non-trivial amount of the Nation's plant and equipment permanently non-economic overnight. As a result, real GNP growth was decreased and GNP inflation increased; both, however, only temporarily. Estimates provided in a recent study by the House Subcommittee on Domestic Monetary Policy indicate that the 1973 to 1974 OPEC oil supply shock reduced real GNP growth about 4 percentage points below what it otherwise would have been in 1974 and raised GNP inflation about 3 percentage points that same year. These estimates are close enough in absolute value to be considered as balancing with respect to total spending on GNP goods and services.

Droughts and other supply shocks produce the same results. All operate to reduce temporarily overall real GNP growth and raise GNP inflation. Nothing can be gained from trying to change these results by increasing money growth.

Increasing money growth above a pre-set target growth to accommodate supply shocks and somehow soften their blows can only add to inflation. It will not make up for the direct reduction of supply. Nor will it make it profitable to operate plant and equipment that has been rendered noneconomic by the shock. It will only increase prices more than they would otherwise rise—the price of the product immediately impacted by the supply shock as well as prices in general.

On the other hand, it also would be wrong to drop money growth below targeted growth in response to the sudden surge of inflation which accompanies the supply shock. The surge will pass. Dropping money growth to resist it will only exacerbate the temporary shock to output.

In this regard, it is well to remember that in 1973 and 1974, the Federal Reserve allowed—or caused—a sharp break in money growth. M1B growth plunged from 7.93 percent in the four quarters ending with the second quarter of 1973, preceding the OPEC oil embargo, to 3.55 percent in the four quarters, after the embargo, ending with the first quarter of 1975. (Velocity was not a problem at the time as shown by the fact that, between these same endpoints, the four-quarter rate of rise in the velocity at which M1B turns over into GNP goods and services fell only slightly, from 3.21 percent to 2.62 percent.) Together, the drop in money growth and the oil supply shock decreased real

GNP growth from 5.46 percent in 1973 to -1.39 percent in 1974. Part of that decline could have been avoided without doing violence to the long-term fight against inflation if the decline in M1B growth had been limited to 2 or 3 percentage points during the period instead of being allowed—or caused—to fall nearly 5 percentage points.

Changes in Velocity

Many, including both Federal Reserve spokespersons and critics of the monetary authorities, argue that the velocity at which M1B turns over each year into GNP goods and services is unstable. They counsel that the Fed must be prepared to lean against the winds of increases or decreases in the rate of rise of velocity by moving M1B growth below or above the pre-set target as the new velocity "trend" dictates. We cannot accept this counsel. We reject it because, although the rate of rise of M1B velocity is quite erratic measured from one quarter to the next (and even from one year to the next), it has been remarkably stable over the long run; that is, since the Korean War. Measured from one three-year period to the next, yearly average percentage changes in M1B's velocity ranged between 1.62 percent and 4 percent in the post-Korean War period. Pertinent data are set forth below:

TABLE II-2.—M1B AND ITS VELOCITY

[Yearly percentage changes]

Period	Velocity	M1B	Period	Velocity	M-1B
1956-58.....	3.00	0.97	1968-70.....	1.62	5.55
1959-61.....	3.90	1.32	1971-73.....	2.74	7.04
1962-64.....	3.45	3.13	1974-76.....	4.00	5.02
1965-67.....	3.41	4.25	1977-79.....	3.56	7.81
12-year average.....	3.45	2.42	12-year average.....	2.97	6.35

In 1980, velocity increased 2.6 percent. The data indicate that neither our economy's recent instability, nor the accelerating inflation that has been its principle manifestation, can be attributed to changes in velocity's rate of rise. They also indicate the danger of trying to lean against perceived changes in velocity's "trend" rate of rise based on quarterly or even yearly information. The data show that, in the past, these changes have not lasted. Thus, were the Fed to compensate for a sudden slowdown in the rate of rise of M1B's velocity for one or even a few quarters by accelerating M1B growth, it would court faster inflation. This is so because, as the growth of M1B accelerated, its impact on spending and prices would be reinforced by the return of the rate of rise of velocity to its historic trend.

We recognize that the future may be different than the past. The trend rate of rise of velocity may slow as NOW accounts spread. However, we caution against anticipating this event, based on data for less than three to six years. Before raising money growth to compensate for any observed slowdown in the rate of rise of M1B's velocity, the Fed should wait long enough to make sure the slowdown is permanent.

In the same way, it would be a mistake to reduce money growth "below target" to offset a perceived speed-up in the rise of velocity until

sure the speed-up is permanent. In this regard, a temporary speed up is likely in the wake of a tax cut.

The Final Objection

In the final analysis, real GNP growth is unaffected by money growth. However, in the short run, decreases in money growth will, other things the same, decrease real growth. We recognize this but reject counsel to keep money growth high in consideration of this effect. To do so would keep inflation and interest rates high and require, in time, accelerating money growth and thus higher and higher inflation and interest rates. The end result of this course of action would be a calamitous boom-bust cycle.

If we want to stop inflation and reduce interest rates, we must reduce money growth as part of the overall strategy described in Section One. There is no other way. Fortunately, the short-run decrease in real growth which reducing M1B growth will bring, other things the same, can be minimized and possibly even avoided entirely. Other things need not stay the same. In particular, new fiscal policies can be put in place which will propel economic growth upward while, at the same time, our recommended monetary policy is damping inflation. We turn now to the new fiscal policies to be put in place.

III. FISCAL POLICY

Decelerating money growth will in time eliminate inflation. The Nation must recognize that it will take a period of years, not months, for inflation to slow substantially. Many warn that the transition to stable prices will be hard. However, the bumps can be smoothed in advance. A properly coordinated fiscal policy can make the transition from a stagnant, inflationary economy to a robust, non-inflationary economy more certain and less painful. The elements of such a fiscal policy would include:

An across-the-board reduction in personal marginal income tax rates;

Business tax and depreciation reform;

Targeted incentives for saving and investment;

A reduction in Federal Government spending as a percentage of gross national product; and

A reduction in off-budget borrowing and spending by the Federal Government.

It is unfortunate that the national debate over fiscal policy has centered around whether tax cuts, by themselves, could reverse the economy's poor performance. This is unfortunate because it has been evident for some time that tax cuts would be accompanied by reductions in government spending and borrowing. In the past, this Committee has made it clear that supply-side tax cuts must be accompanied by reductions in government spending. The last election campaign saw both candidates support reductions in the growth of taxes and government restraints on the economy. President Reagan made no secret of his plan to propose a fiscal package including major spending cuts as well as marginal tax rate cuts. The question of whether tax cuts alone could turn the economy around was never a meaningful, operational issue and today definitely is moot.

Nonetheless, there is considerable controversy about the proposal to cut marginal personal income tax rates across the board. Those opposed deny that such a cut would have significant positive impact on productivity and real growth, and assert that it would be inflationary. Their arguments require us to evaluate how across-the-board personal marginal income tax rate cuts will impact on the economy. In this evaluation it is useful to distinguish between the direct effects on markets for goods and services and the effects which some say we must expect as a result of credit market changes that will be induced by such tax cuts.

DIRECT EFFECTS OF REDUCING PERSONAL MARGINAL INCOME TAX RATES

Our view is that across-the-board personal marginal income tax reduction will increase productivity and real growth substantially and will not increase inflation. The effect on real growth is unambiguous. It

is a logical deduction from *both* demand and supply-side economics. In demand models, tax reduction increases demand which pulls up supply. In supply models, supply is increased directly. President Kennedy recognized this in his 1963 *Economic Report* when he stated, "Only when we have removed the heavy drag our fiscal system now exerts on personal and business purchasing power and on the financial incentives for *greater risk-taking and personal effort* can we expect to restore the high levels of employment and high rate of growth that we took for granted in the first decade after the war." (Our emphasis.)

However, the direct inflationary impact of across-the-board personal marginal income tax cuts cannot be determined by logical deduction from economic theory. On the demand side, personal income tax rate cuts will stimulate spending, and could thereby add to inflationary pressures. On the supply side, personal marginal tax rate cuts will impel additional work effort and production, and thereby operate to slow the rate of rise of prices. The question is which of these effects dominates. It is our view that the supply effect does. In addition, we want to stress that our fiscal policy program calls for spending cuts—which may reduce demand somewhat—and special incentives for saving and investment. These incentives, which are aimed at substantially reducing the marginal tax rate on *all* savings income, will help shift individual activities toward saving and away from consumption. Consequently, we can expect an extra large part of the personal tax cut and the income it generates to be used to increase supply (saving and investment) as opposed to demand (consumption).

In summary, then, we believe that the direct impact of across-the-board personal marginal tax rate cuts will be to increase real growth without increasing inflation.

CREDIT MARKET EFFECTS AND THEIR CHANGES

Those opposed to enacting across-the-board cuts in personal marginal income tax rates fear that, unless government spending is cut dollar-for-dollar with the cut in taxes, there will be either a catastrophic collision in credit markets or abandonment of the attempt to reduce money growth. In this view, faster inflation would be the necessary result. The argument contains a kernel of truth. It would have validity if the purpose of cutting taxes were to increase consumption. A tax cut such as a tax rebate, which does not alter relative prices or marginal incentives would produce a collision in credit markets or accelerate inflation. The linkage is as follows:

- (1) The rebate increases the Federal deficit.
- (2) An increase in the deficit increases Federal borrowing.
- (3) This leads to "crowding-out" in credit markets, putting upward pressures on interest rates. Chaos results, unless the Federal Reserve relieves the pressures by accelerating the growth of money, which in time would increase inflation and, ironically, interest rates.

We need not fear such a collision and cannot allow such fear to prevent us from reducing personal marginal income tax rates across the board. Spending cuts which, as stated earlier, are an integral part of our fiscal policy program, need not be made dollar-for-dollar with the tax cuts. By way of clarification, we provide the following description of how marginal rate cuts will be financed in major part by feed-

back from economic growth induced by the cuts themselves and by corollary changes in after-tax interest rates.

Funding the Tax Cuts

There will be some actual revenue increases resulting from the tax reduction itself. This is indisputable. Expansion of the Nation's economic base and real GNP will cause the tax revenues of all levels of government to rise more than they would without the expansionary effects of the reduction in personal marginal tax rates.

(1) *Reflows from higher economic growth.*—Even in the short-run—when plant and equipment are fixed—there will be some stimulation of real economic growth and employment, yielding additional tax revenues. The major part of this reflow will come from taxes already in place (adjusted for the cut in rates) on the incremental real GNP induced by the tax cuts.

(2) *Reduction in the underground economy.*—In recent years there has been much research done on the so-called underground economy; that is, on economic transactions that are not taxed. Estimates of the size of the underground economy range between \$100 billion and well over \$200 billion. Much of this economic activity is said to result from high marginal tax rates on individuals and businesses—employees, employers and self-employed persons working for cash “off the books,” and the like.

Clearly, it is not unreasonable to assume that an across-the-board reduction in tax rates will generate some new tax revenue, at the expense of the underground economy. This is because the incentive to cheat the system will be much diminished.

(3) *Reduction in tax deductible consumer borrowing costs.*—Across-the-board personal marginal income tax rate cuts will raise consumer after-tax borrowing costs. For example, for persons in the 40 percent tax bracket, under present law, a 10 percent tax rate reduction will raise borrowing costs nearly 7 percent. For such persons, each dollar of interest received by the lender now costs the borrower, after taxes, only 60 cents (\$1 less 40 percent of \$1). After a 10 percent tax rate reduction, it will cost the borrower 64 cents, or 6.7 percent more than presently. A 30 percent tax rate reduction will raise after-tax borrowing costs to 72 cents for each \$1 borrowed, or 20 percent more than presently. We do not doubt that these changes will reduce both household borrowing for consumption purposes and interest deductions on personal tax returns. The latter will provide an additional increase in tax revenues.

(4) *Reduction in tax-shelter investments.*—About a third of all taxpayers itemize deductions, and about 5 percent of all taxpayers are in the 50 percent tax bracket or above (counting only Federal income taxes). These individuals have a powerful incentive to seek tax-sheltered investments. If one's income is taxed on the margin at more than 50 percent, it is more profitable to have a dollar in taxes than to earn a dollar of “unearned” income. As a result, the existing tax structure has led to a proliferation of investment advisors, tax lawyers, accountants and others whose job it is to help high income people avoid taxes. By and large they reduce their clients' taxes and the presumption is that the more powerful the incentive to avoid taxes

(i.e., the higher tax rates are) the more tax liabilities are reduced. Closing "loopholes" is not apt to help much in this regard and may not be cost effective.

On the other hand, if marginal tax rates are reduced, the relative attractiveness of investments in tax-sheltered investments is also reduced. For example, after the Kennedy tax rate reduction of 1963 the proportion of gross private domestic investment channeled into housing declined from 35.4 percent of total investment in 1963 to 33.5 percent in 1964, 29.8 percent in 1965, 25.5 percent in 1966, and 25.4 percent in 1967. This was due to the fact that the decline in marginal tax rates from the 1964 tax rate cuts reduced the tax advantage of home ownership, making other investments relatively more desirable.

Since 1967, the interaction of inflation and the steep progressivity of the personal tax structure has sharply increased the attractiveness of "consumption assets," like housing, relative to "production assets."

Clearly, some revenue reflow will result from personal marginal tax rate reduction because people will reduce their use of tax-sheltered investments and increase investment in more productive investments, the income from which is taxable.

(5) *Reduction in nonproductive investment.*—Inflation and excessive taxation together have produced the phenomenon of nonproductive investment in such things as gold, paintings, rare stamps, antiques, etc. The advantage of such "consumption investments" is that they tend to hold their value during periods of inflation while producing non-taxable pleasure for their owners. As long as a capital gain is not realized it is not taxed. This is why the capital gains tax is such a harmful tax. It encourages people to hold on to assets which, aside from the tax break, yield lower returns than alternative investments. Because of the tax, they cannot afford to sell them, especially during a period in which much of the capital gain is due solely to inflation.

In this connection, the latest data from the Office of Tax Analysis strongly reinforces the view that, in the case of capital gains taxes, a cut in the tax rate very nearly paid for itself the first year. Prior to the 1978 capital gains tax cut, the Department of Treasury estimated that it would "cost" \$2.6 billion in lost revenue in 1979. The data now show the actual revenue loss to have been a mere \$100 million. Indeed, it is possible that when the final tax return figures are examined, even this loss will be eliminated.

In short, much of the investment in recent years in art objects and other nonproductive or "consumption assets" has been fueled by tax considerations. When it becomes relatively more desirable to put one's money elsewhere because of a reduction in tax rates, there will be an "unlocking" of capital in these "consumption investments," which will produce tax revenue for the government and free-up capital for productive investment in business plant and equipment.

For this reason, we support further reductions in the capital gains tax, such as that which would result from a reduction in the highest personal marginal tax rate from 70 percent to 50 percent. Under current law, this would automatically reduce the maximum capital gains tax rate from 28 percent to 20 percent.

Increased Saving

The present tax system makes it twice as costly to save as to consume. We are taxed both on the money we save when we earn it and when that

money earns interest. Therefore, an across-the-board reduction in income tax rates would remove two disincentives to save which, in turn, will help to finance the tax rate cuts. As Dr. Charles Walker told the Committee, an across-the-board personal marginal income tax rate reduction would boost saving for several reasons. Dr. Walker said:

First, the disposable income of many of the nation's thrifter individuals and families would be increased, thereby enlarging the pool of funds from which they can save. Second, and also highly important, the after-tax rate of return on each additional dollar saved would increase sharply, thereby giving a significant boost to the incentive to save.

In addition to the incremental personal savings which will be forthcoming, there will be substantial incremental business savings. Undistributed profits will rise with real GNP. Also, to the extent that depreciation allowances are liberalized, saving will rise by the same amount. This is true by definition, since business depreciation allowances are a major component of gross national saving.

Finally, because incentives to save are greatly reduced in times of high inflation, our fiscal package calls for special incentives to stimulate saving. Across-the-board tax rate reductions and depreciation reform with specific saving incentives, such as splitting earned and unearned income and taxing each at the lowest tax rate, would further increase national saving even in periods of high inflation.

The point is that increased saving induced by the tax cut will not only help build our Nation's capital base, leading to increased employment, growth, and, therefore, tax revenue in the long run, it also will help finance the static deficit arising from tax reduction.

The additional saving and new tax revenues which will be generated by economic growth induced by tax rate reductions and saving incentives mean that we will not have to choose between a collision in financial markets or inflation. Private investors will not be crowded out of credit markets because there will be a larger pool of funds available to finance the tax rate reduction program. Thus, the pressure on the Federal Reserve to monetize that debt will be minimal and shortlived, allowing it to set and hit lower money growth targets and thereby to stop inflation and reduce interest rates.

An Illustration

For fiscal year 1982, the Administration proposes to reduce personal taxes by \$44.2 billion and business taxes by \$9.7 billion, the latter by liberalizing depreciation allowances. A conservative estimate is that over the next few years the fiscal year 1982 tax cuts will increase yearly GNP by about \$92 billion. (The additional tax cuts planned for later years will further increase GNP.) As a result of this expansion of real GNP, the tax revenues of all levels of government (Federal, State and local) will increase by \$30 billion and saving (personal and business) by \$6 billion. Adding these sums to the \$9.7 billion direct reduction in business taxes and corollary increase in business saving, we estimate that less than \$10 billion of the \$53.9 planned fiscal year 1982 tax cuts remains to be financed. We believe that this gap will be funded easily by the increased saving which will result from the after-tax interest

rate effects of personal marginal tax rate reductions and targeted saving incentives, plus tax reflows from—

Reduced tax deductible consumer interest charges;

Reduction of the underground economy;

Reduced tax sheltered investment; and

Liquidation of investments in art objects, precious metals and the like.

In other words, there is no reason to believe private investment will be crowded out. Indeed, we believe private investment will be stimulated. The combination of marginal tax rate reductions on personal income, business depreciation reform, and some form of targeted saving incentive would, in our view, induce a sufficiently large increase in saving to close the budget gap (\$10 billion in the illustration), with enough left over to create a substantial number of new sources of investment capital.

SPENDING CUTS

In a static framework, spending cuts and tax cuts have offsetting effects on the budget deficit. In a dynamic world they do not. In our view, it is not necessary to plan static spending cuts which will exactly equal the static tax cuts that are planned. The planning marginal tax rate reductions will increase real GNP more than the spending cuts will decrease it. This is because marginal tax rate reductions will increase personal effort, saving, investment, entrepreneurship and risktaking. Judicious spending cuts needs not decrease effort, saving, investment, entrepreneurship and risktaking; some spending cuts might, but others will actually increase them.

President Reagan has proposed a broad array of spending cuts to accompany the tax cuts. At first glance, some program cuts will hurt some people. However, in this regard, an expanding economy improves the political climate in which such legislated cuts in spending can be made. When there is full employment and growth, the need for special programs to aid this sector, that industry, these workers and those business firms is less urgent.

Moreover, it is important to recognize that tax cuts not only produce additional saving and revenue reflows to the government, they also lead to automatic spending cuts.

In a stagnating economy it is almost impossible to make significant cuts in Federal spending, which is made up largely of entitlement programs. When the economy stagnates, people become unemployed and real standards of living decline, causing individuals to make claims on government services. When an individual is employed, he or she is a source of government revenue; when the person is unemployed, he or she becomes a consumer of government revenue, through such programs as unemployment compensation, trade adjustment assistance, food stamps, etc. Thus, an increase in unemployment reduces government revenue even as it causes an increase in spending. It is estimated that a one percentage point increase in the national unemployment rate "costs" the Federal Government \$25 billion per year.

The converse also is true. An expanding economy will provide jobs for the unemployed and higher living standards for many now in need. People will go off unemployment rolls, off food stamps, off welfare and will become taxpayers rather than tax consumers. Thus, a reduction in tax rates will partially pay for itself by causing automatically a reduction in Federal spending.

Finally, we want to stress that if money growth is decelerated in a meaningful but not drastic way, as we recommend in Chapter II, inflation will decelerate in time. As it does, and even in anticipation of the event, interest rates, especially long-term interest rates, will decline. Reduction and, ultimately, elimination of the inflation and uncertainty premiums from interest rates will save the Treasury tens of billions of dollars in interest costs every year.

Off-Budget Spending Cuts

We can also help to finance the tax cuts by reducing the Federal Government's off-budget activities. The Federal deficit for fiscal year 1982 was estimated by the Carter Administration to equal \$27.5 billion. However, total Federal and federally-assisted borrowing will be \$126.8 billion. The deficit accounts for only about 21 percent of total Federal borrowing. Clearly, any cuts that can be made in Federal borrowing, loan guarantees, and Federal agency borrowing will have the same positive effects on credit markets and interest rates as a cut in spending.

In conclusion, we strongly support a coordinated program of tax cuts for individuals and businesses, and reductions in Federal spending and borrowing, including off-budget borrowing, to get the economy moving forward again, while gradually slowing money growth to stop inflation and reduce interest rates.

The Equity Issue

Many assert that across the board personal marginal tax cuts are unfair; that they will cut the taxes of the "rich" too much and the taxes of the "poor" too little. In fact, they will scale down all tax rates, and the scalar is the same for all individuals.

In this regard, it is important to recognize that, since 1967, inflation-induced bracket creep has greatly increased the tax burden of middle- and upper-income persons despite some legislated tax cuts. It would be wrong from the standpoint of equity, as well as counterproductive from the standpoint of the economy, not to correct past bracket creep by scaling marginal tax rates down across the board. For the record, some pertinent data are presented in Table III-1.

TABLE III-1.—TAX RATES ON SAME REAL TAXABLE INCOME,¹ 1967 AND 1980

	1980 equivalent inflation- adjusted taxable income	Marginal percent tax rates		Average percent tax rates	
		1967	1980	1967	1980
1967 taxable income:					
\$1,000.....	\$2, 245	15	0	14.0	0
\$4,000.....	8, 980	19	18	15.5	9.8
\$8,000.....	17, 960	22	24	17.3	15.3
\$12,000.....	26, 940	25	32	18.8	19.5
\$16,000.....	35, 920	28	43	20.4	23.6
\$20,000.....	44, 900	32	43	21.9	27.5
\$24,000.....	53, 880	36	49	23.2	31.0
\$28,000.....	62, 860	39	54	25.4	33.8
\$32,000.....	71, 840	42	54	27.1	36.3
\$36,000.....	80, 820	45	54	28.7	38.3
\$40,000.....	89, 800	48	59	30.4	40.1
\$44,000.....	98, 780	50	59	32.0	41.8

¹ For married persons filing joint return.

Across-the-board marginal tax rate cuts will tend to restore the progressivity of the tax code which existed in 1967 before inflation distorted it.

IV. THE INTERNATIONAL ECONOMY

The United States operates in an open world economy. This means that steps taken by the Federal Government for domestic economic policy reasons have rapid international effects and vice versa, steps taken for international reasons have rapid domestic effects. The linkages between domestic economic policy and the international economy take place primarily through the foreign exchange markets. Exchange rate changes affect investment, trade flows and the balance of U.S. international payments. In turn, changes in trade flows and the balance of payments often impede domestic policy responses. In the past, some of these responses have been destabilizing domestically.

The international economy is a far different system from what existed a decade ago. The introduction of floating exchange rates in 1973, the sophistication of today's foreign exchange market traders, and the increased mobility of international capital have removed old constraints but placed new ones on domestic economic policy. Under the new system, domestic policy initiatives can quickly translate into a rise or a fall in the dollar exchange rate before the initiatives themselves have had a chance to take effect in the U.S. economy. Because of the new "openness" in the international economic system, domestic economic policy must be formulated taking into consideration its international effects.

DESIGNING DOMESTIC ECONOMIC POLICIES TO PROMOTE INTERNATIONAL ECONOMIC STABILITY

We believe that our monetary and fiscal policy recommendations described earlier in these views will also serve the international economic objectives of a strong dollar and a stable balance of payments. This is because foreign exchange traders will interpret the policies we are recommending as a sign that the United States at long last is determined to halt the dangerous inflationary trends which have characterized the Federal budget, monetary policy, and the economy over the past decade, and weakened the dollar internationally. The dollar is firming in all exchange markets due to a new confidence in the U.S. economic policy. In turn, this makes it easier to implement the tough domestic policies which we are recommending and which closely parallel those of the new Reagan Administration. It means, for example, that as we unwind inflation and reduce government spending, domestic interest rates can fall without the flight from the dollar that might otherwise accompany a reduction in interest rates. In short, fortunately, we can promote both domestic and international economic stability with the same domestic policies. The key is that these policies must be believed capable of stopping inflation and, in time, prove to be so capable.

Notwithstanding our optimism about the international economy, there are two major areas where the course of events will require a careful U.S. response.

INTERNATIONAL POLICIES WHICH WILL PROMOTE DOMESTIC ECONOMIC GROWTH AND STABILITY

Trade Competitiveness

The progress made in the past two years toward defining the components of a competitive trade policy, as reflected by recommendations made by the Congress, the Executive Branch and by organizations such as the President's Export Council, needs to be followed up immediately with action to ensure that the hard-fought consensus does not evaporate in a constantly shifting international competitive environment. Recent statistics provide little reason to cheer.

The massive 1980 merchandise trade deficit of \$26 billion (c.i.f.), while reflecting modest improvement over 1979, was much too large. The 1980 manufactured goods trade surplus can be largely attributed to business cycle and lagged exchange rate effects from the 1978 period and does not reflect any significant improvement in competitiveness of U.S. manufactured goods. Similarly, the surplus in the current account, although welcome, was due in substantial part to accounting changes affecting retained earnings of overseas subsidiaries. It is not a reason for complacency.

Indeed, for a more accurate assessment of our relative competitive posture, it is best to consider the U.S. share of world exports of manufactured goods. This statistic shows a steady decline throughout the 1970 to 1979 period—from 21.4 percent in 1970 to 17.4 percent in 1979. Further in an era in which international competitiveness is increasingly defined in terms of the home market, U.S. manufactured imports as a share of domestic manufactured goods production have risen to 20 percent in 1979, a 428 percent increase over 1960.

The competitive climate of international commerce demands an aggressive spirit in the private sector as well as in government to deal with the realities of the marketplace. Notwithstanding recent achievements within the GATT to eliminate many tariff and nontariff barriers to free trade, including unfair export incentives, it is still a less than perfectly competitive world in which U.S. producers and consumers must compete. It is for this reason that the "business as usual" mentality must give way to a more realistic perception by business and government of what is required to compete at home and abroad.

Several issues involving incentives and disincentives to trade were addressed inconclusively by Congress in the past year. In our view, they warrant renewed attention. Among these are: legislation to establish export trading companies, a concept which should prove useful in expanding the Nation's export base; legislation reducing the tax burden on U.S. employees stationed overseas; a reconsideration of the extraterritorial application of U.S. antitrust laws, with special note as to how such application deters U.S. companies from seeking new markets; a rational clarification of the accounting and business procedures standards of the Foreign Corrupt Practices Act.

It is critical at this important juncture that the Federal Government improve the climate for U.S. firms' direct investment abroad and increase export of services. U.S. foreign direct investment, while providing an efficient allocation of capital, also has promoted U.S. competitiveness and served to accelerate exports to overseas manufacturing facilities. Such direct investment also serves a development function

by providing needed capital and technology to the developing areas of the World.

Output of the service sector currently accounts for 30 percent of U.S. exports, 70 percent of U.S. jobs, and 65 percent of our gross national product. As the U.S. economy becomes increasingly service oriented and as our balance of payments becomes increasingly reliant on service export earnings, the lack of internationally agreed codes of conduct on such trade will become more costly to U.S. international competitiveness. Similarly, a lack of updated agreement on safeguards, especially in a period of global high unemployment and slow growth, bodes poorly for efficient resolution of trade disputes in the future.

The advances made by the recent Multilateral Trade Negotiations (MTN) Agreements toward a more liberal trading system will contribute to growth in world trade and result in fewer contrived trade impediments and enhanced welfare for all participants. However, it is critical for the trade negotiation process to continue to pursue multilateral agreement respecting service industries and a meaningful safeguards code.

INTERNATIONAL FINANCE

At the present time, non-oil developing countries are encumbered by a set of pressures which carries potential dangers for the world financial system. First, the dramatic increase in the price of crude oil over the past two years has added to the energy bill of those nations. According to the U.S. International Development Cooperation Agency, these countries are now paying \$67 billion a year for energy imports which cost only \$32 billion in 1978. The projected figure for 1985 is \$124 billion.

Second, interest rate increases have added to the cost of financing development. Estimates of the Agency for International Development indicate that the *increase* in interest costs over the past two years has accounted for an additional \$13 billion in current account deficits for the non-oil LDC's.

Third, the slowdown in growth among developed countries has decreased the hard currency foreign exchange earnings which the LDC's might have earned by exporting to developed countries. This helps explain why the total current account deficit of non-oil LDC's increased from \$36 billion at one end of 1978 to \$79 billion for 1980.

Fourth, new financing for non-oil LDC's is expected to grow slowly. This is because official financing is suffering from budget constraints; at the same time, private financing is coming up against the limits that lenders believed to be the prudent ones for exposure to financial risk in these countries. As a group, the non-oil LDC's suffer twice the world average inflation rate. Their external debt has climbed faster than their ability to pay it off. They are in hock to the rest of the world to the tune of \$300 billion. Their bill for energy, a consumable item, is being paid increasingly by loans rather than by the foreign exchange earnings from exports. Partly as a result of this, the debt service of these poorer countries has climbed both absolutely and as a percentage of their GNP.

The international banking system has relieved many of the pressures afflicting non-oil LDC's in recent years. In fact, more than half of the official debt of non-oil LDC's now is owed to private lending sources. This so-called "recycling" process, from the surpluses of OPEC countries, through the banking system of the developed nations to the financing needs of the non-oil LDC's, has become a major aspect of international finance. Preliminary data suggest that all financing needs can be met in 1981. The same data, however, indicate that there may be problems later on. In the final analysis, these problems can only be resolved by the non-oil LDC's themselves. However, the United States can assist two ways: First, by strengthening the capabilities of the International Monetary Fund to reduce pressures on the world monetary system (e.g., disciplining nations that follow irresponsible domestic policies) and second, by working through diplomatic channels to enlist the cooperation of oil exporting countries.

V. GOVERNMENT REGULATION

During the past 15 years 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. These programs usually impose significant compliance costs on businesses which are then passed on to consumers through higher prices.

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. We would not turn back the clock, because many regulatory policies have produced substantial benefits for the public.

However, regulatory programs impose heavy costs and burdens on business (and ultimately consumers) and, until recently, these costs have been almost entirely ignored in setting regulatory policy. It is time we took a hard look at the cost side of this equation.

One measure of the dimension of the problem was provided to the Committee by Murray Weidenbaum in a study that put the 1979 private sector compliance costs at \$97.9 billion, and the agency administrative costs at another \$4.8 billion. That \$97.9 billion was 6 percent of personal consumption expenditures in 1979. Though it would be difficult to ferret out the precise marginal costs imposed by regulation, it is universally acknowledged that regulation has both a direct effect and an indirect effect on prices. The indirect effect comes through the reduction in productivity due to diversion of talent and resources from productive purposes to government paperwork and the diversion of capital expenditures to meet Federal regulatory requirements.

As with many new and rapidly growing government programs, problems have developed with regulations and their impacts. One major problem involves the measurement of benefits and costs. The current techniques for measuring these benefits and costs are not very sophisticated and need further development. As a result, the benefit goals of many regulations are set with little regard to cost. Much of the fault for this lies with Congress, as some laws call for regulations to be put in place without requiring that costs or benefits be weighed, while other laws actually prohibit the consideration of costs.

In addition, the recent proliferation of regulations and lack of coordination among regulatory agencies have often resulted in regulations which are duplicative, conflicting and excessive. Witnesses appearing before the Committee have provided examples where compliance with one regulation requires violation of another. This not only puts businesses in unnecessary jeopardy, both legally and financially; it also reduces respect for the law and the Federal Government. Small businessmen are often hardest hit by the morass of conflicting and duplicative regulation because they cannot afford the necessary legal advice.

COST EFFECTIVE REGULATION

Regulatory programs should attempt systematically to consider costs and benefits whenever possible. As noted, a cost-benefit test for government regulations, as desirable as it is in theory, does create some problems in practice.

However, for most regulatory programs, such computations are not necessary to reduce regulatory-imposed waste and inefficiencies. Congress, in enacting regulatory programs, generally presumes or sets a level of benefits to be achieved, just as it does with spending programs. The benefit level is not, and should not be, determined by the administering agency. Rather, the agency should be charged with achieving the congressionally mandated goals at the least cost. This eliminates the need to measure benefits and instead focuses on costs, which can be more accurately measured.

We believe 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. We believe a cost-effectiveness rule would be a more effective way of controlling regulatory costs without reducing the benefits of regulatory programs than would a cost-benefit test.

REGULATORY BUDGET

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 the use of resources that could be used for several purposes. The more resources that are devoted to one purpose, the less such resources are available for others. Even if all regulations were internally cost effective, the problem of balancing resources for regulatory purposes with resources for other purposes would still exist. This balance could best be accomplished through a regulatory budget.

Prior to the rapid growth of social 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. By adding to these the financial commitments (through loans, guarantees, and insurance) of some 14 "off-budget" agencies, one could get a fairly clear picture of the government's influence on the economy.

But with the recent rapid growth of the new regulatory agencies—the Occupational Health and Safety Administration, the Environmental Protection Agency, the National Highway Traffic Safety Administration and many others—the fiscal budget no longer conveys a complete picture of government's impact on the economy. Most of the economic effect of regulation is hidden, since government-required private sector spending for auto safety, mine safety, pollution control and consumer protection, plus the attendant paperwork costs, do not appear in the government's budget figures. They are cloaked in what might be called "off-off-budget" spending, required of the private sector to comply with Federal regulation.

A clear example of the need for a budget showing the economic impact of regulation on the society may be seen in the environmental regulation of electric utilities. The massive cost of a smokestack scrubber to achieve cleaner air is passed on directly to consumers who pay higher utility bills as surely as they pay taxes. But the Federal budget fails to show these higher prices. It also fails to show the higher prices consumers pay 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 policy-makers and to the public.

If these costs were minor, their omission from the budget would not be a serious problem. But they are not minor, and they are growing. It is important, therefore, that the Budget Act of 1974 be amended to require that Congress annually establish a regulatory budget, along with the fiscal budget, to set a limit on the costs of compliance each agency could impose on the private sector in any one year. The timetable and the process provided for developing a regulatory budget should be similar to those governing the fiscal budget concurrent resolution.

A regulatory budget would constrain the regulatory agencies to limit the compliance costs that their regulations impose. It would certainly make the agencies more conscious of those costs. But it would have other important effects as well. A regulatory budget, along with the fiscal budget, would provide a more accurate picture of the Federal Government's total impact on the economy, allowing Congress to determine how much of the Nation's output is to be devoted to public uses. It would make possible a better balance between regulatory programs and traditional government spending programs. It would enhance the protection of the public's health and safety by requiring that the Federal Government establish consistent priorities in pursuing regulatory objectives.

