Department of the TREASURY NEWS

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TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FISCAL AND INTERGOVERNMENTAL POLICY
OF THE JOINT ECONOMIC COMMITTEE

Mr. Chairman and Members of this distinguished Subcommittee:

Thank you for this opportunity to discuss the economic outlook, its regional impact, and what might be done to mitigate the effects of a recession on our State and local governments. I am pleased that the Subcommittee is giving its attention to this important subject.

Economic Outlook

Let me begin by summarizing briefly my assessment of the current economic outlook. In recent weeks the economy has shown more strength than earlier anticipated. Indeed GNP growth in the third quarter of this year is likely to show some recovery from the depressed levels of the second quarter. The September unemployment rate fell back to 5.8 percent after rising to 6.0 percent in August. Retail sales for August and September were up 5 percent in nominal terms, and almost 3 percent in real terms, from second quarter levels. However, this strengthening of economic

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activity has been coupled with an acceleration of inflation, a heightening of inflationary expectations, an expansion in credit flows and increasing evidence of speculative activity in commodity and financial markets.

In September, the rate of inflation, as measured by producers' finished goods prices, accelerated. The monthly increase of 1.4 percent was the largest single monthly advance since late 1974.

In recognition of accelerating inflationary pressures and developments in the domestic and international financial markets, on Saturday, October 6 the Federal Reserve Board acted to slow the growth in money and credit expansion.

The recent policy actions by the Federal Reserve--actions which are appropriate and necessary--will help us get a better handle on inflation, the dominant economic problem of our time. If we are to preserve the economic advances that have been made since the end of the last recession, we have no reasonable alternative but to mount a strong and broad attack on inflation and inflationary expectations.

We must recognize, however, that the underlying factors have now changed somewhat and we cannot be as certain as previously about the depth and severity of the economic slow-down. However, there are few signs that we are facing a deep

downturn of the 1973-75-type, and with economic policies focused on curbing inflationary expectations, the outlook continues to indicate a moderate recession.

The Administration intends to continue its comprehensive fiscal discipline, monetary restraint, responsible pay-price policy, an overall energy program, reduction of regulatory burden and other measures. This will contribute to a slowing of price increases during the coming months. By doing so, we can avoid an acceleration of wage and price increases and a new inflationary spiral.

By acting to slow the rate of inflation, we will be able to shore-up real incomes, reduce uncertainty, reverse expectations of future inflation, strengthen consumer and business confidence, and reduce significantly the chances for a deeper recession.

The steps that have been taken to reduce inflation are necessary to restore economic stability and balanced growth. We must prove to ourselves and demonstrate to others that we have the conviction, the courage, and the fortitude to stick with the policies that are needed to bring inflation under control.

Regional Impact of Recession

With this brief background on the economic outlook, let me now address the question of the regional impact of a recession.

The sensitivity of regions to a national economic recession varies widely and is dependent upon a number of factors, including industrial composition and growth rates. Historically, during periods of declining economic activity, manufacturing industries (particularly durable goods manufacturing) have tended to experience relatively wider fluctuations in output and employment than other industries. Purchases of consumer durables (such as automobiles and large household applicances) and capital goods are more readily postponed during economic slowdowns than purchases of non-durables (such as clothing and food) and many services. Thus regions which are heavily dependent upon manufacturing activity as a source of income and employment are generally more severely impacted by national recessions.

Regions that have been experiencing rapid increases in economic growth due to increased capital investment, in-migration of labor, favorable climate, relatively cheap resources, or any number of other factors may be less severely affected by national economic recession than regions with slower growth rates and regions that have a relatively older, less-efficient capital base.
Regions heavily engaged in agriculture are not usually affected by recession to the same degree as regions heavily dependent upon industry.

During the post-war period, 1948-1975, the East North Central, New England, and Mid-Atlantic States have displayed the greatest sensitivity to national economic slowdowns in terms of employment declines relative to the national average. On the other hand, the Mountain, West South Central, West North Central and South Atlantic States have shown the least sensitivity. The degree of sensitivity is explainable basically in terms of the make-up of the economic base of the various regions.

Using the latest data then available, a 1978 Boston Federal Reserve Bank study indicates that:

(1) During the six business cycle episodes of the post-war period, employment in the East North Central, New England and Middle Atlantic States has almost always shown percentage declines far in excess of the national average. In the 1973-1975 recession, for example, total U.S. employment declined 2.9 percent from its peak-to-trough. Employment declined 4.7 percent, however, in the East North Central States, 4.3 percent in the New England States and 3.8 percent in the Middle Atlantic States. Although employment declines in other regions occasionally exceeded the national average, this has been the exception rather than the rule.

In the three regions where employment declines are more severe than the nationwide average, manufacturing is the predominant source of labor and proprietor's income. Manufacturing is also more important to these three regions than to any other region in the Nation and durable manufacturing is substantially more important than nondurable manufacturing.

(2) Except for the 1969-1970 recession, when employment losses in the Pacific States were aggravated by the winding down of the Vietnam War and its impact on the aerospace industry, employment declines in this region have been less than the national average. During the last recession, the Pacific States suffered employment declines of only 1.3 percent, less than half of the national average. Although manufacturing accounts for about 25 percent of the region's total labor and proprietor's income, the relative importance of income from government, services, trade, and other nonmanufacturing sectors is greater in the Pacific region than in the Nation as a whole. Thus, the Pacific region is more diversified than many of the other regions and is less sensitive to recessions.

(3) In each of the six post-war recessions, employment declines in the Mountain States have also been substantially less than the national average. During the severe 1973-1975 recession, for example, this region experienced an employ-

ment decline only half that of the national average; and in the two preceding recessions these States suffered no declines in nonagricultural employment. The Mountain States receive a smaller share of their income (less than 15 percent) from manufacturing than any other region. This fact and the fact that government and services account for larger income shares than in any other region probably assures this region of only a minimal adverse impact from recessions.

A region's industrial mix also has implications for the timing of the recession's impact. Since manufacturing activity is most sensitive to a recession, those States or regions most heavily dependent upon manufacturing (particularly durable manufacturing) generally should feel the effects of a recession first. Those States or regions also would probably be among the first to qualify for fiscal assistance from the Federal Government under the Administration's proposed Intergovernmental Fiscal Assistance program that I will discuss shortly. Private forecasts of the regional impacts of the current recession seem to bear out this point.

Not all regions will be affected to the same extent by the current recession. Only those regions relatively heavily engaged in manufacturing (particularly durable goods manu-

facturing) or experiencing slow growth are likely to be seriously affected. In the mild 1969-1970 recession, for instance, the South Atlantic, East South Central, and Mountain States experienced no declines in employment while the West South Central States showed only minimal declines. In contrast, the New England, East North Central, and Mid-Atlantic regions endured employment declines far above the national average. (Regional employment data for past recessions is presented in Table 1 and regional definitions are shown in Table 2.)

During the 1973-1975 recession, the most severe economic downturn since the Great Depression, no region escaped unscathed. All suffered employment losses. Even the East South Central and South Atlantic States, which experienced no employment declines during the mild 1969-1970 recession, showed large declines. At the same time, however, three regions--the West South Central, Pacific and the West North Central States--experienced milder relative declines in employment during the last recession than they had during the mild 1969-1970 recession, highlighting the fact that the regional impacts of recession differ from recession to recession.

<u>Studies of the Regional Impacts of the Current Recession</u>

The Administration has no official economic forecasts of individual States, local areas, or regions. However, there

have been a number of private forecasts of the regional impacts of the expected current recession. Those forecasts were undertaken several months ago and are predicated upon the assumption of a modest recession for the national economy.

The private forecasts indicate that the recession's regional impact pattern will not differ greatly from that experienced during the mild 1969-1970 recession.

- The New England, Middle Atlantic, and East North Central regions are expected to bear the brunt of the recession. As noted previously, all three of these regions rely heavily upon durable manufacturing for jobs and income.
- The Mountain States are expected to suffer little or no employment losses--only a slowdown in employment growth. As also noted earlier, of all the regions of the country, this one is least dependent upon manufacturing.
- The Pacific, South Atlantic, East South Central, West North Central and West South Central States all are predicted to experience mild employment declines. Except for the Pacific region, where specific factors were operative, none of these areas experienced marked

employment declines during the mild 1969-1970 recession.

Of course, these studies of the regional impacts of the current recession are largely based upon historical regional impact patterns. To the extent that the weaknesses and causes underlying the current recession differ significantly from previous recessions and to the extent that structural changes in communications and transportation have taken place, the regional impact of the current recession could differ from the past.

Current Fiscal Position of State and Local Governments

There has been considerable attention directed to the "huge" budget surpluses enjoyed by States. However, only a few States account for most of these surpluses. More importantly, virtually all of these surpluses consist of contributions to various social insurance funds (such as retirement funds, workmen compensation, and temporary disability insurance funds) which are not generally available for other purposes. During the second quarter of this year, State and local governments actually ran a $6.3 billion deficit (based on national income and product accounts data) after allowances are made for contributions to social insurance funds (See Table 3). This was the first such deficit since

the second quarter of 1976. With the anticipated declines in the growth of employment, personal income, and retail sales due to the recession, further reductions in the rate of growth in State and local government revenues can be expected. If it were to continue for some time, such a development could jeopardize the fiscal posture of many State and local governments.

The spread of public sentiment for Proposition 13-type tax reductions could result in a further deterioration of the fiscal position of States and localities unless public spending is also curtailed. Curtailing public spending, however, could exacerbate the recession. A countercyclical fiscal assistance program for State and local governments would help avoid such pro-cyclical actions.

Many of the regions that will be most affected by the recession have older cities that are experiencing secularly declining economic growth rates. These cities may be particularly hard-pressed to maintain service levels in the face of the current slowdown.

The Administration considered the prospects for regional variation in the effects of a recession in preparing its fiscal assistance proposal, which was submitted to the Congress last March. Let me first relate the basic justification for a countercyclical program to the evidence on

varying regional effects from a recession. Then, I will summarize the provisions of the bill recently passed by the Senate, which is very similar to the Administration's March proposal.

The Rationale for Countercyclical Fiscal Assistance

During periods of economic prosperity, most States and local governments accumulate fund balances that allow them to sustain spending for as much as a year after a recession begins. At such a point, typically about the time recovery begins, fund balances have been reduced to the point where the normal spending trend can no longer be sustained, and outlays in real terms may actually begin to decline. This pattern is observable in the record of every recession and recovery since World War II, including the 1973-77 period. Although the continued growth in spending during the decline helps to reduce the seriousness of the recession, the fall-off in spending tends to slow the pace of the early phase of the recovery. Thus, from the perspective of macroeconomic policy, countercyclical fiscal assistance should be triggered well after the economy has turned down. However, payments should cease after the recovery is well under way, in order to minimize potential inflationary effects.

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In the current economic environment, decisions on macroeconomic policy must take serious account of the potential inflationary side-effects of any anti-recession fiscal policy option under consideration. The choice among the available policy options should be based upon a careful balancing of relative job-creation effectiveness per dollar of federal deficit against potential inflationary side-effects.

Other things equal, a policy that targets the first-round economic stimulus to areas with significant concentrations of unemployed or underutilized human and capital resources is likely to have the least inflationary effect on prices. Such targeting cannot be achieved by traditional forms of antirecession tax cuts, which must apply uniformly throughout the nation. However, a geographically differentiated spending program can be targeted to areas with high levels of unemployed resources.

Studies of the recent experience suggest that a countercyclical fiscal assistance program--such as Antirecession Fiscal Assistance (ARFA) adopted in 1976 and extended in 1977, or the similar countercyclical tier of the Targeted Fiscal Assistance Program currently before the House--can be very effective in terms of job creation with minimal inflationary side-effects.

Logic and the evidence on the experience with ARFA suggest that local governments with high unemployment rates are most likely to commit such grants quickly and for job-creating purposes. This is a major reason why the targeting mechanism in the proposed program is based on local unemployment rates, rather than on such alternatives as the change in real wages and salaries.

While the recession facing the nation is expected to be moderate, the current economic outlook remains volatile, particularly in light of the uncertainties about energy prices and availability. It therefore seems prudent to put in place a stand-by countercyclical fiscal assistance program, such as the countercyclical tier of the Senate-approved bill that is now pending before the House Subcommittee on Intergovernmental Relations and Human Resources.

As in the Administration's March proposal, there are two tiers in the Senate bill. The first involves the payment of $85 million per quarter in targeted fiscal assistance payments in FY 1980 to a very small number of particularly distressed local governments.

The second tier, which is germane to this discussion today, involves a stand-by countercyclical fiscal assistance program which would trigger on during periods of high national unemployment rates.

Stand-by Countercyclical Fiscal Assistance Program

Let me indicate briefly how this countercyclical tier would work. By comparison with the 1976-78 ARFA program, the proposed program is much more highly targeted. It would only operate when the national unemployment rate reaches 6.5 percent or more for a full quarter, instead of 6 percent as under ARFA. Once the program is triggered, a recipient government would be eligible for payment under the Senate-passed bill only if its quarterly unemployment rate is at least 6 percent, instead of the 4.5 percent under ARFA. This additional targeting, in the present inflationary context, is highly desirable. It would ensure that countercyclical funds go only to areas with substantial amounts of unemployed human and physical capital, and thus are less likely to fuel inflation. Moreover, governments in areas with high unemployment rates are more likely to be experiencing significant fiscal stress, and such governments are most likely to use the payments for purposes that involve maximum job-creation effects.

The Administration's mid-session economic forecast anticipated that national unemployment rates would have reached 6.5 percent or more by the last calendar quarter of 1979. This would have triggered payments under the proposed stand-by program. The apparent strength of the economy in the third quarter, and the events of the last few weeks, have caused us to reconsider the economic forecast, but a new one is not

yet available. If the national unemployment rate reaches 6.5 percent by the first calendar quarter of 1980, this would trigger payments under the countercyclical tier, which would be distributed in the last quarter of fiscal year 1980. Given the lags in State and local budgetary processes and the spend-down of balances accumulated during the past few years, this is approximately the time when recession induced revenue losses raise the prospect of serious budgetary disruption. This disruption will then threaten to require fiscal behavior by State and local governments that will tend to impede the early stage of the recovery from the recession.

When the program provided for in the Senate bill is triggered, it would distribute $125 million per quarter plus an additional $30 million for each one-tenth of one percent by which national unemployment exceeds 6.5 percent. One-third of the funds would be distributed to the States, the balance to eligible local governments.

Conclusions

The proposed fiscal assistance program is an important element of the President's domestic program. It is a balanced, two-tiered program that would address the immediate needs of a limited number of fiscally strained local communities, as well as the prospective needs of State and local governments as they strive to deal with substantial economic uncertainty.

In particular, the stand-by tier of the program is a sensible fiscal insurance program for State and local governments in the event of future excessive unemployment.

I appreciate the opportunity to discuss the pending proposals for countercyclical fiscal assistance in the context of regional variation in the economic effects of a recession. I look forward to working with you and other members of Congress toward enactment and implementation of the program.

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Table 1

Percentage Drop in Nonagricultural Employment
during Six Postwar Recessions

	United States	New England	Middle Atlantic	East North Central	West North Central	South Atlantic	East South Central	West South Central	Mountain	Pacific**
1948-49	5.0	5.6	6.8	6.7	1.8	4.8	7.4	2.3	1.8	4.5
1953-54	3.5	3.9	4.5	6.2	2.3	3.0	3.6	2.2	2.7	1.9
1957-58	4.4	5.0	4.5	8.5	2.3	2.0	2.5	1.8	1.4	3.1
1960-61	2.3	1.1	2.5	4.9	1.2	1.3	*	1.6	*	0.4
1969-70	1.4	3.1	2.1	4.3	1.7	*	*	0.5	*	2.6
1973-75	2.9	4.3	3.8	4.7	2.8	4.5	4.3	0.7	1.5	1.3

* No decline in absolute level of employment during the recession.

** Data for the first three expansion periods calculated using California and Oregon employment only; data for final three periods calculated using employment figures for the entire region.

Source: Federal Reserve Bank of Boston, New England Economic Review (November/December 1978).

Table 2

Census Bureau's Regions of the United States

New England

Connecticut
Maine
Massachusetts
New Hampshire
Rhode Island
Vermont

Middle Atlantic

New Jersey
New York
Pennsylvania

South Atlantic

Delaware
District of Columbia
Florida
Georgia
Maryland
North Carolina
South Carolina
Virginia
West Virgina

East North Central

Illinois
Indiana
Michigan
Ohio
Wisconsin

East South Central

Alabama
Kentucky
Mississippi
Tennessee

West North Central

Iowa
Kansas
Minnesota
Missouri
Nebraska
North Dakota
South Dakota

West South Central

Arkansas
Louisiana
Oklahoma
Texas

Mountain

Arizona
Colorado
Idaho
Montana
Nevada
New Mexico
Utah
Wyoming

Pacific

Alaska
California
Hawaii
Oregon
Washington

Table 3
State and Local Government
Receipts and Expenditures

	1975	1976	1977	1978	1979 I	1979 II
	Billions of dollars; annual rates					
Receipts	236.9	268.0	298.8	331.0	343.9	345.9
Expenditures	230.6	250.1	271.9	303.6	316.3	326.1
Surplus or deficit (-) National income and Product accounts	6.2	17.9	22.8	27.4	27.6	19.7
Social insurance funds	12.4	15.7	19.6	23.2	25.0	26.0
Other funds	-6.2	2.3	7.3	4.2	2.6	-6.3

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

Note: Figures may not add due to rounding.

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Regional Impact of Recession

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Regions that have been experiencing rapid increases in economic growth due to increased capital investment, in-migration of labor, favorable climate, relatively cheap resources, or any number of other factors may be less severely affected by national economic recession than regions with slower growth rates and regions that have a relatively older, less-efficient capital base. Regions heavily engaged in agriculture are not usually affected by recession to the same degree as regions heavily dependent upon industry.

During the post-war period, 1948-1975, the East North Central, New England, and Mid-Atlantic States have displayed the greatest sensitivity to national economic slowdowns in terms of employment declines relative to the national average. On the other hand, the Mountain, West South Central, West North Central and South Atlantic States have shown the least sensitivity. The degree of sensitivity is explainable basically in terms of the make-up of the economic base of the various regions.

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(2) Except for the 1969-1970 recession, when employment losses in the Pacific States were aggravated by the winding down of the Vietnam War and its impact on the aerospace industry, employment declines in this region have been less than the national average. During the last recession, the Pacific States suffered employment declines of only 1.3 percent, less than half of the national average. Although manufacturing accounts for about 25 percent of the region's total labor and proprietor's income, the relative importance of income from government, services, trade, and other nonmanufacturing sectors is greater in the Pacific region than in the Nation as a whole. Thus, the Pacific region is more diversified than many of the other regions and is less sensitive to recessions.

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ment decline only half that of the national average; and in the two preceding recessions these States suffered no declines in nonagricultural employment. The Mountain States receive a smaller share of their income (less than 15 percent) from manufacturing than any other region. This fact and the fact that government and services account for larger income shares than in any other region probably assures this region of only a minimal adverse impact from recessions.

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Other things equal, a policy that targets the first-round economic stimulus to areas with significant concentrations of unemployed or underutilized human and capital resources is likely to have the least inflationary effect on prices. Such targeting cannot be achieved by traditional forms of antirecession tax cuts, which must apply uniformly throughout the nation. However, a geographically differentiated spending program can be targeted to areas with high levels of unemployed resources.

Studies of the recent experience suggest that a countercyclical fiscal assistance program--such as Antirecession Fiscal Assistance (ARFA) adopted in 1976 and extended in 1977, or the similar countercyclical tier of the Targeted Fiscal Assistance Program currently before the House--can be very effective in terms of job creation with minimal inflationary side-effects.

Logic and the evidence on the experience with ARFA suggest that local governments with high unemployment rates are most likely to commit such grants quickly and for job-creating purposes. This is a major reason why the targeting mechanism in the proposed program is based on local unemployment rates, rather than on such alternatives as the change in real wages and salaries.

While the recession facing the nation is expected to be moderate, the current economic outlook remains volatile, particularly in light of the uncertainties about energy prices and availability. It therefore seems prudent to put in place a stand-by countercyclical fiscal assistance program, such as the countercyclical tier of the Senate-approved bill that is now pending before the House Subcommittee on Intergovernmental Relations and Human Resources.

As in the Administration's March proposal, there are two tiers in the Senate bill. The first involves the payment of $85 million per quarter in targeted fiscal assistance payments in FY 1980 to a very small number of particularly distressed local governments.

The second tier, which is germane to this discussion today, involves a stand-by countercyclical fiscal assistance program which would trigger on during periods of high national unemployment rates.

Stand-by Countercyclical Fiscal Assistance Program

Let me indicate briefly how this countercyclical tier would work. By comparison with the 1976-78 ARFA program, the proposed program is much more highly targeted. It would only operate when the national unemployment rate reaches 6.5 percent or more for a full quarter, instead of 6 percent as under ARFA. Once the program is triggered, a recipient government would be eligible for payment under the Senate-passed bill only if its quarterly unemployment rate is at least 6 percent, instead of the 4.5 percent under ARFA. This additional targeting, in the present inflationary context, is highly desirable. It would ensure that countercyclical funds go only to areas with substantial amounts of unemployed human and physical capital, and thus are less likely to fuel inflation. Moreover, governments in areas with high unemployment rates are more likely to be experiencing significant fiscal stress, and such governments are most likely to use the payments for purposes that involve maximum job-creation effects.

The Administration's mid-session economic forecast anticipated that national unemployment rates would have reached 6.5 percent or more by the last calendar quarter of 1979. This would have triggered payments under the proposed stand-by program. The apparent strength of the economy in the third quarter, and the events of the last few weeks, have caused us to reconsider the economic forecast, but a new one is not

yet available. If the national unemployment rate reaches 6.5 percent by the first calendar quarter of 1980, this would trigger payments under the countercyclical tier, which would be distributed in the last quarter of fiscal year 1980. Given the lags in State and local budgetary processes and the spend-down of balances accumulated during the past few years, this is approximately the time when recession induced revenue losses raise the prospect of serious budgetary disruption. This disruption will then threaten to require fiscal behavior by State and local governments that will tend to impede the early stage of the recovery from the recession.

When the program provided for in the Senate bill is triggered, it would distribute $125 million per quarter plus an additional $30 million for each one-tenth of one percent by which national unemployment exceeds 6.5 percent. One-third of the funds would be distributed to the States, the balance to eligible local governments.

Conclusions

The proposed fiscal assistance program is an important element of the President's domestic program. It is a balanced, two-tiered program that would address the immediate needs of a limited number of fiscally strained local communities, as well as the prospective needs of State and local governments as they strive to deal with substantial economic uncertainty.

In particular, the stand-by tier of the program is a sensible fiscal insurance program for State and local governments in the event of future excessive unemployment.

I appreciate the opportunity to discuss the pending proposals for countercyclical fiscal assistance in the context of regional variation in the economic effects of a recession. I look forward to working with you and other members of Congress toward enactment and implementation of the program.

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Table 1

Percentage Drop in Nonagricultural Employment
during Six Postwar Recessions

	United States	New England	Middle Atlantic	East North Central	West North Central	South Atlantic	East South Central	West South Central	Mountain	Pacific**
1948-49	5.0	5.6	6.8	6.7	1.8	4.8	7.4	2.3	1.8	4.5
1953-54	3.5	3.9	4.5	6.2	2.3	3.0	3.6	2.2	2.7	1.9
1957-58	4.4	5.0	4.5	8.5	2.3	2.0	2.5	1.8	1.4	3.1
1960-61	2.3	1.1	2.5	4.9	1.2	1.3	*	1.6	*	0.4
1969-70	1.4	3.1	2.1	4.3	1.7	*	*	0.5	*	2.6
1973-75	2.9	4.3	3.8	4.7	2.8	4.5	4.3	0.7	1.5	1.3

* No decline in absolute level of employment during the recession.

** Data for the first three expansion periods calculated using California and Oregon employment only; data for final three periods calculated using employment figures for the entire region.

Source: Federal Reserve Bank of Boston, <u>New England Economic Review</u> (November/December 1978).

Table 2

Census Bureau's Regions of the United States

New England

Connecticut
Maine
Massachusetts
New Hampshire
Rhode Island
Vermont

Middle Atlantic

New Jersey
New York
Pennsylvania

South Atlantic

Delaware
District of Columbia
Florida
Georgia
Maryland
North Carolina
South Carolina
Virginia
West Virgina

East North Central

Illinois
Indiana
Michigan
Ohio
Wisconsin

East South Central

Alabama
Kentucky
Mississippi
Tennessee

West North Central

Iowa
Kansas
Minnesota
Missouri
Nebraska
North Dakota
South Dakota

West South Central

Arkansas
Louisiana
Oklahoma
Texas

Mountain

Arizona
Colorado
Idaho
Montana
Nevada
New Mexico
Utah
Wyoming

Pacific

Alaska
California
Hawaii
Oregon
Washington

Table 3
State and Local Government
Receipts and Expenditures

	1975	1976	1977	1978	1979 I	1979 II
	Billions of dollars; annual rates					
Receipts	236.9	268.0	298.8	331.0	343.9	345.9
Expenditures	230.6	250.1	271.9	303.6	316.3	326.1
Surplus or deficit (-) National income and Product accounts	6.2	17.9	22.8	27.4	27.6	19.7
Social insurance funds	12.4	15.7	19.6	23.2	25.0	26.0
Other funds	-6.2	2.3	7.3	4.2	2.6	-6.3

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

Note: Figures may not add due to rounding.

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TESTIMONY OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON FISCAL AND INTERGOVERNMENTAL POLICY
OF THE JOINT ECONOMIC COMMITTEE

Mr. Chairman and Members of this distinguished Subcommittee:

Thank you for this opportunity to discuss the economic outlook, its regional impact, and what might be done to mitigate the effects of a recession on our State and local governments. I am pleased that the Subcommittee is giving its attention to this important subject.

Economic Outlook

Let me begin by summarizing briefly my assessment of the current economic outlook. In recent weeks the economy has shown more strength than earlier anticipated. Indeed GNP growth in the third quarter of this year is likely to show some recovery from the depressed levels of the second quarter. The September unemployment rate fell back to 5.8 percent after rising to 6.0 percent in August. Retail sales for August and September were up 5 percent in nominal terms, and almost 3 percent in real terms, from second quarter levels. However, this strengthening of economic

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activity has been coupled with an acceleration of inflation, a heightening of inflationary expectations, an expansion in credit flows and increasing evidence of speculative activity in commodity and financial markets.

In September, the rate of inflation, as measured by producers' finished goods prices, accelerated. The monthly increase of 1.4 percent was the largest single monthly advance since late 1974.

In recognition of accelerating inflationary pressures and developments in the domestic and international financial markets, on Saturday, October 6 the Federal Reserve Board acted to slow the growth in money and credit expansion.

The recent policy actions by the Federal Reserve--actions which are appropriate and necessary--will help us get a better handle on inflation, the dominant economic problem of our time. If we are to preserve the economic advances that have been made since the end of the last recession, we have no reasonable alternative but to mount a strong and broad attack on inflation and inflationary expectations.

We must recognize, however, that the underlying factors have now changed somewhat and we cannot be as certain as previously about the depth and severity of the economic slowdown. However, there are few signs that we are facing a deep

downturn of the 1973-75-type, and with economic policies focused on curbing inflationary expectations, the outlook continues to indicate a moderate recession.

The Administration intends to continue its comprehensive fiscal discipline, monetary restraint, responsible pay-price policy, an overall energy program, reduction of regulatory burden and other measures. This will contribute to a slowing of price increases during the coming months. By doing so, we can avoid an acceleration of wage and price increases and a new inflationary spiral.

By acting to slow the rate of inflation, we will be able to shore-up real incomes, reduce uncertainty, reverse expectations of future inflation, strengthen consumer and business confidence, and reduce significantly the chances for a deeper recession.

The steps that have been taken to reduce inflation are necessary to restore economic stability and balanced growth. We must prove to ourselves and demonstrate to others that we have the conviction, the courage, and the fortitude to stick with the policies that are needed to bring inflation under control.

Regional Impact of Recession

With this brief background on the economic outlook, let me now address the question of the regional impact of a recession.

The sensitivity of regions to a national economic recession varies widely and is dependent upon a number of factors, including industrial composition and growth rates. Historically, during periods of declining economic activity, manufacturing industries (particularly durable goods manufacturing) have tended to experience relatively wider fluctuations in output and employment than other industries. Purchases of consumer durables (such as automobiles and large household applicances) and capital goods are more readily postponed during economic slowdowns than purchases of non-durables (such as clothing and food) and many services. Thus regions which are heavily dependent upon manufacturing activity as a source of income and employment are generally more severely impacted by national recessions.

Regions that have been experiencing rapid increases in economic growth due to increased capital investment, in-migration of labor, favorable climate, relatively cheap resources, or any number of other factors may be less severely affected by national economic recession than regions with slower growth rates and regions that have a relatively older, less-efficient capital base.
Regions heavily engaged in agriculture are not usually affected by recession to the same degree as regions heavily dependent upon industry.

During the post-war period, 1948-1975, the East North Central, New England, and Mid-Atlantic States have displayed the greatest sensitivity to national economic slowdowns in terms of employment declines relative to the national average. On the other hand, the Mountain, West South Central, West North Central and South Atlantic States have shown the least sensitivity. The degree of sensitivity is explainable basically in terms of the make-up of the economic base of the various regions.

Using the latest data then available, a 1978 Boston Federal Reserve Bank study indicates that:

(1) During the six business cycle episodes of the post-war period, employment in the East North Central, New England and Middle Atlantic States has almost always shown percentage declines far in excess of the national average. In the 1973-1975 recession, for example, total U.S. employment declined 2.9 percent from its peak-to-trough. Employment declined 4.7 percent, however, in the East North Central States, 4.3 percent in the New England States and 3.8 percent in the Middle Atlantic States. Although employment declines in other regions occasionally exceeded the national average, this has been the exception rather than the rule.

In the three regions where employment declines are more severe than the nationwide average, manufacturing is the predominant source of labor and proprietor's income. Manufacturing is also more important to these three regions than to any other region in the Nation and durable manufacturing is substantially more important than nondurable manufacturing.

(2) Except for the 1969-1970 recession, when employment losses in the Pacific States were aggravated by the winding down of the Vietnam War and its impact on the aerospace industry, employment declines in this region have been less than the national average. During the last recession, the Pacific States suffered employment declines of only 1.3 percent, less than half of the national average. Although manufacturing accounts for about 25 percent of the region's total labor and proprietor's income, the relative importance of income from government, services, trade, and other nonmanufacturing sectors is greater in the Pacific region than in the Nation as a whole. Thus, the Pacific region is more diversified than many of the other regions and is less sensitive to recessions.

(3) In each of the six post-war recessions, employment declines in the Mountain States have also been substantially less than the national average. During the severe 1973-1975 recession, for example, this region experienced an employ-

ment decline only half that of the national average; and in the two preceding recessions these States suffered no declines in nonagricultural employment. The Mountain States receive a smaller share of their income (less than 15 percent) from manufacturing than any other region. This fact and the fact that government and services account for larger income shares than in any other region probably assures this region of only a minimal adverse impact from recessions.

A region's industrial mix also has implications for the timing of the recession's impact. Since manufacturing activity is most sensitive to a recession, those States or regions most heavily dependent upon manufacturing (particularly durable manufacturing) generally should feel the effects of a recession first. Those States or regions also would probably be among the first to qualify for fiscal assistance from the Federal Government under the Administration's proposed Intergovernmental Fiscal Assistance program that I will discuss shortly. Private forecasts of the regional impacts of the current recession seem to bear out this point.

Not all regions will be affected to the same extent by the current recession. Only those regions relatively heavily engaged in manufacturing (particularly durable goods manu-

facturing) or experiencing slow growth are likely to be seriously affected. In the mild 1969-1970 recession, for instance, the South Atlantic, East South Central, and Mountain States experienced no declines in employment while the West South Central States showed only minimal declines. In contrast, the New England, East North Central, and Mid-Atlantic regions endured employment declines far above the national average. (Regional employment data for past recessions is presented in Table 1 and regional definitions are shown in Table 2.)

During the 1973-1975 recession, the most severe economic downturn since the Great Depression, no region escaped unscathed. All suffered employment losses. Even the East South Central and South Atlantic States, which experienced no employment declines during the mild 1969-1970 recession, showed large declines. At the same time, however, three regions--the West South Central, Pacific and the West North Central States--experienced milder relative declines in employment during the last recession than they had during the mild 1969-1970 recession, highlighting the fact that the regional impacts of recession differ from recession to recession.

Studies of the Regional Impacts of the Current Recession

The Administration has no official economic forecasts of individual States, local areas, or regions. However, there

have been a number of private forecasts of the regional impacts of the expected current recession. Those forecasts were undertaken several months ago and are predicated upon the assumption of a modest recession for the national economy.

The private forecasts indicate that the recession's regional impact pattern will not differ greatly from that experienced during the mild 1969-1970 recession.

- The New England, Middle Atlantic, and East North Central regions are expected to bear the brunt of the recession. As noted previously, all three of these regions rely heavily upon durable manufacturing for jobs and income.
- The Mountain States are expected to suffer little or no employment losses--only a slowdown in employment growth. As also noted earlier, of all the regions of the country, this one is least dependent upon manufacturing.
- The Pacific, South Atlantic, East South Central, West North Central and West South Central States all are predicted to experience mild employment declines. Except for the Pacific region, where specific factors were operative, none of these areas experienced marked

employment declines during the mild 1969-1970 recession.

Of course, these studies of the regional impacts of the current recession are largely based upon historical regional impact patterns. To the extent that the weaknesses and causes underlying the current recession differ significantly from previous recessions and to the extent that structural changes in communications and transportation have taken place, the regional impact of the current recession could differ from the past.

Current Fiscal Position of State and Local Governments

There has been considerable attention directed to the "huge" budget surpluses enjoyed by States. However, only a few States account for most of these surpluses. More importantly, virtually all of these surpluses consist of contributions to various social insurance funds (such as retirement funds, workmen compensation, and temporary disability insurance funds) which are not generally available for other purposes. During the second quarter of this year, State and local governments actually ran a $6.3 billion deficit (based on national income and product accounts data) after allowances are made for contributions to social insurance funds (See Table 3). This was the first such deficit since

the second quarter of 1976. With the anticipated declines in the growth of employment, personal income, and retail sales due to the recession, further reductions in the rate of growth in State and local government revenues can be expected. If it were to continue for some time, such a development could jeopardize the fiscal posture of many State and local governments.

The spread of public sentiment for Proposition 13-type tax reductions could result in a further deterioration of the fiscal position of States and localities unless public spending is also curtailed. Curtailing public spending, however, could exacerbate the recession. A countercyclical fiscal assistance program for State and local governments would help avoid such pro-cyclical actions.

Many of the regions that will be most affected by the recession have older cities that are experiencing secularly declining economic growth rates. These cities may be particularly hard-pressed to maintain service levels in the face of the current slowdown.

The Administration considered the prospects for regional variation in the effects of a recession in preparing its fiscal assistance proposal, which was submitted to the Congress last March. Let me first relate the basic justification for a countercyclical program to the evidence on

varying regional effects from a recession. Then, I will summarize the provisions of the bill recently passed by the Senate, which is very similar to the Administration's March proposal.

The Rationale for Countercyclical Fiscal Assistance

During periods of economic prosperity, most States and local governments accumulate fund balances that allow them to sustain spending for as much as a year after a recession begins. At such a point, typically about the time recovery begins, fund balances have been reduced to the point where the normal spending trend can no longer be sustained, and outlays in real terms may actually begin to decline. This pattern is observable in the record of every recession and recovery since World War II, including the 1973-77 period. Although the continued growth in spending during the decline helps to reduce the seriousness of the recession, the fall-off in spending tends to slow the pace of the early phase of the recovery. Thus, from the perspective of macroeconomic policy, countercyclical fiscal assistance should be triggered well after the economy has turned down. However, payments should cease after the recovery is well under way, in order to minimize potential inflationary effects.

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In the current economic environment, decisions on macroeconomic policy must take serious account of the potential inflationary side-effects of any anti-recession fiscal policy option under consideration. The choice among the available policy options should be based upon a careful balancing of relative job-creation effectiveness per dollar of federal deficit against potential inflationary side-effects.

Other things equal, a policy that targets the first-round economic stimulus to areas with significant concentrations of unemployed or underutilized human and capital resources is likely to have the least inflationary effect on prices. Such targeting cannot be achieved by traditional forms of antirecession tax cuts, which must apply uniformly throughout the nation. However, a geographically differentiated spending program can be targeted to areas with high levels of unemployed resources.

Studies of the recent experience suggest that a countercyclical fiscal assistance program--such as Antirecession Fiscal Assistance (ARFA) adopted in 1976 and extended in 1977, or the similar countercyclical tier of the Targeted Fiscal Assistance Program currently before the House--can be very effective in terms of job creation with minimal inflationary side-effects.

Logic and the evidence on the experience with ARFA suggest that local governments with high unemployment rates are most likely to commit such grants quickly and for job-creating purposes. This is a major reason why the targeting mechanism in the proposed program is based on local unemployment rates, rather than on such alternatives as the change in real wages and salaries.

While the recession facing the nation is expected to be moderate, the current economic outlook remains volatile, particularly in light of the uncertainties about energy prices and availability. It therefore seems prudent to put in place a stand-by countercyclical fiscal assistance program, such as the countercyclical tier of the Senate-approved bill that is now pending before the House Subcommittee on Intergovernmental Relations and Human Resources.

As in the Administration's March proposal, there are two tiers in the Senate bill. The first involves the payment of $85 million per quarter in targeted fiscal assistance payments in FY 1980 to a very small number of particularly distressed local governments.

The second tier, which is germane to this discussion today, involves a stand-by countercyclical fiscal assistance program which would trigger on during periods of high national unemployment rates.

Stand-by Countercyclical Fiscal Assistance Program

Let me indicate briefly how this countercyclical tier would work. By comparison with the 1976-78 ARFA program, the proposed program is much more highly targeted. It would only operate when the national unemployment rate reaches 6.5 percent or more for a full quarter, instead of 6 percent as under ARFA. Once the program is triggered, a recipient government would be eligible for payment under the Senate-passed bill only if its quarterly unemployment rate is at least 6 percent, instead of the 4.5 percent under ARFA. This additional targeting, in the present inflationary context, is highly desirable. It would ensure that countercyclical funds go only to areas with substantial amounts of unemployed human and physical capital, and thus are less likely to fuel inflation. Moreover, governments in areas with high unemployment rates are more likely to be experiencing significant fiscal stress, and such governments are most likely to use the payments for purposes that involve maximum job-creation effects.

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yet available. If the national unemployment rate reaches 6.5 percent by the first calendar quarter of 1980, this would trigger payments under the countercyclical tier, which would be distributed in the last quarter of fiscal year 1980. Given the lags in State and local budgetary processes and the spend-down of balances accumulated during the past few years, this is approximately the time when recession induced revenue losses raise the prospect of serious budgetary disruption. This disruption will then threaten to require fiscal behavior by State and local governments that will tend to impede the early stage of the recovery from the recession.

When the program provided for in the Senate bill is triggered, it would distribute $125 million per quarter plus an additional $30 million for each one-tenth of one percent by which national unemployment exceeds 6.5 percent. One-third of the funds would be distributed to the States, the balance to eligible local governments.

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In particular, the stand-by tier of the program is a sensible fiscal insurance program for State and local governments in the event of future excessive unemployment.

I appreciate the opportunity to discuss the pending proposals for countercyclical fiscal assistance in the context of regional variation in the economic effects of a recession. I look forward to working with you and other members of Congress toward enactment and implementation of the program.

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Table 1

Percentage Drop in Nonagricultural Employment during Six Postwar Recessions

	United States	New England	Middle Atlantic	East North Central	West North Central	South Atlantic	East South Central	West South Central	Mountain	Pacific**
1948-49	5.0	5.6	6.8	6.7	1.8	4.8	7.4	2.3	1.8	4.5
1953-54	3.5	3.9	4.5	6.2	2.3	3.0	3.6	2.2	2.7	1.9
1957-58	4.4	5.0	4.5	8.5	2.3	2.0	2.5	1.8	1.4	3.1
1960-61	2.3	1.1	2.5	4.9	1.2	1.3	*	1.6	*	0.4
1969-70	1.4	3.1	2.1	4.3	1.7	*	*	0.5	*	2.6
1973-75	2.9	4.3	3.8	4.7	2.8	4.5	4.3	0.7	1.5	1.3

* No decline in absolute level of employment during the recession.

** Data for the first three expansion periods calculated using California and Oregon employment only; data for final three periods calculated using employment figures for the entire region.

Source: Federal Reserve Bank of Boston, New England Economic Review (November/December 1978).

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New Hampshire
Rhode Island
Vermont

Middle Atlantic

New Jersey
New York
Pennsylvania

South Atlantic

Delaware
District of Columbia
Florida
Georgia
Maryland
North Carolina
South Carolina
Virginia
West Virgina

East North Central

Illinois
Indiana
Michigan
Ohio
Wisconsin

East South Central

Alabama
Kentucky
Mississippi
Tennessee

West North Central

Iowa
Kansas
Minnesota
Missouri
Nebraska
North Dakota
South Dakota

West South Central

Arkansas
Louisiana
Oklahoma
Texas

Mountain

Arizona
Colorado
Idaho
Montana
Nevada
New Mexico
Utah
Wyoming

Pacific

Alaska
California
Hawaii
Oregon
Washington

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State and Local Government
Receipts and Expenditures

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Other funds	-6.2	2.3	7.3	4.2	2.6	-6.3

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

Note: Figures may not add due to rounding.