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BEFORE THE

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I. Economic Program and the Outlook

The 1970's were a decade of economic turmoil. The price of oil rose more than tenfold. The world's cost of importing oil swelled from less than $25 billion at the beginning of the decade to almost $300 billion at the end. In the middle of the decade the world experienced the largest recession of the past forty years. Inflation averaged much higher than in the prior two decades; inflationary expectations became embedded in the consciousness of consumers and businesses; and the decade closed with inflation running in double-digit figures. Finally, the pace of productivity, upon which the advance of our real income and living standards ultimately depends, slowed sharply.

As we enter the 1980's, economic policy has to concentrate on three major priorities:

- controlling and then reducing inflation;
- adjusting to a world of higher energy prices, and reducing our dangerous dependence on foreign oil;
- improving the structure and functioning of the American economy so as to restore a healthy growth in productivity and real incomes.

While the problems and challenges that confront economic policy are difficult ones, it is reassuring to recall that the American economy has made substantial progress on many fronts during the past several years.

Output and Employment During the Expansion

Three years ago our economy was suffering from very high unemployment and idle plant capacity. Recovery from the severe recession of 1974-75 was still far from complete. Major progress has been made during the past three years in bringing the Nation's human and capital resources back into production.

Real output is almost 12 percent above its level 3 years earlier. Adjusted for inflation, after-tax income per capita has increased 7-1/2 percent. Increased use of plant capacity was accompanied by a heartening rise of business investment in the new plant and equipment we need for future growth of output and better productivity performance.

Gains in employment over these past three years -- 4.1 million new jobs in 1977; 3.0 million in 1978, and 2.1 million more in 1979 -- have been phenomenal. Employment growth in recent years has no parallel in the postwar period.

Two particular features of the employment expansion have been particularly encouraging. First, job creation has been concentrated in the private sector. Employment at private nonfarm establishments climbed 14 percent over the past three years, while state and local government employment increased 4 percent and Federal employment was essentially level.

Second, employment gains have been largest for those groups most in need of jobs. For every 100 black adults holding a job in late 1976, there are now 115 gainfully employed. For every 100 black teenagers at work then, 115 are at work now. For every 100 Hispanics with jobs three years ago, there are now 120.

As idle resources were increasingly put to work, it became necessary to shift policy towards restraint in order to moderate economic growth. We reached that point over a year ago, when accelerating inflation also required greater fiscal and monetary discipline. The pace of economic expansion in 1979 slowed more than expected, however, largely because of the heavy blow to the economy from rising OPEC oil prices.

The economic effect of higher oil prices on the economy is similar to that of an excise tax. Because prices are increased, real purchasing power of consumers is drained away. The higher revenues of OPEC oil producers and domestic oil companies are only gradually spent on additional imports and investment projects. The economy suffers a net reduction in demand and output. The Council of Economic Advisers estimates that the net drag on the economy imposed by last year's rising oil prices was equivalent, by the fourth quarter, to a tax increase of $53 billion, far larger than the tax relief provided by the Revenue Act of 1978. Of course the increase in the price of imported oil was unlike an excise tax in one crucial respect: it extracted real wealth from our economy, an effect not reversible by domestic tax reductions or spending.

Table 1

Growth of Major Components of Real GNP
(Fourth Quarter to Fourth Quarter)

	(Percent Change) 1978	1979
Real GNP	4.8	0.8
Personal Consumption expenditures	4.5	1.6
Business Fixed Investment	10.5	1.7
Residential Construction	1/	-8.3
Government Purchases of Goods and Services	1.7	0.1
Domestic Final Sales	4.3	0.9
	Change as a Percent of Real GNP 1978	1979
Inventory Accumulation	1/	-0.6
Net exports	0.5	0.5

1/ Less than .05.

The drain of purchasing power was so large that the total after-tax income of consumers, adjusted for inflation, remained unchanged over the four quarters of last year. Since consumers were willing to reduce their rate of saving substantially, however, consumption expenditures in real terms continued to increase, but more slowly than in 1978. Other major categories of demand also weakened in 1979. The rise of business capital spending also slowed, and residential construction declined. Businesses curtailed their orders and production to keep inventories in balance with slowing sales; consequently, the rate of inventory accumulation at the end of 1979 was below the year-earlier level. Net exports of goods and services rose in 1979, however, as the volume of exports rose substantially more than the volume of imports.

Although, as shown in Table 1, real output rose less than 1 percent during 1979, employment continued to increase strongly. Demand for labor was sustained by a sharp decline in productivity that aggravated inflation and put a squeeze on the profit margins of most American businesses outside of oil companies. The profit share of total output originating in nonfinancial corporate businesses other than petroleum and coal companies fell 15 percent during the first 3 quarters of last year.

Declining profit margins, a gradual increase in excess capacity, and concerns about the possibility of recession contributed to the substantial slowdown in the pace of business capital formation last year. Business purchases of cars and trucks declined sharply. Since the growth of real GNP slowed even more than the rise in business fixed investment, the share of total real output devoted to business outlays for new plant and equipment was a little higher last year than in 1978. But the proportion of our national output devoted to increasing and modernizing our capital stock is well below that of most other major industrial countries. It is also below the amount required to assure long-run improvement in productivity and to meet increased needs for energy and the requirements of environmental, health, and safety regulations.

Inflation

Developments on the inflation front were the most significant disappointment in the 1979 economic performance. At the beginning of the year, it was widely expected that inflation would moderate. Those hopes were destroyed, however, by skyrocketing energy prices.

Last year, the consumer price index rose by over 13 percent. Within the index, energy prices rose by 37.4 percent. Had energy prices risen at the previous year's rate of 8.0%, the CPI would have increased by 2-1/2 percentage points less, considering only the direct effects of energy prices on the index.

Sharply rising costs of home purchase and finance also added a large element to CPI inflation. The way the CPI treats the cost of purchasing a home, and the associated costs of home financing, tends to overstate the rise in the cost of living to the average consumer when home prices and mortgage interest rates increase rapidly. Beginning with the December CPI, the Bureau of Labor Statistics has begun to release data that provide additional perspective on changes in consumer prices. For example, the Department has calculated the cost of home ownership in a way that makes it roughly equivalent to rent. If this rent index is substituted for the homeownership and finance component of the CPI, the rise in consumer prices last year is found to be 10.8 percent. And when energy is removed, the alternative index rises only about 8.0 percentage points in 1979, the same as in 1978.

The President's program of voluntary standards for pay and price incresaes could not prevent the rise in OPEC oil prices or the increases in housing and home finance costs. But they were instrumental in keeping the rising inflation in those areas from setting off a major acceleration of price and wage increases elsewhere. Compliance with the program was widespread. Although the overall rate of inflation rose to 13 percent, increases in wages and fringe benefits were no higher than in 1978. The rise in prices of goods and services outside of energy, housing and home finance was less than the rise in the unit costs of production, and as pointed out earlier, very little greater than in 1978. Had the huge increase in energy prices spilled over into the broad structure of industrial wages and prices, our basic inflation problem would have worsened for many years to come.

<u>Why the Economy Avoided Recession in 1979</u>

The economy's resilience in the face of dramatic increases in oil prices and the attendant worsening of inflation was one of the more surprising features of economic developments in 1979. Forecasts of impending recession were becoming frequent by late 1978, long before the magnitude of the 1979 rise in OPEC oil prices was perceived. By the middle of 1979, they were common. Yet, the characteristics of cumulating recession are still not in evidence at the present time.

The reasons why the economy was able to absorb the shocks of rising oil prices, a substantial acceleration of inflation and sharply rising interest rates without going into a steep decline are only partially understood. Three factors, however, have played a role.

<u>First</u>, individuals as consumers and homebuyers appear to be more strongly affected by inflationary expectations now than in the past. Such expectations help account for the further decline in the personal saving rate during 1979, and for the continued strength of housing sales until late last year, despite a rise of mortgage interest rates to unprecedented heights.

<u>Second</u>, monetary restraint no longer produces the abrupt changes in availability of credit to borrowers that used to bring

an end to economic expansion. A number of changes have taken place in financial markets during recent years that have removed or reduced the constraints which used to limit access to credit by some borrowers during periods of general credit restraint. The most recent of these -- the introduction in mid-1978 of money market certificates of deposit sold by banks and thrift institutions -- has been a major factor sustaining credit flows to housing. Because of these developments in financial markets, monetary policy now works more through changes in interest rates that affect a borrower's willingness to incur debt, and less through changes in his ability to obtain credit. For this reason, monetary restraint now tends to affect aggregate demand less abruptly and with a less uneven impact across major economic sectors. As events in financial markets late last year attest, however, significant changes in monetary policy may still lead to constraints on the availability of credit, particularly for housing.

Third, the continued growth of the economy last year reflects the relative absence of cyclical imbalances characteristic of earlier periods of economic expansion. Most notable in this regard is the fact that inventories have remained in good balance with sales throughout the expansion. When consumer spending declined in the second quarter of last year, therefore, businesses did not find themselves seriously overstocked. To be sure, auto inventories, particularly for large cars, increased substantially, and major auto producers are still trying to redress the balance between stocks and sales. In other industries, however, production cutbacks to reduce excess stocks remained modest in 1979.

Economic Outlook

The unsettled state of world oil markets and the unexpected resilience of the economy last year makes forecasting in 1980 an unusually hazardous exercise. The factors that sustained growth in 1979 will continue to affect economic performance in 1980. But it is unlikely that they will cushion the economy's response to shocks to the same extent that they did in 1979.

Key elements of the economic forecast underlying the fiscal year 1981 Budget are shown in Table 2 below.

Table 2

Key Elements of the Administration's Economic Forecast

	1980	1981
Real GNP Growth (Q4/Q4, Percent)...................	-1.0	2.8
Unemployment Rate (Q4, Percent)....................	7.5	7.3
Increase in the CPI (Dec./Dec., Percent)..........	10.4	8.6

Over the four quarters of 1980, real GNP is forecast to decline by 1 percent; in 1981, an increase of 2.8 percent is expected, as indicated in the table. This forecast is broadly in line with many others, including that of the Congressional Budget Office. The decline in real GNP this year is expected to be accompanied by an increase in the unemployment rate to about 7-1/2 percent in late 1980. Resumption of economic expansion next year, however, is expected to bring unemployment down to 7-1/4 percent by the end of 1981.

The forecast assumes that the economy will head into a mild recession in the first half of this year. Housing starts turned down in the fourth quarter of last year and may decline somewhat further. New car sales also fell, and auto companies have curtailed their production schedules for the first quarter of 1980 to reduce abnormally large inventories, especially of large, fuel-inefficient models. The downward pressure on consumers' real incomes, resulting from rising oil prices and increasing marginal tax rates caused by inflation, is continuing. With the personal saving rate already at exceptionally low levels, slow growth of real income is likely to mean sluggish consumer markets. Current indicators suggest, moreover, that real business fixed capital spending will turn down moderately in 1980. As final demand weakens, the rate of inventory accumulation may also fall somewhat further.

If a recession does occur early this year, it is likely to be brief, mild and largely over by mid-year. A large cutback in production to reduce inventories has often magnified recessionary forces in the past. Such a development is unlikely this year because the cautious inventory policies followed most business firms have prevented a large buildup of undesired stocks. Interest rates are likely to decline because of the abatement of credit demands in a weakening economy. This would permit housing starts to turn up in response to strong underlying demands.

The rise in consumer prices is expected to slow somewhat this year to about 10-1/2 percent. This moderation of inflation during the course of 1980 will contribute to strengthening consumer purchasing power. Early this year, we will continue to face the shock effects of the latest round of OPEC oil price increases. Once those effects wear off, the rise in energy prices is expected to moderate. Moreover, in a weak economy, cost increases will be more difficult to pass through to product prices. Mortgage interest rates may also come down from their very high present levels. Next year, a further reduction of inflation to around 8-1/2 percent is forecast. By any historical yardstick, however, inflation next year will still be extraordinarily high.

The progress against inflation we expect, and which we sorely need, would not be achieved if last year's sharp increase in energy prices and the costs of home purchase and finance were to spill over into wages, costs, and the broad range of industrial and service prices. Preventing that from happening is the first priority for economic policy in our country in 1980. The problem is not ours alone. Every oil importing country around the world is facing starkly higher energy prices and a potentially dangerous acceleration of inflation.

No one can be satisfied with an economic outlook for this year that implies declining real output, rising unemployment, and continuing very high inflation. Appropriate economic policies can help the economy adjust to the impact of recent OPEC oil price increases. But no policies can change the realities which these increases impose.

Economic policy at the present time must hold firm against inflation, despite the prospect of a weakening economy. The Administration recognizes, however, that fiscal policies cannot be set on an unswerving course regardless of how economic developments unfold. We will monitor developments closely this year. If economic conditions and prospects deteriorate significantly, we will be prepared to take corrective action in ways and under circumstances that do not aggravate inflation.

II. The 1981 Budget and Fiscal Policy

The fiscal policy in the 1981 budget recognizes that inflation remains our paramount economic problem. If we do not deal effectively with inflation, the very substantial economic progress achieved under this Administration will be reversed, and our long-term goals of balanced growth with full employment and price stability will be even more difficult to achieve. The 1981 budget is, therefore, a restrictive budget. The growth of budget outlays is held to the lowest rate consistent with our national security and energy security objectives and the most urgent domestic requirements. Budget increases for less critical needs have been rejected. There are no major tax reductions. This austere budgetary policy is a necessary condition for controlling inflation.

Reasons for Fiscal Restraint

A restrained budget is necessary to lower inflationary expectations. There have recently been disquieting signs that consumers expect high inflation to continue indefinitely, as a permanent fixture of economic life. Workers and businesses increasingly appear to make their wage and price decisions on the basis of that expectation. Such expectations could become self-fulfilling, leading to a dangerous wage-price spiral which would do permanent damage to the economy. The public must be convinced that this will not happen, and make their price, wage, borrowing and expenditure decisions accordingly.

Budget restraint is also necessary because forecasts are highly uncertain, and there are risks to any policy. Under present circumstances, the risks of a restrained fiscal policy are far less than the risks of fiscal stimulus. Expansive policies are difficult to reverse, and the long-term inflationary damage resulting from a mistakenly expansive policy would be severe. On the other hand, if economic conditions should significantly worsen, changing to a policy of less restraint would be less difficult.

A restrained budget is also necessary to preserve the international confidence in the dollar required to prevent destabilizing and inflationary exchange rate changes. A bloated 1981 budget would be a signal to the world that the United States has accepted double-digit inflation and is unwilling to make the sacrifices needed to restore price stability. This could be damaging not only for the U.S., but for the world trading and financial system as well.

For the longer-term, budgetary restraint is required to generate the savings and capital formation required for higher productivity growth, lower inflation, and rising employment and living standards. Federal spending must be held down to make resources available for additional capital formation, and this will be especially difficult at a time when demands on the budget from energy and national security requirements are growing. Because of the difficulties in controlling expenditures in the short-term, this long-term problem must be addressed now, in the 1981 budget.

Restraint in the 1981 Budget

This budget recommends outlays for 1981 of $615.8 billion. This is effectively a zero-growth budget; after allowing for inflation, 1981 outlays are at virtually the same level as 1980. Receipts are estimated at $600.0 billion, and the recommended deficit is $15.8 billion, the lowest in seven years. Because of the urgent necessity for fiscal restraint, tax reductions are not proposed. The only major tax proposal included in the budget is the windfall profit tax.

Table 3

THE BUDGET TOTALS
(in billions of dollars)

	1979 actual	Estimated 1980	Estimated 1981	Estimated 1982	Estimated 1983
Budget receipts........	465.9	523.8	600.0	691.1	798.8
Budget outlays.........	493.7	563.6	615.8	686.3	774.3
Surplus or deficit (-)	-27.7	-39.8	-15.8	+4.8	+24.5
	=====	=====	=====	=====	=====
Budget authority.....	556.7	654.0	696.1	775.1	808.5

It is regrettable that present difficult economic conditions do not permit a balanced 1981 budget. However, the proposed 1981 deficit marks substantial progress toward that goal. The deficit proposed for 1981 is $50 billion lower than when President Carter ran for President. As a percentage of the budget and of the GNP, the proposed deficit is the second lowest of the preceding decade, and less than a third of the average for the 1970's. If, contrary to our expectation, the economy were to expand rapidly enough to keep the unemployment rate at its current level, the 1981 budget would be in surplus by about $15 billion.

A common measure of fiscal stimulus or restraint is the change in the high-employment budget surplus or deficit, a measure which excludes the budgetary effects of changes in the degree of resource utilization. This measure of fiscal restraint increases from a $12 billion deficit during fiscal year 1979 to a surplus of $5 billion in 1980 and a surplus of $57 billion in 1981. The 1981 budget thus continues -- and intensifies -- the policy of fiscal restraint begun earlier. The increase in the high employment surplus from 1979 to 1981 is over 1-3/4 percent of GNP -- a very substantial degree of restraint.

Budgetary stringency can also be measured by examining proposed budget outlays in comparison with current services, the level of spending required to maintain existing program levels. The level of outlays in FY 1981 is only 0.6% above the level needed to maintain the current level of services. The $3.7 billion difference is more than accounted for by $6.3 billion of increased spending on defense and energy, which are critical to our national security. The rest of the budget shows a reduction of $2.5 billion below current services.

Because the 1981 budget is restrictive, the pressures to expand it will be strong. Unemployment later in 1980 and in 1981 is expected to be higher than it is today. Businesses will need greater incentives to invest in plant and equipment. Worthwhile social programs will seem to require additional funding. Many of these needs are legitimate, and under other circumstances they might deserve room in the budget. But the harsh reality of inflation makes it critical for the Congress to resist those pressures, as the Administration has done.

Major Budget Priorities

The budget is more than an instrument of macroeconomic policy. It is also a means of addressing the needs of our society and the ordering of national priorities. Although spending growth has been held to a minimum in this budget, the President has recommended program increases in a few critical areas. The most important of these in 1981 are defense, energy, basic research, and the development of our young people.

Defense.--When the Administration assumed office, real defense spending had declined for almost a decade. Even in 1978, outlays for defense largely reflected decisions of the previous Administration. In real terms, those outlays were lower than they had been four years earlier. In the 1979 budget, the President proposed a long term policy of substantial and sustained growth in real defense spending. Developments in Iran and Afghanistan during recent months attest to this need. Therefore, this budget proposes a defense program in 1981 of \$158.2 billion in budget authority, an increase of over 5% in real terms. Outlays for defense will be \$142.7 billion, a real increase of over 3%. With this budget, spending on defense will have increased by 9.4% in real terms since 1978. This Administration is committed as a matter of fundamental policy to continued large real increases in defense spending beyond 1981.

Energy.--Solutions to our energy problem are essential for both economic progress and national security. This budget reflects the important progress being made by this Administration, in cooperation with the Congress, through a broad and practical program addressing the energy problems the Nation is facing in this new decade. The 1981 budget assumes that, early in the 1980 session, the Congress will pass the crucial measures proposed last year: the windfall profit tax, the Energy Security Corporation, the conservation measures and the Energy Mobilization Board.

The energy program supported in the 1981 Budget is comprehensive and balanced, addressing both production and conservation. To stimulate production, it recommends resources for the Energy Security Corporation that would help to create a synthetic fuels industry, and it supports major increases for solar, fossil, and fusion energy. It provides for an ambitious gasohol program and emphasizes safety and the solving of current problems in nuclear fission programs. Overall, spending on energy programs will increase to $8.1 billion in 1981, an increase of over 90% during the first four years of this Administration.

As the Nation adjusts to energy scarcity, we must protect those who are most vulnerable. Much of this protection is achieved automatically, through programs such as social security and retirement which are indexed to the cost of living. The 1981 budget expands this protection, providing funds for the poor for weatherization of their homes, and for energy cash and crisis assistance. In all, the 1981 budget proposes $2.4 billion in energy assistance for the disadvantaged, an increase of 50% over the 1980 level.

Youth Employment.--Despite the economic gains that have been made over the past three years, youth unemployment, especially for minorities, remains distressingly high. When youth have significant employment problems upon leaving school, their employment and earnings may be adversely affected for a lifetime. To eliminate this waste of national resources, this budget proposes a major new education and employment initiative designed to prepare today's youth for the labor market of the 1980's. This program will help schools to provide disadvantaged youth with the basic skills needed to get and keep jobs, and to reinforce those skills with job experience in the private sector. Disadvantaged youth out of school would acquire these basic skills in improved training and employment programs. By 1982 this program will add $2 billion to the over $4 billion currently being spent on education and employment programs for 14 to 21 year old disadvantaged youth.

Basic Research.--Between 1968 and 1975, Federal spending for basic research, measured in constant dollars, declined substantially. In order to maintain our Nation's position as a leader in the development of new technology, the budgets of this Administration have increased real spending on basic research each year. The 1981 budget continues this policy and provides for major and sustained increases above the rate of inflation for all research and development programs. Obligations for research and development will increase by 13%; for basic research by 12%.

Since 1978, obligations for basic research will have increased by 40%, or 9% in real terms.

Agriculture.--Because of the aggression of the Soviet Union against Afghanistan, the President has significantly limited Soviet grain purchases from the United States, while at the same time taking steps to ensure that the burden of the export limitation does not fall disproportionately on farmers. Specifically, the Secretary of Agriculture will:

-- Purchase from shippers contracts entered into with the Soviet Union and sell the contracts back into export markets only at prices above those prevailing on January 4.

-- If necessary, take title to the grain intended for export to the Soviet Union and isolate it from the market.

-- Purchase up to 4 million metric tons of wheat for an international food aid reserve.

-- Increase the loan level for feed grains and wheat by 10 and 15 cents per bushel respectively.

-- Expand CCC export credit guarantee coverage to include full commercial risk.

-- Modify the farmer-owned grain reserve to encourage farmers to place additional grain in their reserve.

-- Purchase grain in local markets to stabilize markets and relieve the congestion of grain in transit to major ports.

It is estimated that these measures will increase outlays by $2.0 billion in 1980 and $0.8 billion in 1981. In addition, the President will propose additional funding for P.L. 480 for FY 1980 and FY 1981 of $100 million per year. The Administration stands ready to take further steps if these actions prove insufficient, taking care, however, to avoid long-term distortions in out basic farm policies.

Initiatives to Reduce Federal Spending

These initiatives of high national priority have been proposed in the context of overall budgetary restraint. The required restraint has made it essential to propose a number of reductions in Federal programs. Restraint has been applied carefully. For the third consecutive year, zero-base budgeting has been used to establish priorities that put taxpayers' dollars to best use. Desirable new programs have been deferred. Increases in existing programs have been limited. Past efforts to achieve program efficiencies and improve management are beginning to pay off, and further efforts in this direction are undertaken in this budget. Reductions in lower priority programs have been proposed, and this budget contains specific outlay reductions of $9.7 billion from current service levels.

A substantial portion of these reductions take the form of legislative proposals that would reduce Federal spending. Together, these legislative proposals will reduce Federal spending by $5.6 billion in 1981 and by significantly larger amounts in subsequent years. Savings would be achieved through several health-related proposals, modification of entitlement programs to relate benefits more closely to need or to earned rights, increased administrative efficiencies, and reduction of waste, fraud, and abuse. In addition, this budget contains proposals to reform Federal compensation practices and procedures, place the railroad retirement system on a solid financial footing, and dispose of excess materials in the national stockpile of strategic materials.

Large spending reductions are extraordinarily difficult to achieve in the immediate budget year, because so much of the budget is relatively uncontrollable in the near-term. In the 1981 budget, fully 77% of outlays are classified as relatively uncontrollable, and these will account for $37 billion of the $52 billion increase in total outlays between 1980 and 1981. The remaining $15 billion will be due entirely to increased spending for national defense. The rest of the budget, in total, has been held at the 1980 level. For every increase in spending for controllable, non-defense programs an offsetting reduction within other programs has been made.

As inflation gradually comes down, its severe impact on the growth of budget outlays will be mitigated. But future spending levels can only be be held down by efforts begun now -- in 1981 -- to hold the lid on spending initiatives.

Receipts

Total receipts for 1981 are estimated to be $600.0 billion, $76.2 billion more than in 1980.

Table 4

ESTIMATED UNIFIED BUDGET RECEIPTS
(Fiscal years; in billions of dollars)

	1979	1980	1981
Individual income tax.....................	217.8	238.7	274.4
Corporation income tax....................	65.7	72.3	71.6
Contributions for social insurance......	141.6	162.2	187.4
Other receipts............................	40.8	50.6	66.6
Total.....................................	465.9	523.8	600.0

These estimates assume a windfall profit tax which, on a net basis, produces excise tax receipts of $5.5 billion in 1980 and $13.9 billion in 1981. The windfall profit tax will ensure that the burden of higher energy costs is equitably shared, and will provide additional receipts to finance energy programs essential to our economic well-being and national security.

Because the windfall profit tax is deductible, it will reduce the corporation income tax liabilities of oil firms. This, combined with lower growth in corporate profits due to a sluggish 1980 economy, results in a slight reduction in corporation income tax receipts in 1981.

Control of Federal Credit Activities

In recent years, direct loans and loan guarantees have come to play an increasingly important role in economic policy. Unfortunately, too much of this activity has escaped the normal discipline of the budget process. In the 1980 budget, we announced our intention to institute a system to control the use of Federal credit. This system, which is now in place, recommends specific credit limitations for most credit programs. It also provides estimates of the new direct loan obligations and new loan guarantee commitments to be made in the coming fiscal year.

Table 5

THE CREDIT BUDGET TOTALS

(in billions of dollars)

	1979	1980	1981
New direct loan obligations.............	51.4	59.7	60.7
New loan guarantee commitments..........	74.7	75.2	81.4
Total................................	126.1	134.9	142.1

In 1981, new direct loan obligations increase by 1.7% over 1980 compared with a 16.1% increase in the previous year. Loan guarantee commitments, on the other hand, increase 8.3% in 1981 after increasingly only a small amount in 1980. The total increase for direct loans and loan guarantees together is 5.3% in 1981.

The credit control system is an important improvement of Federal budgeting practices. The new system has three long-run goals:

— To ensure that credit programs meet the purposes for which they were intended, that they do so effectively, and that the level of resources is justified.

— To provide a closer examination of the allocation of credit and real resources across broad sectors of the economy.

-- To encourage more careful consideration of the impact of total Federal credit activity on the private economy as a whole -- on the borrowing needs of the private sector, and on economic growth, inflation and unemployment.

This new system of credit control, in conjunction with zero based budgeting and multi-year planning, will help ensure that the government runs more intelligently and efficiently.

III. Other Measures to Fight Inflation

Budgetary restraint, of course, is not the only anti-inflationary policy at our disposal. But it is a necessary condition for the success of other policies. Fiscal discipline must be combined with responsible monetary policy to provide the economic environment necessary to reduce inflation. But more is required. Inflation has been building in our country for 15 years, and its momentum is very strong. Reducing inflation cannot be accomplished by traditional macroeconomic policies alone without enormous losses of output and jobs. Maintenance of effective standards for pay and price restraint is essential. We must also attack other structural causes of inflation, especially those related to energy and low productivity growth.

Monetary Policy

Policies of monetary restraint are never popular. They hit some sectors harder than others. They are associated with shortages of credit and high interest rates, even though those developments stem principally from the forces of inflation that dictate monetary restraint, rather than from those policies themselves. However, inflation will not come down unless the growth of money and credit is gradually reduced to a rate consistent with lower inflation.

The Federal Reserve has been pursuing a responsible course. Growth of the major monetary aggregates was within the established target ranges last year. When an excessive pace of monetary growth did emerge in mid-1979 the Federal Reserve took steps to deal with the situation.

In the first few weeks following the Federal Reserve's October 6 actions, there was considerable turmoil in financial markets. Interest rates rose sharply, and uncertainties were created in the minds of lenders and borrowers regarding the outlook for the cost and availability of credit. Mortgage markets were most severely affected.

Subsequently, however, interest rates on market securities began to decline. Credit has now begun to flow more freely to mortgage borrowers, and mortgage interest rates have declined somewhat in some regions of the country. While housing starts have been adversely affected, the decline has been much less substantial than in previous cycles. Moreover, mortgage credit flows and housing construction will be sustained early this year by the temporary Federal preemption of State usury ceilings.

These painful effects of monetary restraint are a price that has to be paid to prevent the excess growth in money and credit which would aggravate inflation. By placing greater emphasis on the supply of bank reserves, the Federal Reserve's present operating strategy will allow more effective control over the growth of money and credit. Growth in virtually all of the monetary aggregates fell back to a moderate pace during the closing months of last year, and interest rates have shown remarkable stability recently.

If the pace of economic activity slackens next year, a modest decline in interest rates should accompany reduced demand for credit. However, a significant and lasting decline in interest rates cannot be achieved without progress in reducing inflation.

The relatively small deficit that will result from the Administration's 1981 budget will help to relieve pressures in financial markets. Net Federal borrowing from the public will be an estimated $33 billion in FY 1981, compared with $34 billion in FY 1979, and $44 billion in FY 1980. Private credit demands in 1980, however, are expected to decline by more than the increase in net Federal borrowing.

Pay and Price Policies

Dealing effectively with inflation requires policies aimed directly at promoting restraint in wage and price increases in the private sector. The cooperation of business and labor in adhering to voluntary wage and price standards is essential in this endeavor. Standards for wages and prices are not only a means of reducing inflation; to the extent that they succeed, they reduce the burden on monetary and fiscal policies in fighting inflation, and thus make increased employment and output possible.

The standards have a critical role to play in 1980. Our most immediate problem this year is to prevent last year's large price increases in energy and housing from spilling over into wages, costs, and the broad range of industrial and service prices. Should that happen, inflation could worsen for many years to come.

To promote continued cooperation with the standards, the Administration and organized labor arrived at a National Accord announced on September 28, 1979. The Accord called for the creation of two advisory committees, one on pay and one on prices. The Pay Advisory Committee consists of representatives from labor, business and the public and has already recommended a number of modifications in the pay standard. For the basic pay standard, the recommendation contemplates that pay increases in normal circumstances would average 8-1/2%, with possible variation within a range of 7-1/2 to 9-1/2 percent. The Council on Wage and Price Stability is now reviewing this recommendation.

Energy

All of our efforts to defeat inflation will be severely compromised if we experience continued shocks from sharp increases in oil prices.

Price controls on domestic energy supplies were a significant factor behind our excess reliance on imported oil. Price controls encouraged the wasteful use of energy and discouraged the development of domestic energy sources. As a result, oil imports increased from about 2.2 million barrels a day in 1967 to a peak of 8.5 million barrels a day in 1977.

In order to reverse this trend, to encourage conservation and stimulate domestic production, the Administration has begun phased decontrol of domestic oil and gas prices.

Higher energy prices have already begun to reduce energy consumption dramatically. Since 1973, the rise in per capita use of energy has slowed substantially. Had the trend of the 6 years prior to 1973 continued, oil imports in 1978 would have been nearly 6 million barrels a day higher than they were. In 1979, efforts by Americans to conserve energy accelerated. Consumption of gasoline in the fourth quarter of last year, for example, was 10 percent below a year earlier.

Decontrol is an essential part, but only one part, of our program to stimulate conservation and encourage domestic production of energy. Other conservation efforts, as well as programs to develop conventional energy sources, renewable energy resources and synthetic fuels, are also urgently needed.

We have proposed two important pieces of legislation that would promote domestic energy production. The first of these, the Energy Security Corporation, would facilitate private sector development of synthetic fuels to substitute for imported oil. The second, the Energy Mobilization Board, would help to reduce the regulatory delay involved in building new energy facilities. It is essential that Congress complete action expeditiously on both of these proposals.

Legislation will soon be sent to the Congress setting targets for reduced oil use by electric utilities. To enable utilities to meet these goals, financial assistance will be proposed to facilitate their conversion to coal. There will also be submitted to Congress a standby gasoline rationing plan which could be put into place quickly in case of a severe energy shortgage.

The U.S. is working with other oil importing nations, through the International Energy Agreement, to coordinate import policies to avert a costly scramble for oil when supplies are short. In 1977, the U.S. used 8.5 mmb/d of imported oil. President Carter set a limit of 8.2 mmb/d for U.S. oil imports during 1979 and this goal has been continued for 1980. If discussions in the IEA produce a fair and equitable agreement for sharing import reductions, the President is prepared to lower the 1980 target.

Agricultural Policy

Periodic scarcities of food have often occasioned an acceleration of inflation. The history of the past 15 years indicates clearly that price shocks stemming from temporary scarcities of food or energy can have a lasting effect on inflation, because they tend to become built into the structure of wages and other costs and thus into the underlying inflation rate.

Prior to 1972, agricultural policy had concentrated on supporting prices and controlling excess supply through production adjustments. The Food and Agricultural Act of 1977 established a system of farmer-owned reserves designed to protect both producers and consumers against volatile food prices, while promoting intensive use of U.S. agricultural productive capacity.

The reserve system has been successful during its short existence. Grain prices began to rise during the spring of 1979 when export demand was projected to rise sharply. This increase was moderated, and an inflationary spurt in food prices avoided, by a substantial release of stocks from the reserve. When grain shipments to the Soviet Union were suspended in response to that country's invasion of Afghanistan, increased incentives to place grain in reserve served as an important line of defense to protect farmers against a precipitous decline in prices.

Hospital Cost Containment

Inflation must also be attacked directly in the health care sector. The costs of medical care have been rising faster than prices of all other consumer goods and services for a number of years. The costs of hospital care have risen even faster than the rise in costs of other health care services. These costs affect consumers both directly and through the higher taxes needed to pay for public health services.

Aggregate demand policies have very little effect in this sector of the economy. Furthermore, we cannot expect market forces to work effectively in this sector. Often buyers or sellers of medical services lack the incentive or information necessary to take actions that would limit the rise in medical costs to the levels that would exist in a competitive market.

The Administration therefore, will continue to urge enactment of its important initiatives to restrain unnecessary spending and help contain hospital costs. Passage of the Administration's hospital cost containment legislation is one of the most important steps Congress can take now to fight inflation.

Improving Productivity

The disappointing performance of productivity has been an important factor behind the inflation of the last few years. In the early 1960's, productivity gains averaged more than 3 percent per year. In recent years, productivity increases have dwindled to about 1 percent, and a sizable decline occurred in 1979.

Improvement in productivity growth would obviously have highly beneficial effects. Besides reducing the rise of costs and prices, increased productivity would mean higher real output and improved living standards for Americans. However, bettering our productivity performance cannot be achieved quickly or at low cost.

Indeed, since we do not fully understand the causes of the slowdown in productivity, we are hampered in our efforts to deal with it. We do know, however, that basic research and development and a stronger pace of business investment in new plant and equipment are indispensable ingredients for increased economic efficiency.

Increased investment will enhance the productivity of workers in two ways: first, by giving them more capital to work with; second, and perhaps more importantly, by putting the latest technological advances into practice.

The budget for 1981, as noted earlier, contains additional funds for basic research and development, continuing the strong Federal backing for basic research that began in fiscal 1978. The budget does not contain new tax incentives for investment. Reductions of significant magnitude in business taxation would have been inconsistent with the basic policy of fiscal restraint that characterizes this budget. Tax incentives will not result in increased investment unless investors can be confident that we will have a strong and stable economy. A lean budget geared to reducing inflation is the most important step we can take now to stimulate investment. Furthermore, as explained in the Economic Report, higher national savings and capital formation will not be compatible with large budgetary deficits over the longer term.

In the years immediately ahead, tax reduction will become possible if the Administration and the Congress work together to hold the line on growth in Federal spending. When that time comes, the Administration will give very high priority to tax changes that will stimulate of investment and direct a larger fraction of our national resources to capital formation.

<u>Dealing with Structural Unemployment</u>

Investment in human capital is as important to enhancement of productivity as investment in physical assets. At the present time our nation is wasting a significant part of our human resources. Unemployment among blacks and minorities is still unacceptably high. By improving employment opportunities for these groups, the supply of goods and services will be increased and efficiency in resource use will be improved.

Reducing unemployment and increasing the earnings of these groups cannot be accomplished merely by stimulating the economy. Attempting to do so would add to inflation while yielding, at best, minimal benefits to those suffering special employment problems. Instead we must have targeted programs to enable these groups to expand their skills and give them the opportunity to work.

This Administration has already increased expenditures on employment and training programs for the disadvantaged by 73%, and spending on special programs for youth three-fold. The most significant new domestic initiative the President is sending the Congress this year deals with the problem of teenage unemployment. As discussed earlier, this program will emphasize improved classroom provision of basic skills and useful work experience for low achieving youth still in school; disadvantaged out-of-school youth will be given such skills through redesigned and improved training and employment programs.

The Administration's welfare reform proposals also contain important initiatives for improving the employment and wages of principal wage earners in low-income families with children.

In the years ahead, efforts to promote productive employment for the structurally unemployed must continue. We are learning from experience which programs provide lasting benefits to workers while avoiding waste and unnecessary expenditures of public funds. We will strongly emphasize, as we have with several of the new programs developed recently, the active involvement of the private sector in hiring and training the disadvantaged.

Regulatory Reform

Unnecessary and sometimes counterproductive government regulation has added to inflation. Recognizing this, the President, working with the Congress, has started to dismantle economic regulations that contribute to inflation. The first step was the deregulation of the airline industry. The Administration is now working with the Congress to eliminate costly and inefficient aspects of regulation in the trucking, railroad, and communications industries. We are also proposing the reform of regulations over financial institutions to promote equity for small savers, maintain the viability of our thrift institutions, and enhance competition and efficiency in financial markets.

In fulfilling environmental, health, safety, and other social objectives, governmental regulations serve a function that cannot be performed by the market place. In these areas, important cost savings are possible by improving the design of individual regulations, setting standards that will meet objectives without being unnecessarily stringent, and encouraging the most cost-effective approach to meeting those standards.

The Administration has taken steps of fundamental importance to the long-run impact of social regulations on costs, productivity, and inflation. Executive Order 12044 established a regulatory analysis review procedure that requires policymakers in regulatory agencies to give greater attention to the cost of regulations. A Regulatory Council has also been established to help achieve better coordination of important regulations issued by the various executive branch and independent agencies, and to develop a calendar of important regulations that will provide a broad overview of the potential impact of regulations on the economy. Moreover, the regulatory analysis procedure undertaken under Executive Order 12044 would be made permanent, and extended to the independent regulatory agencies, by the regulatory reform legislation that the Administration has sent to the Congress. Prompt passage of that legislation is a high priority in the Administration's legislative agenda for 1980.

IV. U.S. International Economic Policy

Our fight against inflation must include international as well as domestic policy initiatives. A stable dollar is essential to avoid additional inflationary pressures. A fair and open system of international trade and investment promotes competition within our own economy. Food and commodity prices can be stabilized through international action. Intensive cooperation with both industrialized and developing countries can help to promote our economic objectives in today's interdependent world economy.

The U.S. economy is inextricably linked to the other industrial economies, and is increasingly affected by the developing nations as well. We depend on the world economy:

-- to purchase the production from 1 in 7 U.S. manufacturing jobs and 1 in 3 acres of U.S. farmland;

-- to provide almost 1 in 3 dollars of U.S. corporate profits;

-- to provide one-fifth of our total energy requirements;

-- to assure a wide variety of consumer choice, promote efficient production at home, and stimulate competition in our markets;

-- to supply essential inputs for U.S. industries, including more than one-fourth of U.S. consumption of 12 of the 15 key industrial raw materials.

U.S. economic policy must therefore be developed in full recognition of the linkages between our own economy and the rest of the world.

A strong, stable dollar is fundamental to the stability of both our own economy and the international financial system. Changes in the value of the dollar have an important effect on jobs, investment, inflation and growth at home. Maintaining a stable dollar is particularly important in our fight against inflation, because a strong dollar holds down the price of imports and promotes domestic competition.

During the period of exchange market instability in the autumn of 1978 the United States took strong measures, including monetary actions and the mobilization of adequate resources for forceful intervention in exchange markets. The effectiveness of those measures has been enhanced recently by continued monetary discipline and strengthened cooperation between U.S. monetary authorities and those in other major nations. The emphasis of our economic policy on eliminating inflation and reducing our dependence on imported oil will make an essential contribution toward maintaining a sound and stable dollar.

A sound dollar is aided by a stable international monetary system, the goal of the International Monetary Fund. The IMF promotes the adoption and maintenance of appropriate economic policies by member countries, both those in balance of payments surplus and deficit. The IMF also maintains multilateral surveillance over the world financial system as a whole. In addition, the U.S. has itself borrowed from the Fund during the past year to augment the resources available for exchange market intervention. The Fund thus provides direct support for fundamental U.S. interests, and is an integral part of our overall economic policy strategy.

A stable monetary system is important not only in its own right, but because it helps to preserve and strengthen the .rospects for open and fair international trade and investment, which are vital for our economic interests. American industry and agriculture must expand their exports aggressively if we are to have a stable dollar, and American consumers must have access to competitive foreign products if we are to check inflation.

To foster open and fair trade,, U.S. policy must continue to seek the freest possible international market. The Multilateral Trade Agreements signed in December 1979 set the stage for significant reduction or elimination of both tariff and non-tariff trade barriers in all key trading nations. More than ever before, U.S. business must look to export market as a means of increasing production, providing jobs, and paying for essential U.S. imports.

As both a major producer and consumer of raw materials, the United States also has an important interest in international commodity markets. We seek to mitigate the effects of commodity price instability through international commodity agreements. Properly constructed arrangements can provide benefits to both producers and consumers by reducing inflationary pressures, promoting greater stability of commodity export earnings, and increasing incentives for primary commodity production. The recently negotiated Natural Rubber Agreement provides an excellent example of an international commodity arrangement which balances producer and consumer interests to their mutual benefit.

Finally, our national dependence on the world economy requires us to cooperate closely with both industrialized and developing nations across a whole range of international economic issues. Economic summit meetings, the IMF, GATT, and OECD are simply a few of the institutions through which we carry out such cooperation.

The multilateral development banks -- the World Bank and the similar regional institutions -- are the centerpiece of international efforts to mobilize resources to aid developing countries. Our fundamental national interests require a reasonable program of foreign assistance, and participation in the multilateral development banks is a particularly cost-effective approach to development cooperation. For example, the World Bank has lent $50 for every $1 which we have paid into it.

The development banks are efficient instruments of development cooperation. During their 35-year history, developing country growth has considerably exceeded their historical experience or reasonable expectation. Part of the credit for this growth must go to the catalytic effect of external assistance flows, including those from the banks. Positive support for these institutions enhances the likelihood of constructive LDC cooperation in other global institutions which are addressing problems of key importance to the United States.

Each of these individual initiatives forms part of a comprehensive and cohesive U.S. international economic strategy, which supports stable prices and increased employment at home. We can ensure that other countries respond to our vital concerns only if we also respond to their interests. Our own domestic economy can prosper at home only if we maintain, and indeed intensify, our joint efforts with other countries to improve the collective management of the world economy.

V. Conclusion

In sum, the 1981 budget is a key element of the Administration's comprehensive program for containing and reducing inflation. This budget attacks inflation in two ways: first, through overall fiscal discipline; second by emphasizing programs which ensure our national security and lay the foundation for a more efficient and productive economy.

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STATEMENT OF

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BEFORE THE

SENATE COMMITTEE ON THE BUDGET

I. Economic Program and the Outlook

The 1970's were a decade of economic turmoil. The price of oil rose more than tenfold. The world's cost of importing oil swelled from less than $25 billion at the beginning of the decade to almost $300 billion at the end. In the middle of the decade the world experienced the largest recession of the past forty years. Inflation averaged much higher than in the prior two decades; inflationary expectations became embedded in the consciousness of consumers and businesses; and the decade closed with inflation running in double-digit figures. Finally, the pace of productivity, upon which the advance of our real income and living standards ultimately depends, slowed sharply.

As we enter the 1980's, economic policy has to concentrate on three major priorities:

- -- controlling and then reducing inflation;
- -- adjusting to a world of higher energy prices, and reducing our dangerous dependence on foreign oil;
- — improving the structure and functioning of the American economy so as to restore a healthy growth in productivity and real incomes.

While the problems and challenges that confront economic policy are difficult ones, it is reassuring to recall that the American economy has made substantial progress on many fronts during the past several years.

Output and Employment During the Expansion

Three years ago our economy was suffering from very high unemployment and idle plant capacity. Recovery from the severe recession of 1974-75 was still far from complete. Major progress has been made during the past three years in bringing the Nation's human and capital resources back into production.

Real output is almost 12 percent above its level 3 years earlier. Adjusted for inflation, after-tax income per capita has increased 7-1/2 percent. Increased use of plant capacity was accompanied by a heartening rise of business investment in the new plant and equipment we need for future growth of output and better productivity performance.

Gains in employment over these past three years -- 4.1 million new jobs in 1977; 3.0 million in 1978, and 2.1 million more in 1979 -- have been phenomenal. Employment growth in recent years has no parallel in the postwar period.

Two particular features of the employment expansion have been particularly encouraging. First, job creation has been concentrated in the private sector. Employment at private nonfarm establishments climbed 14 percent over the past three years, while state and local government employment increased 4 percent and Federal employment was essentially level.

Second, employment gains have been largest for those groups most in need of jobs. For every 100 black adults holding a job in late 1976, there are now 115 gainfully employed. For every 100 black teenagers at work then, 115 are at work now. For every 100 Hispanics with jobs three years ago, there are now 120.

As idle resources were increasingly put to work, it became necessary to shift policy towards restraint in order to moderate economic growth. We reached that point over a year ago, when accelerating inflation also required greater fiscal and monetary discipline. The pace of economic expansion in 1979 slowed more than expected, however, largely because of the heavy blow to the economy from rising OPEC oil prices.

The economic effect of higher oil prices on the economy is similar to that of an excise tax. Because prices are increased, real purchasing power of consumers is drained away. The higher revenues of OPEC oil producers and domestic oil companies are only gradually spent on additional imports and investment projects. The economy suffers a net reduction in demand and output. The Council of Economic Advisers estimates that the net drag on the economy imposed by last year's rising oil prices was equivalent, by the fourth quarter, to a tax increase of $53 billion, far larger than the tax relief provided by the Revenue Act of 1978. Of course the increase in the price of imported oil was unlike an excise tax in one crucial respect: it extracted real wealth from our economy, an effect not reversible by domestic tax reductions or spending.

Table 1

Growth of Major Components of Real GNP
(Fourth Quarter to Fourth Quarter)

	(Percent Change) 1978	1979
Real GNP	4.8	0.8
Personal Consumption expenditures	4.5	1.0
Business Fixed Investment	10.5	1.7
Residential Construction	1/	-8.3
Government Purchases of Goods and Services	1.7	0.1
Domestic Final Sales	4.3	0.9

	Change as a Percent of Real GNP 1978	1979
Inventory Accumulation	1/	-0.6
Net exports	0.5	0.5

1/ Less than .05.

The drain of purchasing power was so large that the total after-tax income of consumers, adjusted for inflation, remained unchanged over the four quarters of last year. Since consumers were willing to reduce their rate of saving substantially, however, consumption expenditures in real terms continued to increase, but more slowly than in 1978. Other major categories of demand also weakened in 1979. The rise of business capital spending also slowed, and residential construction declined. Businesses curtailed their orders and production to keep inventories in balance with slowing sales; consequently, the rate of inventory accumulation at the end of 1979 was below the year-earlier level. Net exports of goods and services rose in 1979, however, as the volume of exports rose substantially more than the volume of imports.

Although, as shown in Table 1, real output rose less than 1 percent during 1979, employment continued to increase strongly. Demand for labor was sustained by a sharp decline in productivity that aggravated inflation and put a squeeze on the profit margins of most American businesses outside of oil companies. The profit share of total output originating in nonfinancial corporate businesses other than petroleum and coal companies fell 15 percent during the first 3 quarters of last year.

Declining profit margins, a gradual increase in excess capacity, and concerns about the possibility of recession contributed to the substantial slowdown in the pace of business capital formation last year. Business purchases of cars and trucks declined sharply. Since the growth of real GNP slowed even more than the rise in business fixed investment, the share of total real output devoted to business outlays for new plant and equipment was a little higher last year than in 1978. But the proportion of our national output devoted to increasing and modernizing our capital stock is well below that of most other major industrial countries. It is also below the amount required to assure long-run improvement in productivity and to meet increased needs for energy and the requirements of environmental, health, and safety regulations.

Inflation

Developments on the inflation front were the most significant disappointment in the 1979 economic performance. At the beginning of the year, it was widely expected that inflation would moderate. Those hopes were destroyed, however, by skyrocketing energy prices.

Last year, the consumer price index rose by over 13 percent. Within the index, energy prices rose by 37.4 percent. Had energy prices risen at the previous year's rate of 8.0%, the CPI would have increased by 2-1/2 percentage points less, considering only the direct effects of energy prices on the index.

Sharply rising costs of home purchase and finance also added a large element to CPI inflation. The way the CPI treats the cost of purchasing a home, and the associated costs of home financing, tends to overstate the rise in the cost of living to the average consumer when home prices and mortgage interest rates increase rapidly. Beginning with the December CPI, the Bureau of Labor Statistics has begun to release data that provide additional perspective on changes in consumer prices. For example, the Department has calculated the cost of home ownership in a way that makes it roughly equivalent to rent. If this rent index is substituted for the homeownership and finance component of the CPI, the rise in consumer prices last year is found to be 10.8 percent. And when energy is removed, the alternative index rises only about 8.0 percentage points in 1979, the same as in 1978.

The President's program of voluntary standards for pay and price incresaes could not prevent the rise in OPEC oil prices or the increases in housing and home finance costs. But they were instrumental in keeping the rising inflation in those areas from setting off a major acceleration of price and wage increases elsewhere. Compliance with the program was widespread. Although the overall rate of inflation rose to 13 percent, increases in wages and fringe benefits were no higher than in 1978. The rise in prices of goods and services outside of energy, housing and home finance was less than the rise in the unit costs of production, and as pointed out earlier, very little greater than in 1978. Had the huge increase in energy prices spilled over into the broad structure of industrial wages and prices, our basic inflation problem would have worsened for many years to come.

Why the Economy Avoided Recession in 1979

The economy's resilience in the face of dramatic increases in oil prices and the attendant worsening of inflation was one of the more surprising features of economic developments in 1979. Forecasts of impending recession were becoming frequent by late 1978, long before the magnitude of the 1979 rise in OPEC oil prices was perceived. By the middle of 1979, they were common. Yet, the characteristics of cumulating recession are still not in evidence at the present time.

The reasons why the economy was able to absorb the shocks of rising oil prices, a substantial acceleration of inflation and sharply rising interest rates without going into a steep decline are only partially understood. Three factors, however, have played a role.

First, individuals as consumers and homebuyers appear to be more strongly affected by inflationary expectations now than in the past. Such expectations help account for the further decline in the personal saving rate during 1979, and for the continued strength of housing sales until late last year, despite a rise or mortgage interest rates to unprecedented heights.

Second, monetary restraint no longer produces the abrupt changes in availability of credit to borrowers that used to bring an end to economic expansion. A number of changes have taken place in financial markets during recent years that have removed or reduced the constraints which used to limit access to credit by some borrowers during periods of general credit restraint. The most recent of these -- the introduction in mid-1978 of money market certificates of deposit sold by banks and thrift institutions -- has been a major factor sustaining credit flows to housing. Because of these developments in financial markets, monetary policy now works more through changes in interest rates that affect a borrower's willingness to incur debt, and less through changes in his ability to obtain credit. For this reason, monetary restraint now tends to affect aggregate demand less abruptly and with a less uneven impact across major economic sectors. As events in financial markets late last year attest, however, significant changes in monetary policy may still lead to constraints on the availability of credit, particularly for housing.

Third, the continued growth of the economy last year reflects the relative absence of cyclical imbalances characteristic of earlier periods of economic expansion. Most notable in this regard is the fact that inventories have remained in good balance with sales throughout the expansion. When consumer spending declined in the second quarter of last year, therefore, businesses did not find themselves seriously overstocked. To be sure, auto inventories, particularly for large cars, increased substantially, and major auto producers are still trying to redress the balance between stocks and sales. In other industries, however, production cutbacks to reduce excess stocks remained modest in 1979.

Economic Outlook

The unsettled state of world oil markets and the unexpected resilience of the economy last year makes forecasting in 1980 an unusually hazardous exercise. The factors that sustained growth in 1979 will continue to affect economic performance in 1980. But it is unlikely that they will cushion the economy's response to shocks to the same extent that they did in 1979.

Key elements of the economic forecast underlying the fiscal year 1981 Budget are shown in Table 2 below.

Table 2

Key Elements of the Administration's
Economic Forecast

	1980	1981
Real GNP Growth (Q4/Q4, Percent)..................	-1.0	2.8
Unemployment Rate (Q4, Percent)..................	7.5	7.3
Increase in the CPI (Dec./Dec., Percent)..........	10.4	8.6

Over the four quarters of 1980, real GNP is forecast to decline by 1 percent; in 1981, an increase of 2.8 percent is expected, as indicated in the table. This forecast is broadly in line with many others, including that of the Congressional Budget Office. The decline in real GNP this year is expected to be accompanied by an increase in the unemployment rate to about 7-1/2 percent in late 1980. Resumption of economic expansion next year, however, is expected to bring unemployment down to 7-1/4 percent by the end of 1981.

The forecast assumes that the economy will head into a mild recession in the first half of this year. Housing starts turned down in the fourth quarter of last year and may decline somewhat further. New car sales also fell, and auto companies have curtailed their production schedules for the first quarter of 1980 to reduce abnormally large inventories, especially of large, fuel-inefficient models. The downward pressure on consumers' real incomes, resulting from rising oil prices and increasing marginal tax rates caused by inflation, is continuing. With the personal saving rate already at exceptionally low levels, slow growth of real income is likely to mean sluggish consumer markets. Current indicators suggest, moreover, that real business fixed capital spending will turn down moderately in 1980. As final demand weakens, the rate of inventory accumulation may also fall somewhat further.

If a recession does occur early this year, it is likely to be brief, mild and largely over by mid-year. A large cutback in production to reduce inventories has often magnified recessionary forces in the past. Such a development is unlikely this year because the cautious inventory policies followed most business firms have prevented a large buildup of undesired stocks. Interest rates are likely to decline because of the abatement of credit demands in a weakening economy. This would permit housing starts to turn up in response to strong underlying demands.

The rise in consumer prices is expected to slow somewhat this year to about 10-1/2 percent. This moderation of inflation during the course of 1980 will contribute to strengthening consumer purchasing power. Early this year, we will continue to face the shock effects of the latest round of OPEC oil price increases. Once those effects wear off, the rise in energy prices is expected to moderate. Moreover, in a weak economy, cost increases will be more difficult to pass through to product prices. Mortgage interest rates may also come down from their very high present levels. Next year, a further reduction of inflation to around 8-1/2 percent is forecast. By any historical yardstick, however, inflation next year will still be extraordinarily high.

The progress against inflation we expect, and which we sorely need, would not be achieved if last year's sharp increase in energy prices and the costs of home purchase and finance were to spill over into wages, costs, and the broad range of industrial and service prices. Preventing that from happening is the first priority for economic policy in our country in 1980. The problem is not ours alone. Every oil importing country around the world is facing starkly higher energy prices and a potentially dangerous acceleration of inflation.

No one can be satisfied with an economic outlook for this year that implies declining real output, rising unemployment, and continuing very high inflation. Appropriate economic policies can help the economy adjust to the impact of recent OPEC oil price increases. But no policies can change the realities which these increases impose.

Economic policy at the present time must hold firm against inflation, despite the prospect of a weakening economy. The Administration recognizes, however, that fiscal policies cannot be set on an unswerving course regardless of how economic developments unfold. We will monitor developments closely this year. If economic conditions and prospects deteriorate significantly, we will be prepared to take corrective action in ways and under circumstances that do not aggravate inflation.

II. The 1981 Budget and Fiscal Policy

The fiscal policy in the 1981 budget recognizes that inflation remains our paramount economic problem. If we do not deal effectively with inflation, the very substantial economic progress achieved under this Administration will be reversed, and our long-term goals of balanced growth with full employment and price stability will be even more difficult to achieve. The 1981 budget is, therefore, a restrictive budget. The growth of budget outlays is held to the lowest rate consistent with our national security and energy security objectives and the most urgent domestic requirements. Budget increases for less critical needs have been rejected. There are no major tax reductions. This austere budgetary policy is a necessary condition for controlling inflation.

Reasons for Fiscal Restraint

A restrained budget is necessary to lower inflationary expectations. There have recently been disquieting signs that consumers expect high inflation to continue indefinitely, as a permanent fixture of economic life. Workers and businesses increasingly appear to make their wage and price decisions on the basis of that expectation. Such expectations could become self-fulfilling, leading to a dangerous wage-price spiral which would do permanent damage to the economy. The public must be convinced that this will not happen, and make their price, wage, borrowing and expenditure decisions accordingly.

Budget restraint is also necessary because forecasts are highly uncertain, and there are risks to any policy. Under present circumstances, the risks of a restrained fiscal policy are far less than the risks of fiscal stimulus. Expansive policies are difficult to reverse, and the long-term inflationary damage resulting from a mistakenly expansive policy would be severe. On the other hand, if economic conditions should significantly worsen, changing to a policy of less restraint would be less difficult.

A restrained budget is also necessary to preserve the international confidence in the dollar required to prevent destabilizing and inflationary exchange rate changes. A bloated 1981 budget would be a signal to the world that the United States has accepted double-digit inflation and is unwilling to make the sacrifices needed to restore price stability. This could be damaging not only for the U.S., but for the world trading and financial system as well.

For the longer-term, budgetary restraint is required to generate the savings and capital formation required for higher productivity growth, lower inflation, and rising employment and living standards. Federal spending must be held down to make resources available for additional capital formation, and this will be especially difficult at a time when demands on the budget from energy and national security requirements are growing. Because of the difficulties in controlling expenditures in the short-term, this long-term problem must be addressed now, in the 1981 budget.

Restraint in the 1981 Budget

This budget recommends outlays for 1981 of $615.8 billion. This is effectively a zero-growth budget; after allowing for inflation, 1981 outlays are at virtually the same level as 1980. Receipts are estimated at $600.0 billion, and the recommended deficit is $15.8 billion, the lowest in seven years. Because of the urgent necessity for fiscal restraint, tax reductions are not proposed. The only major tax proposal included in the budget is the windfall profit tax.

Table 3

THE BUDGET TOTALS
(in billions of dollars)

	1979 actual	Estimated 1980	1981	1982	1983
Budget receipts.......	465.9	523.8	600.0	691.1	798.8
Budget outlays........	493.7	563.6	615.8	686.3	774.3
Surplus or deficit (-)	-27.7	-39.8	-15.8	+4.8	+24.5
	=====	=====	=====	=====	=====
Budget authority....	556.7	654.0	696.1	775.1	868.5

It is regrettable that present difficult economic conditions do not permit a balanced 1981 budget. However, the proposed 1981 deficit marks substantial progress toward that goal. The deficit proposed for 1981 is $50 billion lower than when President Carter ran for President. As a percentage of the budget and of the GNP, the proposed deficit is the second lowest of the preceding decade, and less than a third of the average for the 1970's. If, contrary to our expectation, the economy were to expand rapidly enough to keep the unemployment rate at its current level, the 1981 budget would be in surplus by about $15 billion.

A common measure of fiscal stimulus or restraint is the change in the high-employment budget surplus or deficit, a measure which excludes the budgetary effects of changes in the degree of resource utilization. This measure of fiscal restraint increases from a $12 billion deficit during fiscal year 1979 to a surplus of $5 billion in 1980 and a surplus of $57 billion in 1981. The 1981 budget thus continues -- and intensifies -- the policy of fiscal restraint begun earlier. The increase in the high employment surplus from 1979 to 1981 is over 1-3/4 percent of GNP -- a very substantial degree of restraint.

Budgetary stringency can also be measured by examining proposed budget outlays in comparison with current services, the level of spending required to maintain existing program levels. The level of outlays in FY 1981 is only 0.6% above the level needed to maintain the current level of services. The $3.7 billion difference is more than accounted for by $6.3 billion of increased spending on defense and energy, which are critical to our national security. The rest of the budget shows a reduction of $2.5 billion below current services.

Because the 1981 budget is restrictive, the pressures to expand it will be strong. Unemployment later in 1980 and in 1981 is expected to be higher than it is today. Businesses will need greater incentives to invest in plant and equipment. Worthwhile social programs will seem to require additional funding. Many of these needs are legitimate, and under other circumstances they might deserve room in the budget. But the harsh reality of inflation makes it critical for the Congress to resist those pressures, as the Administration has done.

Major Budget Priorities

The budget is more than an instrument of macroeconomic policy. It is also a means of addressing the needs of our society and the ordering of national priorities. Although spending growth has been held to a minimum in this budget, the President has recommended program increases in a few critical areas. The most important of these in 1981 are defense, energy, basic research, and the development of our young people.

Defense.--When the Administration assumed office, real defense spending had declined for almost a decade. Even in 1978, outlays for defense largely reflected decisions of the previous Administration. In real terms, those outlays were lower than they had been four years earlier. In the 1979 budget, the President proposed a long term policy of substantial and sustained growth in real defense spending. Developments in Iran and Afghanistan during recent months attest to this need. Therefore, this budget proposes a defense program in 1981 of \$158.2 billion in budget authority, an increase of over 5% in real terms. Outlays for defense will be \$142.7 billion, a real increase of over 3%. With this budget, spending on defense will have increased by 9.4% in real terms since 1978. This Administration is committed as a matter of fundamental policy to continued large real increases in defense spending beyond 1981.

Energy.--Solutions to our energy problem are essential for both economic progress and national security. This budget reflects the important progress being made by this Administration, in cooperation with the Congress, through a broad and practical program addressing the energy problems the Nation is facing in this new decade. The 1981 budget assumes that, early in the 1980 session, the Congress will pass the crucial measures proposed last year: the windfall profit tax, the Energy Security Corporation, the conservation measures and the Energy Mobilization Board.

The energy program supported in the 1981 Budget is comprehensive and balanced, addressing both production and conservation. To stimulate production, it recommends resources for the Energy Security Corporation that would help to create a synthetic fuels industry, and it supports major increases for solar, fossil, and fusion energy. It provides for an ambitious gasohol program and emphasizes safety and the solving of current problems in nuclear fission programs. Overall, spending on energy programs will increase to $8.1 billion in 1981, an increase of over 90% during the first four years of this Administration.

As the Nation adjusts to energy scarcity, we must protect those who are most vulnerable. Much of this protection is achieved automatically, through programs such as social security and retirement which are indexed to the cost of living. The 1981 budget expands this protection, providing funds for the poor for weatherization of their homes, and for energy cash and crisis assistance. In all, the 1981 budget proposes $2.4 billion in energy assistance for the disadvantaged, an increase of 50% over the 1980 level.

Youth Employment.--Despite the economic gains that have been made over the past three years, youth unemployment, especially for minorities, remains distressingly high. When youth have significant employment problems upon leaving school, their employment and earnings may be adversely affected for a lifetime. To eliminate this waste of national resources, this budget proposes a major new education and employment initiative designed to prepare today's youth for the labor market of the 1980's. This program will help schools to provide disadvantaged youth with the basic skills needed to get and keep jobs, and to reinforce those skills with job experience in the private sector. Disadvantaged youth out of school would acquire these basic skills in improved training and employment programs. By 1982 this program will add $2 billion to the over $4 billion currently being spent on education and employment programs for 14 to 21 year old disadvantaged youth.

Basic Research.--Between 1968 and 1975, Federal spending for basic research, measured in constant dollars, declined substantially. In order to maintain our Nation's position as a leader in the development of new technology, the budgets of this Administration have increased real spending on basic research each year. The 1981 budget continues this policy and provides for major and sustained increases above the rate of inflation for all research and development programs. Obligations for research and development will increase by 13%; for basic research by 12%.

since 1978, obligations for basic research will have increased by 40%, or 9% in real terms.

Agriculture.--Because of the aggression of the Soviet Union against Afghanistan, the President has significantly limited Soviet grain purchases from the United States, while at the same time taking steps to ensure that the burden of the export limitation does not fall disproportionately on farmers. Specifically, the Secretary of Agriculture will:

-- Purchase from shippers contracts entered into with the Soviet Union and sell the contracts back into export markets only at prices above those prevailing on January 4.

-- If necessary, take title to the grain intended for export to the Soviet Union and isolate it from the market.

-- Purchase up to 4 million metric tons of wheat for an international food aid reserve.

-- Increase the loan level for feed grains and wheat by 10 and 15 cents per bushel respectively.

-- Expand CCC export credit guarantee coverage to include full commercial risk.

-- Modify the farmer-owned grain reserve to encourage farmers to place additional grain in their reserve.

-- Purchase grain in local markets to stabilize markets and relieve the congestion of grain in transit to major ports.

It is estimated that these measures will increase outlays by $2.0 billion in 1980 and $0.8 billion in 1981. In addition, the President will propose additional funding for P.L. 480 for FY 1980 and FY 1981 of $100 million per year. The Administration stands ready to take further steps if these actions prove insufficient, taking care, however, to avoid long-term distortions in out basic farm policies.

Initiatives to Reduce Federal Spending

These initiatives of high national priority have been proposed in the context of overall budgetary restraint. The required restraint has made it essential to propose a number of reductions in Federal programs. Restraint has been applied carefully. For the third consecutive year, zero-base budgeting has been used to establish priorities that put taxpayers' dollars to best use. Desirable new programs have been deferred. Increases in existing programs have been limited. Past efforts to achieve program efficiencies and improve management are beginning to pay off, and further efforts in this direction are undertaken in this budget. Reductions in lower priority programs have been proposed, and this budget contains specific outlay reductions of $9.7 billion from current service levels.

A substantial portion of these reductions take the form of legislative proposals that would reduce Federal spending. Together, these legislative proposals will reduce Federal spending by $5.6 billion in 1981 and by significantly larger amounts in subsequent years. Savings would be achieved through several health-related proposals, modification of entitlement programs to relate benefits more closely to need or to earned rights, increased administrative efficiencies, and reduction of waste, fraud, and abuse. In addition, this budget contains proposals to reform Federal compensation practices and procedures, place the railroad retirement system on a solid financial footing, and dispose of excess materials in the national stockpile of strategic materials.

Large spending reductions are extraordinarily difficult to achieve in the immediate budget year, because so much of the budget is relatively uncontrollable in the near-term. In the 1981 budget, fully 77% of outlays are classified as relatively uncontrollable, and these will account for $37 billion of the $52 billion increase in total outlays between 1980 and 1981. The remaining $15 billion will be due entirely to increased spending for national defense. The rest of the budget, in total, has been held at the 1980 level. For every increase in spending for controllable, non-defense programs an offsetting reduction within other programs has been made.

As inflation gradually comes down, its severe impact on the growth of budget outlays will be mitigated. But future spending levels can only be be held down by efforts begun <u>now</u> -- in 1981 -- to hold the lid on spending initiatives.

<u>Receipts</u>

Total receipts for 1981 are estimated to be $600.0 billion, $76.2 billion more than in 1980.

Table 4

ESTIMATED UNIFIED BUDGET RECEIPTS
(Fiscal years; in billions of dollars)

	1979	1980	1981
Individual income tax....................	217.8	238.7	274.4
Corporation income tax...................	65.7	72.3	71.6
Contributions for social insurance......	141.6	162.2	187.4
Other receipts..........................	40.8	50.6	66.6
Total..................................	465.9	523.8	600.0

These estimates assume a windfall profit tax which, on a net basis, produces excise tax receipts of $5.5 billion in 1980 and $13.9 billion in 1981. The windfall profit tax will ensure that the burden of higher energy costs is equitably shared, and will provide additional receipts to finance energy programs essential to our economic well-being and national security.

Because the windfall profit tax is deductible, it will reduce the corporation income tax liabilities of oil firms. This, combined with lower growth in corporate profits due to a sluggish 1980 economy, results in a slight reduction in corporation income tax receipts in 1981.

Control of Federal Credit Activities

In recent years, direct loans and loan guarantees have come to play an increasingly important role in economic policy. Unfortunately, too much of this activity has escaped the normal discipline of the budget process. In the 1980 budget, we announced our intention to institute a system to control the use of Federal credit. This system, which is now in place, recommends specific credit limitations for most credit programs. It also provides estimates of the new direct loan obligations and new loan guarantee commitments to be made in the coming fiscal year.

Table 5

THE CREDIT BUDGET TOTALS

(in billions of dollars)

	1979	1980	1981
New direct loan obligations.............	51.4	59.7	60.7
New loan guarantee commitments..........	74.7	75.2	81.4
Total..................................	126.1	134.9	142.1

In 1981, new direct loan obligations increase by 1.7% over 1980 compared with a 16.1% increase in the previous year. Loan guarantee commitments, on the other hand, increase 8.3% in 1981 after increasingly only a small amount in 1980. The total increase for direct loans and loan guarantees together is 5.3% in 1981.

The credit control system is an important improvement of Federal budgeting practices. The new system has three long-run goals:

— To ensure that credit programs meet the purposes for which they were intended, that they do so effectively, and that the level of resources is justified.

— To provide a closer examination of the allocation of credit and real resources across broad sectors of the economy.

-- To encourage more careful consideration of the impact of total Federal credit activity on the private economy as a whole -- on the borrowing needs of the private sector, and on economic growth, inflation and unemployment.

This new system of credit control, in conjunction with zero based budgeting and multi-year planning, will help ensure that the government runs more intelligently and efficiently.

III. Other Measures to Fight Inflation

Budgetary restraint, of course, is not the only anti-inflationary policy at our disposal. But it is a necessary condition for the success of other policies. Fiscal discipline must be combined with responsible monetary policy to provide the economic environment necessary to reduce inflation. But more is required. Inflation has been building in our country for 15 years, and its momentum is very strong. Reducing inflation cannot be accomplished by traditional macroeconomic policies alone without enormous losses of output and jobs. Maintenance of effective standards for pay and price restraint is essential. We must also attack other structural causes of inflation, especially those related to energy and low productivity growth.

Monetary Policy

Policies of monetary restraint are never popular. They hit some sectors harder than others. They are associated with shortages of credit and high interest rates, even though those developments stem principally from the forces of inflation that dictate monetary restraint, rather than from those policies themselves. However, inflation will not come down unless the growth of money and credit is gradually reduced to a rate consistent with lower inflation.

The Federal Reserve has been pursuing a responsible course. Growth of the major monetary aggregates was within the established target ranges last year. When an excessive pace of monetary growth did emerge in mid-1979 the Federal Reserve took steps to deal with the situation.

In the first few weeks following the Federal Reserve's October 6 actions, there was considerable turmoil in financial markets. Interest rates rose sharply, and uncertainties were created in the minds of lenders and borrowers regarding the outlook for the cost and availability of credit. Mortgage markets were most severely affected.

Subsequently, however, interest rates on market securities began to decline. Credit has now begun to flow more freely to mortgage borrowers, and mortgage interest rates have declined somewhat in some regions of the country. While housing starts have been adversely affected, the decline has been much less substantial than in previous cycles. Moreover, mortgage credit flows and housing construction will be sustained early this year by the temporary Federal preemption of State usury ceilings.

These painful effects of monetary restraint are a price that has to be paid to prevent the excess growth in money and credit which would aggravate inflation. By placing greater emphasis on the supply of bank reserves, the Federal Reserve's present operating strategy will allow more effective control over the growth of money and credit. Growth in virtually all of the monetary aggregates fell back to a moderate pace during the closing months of last year, and interest rates have shown remarkable stability recently.

If the pace of economic activity slackens next year, a modest decline in interest rates should accompany reduced demand for credit. However, a significant and lasting decline in interest rates cannot be achieved without progress in reducing inflation.

The relatively small deficit that will result from the Administration's 1981 budget will help to relieve pressures in financial markets. Net Federal borrowing from the public will be an estimated $33 billion in FY 1981, compared with $34 billion in FY 1979, and $44 billion in FY 1980. Private credit demands in 1980, however, are expected to decline by more than the increase in net Federal borrowing.

Pay and Price Policies

Dealing effectively with inflation requires policies aimed directly at promoting restraint in wage and price increases in the private sector. The cooperation of business and labor in adhering to voluntary wage and price standards is essential in this endeavor. Standards for wages and prices are not only a means of reducing inflation; to the extent that they succeed, they reduce the burden on monetary and fiscal policies in fighting inflation, and thus make increased employment and output possible.

The standards have a critical role to play in 1980. Our most immediate problem this year is to prevent last year's large price increases in energy and housing from spilling over into wages, costs, and the broad range of industrial and service prices. Should that happen, inflation could worsen for many years to come.

To promote continued cooperation with the standards, the Administration and organized labor arrived at a National Accord announced on September 28, 1979. The Accord called for the creation of two advisory committees, one on pay and one on prices. The Pay Advisory Committee consists of representatives from labor, business and the public and has already recommended a number of modifications in the pay standard. For the basic pay standard, the recommendation contemplates that pay increases in normal circumstances would average 8-1/2%, with possible variation within a range of 7-1/2 to 9-1/2 percent. The Council on Wage and Price Stability is now reviewing this recommendation.

Energy

All of our efforts to defeat inflation will be severely compromised if we experience continued shocks from sharp increases in oil prices.

Price controls on domestic energy supplies were a significant factor behind our excess reliance on imported oil. Price controls encouraged the wasteful use of energy and discouraged the development of domestic energy sources. As a result, oil imports increased from about 2.2 million barrels a day in 1967 to a peak of 8.5 million barrels a day in 1977.

In order to reverse this trend, to encourage conservation and stimulate domestic production, the Administration has begun phased decontrol of domestic oil and gas prices.

Higher energy prices have already begun to reduce energy consumption dramatically. Since 1973, the rise in per capita use of energy has slowed substantially. Had the trend of the 6 years prior to 1973 continued, oil imports in 1978 would have been nearly 6 million barrels a day higher than they were. In 1979, efforts by Americans to conserve energy accelerated. Consumption of gasoline in the fourth quarter of last year, for example, was 10 percent below a year earlier.

Decontrol is an essential part, but only one part, of our program to stimulate conservation and encourage domestic production of energy. Other conservation efforts, as well as programs to develop conventional energy sources, renewable energy resources and synthetic fuels, are also urgently needed.

We have proposed two important pieces of legislation that would promote domestic energy production. The first of these, the Energy Security Corporation, would facilitate private sector development of synthetic fuels to substitute for imported oil. The second, the Energy Mobilization Board, would help to reduce the regulatory delay involved in building new energy facilities. It is essential that Congress complete action expeditiously on both of these proposals.

Legislation will soon be sent to the Congress setting targets for reduced oil use by electric utilities. To enable utilities to meet these goals, financial assistance will be proposed to facilitate their conversion to coal. There will also be submitted to Congress a standby gasoline rationing plan which could be put into place quickly in case of a severe energy shortage.

The U.S. is working with other oil importing nations, through the International Energy Agreement, to coordinate import policies to avert a costly scramble for oil when supplies are short. In 1977, the U.S. used 8.5 mmb/d of imported oil. President Carter set a limit of 8.2 mmb/d for U.S. oil imports during 1979 and this goal has been continued for 1980. If discussions in the IEA produce a fair and equitable agreement for sharing import reductions, the President is prepared to lower the 1980 target.

Agricultural Policy

Periodic scarcities of food have often occasioned an acceleration of inflation. The history of the past 15 years indicates clearly that price shocks stemming from temporary scarcities of food or energy can have a lasting effect on inflation, because they tend to become built into the structure of wages and other costs and thus into the underlying inflation rate.

Prior to 1972, agricultural policy had concentrated on supporting prices and controlling excess supply through production adjustments. The Food and Agricultural Act of 1977 established a system of farmer-owned reserves designed to protect both producers and consumers against volatile food prices, while promoting intensive use of U.S. agricultural productive capacity.

The reserve system has been successful during its short existence. Grain prices began to rise during the spring of 1979 when export demand was projected to rise sharply. This increase was moderated, and an inflationary spurt in food prices avoided, by a substantial release of stocks from the reserve. When grain shipments to the Soviet Union were suspended in response to that country's invasion of Afghanistan, increased incentives to place grain in reserve served as an important line of defense to protect farmers against a precipitous decline in prices.

Hospital Cost Containment

Inflation must also be attacked directly in the health care sector. The costs of medical care have been rising faster than prices of all other consumer goods and services for a number of years. The costs of hospital care have risen even faster than the rise in costs of other health care services. These costs affect consumers both directly and through the higher taxes needed to pay for public health services.

Aggregate demand policies have very little effect in this sector of the economy. Furthermore, we cannot expect market forces to work effectively in this sector. Often buyers or sellers of medical services lack the incentive or information necessary to take actions that would limit the rise in medical costs to the levels that would exist in a competitive market.

The Administration therefore, will continue to urge enactment of its important initiatives to restrain unnecessary spending and help contain hospital costs. Passage of the Administration's hospital cost containment legislation is one of the most important steps Congress can take now to fight inflation.

Improving Productivity

The disappointing performance of productivity has been an important factor behind the inflation of the last few years. In the early 1960's, productivity gains averaged more than 3 percent per year. In recent years, productivity increases have dwindled to about 1 percent, and a sizable decline occurred in 1979.

Improvement in productivity growth would obviously have highly beneficial effects. Besides reducing the rise of costs and prices, increased productivity would mean higher real output and improved living standards for Americans. However, bettering our productivity performance cannot be achieved quickly or at low cost.

Indeed, since we do not fully understand the causes of the slowdown in productivity, we are hampered in our efforts to deal with it. We do know, however, that basic research and development and a stronger pace of business investment in new plant and equipment are indispensable ingredients for increased economic efficiency.

Increased investment will enhance the productivity of workers in two ways: first, by giving them more capital to work with; second, and perhaps more importantly, by putting the latest technological advances into practice.

The budget for 1981, as noted earlier, contains additional funds for basic research and development, continuing the strong Federal backing for basic research that began in fiscal 1978. The budget does not contain new tax incentives for investment. Reductions of significant magnitude in business taxation would have been inconsistent with the basic policy of fiscal restraint that characterizes this budget. Tax incentives will not result in increased investment unless investors can be confident that we will have a strong and stable economy. A lean budget geared to reducing inflation is the most important step we can take now to stimulate investment. Furthermore, as explained in the Economic Report, higher national savings and capital formation will not be compatible with large budgetary deficits over the longer term.

In the years immediately ahead, tax reduction will become possible if the Administration and the Congress work together to hold the line on growth in Federal spending. When that time comes, the Administration will give very high priority to tax changes that will stimulate of investment and direct a larger fraction of our national resources to capital formation.

Dealing with Structural Unemployment

Investment in human capital is as important to enhancement of productivity as investment in physical assets. At the present time our nation is wasting a significant part of our human resources. Unemployment among blacks and minorities is still unacceptably high. By improving employment opportunities for these groups, the supply of goods and services will be increased and efficiency in resource use will be improved.

Reducing unemployment and increasing the earnings of these groups cannot be accomplished merely by stimulating the economy. Attempting to do so would add to inflation while yielding, at best, minimal benefits to those suffering special employment problems. Instead we must have targeted programs to enable these groups to expand their skills and give them the opportunity to work.

This Administration has already increased expenditures on employment and training programs for the disadvantaged by 73%, and spending on special programs for youth three-fold. The most significant new domestic initiative the President is sending the Congress this year deals with the problem of teenage unemployment. As discussed earlier, this program will emphasize improved classroom provision of basic skills and useful work experience for low achieving youth still in school; disadvantaged out-of-school youth will be given such skills through redesigned and improved training and employment programs.

The Administration's welfare reform proposals also contain important initiatives for improving the employment and wages of principal wage earners in low-income families with children.

In the years ahead, efforts to promote productive employment for the structurally unemployed must continue. We are learning from experience which programs provide lasting benefits to workers while avoiding waste and unnecessary expenditures of public funds. We will strongly emphasize, as we have with several of the new programs developed recently, the active involvement of the private sector in hiring and training the disadvantaged.

Regulatory Reform

Unnecessary and sometimes counterproductive government regulation has added to inflation. Recognizing this, the President, working with the Congress, has started to dismantle economic regulations that contribute to inflation. The first step was the deregulation of the airline industry. The Administration is now working with the Congress to eliminate costly and inefficient aspects of regulation in the trucking, railroad, and communications industries. We are also proposing the reform of regulations over financial institutions to promote equity for small savers, maintain the viability of our thrift institutions, and enhance competition and efficiency in financial markets.

In fulfilling environmental, health, safety, and other social objectives, governmental regulations serve a function that cannot be performed by the market place. In these areas, important cost savings are possible by improving the design of individual regulations, setting standards that will meet objectives without being unnecessarily stringent, and encouraging the most cost-effective approach to meeting those standards.

The Administration has taken steps of fundamental importance to the long-run impact of social regulations on costs, productivity, and inflation. Executive Order 12044 established a regulatory analysis review procedure that requires policymakers in regulatory agencies to give greater attention to the cost of regulations. A Regulatory Council has also been established to help achieve better coordination of important regulations issued by the various executive branch and independent agencies, and to develop a calendar of important regulations that will provide a broad overview of the potential impact of regulations on the economy. Moreover, the regulatory analysis procedure undertaken under Executive Order 12044 would be made permanent, and extended to the independent regulatory agencies, by the regulatory reform legislation that the Administration has sent to the Congress. Prompt passage of that legislation is a high priority in the Administration's legislative agenda for 1980.

IV. U.S. International Economic Policy

Our fight against inflation must include international as well as domestic policy initiatives. A stable dollar is essential to avoid additional inflationary pressures. A fair and open system of international trade and investment promotes competition within our own economy. Food and commodity prices can be stabilized through international action. Intensive cooperation with both industrialized and developing countries can help to promote our economic objectives in today's interdependent world economy.

The U.S. economy is inextricably linked to the other industrial economies, and is increasingly affected by the developing nations as well. We depend on the world economy:

-- to purchase the production from 1 in 7 U.S. manufacturing jobs and 1 in 3 acres of U.S. farmland;

-- to provide almost 1 in 3 dollars of U.S. corporate profits;

-- to provide one-fifth of our total energy requirements;

-- to assure a wide variety of consumer choice, promote efficient production at home, and stimulate competition in our markets;

-- to supply essential inputs for U.S. industries, including more than one-fourth of U.S. consumption of 12 of the 15 key industrial raw materials.

U.S. economic policy must therefore be developed in full recognition of the linkages between our own economy and the rest of the world.

A strong, stable dollar is fundamental to the stability of both our own economy and the international financial system. Changes in the value of the dollar have an important effect on jobs, investment, inflation and growth at home. Maintaining a stable dollar is particularly important in our fight against inflation, because a strong dollar holds down the price of imports and promotes domestic competition.

During the period of exchange market instability in the autumn of 1978 the United States took strong measures, including monetary actions and the mobilization of adequate resources for forceful intervention in exchange markets. The effectiveness of those measures has been enhanced recently by continued monetary discipline and strengthened cooperation between U.S. monetary authorities and those in other major nations. The emphasis of our economic policy on eliminating inflation and reducing our dependence on imported oil will make an essential contribution toward maintaining a sound and stable dollar.

A sound dollar is aided by a stable international monetary system, the goal of the International Monetary Fund. The IMF promotes the adoption and maintenance of appropriate economic policies by member countries, both those in balance of payments surplus and deficit. The IMF also maintains multilateral surveillance over the world financial system as a whole. In addition, the U.S. has itself borrowed from the Fund during the past year to augment the resources available for exchange market intervention. The Fund thus provides direct support for fundamental U.S. interests, and is an integral part of our overall economic policy strategy.

A stable monetary system is important not only in its own right, but because it helps to preserve and strengthen the .rospects for open and fair international trade and investment, which are vital for our economic interests. American industry and agriculture must expand their exports aggressively if we are to have a stable dollar, and American consumers must have access to competitive foreign products if we are to check inflation.

To foster open and fair trade,, U.S. policy must continue to seek the freest possible international market. The Multilateral Trade Agreements signed in December 1979 set the stage for significant reduction or elimination of both tariff and non-tariff trade barriers in all key trading nations. More than ever before, U.S. business must look to export market as a means of increasing production, providing jobs, and paying for essential U.S. imports.

As both a major producer and consumer of raw materials, the United States also has an important interest in international commodity markets. We seek to mitigate the effects of commodity price instability through international commodity agreements. Properly constructed arrangements can provide benefits to both producers and consumers by reducing inflationary pressures, promoting greater stability of commodity export earnings, and increasing incentives for primary commodity production. The recently negotiated Natural Rubber Agreement provides an excellent example of an international commodity arrangement which balances producer and consumer interests to their mutual benefit.

Finally, our national dependence on the world economy requires us to cooperate closely with both industrialized and developing nations across a whole range of international economic issues. Economic summit meetings, the IMF, GATT, and OECD are simply a few of the institutions through which we carry out such cooperation.

The multilateral development banks -- the World Bank and the similar regional institutions -- are the centerpiece of international efforts to mobilize resources to aid developing countries. Our fundamental national interests require a reasonable program of foreign assistance, and participation in the multilateral development banks is a particularly cost-effective approach to development cooperation. For example, the World Bank has lent $50 for every $1 which we have paid into it.

The development banks are efficient instruments of development cooperation. During their 35-year history, developing country growth has considerably exceeded their historical experience or reasonable expectation. Part of the credit for this growth must go to the catalytic effect of external assistance flows, including those from the banks. Positive support for these institutions enhances the likelihood of constructive LDC cooperation in other global institutions which are addressing problems of key importance to the United States.

Each of these individual initiatives forms part of a comprehensive and cohesive U.S. international economic strategy, which supports stable prices and increased employment at home. We can ensure that other countries respond to our vital concerns only if we also respond to their interests. Our own domestic economy can prosper at home only if we maintain, and indeed intensify, our joint efforts with other countries to improve the collective management of the world economy.

V. Conclusion

In sum, the 1981 budget is a key element of the Administration's comprehensive program for containing and reducing inflation. This budget attacks inflation in two ways: first, through overall fiscal discipline; second by emphasizing programs which ensure our national security and lay the foundation for a more efficient and productive economy.

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Date: January 7, 1980

MEMORANDUM FOR: SECRETARY MILLER

From: Dick Syron, Bea Vaccara
(Initialed) (Initialed)

Subject: Budget Testimony

You are scheduled to meet with Charlie Schultze and Jim McIntyre Tuesday (1/8/80) at 10:30 a.m. to discuss this year's budget testimony. The three of you are scheduled to testify before the Senate Budget Committee in a panel format on the morning of January 30th; you and Schultze will also testify together the morning of January 31st before the House Budget Committee. In previous years the Secretary of the Treasury has usually testified alone, so a somewhat different approach may be called for than in the past.

One of the first issues to be resolved is the topics to be handled by each of you. One possible approach you may want to consider follows.

Secretary Miller: Overall strategy for economic policy for 1980/81. Summary of economic outlook - importance administration places on fighting inflation. Interrelationship between energy, inflation, the economy and the dollar.

Chairman Schultze: Review of economic accomplishments over the last three years. Performance of economy in 1979, details of economic forecast for 1980 and outlook for next few years.

Director McIntyre: Detail of budget for 1981, spending changes for major categories and reasons for them.

We will prepare a detailed outline of your testimony for your approval after you have decided on the approach you want to take. We may want to consider using several charts or other visual aids.

	Initiator	Reviewer	Reviewer	Reviewer	Reviewer	Ex. Sec.
Surname						
Initials / Date	/	/	/	/	/	/

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