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STATEMENT OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for inviting me to present the Administration's views on the important subject of tax policy. The question is whether a tax reduction package should be enacted in the near future, and if so when and with what characteristics and of what magnitude.

The issues involved are complex and require careful study and deliberation. There are many criteria against which alternate courses of tax action should be evaluated. The timing and scale of any tax reduction are particularly critical in view of inflationary expectations and budgetary realities--and the impact of these factors on domestic and international financial markets.

It is the considered judgment of the Administration that the Congress should not seek to enact tax cutting legislation prior to the national election.

During 1981, properly targeted tax cuts directed at strengthening the productive foundations of the economy may well prove to be desirable. If designed with care and deliberation as part of an overall economic program, such action may well improve our economic performance over the next several years.

But hasty tax cutting now could be counterproductive. One proximate cause of the current recession was the fever of inflationary expectations early this year which brought serious disarray into the financial markets and resulted in severe credit constraints on businesses, farmers, and families. Following strong initiatives undertaken by the Administration last March after extensive consultations with Congress, both inflation rates and interest rates have come down dramatically. These trends, aided by responsible budgetary actions by the Congress, are laying a foundation for recovery. Taking premature action which might be perceived as undermining fiscal responsibility could well interrupt or reverse those trends and thus complicate the recovery.

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In addition, the brief and busy legislative session remaining before the election is not likely to provide the time or climate for properly analyzing the kind of structural and well-focused tax and other economic measures essential to the long-term health of the economy. Our joint responsibility is to secure a robust, non-inflationary path of growth for the economy over the years ahead. This objective is not served by rushing forward at this time with large injections of purchasing power or undigested plans for transforming the revenue side of the fiscal accounts.

Acting after the election rather than in haste over the coming weeks would also allow us to gain a much better understanding of the economy's evolution into recovery, a much better view of trends and decisions on federal spending, and a firmer consensus on other economic measures needed to improve the economy's performance over the new decade.

Nevertheless, the opportunity to examine in depth the important issues before this Committee is greatly appreciated. In order to do so, it is proposed to review long- and short-term economic developments, to suggest appropriate criteria against which to evaluate any future tax program, and to outline some of the major choices in establishing tax policy.

NEED FOR LONGER-RUN PERSPECTIVE

There is a natural tendency to place emphasis on short-term economic policy even though the underlying problems are long-term in nature. The adverse trends in inflation and productivity which we are experiencing did not occur overnight. They have been developing for at least the last fifteen years. Therefore, we need to give serious attention to the origin of these and other economic problems as a basis for dealing with them effectively.

The 1950's and the early 1960's were a period of strong U.S. economic performance in both domestic and international markets. Throughout much of the period, U.S. productive strength was unquestioned and the dollar was strong. It has become a more difficult world during the 1970's and early 1980's. Inflation has become a clear and present danger. Energy prices have been pushed up very sharply by the oil exporting countries. The international financial system has been placed under great strain. International trade has become increasingly competitive, and domestic industries sometimes bear a heavy burden of adjustment. We face a range of complex economic problems at home and abroad. There are no simple solutions, no easy ways out. These problems can be mastered -- but only if we face them squarely and resolutely, eschewing easy answers based purely on hope or rhetoric.

Significant gains have been made in the last few years. There is an increasing realization throughout the country that many of our economic problems are structural in nature and long-standing in origin. The energy problem is being attacked now in a coordinated way for the first time. Fiscal and monetary policies are being formulated with greater discipline to bring inflation under control. New approaches are being explored to reinvigorate the industrial sector of our economy. Substantial progress has been made in reducing the burden of government regulation on the private economy.

At the present, a great deal of attention is properly being focused on the economic downturn. There have been six previous periods of contraction since World War II and on average they have lasted a little less than one year. The weight of informed economic opinion--inside and outside of government--is that the current period of contraction will end late this year or early next, and will not be as deep as in 1973-75.

The current recession was not deliberately sought. It has inevitably caused real suffering, which we are acting to mitigate. The downturn, also inevitably, will result in some reduction in the rate of inflation. Recovery must proceed without reigniting inflationary forces.

As we contemplate recovery over the coming year, economic policies should therefore be shaped in the interest of longer-run stability. The economy needs to perform much more strongly in the future in the key areas of capital formation, productivity growth, and international competitiveness, so that employment gains can be sustained, without generating new waves of inflation. That will not be accomplished by a hasty, across-the-board tax cut. Any tax program to reinforce recovery should be carefully constructed to be consistent with overall economic objectives.

If our difficulties were simple or of recent origin, the straightforward countercyclical use of fiscal policy might meet the needs of the situation. But our problems are deep-seated. They have developed over a long period of time. Simply pumping purchasing power into the economy will not raise the capital-labor ratio, increase the rate of growth of potential output or improve U.S. competitive ability in foreign markets.

The range of policy options that we should have under active consideration can best be appreciated by reviewing the general trend of economic events that forms the background to the current situation.

THE POST WAR ERA, 1945-65

The roots of our current economic problems go back several decades. During the 1950's our economy performed significantly below its potential. As a result, in the early 1960's we were able to improve our economic performance by exploiting under-utilized resources. We did not have to face difficult trade-offs, but were able to have more of everything by running the economy closer to capacity. Our current problems began after the mid-1960's when we tried to continue this approach long after we were running up against economic limits. Policies of economic stimulus began to be reflected primarily in rising prices, not in rising output.

In the first twenty years of the postwar era, the U.S. international payments position was strong and we were able to assist in the rebuilding of war-ravaged foreign economies. Thereafter, we have been faced intermittently with balance of payments difficulties in an intensely competitive international economic environment. In the earlier period, energy was cheap and readily available. As a result, U.S. production methods and patterns of consumption were heavily conditioned by low relative prices of energy. Subsequently, a difficult and painful adjustment has had to be made in an environment of energy scarcity.

Relatively Stable Prices. During the period from 1947 to 1965, the GNP deflator rose at a 2.3 percent annual rate and the consumer price index at a 1.9 percent annual rate. There was a sharp run-up of prices at the time of the Korean War, but relative stability in the price level was characteristic of much of the rest of the time. During the same 1947 to 1965 period, compensation per hour (wages plus fringes) in the private business sector rose at an average of 5.1 percent annually, but there was a strong 3.2 percent annual rate of increase in productivity, which held the rise in unit labor costs to a relatively modest 1.8 percent annual rate of increase. This was about in line with the rise in the price level. Cost-push factors were no particular problem and inflation was held fairly well in check.

Longer-term price movements over this period masked some shorter-term swings. For example, the period 1955 through 1957 was one of moderately accelerating inflation and relatively high rates of resource utilization. The capacity utilization rate in manufacturing was pushed into the range generally associated with accelerating rates of inflation. Considerable concern was expressed at the time over the threat of inflation. However, the ensuing period from 1957-1963 was one of relatively low resource utilization and decelerating inflation. The manufacturing utilization rate dropped to 80 percent and the rate of unemployment averaged 6 percent during those years. As a result, the annual rate of increase in the GNP deflator fell back to 1-1/2 percent, about one-half of the rate experienced in the 1955-57 period. The following two years, 1964 and 1965, saw a transition to a fully utilized economy, and by the mid-1960's the postwar period of relatively low rates of inflation was drawing to a close.

Strong Growth in Productivity. The early postwar decades featured a return to the fairly steady rates of growth in productivity which had been characteristic of much of U.S. 19th and early 20th century economic experience. Between 1947 and 1965, output per hour in the private business sector rose at a 3.2 percent annual rate, or at a 2.6 percent annual rate with agriculture excluded. Real nonresidential fixed investment averaged in the 9 to 10 percent range as a percentage of GNP throughout the period. There was a relatively strong rate of growth in the stock of capital employed in the private business sector, about 3-1/2 percent per year on a gross basis and more than 4-1/2 percent per year on a net basis (after allowance for capital replacement). These rates of growth in the capital stock were substantially higher than have been achieved in subsequent periods.

The civilian labor force grew at a relatively modest rate by current standards, only 1.2 percent annually over the years from 1947 to 1965. The combination of a rapid rate of growth in the capital stock and a relatively slow rate of growth in the labor force meant that the capital-labor ratio showed strong gains during the first two postwar decades, rising at a 3 percent annual rate on a net basis over the 1947-1965 period.

There is general agreement that the growth in economy-wide productivity reflects many influences. However, there has been a close association in the postwar period between the capital-labor ratio and the rate of growth in productivity. The more rapid application of capital into the productive process means that labor works on the average with more and better tools of production. This generally results in improved productive performance.

By the early 1960's, there was some expression of concern that the U.S. rate of investment was beginning to lag, particularly in relation to that of some other major industrial countries. Through much of the early postwar period, however, the capital stock had expanded steadily and the rate of growth in productivity was relatively satisfactory. Difficulties in this crucial area only surfaced in unmistakable fashion during the 1970's.

<u>Cheap and Readily Available Energy</u>. In the early postwar period, domestic energy production was able to supply the needs of the economy at relatively stable and even falling prices. Total energy consumption rose at about a 3% annual rate and the ratio of energy per unit of GNP drifted down slightly. Gasoline, heating oil, and electricity prices rose less rapidly than the consumer price index, thereby encouraging energy consumption rather than conservation. Natural gas prices rose faster than the consumer price index, but on a heat-content basis, natural gas use rose faster then heating oil throughout the period. The average price of electricity dropped and electricity consumption expanded.

The average fuel costs to the electrical generation industry can be used as a proxy for industrial energy prices. Between 1950 and 1965, coal costs decreased 9 percent in current dollars and fuel oil costs rose only 5 percent. Natural gas costs on a heat-content basis were less than oil, and less than, or about the same as, coal throughout the period. In the 1950's, natural gas was still largely an unwanted by-product of oil production and exploration.

Between 1950 and 1965, crude oil reserves grew from 25.3 billion barrels to 31.4 billion barrels. Quotas limited the importation of foreign oils, which undersold domestic production. Nevertheless, imports of petroleum grew from 550,000 barrels per day in 1950 to 2.3 million barrels per day in 1965. Natural gas reserves grew from 185 trillion cubic feet in 1950 to 287 trillion cubic feet in 1965, and natural gas distribution systems and consumption expanded rapidly during the period. Coal production was limited only by demand.

In general, the energy situation in the early postwar period was conducive to rapid economic growth and relatively low energy prices encouraged its consumption. Supplies of energy increased rapidly and there were periods of overproduction and falling prices. No serious constraints to growth had emerged by the mid-1960's, although it was becoming apparent by then that the long period of cheap and abundant U.S. crude oil resources was coming to an end.

<u>Strong Dollar Internationally</u>. In the immediate postwar period, the dollar reigned supreme. This was the era of "dollar shortage" during which foreign countries resorted extensively to capital and exchange controls to protect their currencies. Full currency convertibility was only established for the European countries in the late 1950's.

The U.S. balance of payments situation was very strong from 1946 to 1949 with a merchandise trade surplus averaging about $7 billion a year and a favorable balance on current account averaging nearly $4-1/2 billion, even after massive unilateral transfers to enable other countries to rebuild their devastated economies. From 1950 to 1959, the merchandise trade surplus averaged only about $3 billion a year, and the favorable balance on current account averaged less than $1 billion annually. Subsequently, in the 1960 to 1965 period, the U.S. payments position swung back in the direction of improvement with an average annual trade surplus of nearly $5-1/2 billion and a favorable balance on current account of nearly $4-1/2 billion annually. By the end of this period, some signs of strain began to emerge, but chiefly on capital account where low U.S. interest rates and freely accessible capital markets encouraged a high rate of U.S. lending to foreign borrowers.

Exchange rate adjustments throughout the first two postwar decades were on the initiative of foreign countries against the dollar, which remained at the center of the international financial system in a fixed relationship with gold. Following the reestablishment of currency convertibility in the late 1950's, the dollar appreciated gradually against other major currencies until the late 1960's and early 1970's. By 1965, although some signs of balance of payments strain were emerging, the dollar remained the anchor of the world monetary system.

Rising Standard of Living. Economic expansion yielded sizable gains during the first twenty years after World War II, despite interruptions to growth during four recessions. From 1947 to 1965, real gross national product rose at about a 3.9 percent annual rate. Real disposable personal income (personal income after taxes and corrected for inflation) rose at about a 3.7 percent annual rate, and at nearly a 2 percent annual rate on a per capita basis. Median family income in real terms was more than 60 percent higher by 1965 than it had been in 1947.

The combination of strong economic growth, rapid rates of increase in the private capital stock and rising productivity contributed to gains in real income. Energy supplies were adequate and a reasonable degree of success in containing inflation kept the dollar strong at home and abroad.

THE ERA OF TRANSITION, 1965-1976

The transition to more difficult times began after 1965 when production was expanded for a war effort without cutting back in other areas. Indeed, a sizeable--although long overdue--expansion of domestic social programs was undertaken at about the same time.

In the early 1970's, new demands were placed on the economy for environmental quality without making trade-offs to give up something else. There was a continued belief that we could have more of everything when this was no longer possible. The oil boycott and oil price shock added to the difficulties. Inflation was the inevitable result. An ill-fated effort to apply mandatory wage-price controls in the early 1970's only worsened the underlying situation.

Partly as a consequence of domestic inflation, the dollar weakened in foreign exchange markets and came under speculative attack. The dollar was devalued twice in the early 1970's, and then was permitted to float, more or less freely, against major currencies. In late 1973 the OPEC oil embargo and subsequent cartel pricing signalled the end of an era of inexpensive energy and placed this country in a position of dangerous dependence on uncertain sources of foreign supply.

The 1965-1976 period was a rude awakening to economic reality. New demands were added onto the economy faster than the capacity to satisfy them was expanded. More and more was demanded from the economy and by the end of the period the capacity to produce in the future had been eroded substantially.

Deteriorating Price Situation. The period from 1965 to 1970 was one of excessively high rates of resource utilization. The rate of unemployment averaged below 4 percent and demand pressures were more or less chronic during most of the period. Inflation as measured by both the GNP deflator and the consumer price index averaged over 4 percent, more than double the rate in the first half of the 1960's. During the period from 1970 to 1975, the after effects of excess demand pressures from the late 1960's combined with a series of shocks, including the OPEC boost in oil prices, to produce additional acceleration in inflation. Inflation as measured by both the GNP deflator and the consumer price index averaged about 6-1/2 percent during the 1970-76 period and peaked in the double-digit range prior to the 1974-75 contraction.

Compensation per hour (wages plus fringes) in the private business sector moved up to a 7.6 percent rate of increase in the 1965-1976 period, some 2-1/2 percentage points above the 1947-1965 average rate of increase. In addition, the rate of growth in productivity fell off by more than a full percentage point to a 1.9 percent rate of growth between 1965 and 1976. As a result, labor costs per unit of output rose at a 5.6 percent annual rate in the 1965-1976 period, nearly 4 percentage points above the increase between 1947-1965. Cost-push pressures became firmly imbedded in the wage-price structure by the mid-1970's, making the permanent reduction of the rate of inflation a difficult task.

Declining Rate of Growth in Productivity. During the 1965-76 period, the strong rate of productivity growth established in the first two postwar decades began to taper off. Output per hour in the private business sector grew at a 1.9 percent annual rate, or 1.6 percent with agriculture excluded. This represented a significant decline from the 3.2 percent, or 2.6 percent rate with agriculture excluded, recorded between 1947 and 1965.

Growth in the civilian labor force picked up speed, rising 2.2 percent annually in the 1965-1976 period in contrast to 1.2 percent between 1947 and 1965. Growth in the stock of private business capital was relatively well maintained, although showing some retardation in growth on a net basis and after exclusion of pollution abatement expenditures. As a result primarily of the more rapid rate of growth in the labor force, the capital-labor ratio grew much more slowly in the 1965-1976 period than it had in the first two postwar decades.

It is not possible to identify the exact point at which the U.S. rate of productivity growth began to decline. Some of the slowdown may have arisen gradually over time. Some may have been occasioned by the sharp rise in energy prices after 1973. It is clear that the rate of growth in productivity had slowed drastically by the close of the 1965-1976 period.

Energy Shock. In 1973, events in international oil markets, in particular the oil embargo, pushed world oil prices far above those for domestic controlled oil. The resulting shock to the U.S. was substantial since imports and consumption of oil had been rising rapidly while domestic production of oil and gas had been declining after 1970.

From 1965 to 1973, total U.S. energy consumption grew at a 4.4 percent annual rate, compared with a 3.1 percent annual rate during the previous fifteen years. The energy to GNP ratio rose to a peak by 1970. Motor gasoline consumption was stimulated by the completion of thousands of miles of interstate highways, increased motor car ownership, and rising personal income.

Supply problems began to appear in the energy field in the early 1970's. The use of coal was inhibited by environmental regulations and other factors. Natural gas deliveries could not keep up with demand and reserves began to top out in 1972. Domestic crude oil production peaked in 1970 and reserves would have fallen appreciably by 1975 except for the discovery of the Alaskan North Slope fields. Domestic oil production could no longer expand to meet demand and imports filled the gap. Imports increased from 2.3 million barrels per day in 1965 to 6 million barrels by 1973 and then dropped slightly by 1975.

The OPEC oil embargo hit with particular force because of the growing dependence of the U.S. economy on oil imports. Imported oil prices rose from $2.14 per barrel in 1966 to $3.37 per barrel in 1973. Following the embargo in the winter of 1973-74, imported oil shot up to $11.45 per barrel in 1975.

Gasoline prices rose 83 percent and heating oil prices by 144 percent in the 1965-1975 period, compared to a 71 percent rise in the consumer price index. Most of the oil price increases were in the last two years of the period when gasoline prices increased by 27 percent and heating oil prices by 71 percent. Natural gas prices increased by 66 percent between 1965 and 1975, with a 33 percent increase between 1973 and 1975.

Industrial energy prices rose much faster than consumer prices during the 1965-1975 period.

- Coal prices advanced 254 percent, with a 106 percent increase between 1973 and 1975.
- Natural gas prices for industrial use increased 201 percent, with a 113 percent increase between 1973 and 1975.
- Fuel oil prices advanced 509 percent, with a 195 percent jump between 1973 and 1975.

A Weakening Dollar. The 1965-1975 period was one of intensifying pressure on the U.S. dollar. At the beginning of the period, the U.S. was running a surplus of about $5 billion both on merchandise trade and on current account. By the early 1970's, both of these surpluses had been wiped out and the international competitive position of the dollar was severely impaired. The international financial system was fundamentally changed in August 1971 when the United States announced suspension of the convertibility into gold of dollars held by foreign monetary authorities. Following this action, major exchange rate alignments, coupled with devaluation of the dollar in terms of gold, were negotiated in December 1971 and February 1973. Subsequently, the international monetary system moved to a regime of managed floating.

Between 1969 and 1974, the U.S. dollar depreciated about 16 percent on a trade weighted basis against the currencies of other major industrial nations. Cyclical improvement in the U.S. balance of payments and other factors led to some temporary strengthening of the dollar and by 1976 the trade weighted depreciation was about 10 percent relative to the base rates of May 1970. By the end of the 1965-75 period, the U.S. trade account had moved back into a $9 billion surplus and the current account was in surplus by $18 billion. Exchange rate adjustments and temporary cyclical factors were largely responsible for the improvement. However, the longer run balance of payments outlook was clouded by the existence of a rapidly rising bill for oil imports.

Standard of Living Continues to Rise. Despite the sharp adjustments occurring after the mid-1960's, standards of living continued to rise. In the 1965-1976 period, real GNP rose at a 2.9 percent annual rate, a little below the postwar average rate of increase. Real disposable income rose at a 3.5 percent annual rate and at about a 2.5 percent annual rate on a per-capita basis. However, constraints on growth were much more evident at the end of the period than at the beginning, and the rate of inflation had accelerated. A sharp decline was developing in the rate of growth in productivity which would limit the potential for future gains.

RECENT ECONOMIC PERFORMANCE, 1976-1980

By the last half of the 1970's, the Nation faced a watershed in its economic history. The world economy was changing at a revolutionary pace. The adverse trends which had developed with respect to inflation, productivity growth, and international competitiveness moved to center stage in the Nation's discussions of economic policy. The Nation responded to these challenges by moving to break important deadlocks in a number of important areas of economic management.

This process has involved painful choices. Changing the Nation's course on matters of such fundamental economic importance as energy policy and control of federal spending could not be accomplished overnight or without intensive debate. We have not succeeded completely on every front: there remains a significant agenda of unfinished business. But in many key areas of economic policy, a new strategic consensus has been forged, laying the basis for improving our basic economic performance over the next decade.

Some of the key areas in which progress has been made include:

- Fiscal prudence: The Administration and Congress have made the containment of domestic spending growth a major priority of economic policy. Working together, we have strengthened budget procedures and discipline and provided for rigorous annual review of "off budget" items through the new Credit Budget. Real growth in non-defense spending has been dramatically reduced from the high rates registered over the previous decade.

- o Domestic monetary policy: The Federal Reserve Board has improved its control over the long-term growth of monetary aggregates as a means for bringing down the inflation rate.

- o Wage-price policy: The Administration has disavowed mandatory controls and has instead developed a structure of voluntary wage-price standards. Econometric tests indicate that the inflation rate is now 1 to 1.5 percentage points lower than it would have been without the program.

- o Energy policy: Programs for implementing the phase-out of price controls on crude oil and new natural gas are now in place. Massive new initiatives have been adopted to develop alternate energy sources and spur conservation of oil. The new Synthetic Fuel Corporation will help create a huge, new industry of energy supply, drawing upon the Nation's abundant coal and shale oil resources.

- o Deregulation: Regulations have been substantially reduced with respect to airlines, trucking and financial institutions. Large portions of the U.S. economy have been returned to the discipline and opportunities of competitive market forces.

While considerable progress has been made, in many areas continuing efforts will be required over a number of years. Future policies must place great stress on controlling inflation and stimulating productivity. In reviewing the record of recent years, it is important to recognize accomplishments, but even more important the need for continued progress.

<u>Real Growth</u>. Substantial gains have been made in recent years in terms of real growth. From the trough quarter of economic activity early in 1975 through the first quarter of 1979, real GNP grew at an annual rate of 5.1 percent. From the end of 1976 through the first quarter of 1979, that growth rate was 4.8%. In the next four quarters, real growth slowed to about a 1 percent annual rate, and in the second quarter of this year real growth declined sharply--at an 9.1 percent annual rate according to the preliminary estimates released recently. However, even after this decline, real GNP is about 20 percent above the early 1975 low.

This is a strong performance by past standards, but it obviously reflects cyclical gains to a considerable extent. Real growth since the last cyclical peak in the fourth quarter of 1973 has been about 2-1/2 percent annual rate. This corresponds more closely to estimates of the economy's current trend rate of potential economic growth. Potential growth has been estimated by CEA as having been about 3 percent between 1973 and 1978 and likely to fall to a 2-1/2 percent annual rate between 1979 and 1982. This stands in marked contrast to an annual trend rate in potential of about 4-1/2 percent from 1947 to 1953, and about 3-1/2 percent from 1953 to the early 1970's. Aside from cyclical movements, the real progress of the economy is inevitably limited to its trend potential.

Tax cuts designed simply for fiscal stimulus do little to enhance the economy's potential to produce goods and services. Attention needs to be directed toward tax policies to promote long-term growth potential, i.e., to raise the economy's ability to produce goods and services. The lesson of the recent expansion is that the economy encounters real barriers to expansion, reflected in an acceleration of inflation, long before unemployment can be reduced to desirable levels. Efforts should therefore be directed at the supply side of the economy, including selective programs to attack structural unemployment.

Productivity and Investment. Productivity fell off sharply in the 1973-75 recession, and then made a strong cyclical recovery in 1975 and 1976. During 1977 and 1978 productivity increased by an average of only 1 percent per year. Over the past year, productivity has actually declined by about 1-1/2 percent. During the early stages of a recovery, growth in output tends to exceed increases in labor input by wide margins, but productivity gains tend to slow rather markedly as the expansion ages. The more disturbing feature of productivity experience is the apparent lower trend since the late 1960's. Between 1948 and 1968, productivity in the private nonfarm business sector of the economy rose 2.6% per year; between 1968 and 1973 that growth slowed to 1.7% per year; and during the 1973 to early 1980 period growth slowed still further to less than 1/2 of one percent.

The causes of the apparent secular decline in productivity are still the subject of academic inquiry and difference of opinion. Some of the more important causes of the slower trend growth in productivity that have been advanced are:

- Demographic factors have been important since the mid-1960's, as the proportion of new, young and inexperienced workers in the labor force increased.

- An increasing proportion of capital investment has been diverted in recent years to meeting government regulations directed at improving the health and safety of workers and the environment. Labor resources have also been diverted. While these are essential efforts they do not contribute directly to measured output in productivity. These programs will continue but are unlikely to increase at the rates of the recent past.

- A variety of other factors-- such as the increase in energy prices and a decline in worker motivation--have also frequently been cited as adverse influences.

- In the opinion of many observers, the most important single factor has been a dramatic slowdown in the rate of growth of the capital-labor ratio. More capital per worker generally contributes to higher productivity, and the sharp fall in that ratio is a matter of real concern. In the 1976-79 period, the ratio of the capital stock to the civilian labor force edged up only slightly on a gross basis and actually fell on a net basis. This stands in marked contrast to average gains in the net capital-labor ratio of 3 percent annually from 1945 to 1965 and nearly 2 percent annually from 1965 to 1976.

It must be emphasized that business fixed investment has made a strong cyclical recovery in recent years. The problem is to assure that these are sufficient incentives to boost the amount of capital investment in the permanent fashion that is required to raise productivity and the trend rate of potential growth. That should be one of the major objectives of tax and other policies over the years ahead.

Employment. Growth in employment has been a major achievement of the Carter Administration. Since late 1976, civilian employment has increased by nearly 11 million persons, even after allowance for the cyclical employment declines of recent months. The ratio of employment to working age population has reached record levels, although receding from its peak in recent months. On the other hand, the rate of unemployment has remained higher than desirable, reaching a low for the expansion in the 5-1/2 to 6 percent range, before rising rapidly in recent months. The rise in the unemployment rate in the current contraction has been heavily concentrated among blue collar jobs which are predominantly held by adult men. This cyclical rise in the unemployment rate will be reduced when the economy turns up again. However, more remains to be done in combatting structural unemployment if the average level of unemployment over the cycle is to be reduced to more acceptable levels.

The largest employment gains have been made by women and minority groups. Employment of adult women has increased by nearly 16 percent since late 1976, compared to about 5-1/2 percent for adult men. Employment of blacks and other minority groups has increased by 12 percent compared to a 9 percent rise for all groups.

Employment gains are an important measure of the performance of the economy. However, it is also crucial that productivity advance rapidly so that increased employment will mean rising standards of living.

Energy. Considerable progress has been made in reducing the Nation's reliance on insecure sources of foreign oil. Programs now in place should yield increasing returns in the period ahead. Already some tangible signs of progress can be seen. Between 1975 and 1979, total energy consumption grew at a 2.4% annual rate, slower than at any time during the previous 25 years. The energy/GNP ratio dropped steadily during the 1975-1979 period, and indications are that the ratio will drop further in 1980. Gasoline consumption peaked in 1978 at 7.4 million barrels per day and dropped to 7.0 million in 1979. In 1980, gasoline consumption could drop to about 6-1/2 million barrels per day if present trends continue.

Domestic energy supply has increased over the period. Crude oil production edged up to 8.53 million barrels per day from 8.38 million barrels per day in 1975. Much of the increase was due to the exploration of the Alaskan North Slope fields beginning in 1977. Oil production in 1980 is expected to increase due to more Alaskan production and in response to the phasing out of crude oil price controls. Natural gas production stayed relatively flat during the 1975-1979 period rather than continuing the decreases exhibited in the preceding years. Production in 1979 exceeded 1978 levels. Coal is making a comeback, with 1979 production 18 percent above 1975, and 1980 production running well above 1979 to this point.

The heavy impact of rising oil prices on the domestic economy and U.S. balance of payments has continued throughout the period. The price of imported oil (f.a.s.) rose by 63 percent from $11.45 per barrel in 1975 to $18.67 per barrel in 1979. The price of imported oil in 1980 will be $31.50 to $32 per barrel or about 70 percent higher than in 1979. Net oil imports rose from 5.9 million barrels per day in 1975 to 7.9 million barrels per day in 1979, with a peak of 8.6 million barrels per day in 1977. So far this year net imports are about 14 percent below the levels of last year. In general, the trends toward slower growth in energy consumption, increased domestic production, and reduced imports are all in the right direction.

Recent experience demonstrates that higher energy prices significantly reduce energy demand. There is no realistic alternative to reliance on the price system to insure that scarce energy resources are employed most efficiently, and that adequate incentives are offered for future domestic energy production and conservation.

Inflation. The most discouraging feature of recent economic performance was the acceleration of inflation in the late stages of the current expansion. The worst of the inflationary fever has now been broken, by the policy measures taken at mid-March and by the onset of recession. The task that lies ahead is to insure that the next period of economic expansion does not simply ratchet the rate of inflation to still higher levels, but instead that recent progress can be continued in a methodical trend toward genuine price stability.

Between 1976 and 1979 on the basis of annual averages, the GNP deflator rose at a 7.4 percent annual rate and the consumer price index at an 8.4 percent annual rate. These compare with 5-1/2 percent annual rates of increase in the 1965 to 1976 period. More recently, rates of inflation have reached even higher levels, before turning down. Over the past six months or so, consumer prices have risen at about a 15 percent annual rate, producer prices at about a 12-1/2 percent annual rate, and the GNP deflator at about 10.

As a result of recent inflationary pressures and workers' attempt to maintain real incomes, compensation per hour (wages plus fringes) has been boosted to the 9 to 10 percent range. Because productivity growth has been negative, unit labor costs have been rising in the 11 to 12 percent range for the past year and a half.

Those who favor an across-the-board tax reduction to stimulate the economy should ponder the implications in terms of inflation. Over the past 15 years, every period of economic expansion has driven the rate of inflation to new heights at the top of the cycle. The ensuing periods of contraction have temporarily lowered the rate of inflation, but each time the rate of inflation at the trough has been higher than before.

The International Position of the Dollar. A major objective of the Administration's international monetary policy has been the maintenance of global confidence in a sound and stable dollar. The program to strengthen the dollar, initiated by President Carter in November 1978, represented a watershed in the U.S. exchange market policy. This program combined domestic measures to improve the U.S. balance of payments--by curbing inflation and reducing dependence on imported oil--with more active intervention in the foreign exchange market to maintain orderly conditions.

The November 1978 program demonstrated a clear-cut U.S. commitment to a sound dollar and stability in exchange markets. Since that program, the dollar has increased in value on average in terms of other major currencies. The U.S. balance of payments has, moreover, scored major gains, despite large increases in oil prices and consequently in oil import costs.

It must be recognized, however, that the strength of the dollar depends, in the last analysis, upon our demonstrated ability to keep the domestic economy strong and to reverse the inflationary trend of the past 15 years.

CURRENT ECONOMIC SITUATION AND THE BUDGET REVISIONS

Change in Economic Assumptions. At the turn of the year when the January Budget estimates were being completed, the economy was continuing to show far more strength than most economists had expected. In fact, some additional momentum appeared to develop late in 1979. A mild recession was generally expected, based on the downturn already underway in housing and the prospect that consumers would slow their rate of spending. The timing of a recession was uncertain, however, and few signs of an imminent downturn were in evidence. Retail sales, production and employment all rose in January.

The economic climate shifted rapidly through early March. The shift was triggered by a number of factors. The long projected recession failed to materialize. As evidence began to build that the first quarter would show positive real growth and January retail sales turned in an especially strong showing, some economic and financial market participants began to question whether a recession was really in prospect. Because of heightened international tensions, financial markets began to anticipate an increased defense effort, in consequence much larger budget deficits, more inflation, and higher interest rates. There was an upsurge of speculative activity in commodity markets which was both a cause and a result of shifting anticipations as to the future course of inflation. Rapidly rising energy prices plus rising mortgage interest rates helped cause the CPI to shoot up by 1.4% (18% annual rate) in each of the first three months of the year.

These developments combined to generate a dramatic shift in inflationary expectations. Businesses began to post price increases in anticipation of higher rates of inflation and the fear that wage-price controls would be imposed. Excluding food and energy, producer prices jumped at a 15% annual rate in the first three months of the year at the finished goods level and a 17% rate for semi-finished goods. Interest rates began to shoot upward. Yields on commercial paper, which had averaged about 13% in December, were well above 16% in early March.

The intensified anti-inflation package announced on March 14 was designed to reverse these developments. Its principal components were increased fiscal discipline, including a reduction of some $17 billion from FY-1981 planned outlays, a program of credit restraint, and structural reforms directed at improving the longer-term performance of the economy. The package also included proposals in the energy area and steps to strengthen the wage-price guideline program.

The program, along with actions taken by the Federal Reserve, reversed the inflationary psychology. Interest rates continued to rise into early April, but then declined dramatically. Commercial paper rates moved above 17-1/2% in early April, but subsequently fell to the 8% range. By early June, commitment rates for conventional home mortgages had fallen 300 basis points from the 16-1/2% of early April to 13-1/2%. The Treasury bill rate temporarily fell below 7 percent in contrast to an early peak near 16 percent. From its peak of 20 percent, the prime rate has fallen back near 11 percent. These interest rate declines are laying the foundation for the recovery of the economy.

Meanwhile, the greater than expected strength in activity early in the year led most economists to mark up their projections of real activity, at least for 1980. However, as figures became available for March, April, and May, it became evident that demand and production had been dropping rapidly. New car sales plunged (from a 10.8 million annual rate in the first quarter to a 7.7 million rate in the second), total retail sales took a record drop, industrial production fell by 4-1/2% between February and May, and orders placed with manufacturers of durable goods plummeted by 17% from January to May.

Again, forecasts for 1980 were revised to incorporate these new realities. The tabulation below shows the shifting consensus forecast of about 40 top private business economists.*

Forecasted 1980 Changes in Real Gross National Product

Forecast date	4th to 4th	year to year
	(--------percent----------)	
January	-1.0	-1.0
March	-0.4	+0.1
July	-3.3	-1.4

*Blue Chip Economic Indicators, Capital Publications Inc., various issues.

The economic path underlying the Mid-Session Review of the Budget registers the downturn in activity that is now underway and parallels the change in assessment of near-term economic events that has taken place among private economists. Real GNP is now projected to decline by 3.1% between the fourth quarter of 1979 and the fourth quarter of 1980, with the steepest part of that decline in the second quarter of this year. The economy is expected to move downward still further in the second half, but at a more moderate rate, with the slide perhaps bottoming out late in the year.

The projected course of the economy would carry the unemployment rate up to the 8.5% range by the turn of the year, and the very moderate recovery of real GNP and employment thereafter would do little to bring the unemployment rate down over 1981. As measured by the GNP deflator, inflation is projected to moderate from 10.1% for this year to 9.7% in 1981, both measured fourth quarter to fourth quarter.

It is important to emphasize the great uncertainty associated with all of these projections. Throughout this year, economic forecasts from virtually all sources have undergone major revisions on nearly a monthly basis.

Nevertheless, it is clear that the projected course of economic performance is not satisfactory. As the recovery develops, policy steps to improve the economy's performance, both in 1981 and for the longer term, may well be appropriate. The Administration is reviewing the various possibilities and welcomes the opportunity to consult with the Congress about them.

However, the steps need not and should not be taken in haste. The economy's structural problems require carefully designed structural answers.

Turning to the nearer term, we expect that the natural forces of recovery will begin to manifest themselves.

The consensus expectation of economists, inside and outside of government, is that the upturn will occur late this year or early next. This would conform in a rough way to the postwar cyclical pattern. The average duration of periods of contraction in the six previous postwar recessions has been 11 months, although 1973-75 was longer, and the peak of the recent expansion has now been dated by the National Bureau of Economic Research as having occurred in January 1980.

A recent survey* of 40 private economists at major banks, corporations, and private research organizations sees successively smaller declines in real GNP during the third and fourth quarters of this year and a return to positive growth early next year. This is the generally expected pattern. It may not occur exactly as predicted. Economic forecasting is a very imperfect art. The important point is that the official forecast accords reasonably with the consensus of private forecasts and constitutes a realistic appraisal of the near-term outlook.

Recent readings on the economy suggest that the decline is still continuing, but not at the accelerated pace of the early part of the second quarter. The economy is still moving downward, the third quarter will almost certainly register another decline in real GNP. However, there are signs that the rate of decline has slowed markedly.

-- Retail sales scored a 1.5% increase in June. Excluding autos, sales rose slightly more than inflation.

-- New car sales in early July bounced up from their depressed second-quarter pace (though we should not attach too much significance to this rise until confirmed by additional data).

-- Seasonally adjusted initial claims for insured unemployment have fallen back in early July from their earlier peaks.

-- Housing starts and permits rose strongly in June, reversing the trend of earlier months. Housing activity appears to be benefiting already from the interest rate declines in recent months.

-- Businesses have been making a determined effort to keep inventories under control. The decline in business inventory holdings in May indicates some success in these efforts, lean inventory positions would imply that when demand turns up, production would shortly follow.

-- Demands for short-term business credit show signs of renewed strength.

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*Blue Chip Economic Indicators, Capital Publications Inc., July 10, 1980, Vol. 5, No. 7, esp. p. 3.

The Revised Budget Estimates. The Mid-Session Review shows substantial changes in budget estimates. The basic numbers are presented in the table below.

BUDGET TOTALS
(in billions of dollars)

	1979	1980 Estimate			1981 Estimate		
	Actual	Jan.	March	July	Jan.	March	July
Receipts	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Deficit, current estimate	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8
Budget authority	556.7	654.0	665.8	653.7	696.1	691.3	707.2

The 1980 deficit is now estimated to be $60.9 billion, up from $36.5 billion in March. Outlays are currently estimated at $578.8 billion and receipts at $517.9 billion. The current estimate for 1981 is for a deficit of $29.8 billion, rather than the $16.5 billion surplus estimated in March. Outlays are currently estimated at $633.8 billion and receipts at $604.0 billion. Both the increase in the 1980 deficit and the shift from surplus to deficit in 1981 are mainly the result of changes in the economic situation, though the estimates also reflect legislative events, higher spending on defense and emergency relief programs, and some minor technical changes.

The 1980 deficit is now estimated to be $24.4 billion higher than in March. Of this amount, about two-thirds, or $16.6 billion is due to the change in economic conditions. Receipts are down nearly $11 billion and outlays up $7 billion for this reason alone. Policy changes and Congressional action have reduced receipts by $4 billion in 1980 and $8.4 billion in 1981, and are partially offset by technical re-estimates and other factors. In addition to the effect of changed economic conditions, outlays are running somewhat higher because of defense outlays and increases for disaster relief, alien assistance, and other unavoidable events.

The larger budget deficits do not reflect an upsurge in discretionary federal spending. Congressional responses to the President's proposal for spending restraint have been constructive. While there are some differences in program priorities, the Congressional budget efforts to this point are generally consistent with the policy of fiscal stringency proposed by the President.

<u>Financing the Deficit</u>. Policy steps over the next 18 months could of course alter the economic and budgetary projections released this week. We have, however, analyzed the financing requirements implicit in these projections.

The Treasury's FY 1980 and FY 1981 financing requirements, while increased from the levels projected in mid-March, are not expected to strain the credit markets. Private demands for credit will likely be more than correspondingly reduced as a result of continued weakness in economic activity for the remainder of 1980.

Even with the Treasury's increased borrowing in the months ahead, the ratio of public holdings of Treasury securities to GNP is not likely to rise much above the current level of about 26 percent. In FY 1976, when a budget deficit of over $66 billion was financed, this ratio rose to nearly 30 percent.

Looking ahead to FY 1981, our borrowing needs will probably be heaviest in the first two quarters of the fiscal year. The use of a wide variety of borrowing options currently available to the Treasury should minimize any undesirable impact of this increased financing.

The recovery in the economy is expected to begin late this year or early in 1981, but in the absence of other actions the upturn is projected to be relatively slow. Private credit demands are typically slow to rise in the initial stages of an upturn, and the expected moderation in the rate of recovery may further hold down private borrowing.

Financing policy is not greatly challenged when the automatic stabilizers in the economy tend to result in deficits in periods of slack economic activity. But the string of deficits experienced in the postwar period in boom years as well as in periods of slack, has imposed an added burden on the performance of the economy and its financial markets. If the monetary authorities finance such untimely deficits, excessive growth of credit is generated, and an inflationary atmosphere is created. If, on the other hand, the monetary authorities decline to make credit available to finance the deficit, the available pool of savings and capital formation and productivity suffer. The solution must be a move toward budget balance over the course of the cycle. Sizable surpluses in periods of prosperity may well be desirable, particularly if tax and other policies are successful in promoting more robust private investment performance. We are making progress toward such a long-term fiscal policy, but continuing efforts are required.

TAX POLICY AND AN APPROPRIATE FISCAL STRATEGY

In turning now to the issue of appropriate fiscal policy under present circumstances, several basic considerations should be kept in mind.

First, Congress has been making progress in restraining the rate of growth in expenditures. This basic fiscal discipline must be maintained. Too often in the past, expenditure control has been a short-term enterprise which was soon abandoned. Now that the painful decisions have been made, we should follow through in a clear demonstration that a new fiscal course is being followed. Failure to do so runs the risk of dissipating all the gains that have been made to this point. Domestic financial markets are functioning smoothly at home and the dollar is showing encouraging stability abroad. Both domestic and international financial stability require that we continue to pursue a responsible fiscal course.

Second, it is difficult to predict the exact course that the economy will follow. Interest rates have fallen much more sharply than most observers expected. This could induce an earlier upturn in credit sensitive sectors of the economy. If the economy were to rebound more quickly than expected, fiscally stimulatory actions might prejudice our progress in bringing down inflation.

The Venice Economic Summit reinforced our view that relaxation of demand management policy in the major world economies would be premature. The Venice communique clearly stated that "the reduction of inflation is our immediate top priority...Determined fiscal and monetary restraint is required to break inflationary expectations." Global inflation rates are still unacceptably high and we have not yet succeeded in reducing inflationary expectations. Too early a retreat from restraint, might re-ignite inflationary expectations and erase the hard-won gains we have just begun to make.

Third, the kind of future tax program that should be developed, with full consultation between the Administration and the Congress, will necessarily involve some complex issues and controversial decisions. There are enough choices and technical problems in depreciation reform alone to consume more legislative time than is now remaining before scheduled adjournment. Even proposals that start with apparently simple formulas would not be easy to enact into law, especially in a politically-charged environment. The only program that is simple enough -- slashing rates according to a formula -- would be counterproductive.

Fourth, it would be unwise to try to complete a large tax cut program in this session of Congress. The effort to do so would be caught up in all of the political cross-currents of an election year. It would be subject to the full weight of pressure from every faction that has an interest in special relief. If any agreement were to emerge from this environment, it would very likely be a melange of special interest provisions -- just the opposite of what is needed.

A tax program may well be appropriate for next year. Anticipating this possibility, now is a good time to set out criteria and to begin to consider the outlines of such a program.

Criteria for a tax reduction program

Accord with fiscal discipline and spending restraint. A tax program should be considered in the context of the restraint demonstrated on the spending side. Any tax reduction agenda must consider the revenue effects for at least five years, not just for the first year. This budget planning should be based on reasonable projections for expenditures and economic conditions, including realistic economic responses to any tax changes. They should not be based on hopes, wishes, or magic formulas.

Combat inflation. An anti-inflation tax program should have at least two main attributes. First, in the short run it should not create excessive additional demand pressures or rekindle inflationary expectations. Second, it should help encourage investment and, thereby, improve productivity and reduce unit labor costs. If, at the same time, the program could directly contribute to cost reduction, that would be an added plus.

Maintain confidence in financial and foreign exchange market. In recent months, the program of fiscal restraint has gone a long way to reassure investors at home and abroad that the long upward trend of inflation has been broken. It is important that any major fiscal program be perceived as one that maintains a steady course. Deliberate development of a program aimed at long-run objectives can reinforce this perception. In contrast, an abrupt shift toward stimulus could disturb financial and currency markets, complicating the recovery.

Focus on improving productivity growth and international competitiveness. We must give more attention to the supply side of the economy. The realization of our public and private goals -- a strong defense, expanding employment, growth in real income and opportunity, energy independence, and improved international accounts -- depends on increasing the rate of investment to modernize the capital stock and increase capital per worker. This requires that tax incentives be concentrated on capital expansion, not dissipated in special interest provisions that only move capital from place to place.

Promote the most effective use of available resources. It is not enough to expand the size of the capital stock and increase jobs. The jobs and capital should go where they will have the highest payoff. This is the least costly way to achieve real economic expansion.

The best judge of the prospective payoff is not the government; it is private markets. Reducing taxes where they interfere the most and avoiding the creation of new tax distortions are the keys to the effective allocation of jobs and capital.

Preserve the progressivity of the tax structure. Inflation and reduced energy supplies have further restricted the choices for families with modest incomes. The payroll tax also takes a disproportionate share from wage earning families of low and moderate income. Although "bracket creep" has occurred for every class, those with lower incomes are least able to absorb or avoid the higher rates. Any plan for reducing individual tax rates must carefully consider the effects on the progressivity of the system.

Reflect close consultation with Congress. The criteria offered here indicate priorities and suggest an agenda, but there are large choices within them concerning methods and degrees of emphasis. The Administration wishes to work out these choices in close consultation with this and other committees and with individual members of Congress. Your knowledge and experience are vital to the process of constructing an effective program.

MAJOR TAX POLICY CHOICES

The principal objectives of economic policy and the current structure of the tax system indicate that any future tax changes should be pointed in two major directions. The first would be to reduce the burden of taxes on households and on labor costs. The second would be to provide incentives for productive business investment. A strong case can be made for a number of tax policy options. Putting a tax program together, however, involves choice. Revenue simply is not available to make all the changes everyone would like.

Reducing the tax burden on labor income

The taxation of wage earners is mainly determined by the structure of individual income tax rates and the rate of payroll taxes for social security. The purpose of the graduated rate structure in the income tax is to apportion the tax burden equitably among households of differing means. A by-product of this structure is automatic tax increases resulting from year-to-year increases in money incomes. This tendency -- often called "bracket creep" -- has led Congress to make periodic adjustments, especially in periods of inflation.

Over the period from 1969 to 1979 legislated adjustments to the rate schedule produced nearly the same effect as indexing for middle-income families. A family of four of median income ($24,400 at 1980 levels) would have paid income tax of 10.0 percent in 1969 and 10.4 percent in 1979, if its income had just kept pace with inflation over those years. However, rapidly increasing money wages continue and more households have begun to encounter the steeper portions of the rate schedule that was enacted in 1978. Consequently, the same family of median income will pay 11.4 percent in federal personal income taxes for 1980 and 12.1 percent in 1981.

Increasing individual tax rates and, particularly, the higher rates that apply to any additions to family income are felt especially by families with two wage earners. Consideration should be given to the marriage penalty in connection with individual rate adjustment.

The other main element in the taxation of labor income -- the payroll tax -- has been increased steadily to provide funding for increasing real benefit levels to a growing population of social security recipients. In combination, the income and payroll taxes add substantially to the differential between the cost of labor to businesses, on the one hand, and the after-tax pay of workers, on the other. At current rates of income and payroll taxes, an employer must pay $1.52 in wages and payroll tax to add $1.00 to the after-tax pay of an employee in a median income family. This represents a combined marginal tax rate on labor income of 34.1 percent.

Scheduled increases in the payroll taxes will increase these marginal rates of tax by nearly a percentage point in 1981, considering the increases for both employer and employee. In seeking equitable ways to reduce the taxation of labor income, attention should be given to the added burden on labor costs from payroll tax increases and also to the funding needs of the Social Security system.

One approach to this problem is the proposal put forward by Congressman Gephardt. Under this plan, individuals and businessmen would be permitted an income tax credit for a portion of social security taxes paid. The credit could be refunded to employers and employees who owe no income tax liability. This method would offset the increase in payroll taxes without interfering with funding for the social security system.

Other approaches to the increasing burden on wages also deserve exploration. A result similar to the Gephardt plan may be attained by matching individual income tax cuts to the payroll tax increases, for example. However, direct reduction of the payroll tax should not be considered except in the context of a comprehensive analysis of trust fund financing issues.

Tax treatment of saving

Taxation of income from ownership of property has also generally been increasing. This is partly because the average individual saver who receives interest, dividend, rental or business income has also moved up into higher income tax brackets. Another reason is that inflation leads to overstatement of business profits. But these increases are by no means uniform. The many sources of property income are subject to a great variety of tax treatments. For example, income from corporate equity may be fully subject to corporate taxes and also subject to individual taxes when distributed as dividends to shareholders. At the other extreme, the first $400 of interest income, interest from municipal bonds, earnings on individual retirement accounts, and vested pension funds are all effectively tax exempt. Still other kinds of property income, such as from real estate, minerals, and appreciation of corporate stock are only partially subject to tax.

While many of the savings incentive provisions adopted piecemeal over the years may have been intended to increase availability of capital, some are extremely inefficient and may even be counterproductive. The ability of taxpayers to switch their assets from one form to another, or to borrow in order to invest in a tax-preferred asset, has reduced, if not eliminated, the ability of many of these provisions to increase overall savings. Revenues lost because of tax preferences for certain types of income require increases in rates of taxation on all taxable income. The approach of providing "saving incentives" to certain narrowly defined uses of funds or special kinds of investments should be rejected in favor of more direct, broad based and efficient incentives for investment.

Another important result of the uneven treatment of property income is to divert saving and investment away from the relatively high-taxed industrial sector. Industrial corporations and public utilities are those most likely to bear the full corporate income tax and produce taxable dividends. They also are hardest hit by the erosion of depreciation allowances resulting from inflation. This causes depreciation--a major cost of using capital goods--to be understated and inflates taxable profits.

Depreciation reform

Among choices for encouraging capital investment and raising productivity, acceleration of depreciation allowances offers the greatest potential for success. In general, such a provision would reduce the tax bite on the return to successful investment and also enable higher returns to be paid to direct or indirect suppliers of capital, whether they are lenders, shareholders, members of pension funds, or depositors in financial institutions. As compared with tax breaks to particular types of saving, the benefits of accelerated depreciation are more directly tied to productive investment and less susceptible to "gaming" by simultaneous borrowing and lending transaction and other shifts in individual portfolios.

The particular program for accelerating depreciation that emerges should avoid the kinds of problems that afflict the 10-5-3 proposal. That proposal would quickly become very expensive. It is uneven and haphazard in the way it spreads benefits among types of assets and industrial sectors. Its transition phase is needlessly complicated and may promote investment delays.

Most proposals to accelerate depreciation for newly acquired assets will generate revenue losses that grow more rapidly than the economy for several years. Careful budget planning is required, therefore, for any depreciation program. The reason for this increasing cost is that each year's investment adds increased depreciation deductions on top of the higher deductions still being taken on investments made before. The 10-5-3 proposal exaggerates this pattern by specifying a phased reduction in lives over the first 5 years. For example, in the first year machinery and equipment would be written off in no more than 9 years, the next year in 8 years, and so on down to 5. This may entice the Congress by offering a very low downpayment. But the revenue cost under this approach would grow about twelve-fold in the first five years, from less than $5 billion to nearly $60 billion.

The 10-5-3 proposal becomes so expensive because it would eventually allow the same combination of deductions and investment credits for nearly all classes of machinery and equipment. These allowances would be more generous than those for even the shortest write-off periods in present law. This approach greatly increases the value of deductions for long-lived kinds of equipment such as those used in power plants and ship building. In contrast, the increased allowances for equipment that wears out rapidly or becomes quickly obsolete (such as tools used in metal fabricating and electronics) would be relatively small. For owners of commercial and industrial buildings the value of additional tax saving is, in turn, much larger than the average increase for investors in machinery and equipment. Thus, the 10-5-3 formula indiscriminately favors the movement of capital to structures as well as to long-lived equipment, a pattern not clearly related to any criteria for cost effectiveness in adding to productivity or other economic goals.

The Administration will support at the appropriate time a more even-handed approach to accelerating depreciation allowances. A connection should be retained between deductions for depreciation and the actual depreciation experience for assets used in different kinds of production activities. Such an approach would be superior to 10-5-3 in a number of important respects:

- It would flatten out the trend in revenue losses, providing the tax reductions earlier and having much less impact on future budget options.

- It would not require the kind of phased introduction scheme that imposes additional accounting burdens and weakens the investment incentives at the time they are most needed.

- It would introduce less distortion into the pattern of investment incentives. Additional capital made available by the promise of increased returns and by prudent budget policy would be generally attracted to industries with profitable investment opportunities not directed to particular kinds of property.

A capital recovery system that involves simpler accounting, greater certainty, and reduced administrative complexity can be designed without the cost or distortions of 10-5-3.

CONCLUSIONS

During the next five years, the U.S. must take the steps required to build a strong foundation for superior economic performance and increased economic security. We must show the discipline to make the sacrifices needed to strengthen our economy for the long run, while at the same time providing assistance to those most adversely affected by short-run economic disruption.

The U.S. stands at the threshold of a new economic era. What we do over the next five years will determine whether this new era brings an unparalleled standard of economic well being or a slow drift to mediocrity. To make the most of this opportunity, we must not only build on past gains, but also be willing to reverse past errors. Many of the economic problems now facing us stem from an unwillingness, stretching back at least 15 years, to confront directly difficult trade-offs and choices. Hard choices must be made if the U.S. economy is to thrive in an increasingly competitive world.

There are four major objectives for economic policy for the next five years: First, to improve our economy's productive capacity so we can enjoy stronger growth in real incomes. Second, to return to longer run price stability, which will permit us not merely to reach a high employment level but to sustain it. Third, to enhance our competitive position internationally. And, fourth, to reduce our vulnerability to externally generated shocks, such as energy interruptions.

A tax program, properly timed, and consistent with the criteria outlined above can make a significant contribution to attaining these objectives. If we move in that direction patiently and responsibly, we will be able to improve greatly our economic outlook for the balance of this century.

Department of the TREASURY
NEWS
WASHINGTON, D.C. 20220 TELEPHONE 566-2041

FOR RELEASE ON DELIVERY
Expected at 10:00 a.m.
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STATEMENT OF THE HONORABLE G. WILLIAM MILLER
SECRETARY OF THE TREASURY BEFORE THE
FINANCE COMMITTEE
UNITED STATES SENATE

Mr. Chairman and Members of the Committee:

Thank you for inviting me to present the Administration's views on the important subject of tax policy. The question is whether a tax reduction package should be enacted in the near future, and if so when and with what characteristics and of what magnitude.

The issues involved are complex and require careful study and deliberation. There are many criteria against which alternate courses of tax action should be evaluated. The timing and scale of any tax reduction are particularly critical in view of inflationary expectations and budgetary realities--and the impact of these factors on domestic and international financial markets.

It is the considered judgment of the Administration that the Congress should not seek to enact tax cutting legislation prior to the national election.

During 1981, properly targeted tax cuts directed at strengthening the productive foundations of the economy may well prove to be desirable. If designed with care and deliberation as part of an overall economic program, such action may well improve our economic performance over the next several years.

But hasty tax cutting now could be counterproductive. One proximate cause of the current recession was the fever of inflationary expectations early this year which brought serious disarray into the financial markets and resulted in severe credit constraints on businesses, farmers, and families. Following strong initiatives undertaken by the Administration last March after extensive consultations with Congress, both inflation rates and interest rates have come down dramatically. These trends, aided by responsible budgetary actions by the Congress, are laying a foundation for recovery. Taking premature action which might be perceived as undermining fiscal responsibility could well interrupt or reverse those trends and thus complicate the recovery.

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In addition, the brief and busy legislative session remaining before the election is not likely to provide the time or climate for properly analyzing the kind of structural and well-focused tax and other economic measures essential to the long-term health of the economy. Our joint responsibility is to secure a robust, non-inflationary path of growth for the economy over the years ahead. This objective is not served by rushing forward at this time with large injections of purchasing power or undigested plans for transforming the revenue side of the fiscal accounts.

Acting after the election rather than in haste over the coming weeks would also allow us to gain a much better understanding of the economy's evolution into recovery, a much better view of trends and decisions on federal spending, and a firmer consensus on other economic measures needed to improve the economy's performance over the new decade.

Nevertheless, the opportunity to examine in depth the important issues before this Committee is greatly appreciated. In order to do so, it is proposed to review long- and short-term economic developments, to suggest appropriate criteria against which to evaluate any future tax program, and to outline some of the major choices in establishing tax policy.

NEED FOR LONGER-RUN PERSPECTIVE

There is a natural tendency to place emphasis on short-term economic policy even though the underlying problems are long-term in nature. The adverse trends in inflation and productivity which we are experiencing did not occur overnight. They have been developing for at least the last fifteen years. Therefore, we need to give serious attention to the origin of these and other economic problems as a basis for dealing with them effectively.

The 1950's and the early 1960's were a period of strong U.S. economic performance in both domestic and international markets. Throughout much of the period, U.S. productive strength was unquestioned and the dollar was strong. It has become a more difficult world during the 1970's and early 1980's. Inflation has become a clear and present danger. Energy prices have been pushed up very sharply by the oil exporting countries. The international financial system has been placed under great strain. International trade has become increasingly competitive, and domestic industries sometimes bear a heavy burden of adjustment. We face a range of complex economic problems at home and abroad. There are no simple solutions, no easy ways out. These problems can be mastered -- but only if we face them squarely and resolutely, eschewing easy answers based purely on hope or rhetoric.

Significant gains have been made in the last few years. There is an increasing realization throughout the country that many of our economic problems are structural in nature and long-standing in origin. The energy problem is being attacked now in a coordinated way for the first time. Fiscal and monetary policies are being formulated with greater discipline to bring inflation under control. New approaches are being explored to reinvigorate the industrial sector of our economy. Substantial progress has been made in reducing the burden of government regulation on the private economy.

At the present, a great deal of attention is properly being focused on the economic downturn. There have been six previous periods of contraction since World War II and on average they have lasted a little less than one year. The weight of informed economic opinion--inside and outside of government--is that the current period of contraction will end late this year or early next, and will not be as deep as in 1973-75.

The current recession was not deliberately sought. It has inevitably caused real suffering, which we are acting to mitigate. The downturn, also inevitably, will result in some reduction in the rate of inflation. Recovery must proceed without reigniting inflationary forces.

As we contemplate recovery over the coming year, economic policies should therefore be shaped in the interest of longer-run stability. The economy needs to perform much more strongly in the future in the key areas of capital formation, productivity growth, and international competitiveness, so that employment gains can be sustained, without generating new waves of inflation. That will not be accomplished by a hasty, across-the-board tax cut. Any tax program to reinforce recovery should be carefully constructed to be consistent with overall economic objectives.

If our difficulties were simple or of recent origin, the straightforward countercyclical use of fiscal policy might meet the needs of the situation. But our problems are deep-seated. They have developed over a long period of time. Simply pumping purchasing power into the economy will not raise the capital-labor ratio, increase the rate of growth of potential output or improve U.S. competitive ability in foreign markets.

The range of policy options that we should have under active consideration can best be appreciated by reviewing the general trend of economic events that forms the background to the current situation.

THE POST WAR ERA, 1945-65

The roots of our current economic problems go back several decades. During the 1950's our economy performed significantly below its potential. As a result, in the early 1960's we were able to improve our economic performance by exploiting under-utilized resources. We did not have to face difficult trade-offs, but were able to have more of everything by running the economy closer to capacity. Our current problems began after the mid-1960's when we tried to continue this approach long after we were running up against economic limits. Policies of economic stimulus began to be reflected primarily in rising prices, not in rising output.

In the first twenty years of the postwar era, the U.S. international payments position was strong and we were able to assist in the rebuilding of war-ravaged foreign economies. Thereafter, we have been faced intermittently with balance of payments difficulties in an intensely competitive international economic environment. In the earlier period, energy was cheap and readily available. As a result, U.S. production methods and patterns of consumption were heavily conditioned by low relative prices of energy. Subsequently, a difficult and painful adjustment has had to be made in an environment of energy scarcity.

Relatively Stable Prices. During the period from 1947 to 1965, the GNP deflator rose at a 2.3 percent annual rate and the consumer price index at a 1.9 percent annual rate. There was a sharp run-up of prices at the time of the Korean War, but relative stability in the price level was characteristic of much of the rest of the time. During the same 1947 to 1965 period, compensation per hour (wages plus fringes) in the private business sector rose at an average of 5.1 percent annually, but there was a strong 3.2 percent annual rate of increase in productivity, which held the rise in unit labor costs to a relatively modest 1.8 percent annual rate of increase. This was about in line with the rise in the price level. Cost-push factors were no particular problem and inflation was held fairly well in check.

Longer-term price movements over this period masked some shorter-term swings. For example, the period 1955 through 1957 was one of moderately accelerating inflation and relatively high rates of resource utilization. The capacity utilization rate in manufacturing was pushed into the range generally associated with accelerating rates of inflation. Considerable concern was expressed at the time over the threat of inflation. However, the ensuing period from 1957-1963 was one of relatively low resource utilization and decelerating inflation. The manufacturing utilization rate dropped to 80 percent and the rate of unemployment averaged 6 percent during those years. As a result, the annual rate of increase in the GNP deflator fell back to 1-1/2 percent, about one-half of the rate experienced in the 1955-57 period. The following two years, 1964 and 1965, saw a transition to a fully utilized economy, and by the mid-1960's the postwar period of relatively low rates of inflation was drawing to a close.

Strong Growth in Productivity. The early postwar decades featured a return to the fairly steady rates of growth in productivity which had been characteristic of much of U.S. 19th and early 20th century economic experience. Between 1947 and 1965, output per hour in the private business sector rose at a 3.2 percent annual rate, or at a 2.6 percent annual rate with agriculture excluded. Real nonresidential fixed investment averaged in the 9 to 10 percent range as a percentage of GNP throughout the period. There was a relatively strong rate of growth in the stock of capital employed in the private business sector, about 3-1/2 percent per year on a gross basis and more than 4-1/2 percent per year on a net basis (after allowance for capital replacement). These rates of growth in the capital stock were substantially higher than have been achieved in subsequent periods.

The civilian labor force grew at a relatively modest rate by current standards, only 1.2 percent annually over the years from 1947 to 1965. The combination of a rapid rate of growth in the capital stock and a relatively slow rate of growth in the labor force meant that the capital-labor ratio showed strong gains during the first two postwar decades, rising at a 3 percent annual rate on a net basis over the 1947-1965 period.

There is general agreement that the growth in economy-wide productivity reflects many influences. However, there has been a close association in the postwar period between the capital-labor ratio and the rate of growth in productivity. The more rapid application of capital into the productive process means that labor works on the average with more and better tools of production. This generally results in improved productive performance.

By the early 1960's, there was some expression of concern that the U.S. rate of investment was beginning to lag, particularly in relation to that of some other major industrial countries. Through much of the early postwar period, however, the capital stock had expanded steadily and the rate of growth in productivity was relatively satisfactory. Difficulties in this crucial area only surfaced in unmistakable fashion during the 1970's.

Cheap and Readily Available Energy. In the early postwar period, domestic energy production was able to supply the needs of the economy at relatively stable and even falling prices. Total energy consumption rose at about a 3% annual rate and the ratio of energy per unit of GNP drifted down slightly. Gasoline, heating oil, and electricity prices rose less rapidly than the consumer price index, thereby encouraging energy consumption rather than conservation. Natural gas prices rose faster than the consumer price index, but on a heat-content basis, natural gas use rose faster then heating oil throughout the period. The average price of electricity dropped and electricity consumption expanded.

The average fuel costs to the electrical generation industry can be used as a proxy for industrial energy prices. Between 1950 and 1965, coal costs decreased 9 percent in current dollars and fuel oil costs rose only 5 percent. Natural gas costs on a heat-content basis were less than oil, and less than, or about the same as, coal throughout the period. In the 1950's, natural gas was still largely an unwanted by-product of oil production and exploration.

Between 1950 and 1965, crude oil reserves grew from 25.3 billion barrels to 31.4 billion barrels. Quotas limited the importation of foreign oils, which undersold domestic production. Nevertheless, imports of petroleum grew from 550,000 barrels per day in 1950 to 2.3 million barrels per day in 1965. Natural gas reserves grew from 185 trillion cubic feet in 1950 to 287 trillion cubic feet in 1965, and natural gas distribution systems and consumption expanded rapidly during the period. Coal production was limited only by demand.

In general, the energy situation in the early postwar period was conducive to rapid economic growth and relatively low energy prices encouraged its consumption. Supplies of energy increased rapidly and there were periods of overproduction and falling prices. No serious constraints to growth had emerged by the mid-1960's, although it was becoming apparent by then that the long period of cheap and abundant U.S. crude oil resources was coming to an end.

Strong Dollar Internationally. In the immediate postwar period, the dollar reigned supreme. This was the era of "dollar shortage" during which foreign countries resorted extensively to capital and exchange controls to protect their currencies. Full currency convertibility was only established for the European countries in the late 1950's.

The U.S. balance of payments situation was very strong from 1946 to 1949 with a merchandise trade surplus averaging about $7 billion a year and a favorable balance on current account averaging nearly $4-1/2 billion, even after massive unilateral transfers to enable other countries to rebuild their devastated economies. From 1950 to 1959, the merchandise trade surplus averaged only about $3 billion a year, and the favorable balance on current account averaged less than $1 billion annually. Subsequently, in the 1960 to 1965 period, the U.S. payments position swung back in the direction of improvement with an average annual trade surplus of nearly $5-1/2 billion and a favorable balance on current account of nearly $4-1/2 billion annually. By the end of this period, some signs of strain began to emerge, but chiefly on capital account where low U.S. interest rates and freely accessible capital markets encouraged a high rate of U.S. lending to foreign borrowers.

Exchange rate adjustments throughout the first two postwar decades were on the initiative of foreign countries against the dollar, which remained at the center of the international financial system in a fixed relationship with gold. Following the reestablishment of currency convertibility in the late 1950's, the dollar appreciated gradually against other major currencies until the late 1960's and early 1970's. By 1965, although some signs of balance of payments strain were emerging, the dollar remained the anchor of the world monetary system.

Rising Standard of Living. Economic expansion yielded sizable gains during the first twenty years after World War II, despite interruptions to growth during four recessions. From 1947 to 1965, real gross national product rose at about a 3.9 percent annual rate. Real disposable personal income (personal income after taxes and corrected for inflation) rose at about a 3.7 percent annual rate, and at nearly a 2 percent annual rate on a per capita basis. Median family income in real terms was more than 60 percent higher by 1965 than it had been in 1947.

The combination of strong economic growth, rapid rates of increase in the private capital stock and rising productivity contributed to gains in real income. Energy supplies were adequate and a reasonable degree of success in containing inflation kept the dollar strong at home and abroad.

THE ERA OF TRANSITION, 1965-1976

The transition to more difficult times began after 1965 when production was expanded for a war effort without cutting back in other areas. Indeed, a sizeable--although long overdue--expansion of domestic social programs was undertaken at about the same time.

In the early 1970's, new demands were placed on the economy for environmental quality without making trade-offs to give up something else. There was a continued belief that we could have more of everything when this was no longer possible. The oil boycott and oil price shock added to the difficulties. Inflation was the inevitable result. An ill-fated effort to apply mandatory wage-price controls in the early 1970's only worsened the underlying situation.

Partly as a consequence of domestic inflation, the dollar weakened in foreign exchange markets and came under speculative attack. The dollar was devalued twice in the early 1970's, and then was permitted to float, more or less freely, against major currencies. In late 1973 the OPEC oil embargo and subsequent cartel pricing signalled the end of an era of inexpensive energy and placed this country in a position of dangerous dependence on uncertain sources of foreign supply.

The 1965-1976 period was a rude awakening to economic reality. New demands were added onto the economy faster than the capacity to satisfy them was expanded. More and more was demanded from the economy and by the end of the period the capacity to produce in the future had been eroded substantially.

Deteriorating Price Situation. The period from 1965 to 1970 was one of excessively high rates of resource utilization. The rate of unemployment averaged below 4 percent and demand pressures were more or less chronic during most of the period. Inflation as measured by both the GNP deflator and the consumer price index averaged over 4 percent, more than double the rate in the first half of the 1960's. During the period from 1970 to 1975, the after effects of excess demand pressures from the late 1960's combined with a series of shocks, including the OPEC boost in oil prices, to produce additional acceleration in inflation. Inflation as measured by both the GNP deflator and the consumer price index averaged about 6-1/2 percent during the 1970-76 period and peaked in the double-digit range prior to the 1974-75 contraction.

Compensation per hour (wages plus fringes) in the private business sector moved up to a 7.6 percent rate of increase in the 1965-1976 period, some 2-1/2 percentage points above the 1947-1965 average rate of increase. In addition, the rate of growth in productivity fell off by more than a full percentage point to a 1.9 percent rate of growth between 1965 and 1976. As a result, labor costs per unit of output rose at a 5.6 percent annual rate in the 1965-1976 period, nearly 4 percentage points above the increase between 1947-1965. Cost-push pressures became firmly imbedded in the wage-price structure by the mid-1970's, making the permanent reduction of the rate of inflation a difficult task.

Declining Rate of Growth in Productivity. During the 1965-76 period, the strong rate of productivity growth established in the first two postwar decades began to taper off. Output per hour in the private business sector grew at a 1.9 percent annual rate, or 1.6 percent with agriculture excluded. This represented a significant decline from the 3.2 percent, or 2.6 percent rate with agriculture excluded, recorded between 1947 and 1965.

Growth in the civilian labor force picked up speed, rising 2.2 percent annually in the 1965-1976 period in contrast to 1.2 percent between 1947 and 1965. Growth in the stock of private business capital was relatively well maintained, although showing some retardation in growth on a net basis and after exclusion of pollution abatement expenditures. As a result primarily of the more rapid rate of growth in the labor force, the capital-labor ratio grew much more slowly in the 1965-1976 period than it had in the first two postwar decades.

It is not possible to identify the exact point at which the U.S. rate of productivity growth began to decline. Some of the slowdown may have arisen gradually over time. Some may have been occasioned by the sharp rise in energy prices after 1973. It is clear that the rate of growth in productivity had slowed drastically by the close of the 1965-1976 period.

Energy Shock. In 1973, events in international oil markets, in particular the oil embargo, pushed world oil prices far above those for domestic controlled oil. The resulting shock to the U.S. was substantial since imports and consumption of oil had been rising rapidly while domestic production of oil and gas had been declining after 1970.

From 1965 to 1973, total U.S. energy consumption grew at a 4.4 percent annual rate, compared with a 3.1 percent annual rate during the previous fifteen years. The energy to GNP ratio rose to a peak by 1970. Motor gasoline consumption was stimulated by the completion of thousands of miles of interstate highways, increased motor car ownership, and rising personal income.

Supply problems began to appear in the energy field in the early 1970's. The use of coal was inhibited by environmental regulations and other factors. Natural gas deliveries could not keep up with demand and reserves began to top out in 1972. Domestic crude oil production peaked in 1970 and reserves would have fallen appreciably by 1975 except for the discovery of the Alaskan North Slope fields. Domestic oil production could no longer expand to meet demand and imports filled the gap. Imports increased from 2.3 million barrels per day in 1965 to 6 million barrels by 1973 and then dropped slightly by 1975.

The OPEC oil embargo hit with particular force because of the growing dependence of the U.S. economy on oil imports. Imported oil prices rose from $2.14 per barrel in 1966 to $3.37 per barrel in 1973. Following the embargo in the winter of 1973-74, imported oil shot up to $11.45 per barrel in 1975.

Gasoline prices rose 83 percent and heating oil prices by 144 percent in the 1965-1975 period, compared to a 71 percent rise in the consumer price index. Most of the oil price increases were in the last two years of the period when gasoline prices increased by 27 percent and heating oil prices by 71 percent. Natural gas prices increased by 66 percent between 1965 and 1975, with a 33 percent increase between 1973 and 1975.

Industrial energy prices rose much faster than consumer prices during the 1965-1975 period.

- o Coal prices advanced 254 percent, with a 106 percent increase between 1973 and 1975.
- o Natural gas prices for industrial use increased 201 percent, with a 113 percent increase between 1973 and 1975.
- o Fuel oil prices advanced 509 percent, with a 195 percent jump between 1973 and 1975.

A Weakening Dollar. The 1965-1975 period was one of intensifying pressure on the U.S. dollar. At the beginning of the period, the U.S. was running a surplus of about $5 billion both on merchandise trade and on current account. By the early 1970's, both of these surpluses had been wiped out and the international competitive position of the dollar was severely impaired. The international financial system was fundamentally changed in August 1971 when the United States announced suspension of the convertibility into gold of dollars held by foreign monetary authorities. Following this action, major exchange rate alignments, coupled with devaluation of the dollar in terms of gold, were negotiated in December 1971 and February 1973. Subsequently, the international monetary system moved to a regime of managed floating.

Between 1969 and 1974, the U.S. dollar depreciated about 16 percent on a trade weighted basis against the currencies of other major industrial nations. Cyclical improvement in the U.S. balance of payments and other factors led to some temporary strengthening of the dollar and by 1976 the trade weighted depreciation was about 10 percent relative to the base rates of May 1970. By the end of the 1965-75 period, the U.S. trade account had moved back into a $9 billion surplus and the current account was in surplus by $18 billion. Exchange rate adjustments and temporary cyclical factors were largely responsible for the improvement. However, the longer run balance of payments outlook was clouded by the existence of a rapidly rising bill for oil imports.

Standard of Living Continues to Rise. Despite the sharp adjustments occurring after the mid-1960's, standards of living continued to rise. In the 1965-1976 period, real GNP rose at a 2.9 percent annual rate, a little below the postwar average rate of increase. Real disposable income rose at a 3.5 percent annual rate and at about a 2.5 percent annual rate on a per-capita basis. However, constraints on growth were much more evident at the end of the period than at the beginning, and the rate of inflation had accelerated. A sharp decline was developing in the rate of growth in productivity which would limit the potential for future gains.

RECENT ECONOMIC PERFORMANCE, 1976-1980

By the last half of the 1970's, the Nation faced a watershed in its economic history. The world economy was changing at a revolutionary pace. The adverse trends which had developed with respect to inflation, productivity growth, and international competitiveness moved to center stage in the Nation's discussions of economic policy. The Nation responded to these challenges by moving to break important deadlocks in a number of important areas of economic management.

This process has involved painful choices. Changing the Nation's course on matters of such fundamental economic importance as energy policy and control of federal spending could not be accomplished overnight or without intensive debate. We have not succeeded completely on every front: there remains a significant agenda of unfinished business. But in many key areas of economic policy, a new strategic consensus has been forged, laying the basis for improving our basic economic performance over the next decade.

Some of the key areas in which progress has been made include:

- Fiscal prudence: The Administration and Congress have made the containment of domestic spending growth a major priority of economic policy. Working together, we have strengthened budget procedures and discipline and provided for rigorous annual review of "off budget" items through the new Credit Budget. Real growth in non-defense spending has been dramatically reduced from the high rates registered over the previous decade.

- Domestic monetary policy: The Federal Reserve Board has improved its control over the long-term growth of monetary aggregates as a means for bringing down the inflation rate.

- Wage-price policy: The Administration has disavowed mandatory controls and has instead developed a structure of voluntary wage-price standards. Econometric tests indicate that the inflation rate is now 1 to 1.5 percentage points lower than it would have been without the program.

- Energy policy: Programs for implementing the phase-out of price controls on crude oil and new natural gas are now in place. Massive new initiatives have been adopted to develop alternate energy sources and spur conservation of oil. The new Synthetic Fuel Corporation will help create a huge, new industry of energy supply, drawing upon the Nation's abundant coal and shale oil resources.

- Deregulation: Regulations have been substantially reduced with respect to airlines, trucking and financial institutions. Large portions of the U.S. economy have been returned to the discipline and opportunities of competitive market forces.

While considerable progress has been made, in many areas continuing efforts will be required over a number of years. Future policies must place great stress on controlling inflation and stimulating productivity. In reviewing the record of recent years, it is important to recognize accomplishments, but even more important the need for continued progress.

Real Growth. Substantial gains have been made in recent years in terms of real growth. From the trough quarter of economic activity early in 1975 through the first quarter of 1979, real GNP grew at an annual rate of 5.1 percent. From the end of 1976 through the first quarter of 1979, that growth rate was 4.8%. In the next four quarters, real growth slowed to about a 1 percent annual rate, and in the second quarter of this year real growth declined sharply--at an 9.1 percent annual rate according to the preliminary estimates released recently. However, even after this decline, real GNP is about 20 percent above the early 1975 low.

This is a strong performance by past standards, but it obviously reflects cyclical gains to a considerable extent. Real growth since the last cyclical peak in the fourth quarter of 1973 has been about 2-1/2 percent annual rate. This corresponds more closely to estimates of the economy's current trend rate of potential economic growth. Potential growth has been estimated by CEA as having been about 3 percent between 1973 and 1978 and likely to fall to a 2-1/2 percent annual rate between 1979 and 1982. This stands in marked contrast to an annual trend rate in potential of about 4-1/2 percent from 1947 to 1953, and about 3-1/2 percent from 1953 to the early 1970's. Aside from cyclical movements, the real progress of the economy is inevitably limited to its trend potential.

Tax cuts designed simply for fiscal stimulus do little to enhance the economy's potential to produce goods and services. Attention needs to be directed toward tax policies to promote long-term growth potential, i.e., to raise the economy's ability to produce goods and services. The lesson of the recent expansion is that the economy encounters real barriers to expansion, reflected in an acceleration of inflation, long before unemployment can be reduced to desirable levels. Efforts should therefore be directed at the supply side of the economy, including selective programs to attack structural unemployment.

Productivity and Investment. Productivity fell off sharply in the 1973-75 recession, and then made a strong cyclical recovery in 1975 and 1976. During 1977 and 1978 productivity increased by an average of only 1 percent per year. Over the past year, productivity has actually declined by about 1-1/2 percent. During the early stages of a recovery, growth in output tends to exceed increases in labor input by wide margins, but productivity gains tend to slow rather markedly as the expansion ages. The more disturbing feature of productivity experience is the apparent lower trend since the late 1960's. Between 1948 and 1968, productivity in the private nonfarm business sector of the economy rose 2.6% per year; between 1968 and 1973 that growth slowed to 1.7% per year; and during the 1973 to early 1980 period growth slowed still further to less than 1/2 of one percent.

The causes of the apparent secular decline in productivity are still the subject of academic inquiry and difference of opinion. Some of the more important causes of the slower trend growth in productivity that have been advanced are:

- Demographic factors have been important since the mid-1960's, as the proportion of new, young and inexperienced workers in the labor force increased.

- An increasing proportion of capital investment has been diverted in recent years to meeting government regulations directed at improving the health and safety of workers and the environment. Labor resources have also been diverted. While these are essential efforts they do not contribute directly to measured output in productivity. These programs will continue but are unlikely to increase at the rates of the recent past.

- A variety of other factors-- such as the increase in energy prices and a decline in worker motivation--have also frequently been cited as adverse influences.

- In the opinion of many observers, the most important single factor has been a dramatic slowdown in the rate of growth of the capital-labor ratio. More capital per worker generally contributes to higher productivity, and the sharp fall in that ratio is a matter of real concern. In the 1976-79 period, the ratio of the capital stock to the civilian labor force edged up only slightly on a gross basis and actually fell on a net basis. This stands in marked contrast to average gains in the net capital-labor ratio of 3 percent annually from 1945 to 1965 and nearly 2 percent annually from 1965 to 1976.

It must be emphasized that business fixed investment has made a strong cyclical recovery in recent years. The problem is to assure that these are sufficient incentives to boost the amount of capital investment in the permanent fashion that is required to raise productivity and the trend rate of potential growth. That should be one of the major objectives of tax and other policies over the years ahead.

Employment. Growth in employment has been a major achievement of the Carter Administration. Since late 1976, civilian employment has increased by nearly 11 million persons, even after allowance for the cyclical employment declines of recent months. The ratio of employment to working age population has reached record levels, although receding from its peak in recent months. On the other hand, the rate of unemployment has remained higher than desirable, reaching a low for the expansion in the 5-1/2 to 6 percent range, before rising rapidly in recent months. The rise in the unemployment rate in the current contraction has been heavily concentrated among blue collar jobs which are predominantly held by adult men. This cyclical rise in the unemployment rate will be reduced when the economy turns up again. However, more remains to be done in combatting structural unemployment if the average level of unemployment over the cycle is to be reduced to more acceptable levels.

The largest employment gains have been made by women and minority groups. Employment of adult women has increased by nearly 16 percent since late 1976, compared to about 5-1/2 percent for adult men. Employment of blacks and other minority groups has increased by 12 percent compared to a 9 percent rise for all groups.

Employment gains are an important measure of the performance of the economy. However, it is also crucial that productivity advance rapidly so that increased employment will mean rising standards of living.

Energy. Considerable progress has been made in reducing the Nation's reliance on insecure sources of foreign oil. Programs now in place should yield increasing returns in the period ahead. Already some tangible signs of progress can be seen. Between 1975 and 1979, total energy consumption grew at a 2.4% annual rate, slower than at any time during the previous 25 years. The energy/GNP ratio dropped steadily during the 1975-1979 period, and indications are that the ratio will drop further in 1980. Gasoline consumption peaked in 1978 at 7.4 million barrels per day and dropped to 7.0 million in 1979. In 1980, gasoline consumption could drop to about 6-1/2 million barrels per day if present trends continue.

Domestic energy supply has increased over the period. Crude oil production edged up to 8.53 million barrels per day from 8.38 million barrels per day in 1975. Much of the increase was due to the exploration of the Alaskan North Slope fields beginning in 1977. Oil production in 1980 is expected to increase due to more Alaskan production and in response to the phasing out of crude oil price controls. Natural gas production stayed relatively flat during the 1975-1979 period rather than continuing the decreases exhibited in the preceding years. Production in 1979 exceeded 1978 levels. Coal is making a comeback, with 1979 production 18 percent above 1975, and 1980 production running well above 1979 to this point.

The heavy impact of rising oil prices on the domestic economy and U.S. balance of payments has continued throughout the period. The price of imported oil (f.a.s.) rose by 63 percent from $11.45 per barrel in 1975 to $18.67 per barrel in 1979. The price of imported oil in 1980 will be $31.50 to $32 per barrel or about 70 percent higher than in 1979. Net oil imports rose from 5.9 million barrels per day in 1975 to 7.9 million barrels per day in 1979, with a peak of 8.6 million barrels per day in 1977. So far this year net imports are about 14 percent below the levels of last year. In general, the trends toward slower growth in energy consumption, increased domestic production, and reduced imports are all in the right direction.

Recent experience demonstrates that higher energy prices significantly reduce energy demand. There is no realistic alternative to reliance on the price system to insure that scarce energy resources are employed most efficiently, and that adequate incentives are offered for future domestic energy production and conservation.

Inflation. The most discouraging feature of recent economic performance was the acceleration of inflation in the late stages of the current expansion. The worst of the inflationary fever has now been broken, by the policy measures taken at mid-March and by the onset of recession. The task that lies ahead is to insure that the next period of economic expansion does not simply ratchet the rate of inflation to still higher levels, but instead that recent progress can be continued in a methodical trend toward genuine price stability.

Between 1976 and 1979 on the basis of annual averages, the GNP deflator rose at a 7.4 percent annual rate and the consumer price index at an 8.4 percent annual rate. These compare with 5-1/2 percent annual rates of increase in the 1965 to 1976 period. More recently, rates of inflation have reached even higher levels, before turning down. Over the past six months or so, consumer prices have risen at about a 15 percent annual rate, producer prices at about a 12-1/2 percent annual rate, and the GNP deflator at about 10.

As a result of recent inflationary pressures and workers' attempt to maintain real incomes, compensation per hour (wages plus fringes) has been boosted to the 9 to 10 percent range. Because productivity growth has been negative, unit labor costs have been rising in the 11 to 12 percent range for the past year and a half.

Those who favor an across-the-board tax reduction to stimulate the economy should ponder the implications in terms of inflation. Over the past 15 years, every period of economic expansion has driven the rate of inflation to new heights at the top of the cycle. The ensuing periods of contraction have temporarily lowered the rate of inflation, but each time the rate of inflation at the trough has been higher than before.

The International Position of the Dollar. A major objective of the Administration's international monetary policy has been the maintenance of global confidence in a sound and stable dollar. The program to strengthen the dollar, initiated by President Carter in November 1978, represented a watershed in the U.S. exchange market policy. This program combined domestic measures to improve the U.S. balance of payments--by curbing inflation and reducing dependence on imported oil--with more active intervention in the foreign exchange market to maintain orderly conditions.

The November 1978 program demonstrated a clear-cut U.S. commitment to a sound dollar and stability in exchange markets. Since that program, the dollar has increased in value on average in terms of other major currencies. The U.S. balance of payments has, moreover, scored major gains, despite large increases in oil prices and consequently in oil import costs.

It must be recognized, however, that the strength of the dollar depends, in the last analysis, upon our demonstrated ability to keep the domestic economy strong and to reverse the inflationary trend of the past 15 years.

CURRENT ECONOMIC SITUATION AND THE BUDGET REVISIONS

Change in Economic Assumptions. At the turn of the year when the January Budget estimates were being completed, the economy was continuing to show far more strength than most economists had expected. In fact, some additional momentum appeared to develop late in 1979. A mild recession was generally expected, based on the downturn already underway in housing and the prospect that consumers would slow their rate of spending. The timing of a recession was uncertain, however, and few signs of an imminent downturn were in evidence. Retail sales, production and employment all rose in January.

The economic climate shifted rapidly through early March. The shift was triggered by a number of factors. The long projected recession failed to materialize. As evidence began to build that the first quarter would show positive real growth and January retail sales turned in an especially strong showing, some economic and financial market participants began to question whether a recession was really in prospect. Because of heightened international tensions, financial markets began to anticipate an increased defense effort, in consequence much larger budget deficits, more inflation, and higher interest rates. There was an upsurge of speculative activity in commodity markets which was both a cause and a result of shifting anticipations as to the future course of inflation. Rapidly rising energy prices plus rising mortgage interest rates helped cause the CPI to shoot up by 1.4% (18% annual rate) in each of the first three months of the year.

These developments combined to generate a dramatic shift in inflationary expectations. Businesses began to post price increases in anticipation of higher rates of inflation and the fear that wage-price controls would be imposed. Excluding food and energy, producer prices jumped at a 15% annual rate in the first three months of the year at the finished goods level and a 17% rate for semi-finished goods. Interest rates began to shoot upward. Yields on commercial paper, which had averaged about 13% in December, were well above 16% in early March.

The intensified anti-inflation package announced on March 14 was designed to reverse these developments. Its principal components were increased fiscal discipline, including a reduction of some $17 billion from FY-1981 planned outlays, a program of credit restraint, and structural reforms directed at improving the longer-term performance of the economy. The package also included proposals in the energy area and steps to strengthen the wage-price guideline program.

The program, along with actions taken by the Federal Reserve, reversed the inflationary psychology. Interest rates continued to rise into early April, but then declined dramatically. Commercial paper rates moved above 17-1/2% in early April, but subsequently fell to the 8% range. By early June, commitment rates for conventional home mortgages had fallen 300 basis points from the 16-1/2% of early April to 13-1/2%. The Treasury bill rate temporarily fell below 7 percent in contrast to an early peak near 16 percent. From its peak of 20 percent, the prime rate has fallen back near 11 percent. These interest rate declines are laying the foundation for the recovery of the economy.

Meanwhile, the greater than expected strength in activity early in the year led most economists to mark up their projections of real activity, at least for 1980. However, as figures became available for March, April, and May, it became evident that demand and production had been dropping rapidly. New car sales plunged (from a 10.8 million annual rate in the first quarter to a 7.7 million rate in the second), total retail sales took a record drop, industrial production fell by 4-1/2% between February and May, and orders placed with manufacturers of durable goods plummeted by 17% from January to May.

Again, forecasts for 1980 were revised to incorporate these new realities. The tabulation below shows the shifting consensus forecast of about 40 top private business economists.*

Forecasted 1980 Changes in Real Gross National Product

Forecast date	4th to 4th	year to year
	(--------percent	----------)
January	-1.0	-1.0
March	-0.4	+0.1
July	-3.3	-1.4

*Blue Chip Economic Indicators, Capital Publications Inc., various issues.

The economic path underlying the Mid-Session Review of the Budget registers the downturn in activity that is now underway and parallels the change in assessment of near-term economic events that has taken place among private economists. Real GNP is now projected to decline by 3.1% between the fourth quarter of 1979 and the fourth quarter of 1980, with the steepest part of that decline in the second quarter of this year. The economy is expected to move downward still further in the second half, but at a more moderate rate, with the slide perhaps bottoming out late in the year.

The projected course of the economy would carry the unemployment rate up to the 8.5% range by the turn of the year, and the very moderate recovery of real GNP and employment thereafter would do little to bring the unemployment rate down over 1981. As measured by the GNP deflator, inflation is projected to moderate from 10.1% for this year to 9.7% in 1981, both measured fourth quarter to fourth quarter.

It is important to emphasize the great uncertainty associated with all of these projections. Throughout this year, economic forecasts from virtually all sources have undergone major revisions on nearly a monthly basis.

Nevertheless, it is clear that the projected course of economic performance is not satisfactory. As the recovery develops, policy steps to improve the economy's performance, both in 1981 and for the longer term, may well be appropriate. The Administration is reviewing the various possibilities and welcomes the opportunity to consult with the Congress about them.

However, the steps need not and should not be taken in haste. The economy's structural problems require carefully designed structural answers.

Turning to the nearer term, we expect that the natural forces of recovery will begin to manifest themselves.

The consensus expectation of economists, inside and outside of government, is that the upturn will occur late this year or early next. This would conform in a rough way to the postwar cyclical pattern. The average duration of periods of contraction in the six previous postwar recessions has been 11 months, although 1973-75 was longer, and the peak of the recent expansion has now been dated by the National Bureau of Economic Research as having occurred in January 1980.

A recent survey* of 40 private economists at major banks, corporations, and private research organizations sees successively smaller declines in real GNP during the third and fourth quarters of this year and a return to positive growth early next year. This is the generally expected pattern. It may not occur exactly as predicted. Economic forecasting is a very imperfect art. The important point is that the official forecast accords reasonably with the consensus of private forecasts and constitutes a realistic appraisal of the near-term outlook.

Recent readings on the economy suggest that the decline is still continuing, but not at the accelerated pace of the early part of the second quarter. The economy is still moving downward, the third quarter will almost certainly register another decline in real GNP. However, there are signs that the rate of decline has slowed markedly.

-- Retail sales scored a 1.5% increase in June. Excluding autos, sales rose slightly more than inflation.

-- New car sales in early July bounced up from their depressed second-quarter pace (though we should not attach too much significance to this rise until confirmed by additional data).

-- Seasonally adjusted initial claims for insured unemployment have fallen back in early July from their earlier peaks.

-- Housing starts and permits rose strongly in June, reversing the trend of earlier months. Housing activity appears to be benefiting already from the interest rate declines in recent months.

-- Businesses have been making a determined effort to keep inventories under control. The decline in business inventory holdings in May indicates some success in these efforts, lean inventory positions would imply that when demand turns up, production would shortly follow.

-- Demands for short-term business credit show signs of renewed strength.

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*Blue Chip Economic Indicators, Capital Publications Inc., July 10, 1980, Vol. 5, No. 7, esp. p. 3.

The Revised Budget Estimates. The Mid-Session Review shows substantial changes in budget estimates. The basic numbers are presented in the table below.

BUDGET TOTALS
(in billions of dollars)

	1979 Actual	1980 Estimate Jan.	March	July	1981 Estimate Jan.	March	July
Receipts	465.9	523.8	532.4	517.9	600.0	628.0	604.0
Outlays	493.7	563.6	568.9	578.8	615.8	611.5	633.8
Deficit, current estimate	-27.7	-39.8	-36.5	-60.9	-15.8	16.5	-29.8
Budget authority	556.7	654.0	665.8	653.7	696.1	691.3	707.2

The 1980 deficit is now estimated to be $60.9 billion, up from $36.5 billion in March. Outlays are currently estimated at $578.8 billion and receipts at $517.9 billion. The current estimate for 1981 is for a deficit of $29.8 billion, rather than the $16.5 billion surplus estimated in March. Outlays are currently estimated at $633.8 billion and receipts at $604.0 billion. Both the increase in the 1980 deficit and the shift from surplus to deficit in 1981 are mainly the result of changes in the economic situation, though the estimates also reflect legislative events, higher spending on defense and emergency relief programs, and some minor technical changes.

The 1980 deficit is now estimated to be $24.4 billion higher than in March. Of this amount, about two-thirds, or $16.6 billion is due to the change in economic conditions. Receipts are down nearly $11 billion and outlays up $7 billion for this reason alone. Policy changes and Congressional action have reduced receipts by $4 billion in 1980 and $8.4 billion in 1981, and are partially offset by technical re-estimates and other factors. In addition to the effect of changed economic conditions, outlays are running somewhat higher because of defense outlays and increases for disaster relief, alien assistance, and other unavoidable events.

The larger budget deficits do not reflect an upsurge in discretionary federal spending. Congressional responses to the President's proposal for spending restraint have been constructive. While there are some differences in program priorities, the Congressional budget efforts to this point are generally consistent with the policy of fiscal stringency proposed by the President.

Financing the Deficit. Policy steps over the next 18 months could of course alter the economic and budgetary projections released this week. We have, however, analyzed the financing requirements implicit in these projections.

The Treasury's FY 1980 and FY 1981 financing requirements, while increased from the levels projected in mid-March, are not expected to strain the credit markets. Private demands for credit will likely be more than correspondingly reduced as a result of continued weakness in economic activity for the remainder of 1980.

Even with the Treasury's increased borrowing in the months ahead, the ratio of public holdings of Treasury securities to GNP is not likely to rise much above the current level of about 26 percent. In FY 1976, when a budget deficit of over $66 billion was financed, this ratio rose to nearly 30 percent.

Looking ahead to FY 1981, our borrowing needs will probably be heaviest in the first two quarters of the fiscal year. The use of a wide variety of borrowing options currently available to the Treasury should minimize any undesirable impact of this increased financing.

The recovery in the economy is expected to begin late this year or early in 1981, but in the absence of other actions the upturn is projected to be relatively slow. Private credit demands are typically slow to rise in the initial stages of an upturn, and the expected moderation in the rate of recovery may further hold down private borrowing.

Financing policy is not greatly challenged when the automatic stabilizers in the economy tend to result in deficits in periods of slack economic activity. But the string of deficits experienced in the postwar period in boom years as well as in periods of slack, has imposed an added burden on the performance of the economy and its financial markets. If the monetary authorities finance such untimely deficits, excessive growth of credit is generated, and an inflationary atmosphere is created. If, on the other hand, the monetary authorities decline to make credit available to finance the deficit, the available pool of savings and capital formation and productivity suffer. The solution must be a move toward budget balance over the course of the cycle. Sizable surpluses in periods of prosperity may well be desirable, particularly if tax and other policies are successful in promoting more robust private investment performance. We are making progress toward such a long-term fiscal policy, but continuing efforts are required.

TAX POLICY AND AN APPROPRIATE FISCAL STRATEGY

In turning now to the issue of appropriate fiscal policy under present circumstances, several basic considerations should be kept in mind.

First, Congress has been making progress in restraining the rate of growth in expenditures. This basic fiscal discipline must be maintained. Too often in the past, expenditure control has been a short-term enterprise which was soon abandoned. Now that the painful decisions have been made, we should follow through in a clear demonstration that a new fiscal course is being followed. Failure to do so runs the risk of dissipating all the gains that have been made to this point. Domestic financial markets are functioning smoothly at home and the dollar is showing encouraging stability abroad. Both domestic and international financial stability require that we continue to pursue a responsible fiscal course.

Second, it is difficult to predict the exact course that the economy will follow. Interest rates have fallen much more sharply than most observers expected. This could induce an earlier upturn in credit sensitive sectors of the economy. If the economy were to rebound more quickly than expected, fiscally stimulatory actions might prejudice our progress in bringing down inflation.

The Venice Economic Summit reinforced our view that relaxation of demand management policy in the major world economies would be premature. The Venice communique clearly stated that "the reduction of inflation is our immediate top priority...Determined fiscal and monetary restraint is required to break inflationary expectations." Global inflation rates are still unacceptably high and we have not yet succeeded in reducing inflationary expectations. Too early a retreat from restraint, might re-ignite inflationary expectations and erase the hard-won gains we have just begun to make.

Third, the kind of future tax program that should be developed, with full consultation between the Administration and the Congress, will necessarily involve some complex issues and controversial decisions. There are enough choices and technical problems in depreciation reform alone to consume more legislative time than is now remaining before scheduled adjournment. Even proposals that start with apparently simple formulas would not be easy to enact into law, especially in a politically-charged environment. The only program that is simple enough -- slashing rates according to a formula -- would be counterproductive.

Fourth, it would be unwise to try to complete a large tax cut program in this session of Congress. The effort to do so would be caught up in all of the political cross-currents of an election year. It would be subject to the full weight of pressure from every faction that has an interest in special relief. If any agreement were to emerge from this environment, it would very likely be a melange of special interest provisions -- just the opposite of what is needed.

A tax program may well be appropriate for next year. Anticipating this possibility, now is a good time to set out criteria and to begin to consider the outlines of such a program.

Criteria for a tax reduction program

Accord with fiscal discipline and spending restraint. A tax program should be considered in the context of the restraint demonstrated on the spending side. Any tax reduction agenda must consider the revenue effects for at least five years, not just for the first year. This budget planning should be based on reasonable projections for expenditures and economic conditions, including realistic economic responses to any tax changes. They should not be based on hopes, wishes, or magic formulas.

Combat inflation. An anti-inflation tax program should have at least two main attributes. First, in the short run it should not create excessive additional demand pressures or rekindle inflationary expectations. Second, it should help encourage investment and, thereby, improve productivity and reduce unit labor costs. If, at the same time, the program could directly contribute to cost reduction, that would be an added plus.

Maintain confidence in financial and foreign exchange market. In recent months, the program of fiscal restraint has gone a long way to reassure investors at home and abroad that the long upward trend of inflation has been broken. It is important that any major fiscal program be perceived as one that maintains a steady course. Deliberate development of a program aimed at long-run objectives can reinforce this perception. In contrast, an abrupt shift toward stimulus could disturb financial and currency markets, complicating the recovery.

Focus on improving productivity growth and international competitiveness. We must give more attention to the supply side of the economy. The realization of our public and private goals -- a strong defense, expanding employment, growth in real income and opportunity, energy independence, and improved international accounts -- depends on increasing the rate of investment to modernize the capital stock and increase capital per worker. This requires that tax incentives be concentrated on capital expansion, not dissipated in special interest provisions that only move capital from place to place.

Promote the most effective use of available resources. It is not enough to expand the size of the capital stock and increase jobs. The jobs and capital should go where they will have the highest payoff. This is the least costly way to achieve real economic expansion.

The best judge of the prospective payoff is not the government; it is private markets. Reducing taxes where they interfere the most and avoiding the creation of new tax distortions are the keys to the effective allocation of jobs and capital.

Preserve the progressivity of the tax structure. Inflation and reduced energy supplies have further restricted the choices for families with modest incomes. The payroll tax also takes a disproportionate share from wage earning families of low and moderate income. Although "bracket creep" has occurred for every class, those with lower incomes are least able to absorb or avoid the higher rates. Any plan for reducing individual tax rates must carefully consider the effects on the progressivity of the system.

Reflect close consultation with Congress. The criteria offered here indicate priorities and suggest an agenda, but there are large choices within them concerning methods and degrees of emphasis. The Administration wishes to work out these choices in close consultation with this and other committees and with individual members of Congress. Your knowledge and experience are vital to the process of constructing an effective program.

MAJOR TAX POLICY CHOICES

The principal objectives of economic policy and the current structure of the tax system indicate that any future tax changes should be pointed in two major directions. The first would be to reduce the burden of taxes on households and on labor costs. The second would be to provide incentives for productive business investment. A strong case can be made for a number of tax policy options. Putting a tax program together, however, involves choice. Revenue simply is not available to make all the changes everyone would like.

Reducing the tax burden on labor income

The taxation of wage earners is mainly determined by the structure of individual income tax rates and the rate of payroll taxes for social security. The purpose of the graduated rate structure in the income tax is to apportion the tax burden equitably among households of differing means. A by-product of this structure is automatic tax increases resulting from year-to-year increases in money incomes. This tendency -- often called "bracket creep" -- has led Congress to make periodic adjustments, especially in periods of inflation.

Over the period from 1969 to 1979 legislated adjustments to the rate schedule produced nearly the same effect as indexing for middle-income families. A family of four of median income ($24,400 at 1980 levels) would have paid income tax of 10.0 percent in 1969 and 10.4 percent in 1979, if its income had just kept pace with inflation over those years. However, rapidly increasing money wages continue and more households have begun to encounter the steeper portions of the rate schedule that was enacted in 1978. Consequently, the same family of median income will pay 11.4 percent in federal personal income taxes for 1980 and 12.1 percent in 1981.

Increasing individual tax rates and, particularly, the higher rates that apply to any additions to family income are felt especially by families with two wage earners. Consideration should be given to the marriage penalty in connection with individual rate adjustment.

The other main element in the taxation of labor income -- the payroll tax -- has been increased steadily to provide funding for increasing real benefit levels to a growing population of social security recipients. In combination, the income and payroll taxes add substantially to the differential between the cost of labor to businesses, on the one hand, and the after-tax pay of workers, on the other. At current rates of income and payroll taxes, an employer must pay $1.52 in wages and payroll tax to add $1.00 to the after-tax pay of an employee in a median income family. This represents a combined marginal tax rate on labor income of 34.1 percent.

Scheduled increases in the payroll taxes will increase these marginal rates of tax by nearly a percentage point in 1981, considering the increases for both employer and employee. In seeking equitable ways to reduce the taxation of labor income, attention should be given to the added burden on labor costs from payroll tax increases and also to the funding needs of the Social Security system.

One approach to this problem is the proposal put forward by Congressman Gephardt. Under this plan, individuals and businessmen would be permitted an income tax credit for a portion of social security taxes paid. The credit could be refunded to employers and employees who owe no income tax liability. This method would offset the increase in payroll taxes without interfering with funding for the social security system.

Other approaches to the increasing burden on wages also deserve exploration. A result similar to the Gephardt plan may be attained by matching individual income tax cuts to the payroll tax increases, for example. However, direct reduction of the payroll tax should not be considered except in the context of a comprehensive analysis of trust fund financing issues.

Tax treatment of saving

Taxation of income from ownership of property has also generally been increasing. This is partly because the average individual saver who receives interest, dividend, rental or business income has also moved up into higher income tax brackets. Another reason is that inflation leads to overstatement of business profits. But these increases are by no means uniform. The many sources of property income are subject to a great variety of tax treatments. For example, income from corporate equity may be fully subject to corporate taxes and also subject to individual taxes when distributed as dividends to shareholders. At the other extreme, the first $400 of interest income, interest from municipal bonds, earnings on individual retirement accounts, and vested pension funds are all effectively tax exempt. Still other kinds of property income, such as from real estate, minerals, and appreciation of corporate stock are only partially subject to tax.

While many of the savings incentive provisions adopted piecemeal over the years may have been intended to increase availability of capital, some are extremely inefficient and may even be counterproductive. The ability of taxpayers to switch their assets from one form to another, or to borrow in order to invest in a tax-preferred asset, has reduced, if not eliminated, the ability of many of these provisions to increase overall savings. Revenues lost because of tax preferences for certain types of income require increases in rates of taxation on all taxable income. The approach of providing "saving incentives" to certain narrowly defined uses of funds or special kinds of investments should be rejected in favor of more direct, broad based and efficient incentives for investment.

Another important result of the uneven treatment of property income is to divert saving and investment away from the relatively high-taxed industrial sector. Industrial corporations and public utilities are those most likely to bear the full corporate income tax and produce taxable dividends. They also are hardest hit by the erosion of depreciation allowances resulting from inflation. This causes depreciation--a major cost of using capital goods--to be understated and inflates taxable profits.

Depreciation reform

Among choices for encouraging capital investment and raising productivity, acceleration of depreciation allowances offers the greatest potential for success. In general, such a provision would reduce the tax bite on the return to successful investment and also enable higher returns to be paid to direct or indirect suppliers of capital, whether they are lenders, shareholders, members of pension funds, or depositors in financial institutions. As compared with tax breaks to particular types of saving, the benefits of accelerated depreciation are more directly tied to productive investment and less susceptible to "gaming" by simultaneous borrowing and lending transaction and other shifts in individual portfolios.

The particular program for accelerating depreciation that emerges should avoid the kinds of problems that afflict the 10-5-3 proposal. That proposal would quickly become very expensive. It is uneven and haphazard in the way it spreads benefits among types of assets and industrial sectors. Its transition phase is needlessly complicated and may promote investment delays.

Most proposals to accelerate depreciation for newly acquired assets will generate revenue losses that grow more rapidly than the economy for several years. Careful budget planning is required, therefore, for any depreciation program. The reason for this increasing cost is that each year's investment adds increased depreciation deductions on top of the higher deductions still being taken on investments made before. The 10-5-3 proposal exaggerates this pattern by specifying a phased reduction in lives over the first 5 years. For example, in the first year machinery and equipment would be written off in no more than 9 years, the next year in 8 years, and so on down to 5. This may entice the Congress by offering a very low downpayment. But the revenue cost under this approach would grow about twelve-fold in the first five years, from less than $5 billion to nearly $60 billion.

The 10-5-3 proposal becomes so expensive because it would eventually allow the same combination of deductions and investment credits for nearly all classes of machinery and equipment. These allowances would be more generous than those for even the shortest write-off periods in present law. This approach greatly increases the value of deductions for long-lived kinds of equipment such as those used in power plants and ship building. In contrast, the increased allowances for equipment that wears out rapidly or becomes quickly obsolete (such as tools used in metal fabricating and electronics) would be relatively small. For owners of commercial and industrial buildings the value of additional tax saving is, in turn, much larger than the average increase for investors in machinery and equipment. Thus, the 10-5-3 formula indiscriminately favors the movement of capital to structures as well as to long-lived equipment, a pattern not clearly related to any criteria for cost effectiveness in adding to productivity or other economic goals.

The Administration will support at the appropriate time a more even-handed approach to accelerating depreciation allowances. A connection should be retained between deductions for depreciation and the actual depreciation experience for assets used in different kinds of production activities. Such an approach would be superior to 10-5-3 in a number of important respects:

- It would flatten out the trend in revenue losses, providing the tax reductions earlier and having much less impact on future budget options.

- It would not require the kind of phased introduction scheme that imposes additional accounting burdens and weakens the investment incentives at the time they are most needed.

- It would introduce less distortion into the pattern of investment incentives. Additional capital made available by the promise of increased returns and by prudent budget policy would be generally attracted to industries with profitable investment opportunities not directed to particular kinds of property.

A capital recovery system that involves simpler accounting, greater certainty, and reduced administrative complexity can be designed without the cost or distortions of 10-5-3.

CONCLUSIONS

During the next five years, the U.S. must take the steps required to build a strong foundation for superior economic performance and increased economic security. We must show the discipline to make the sacrifices needed to strengthen our economy for the long run, while at the same time providing assistance to those most adversely affected by short-run economic disruption.

The U.S. stands at the threshold of a new economic era. What we do over the next five years will determine whether this new era brings an unparalleled standard of economic well being or a slow drift to mediocrity. To make the most of this opportunity, we must not only build on past gains, but also be willing to reverse past errors. Many of the economic problems now facing us stem from an unwillingness, stretching back at least 15 years, to confront directly difficult trade-offs and choices. Hard choices must be made if the U.S. economy is to thrive in an increasingly competitive world.

There are four major objectives for economic policy for the next five years: First, to improve our economy's productive capacity so we can enjoy stronger growth in real incomes. Second, to return to longer run price stability, which will permit us not merely to reach a high employment level but to sustain it. Third, to enhance our competitive position internationally. And, fourth, to reduce our vulnerability to externally generated shocks, such as energy interruptions.

A tax program, properly timed, and consistent with the criteria outlined above can make a significant contribution to attaining these objectives. If we move in that direction patiently and responsibly, we will be able to improve greatly our economic outlook for the balance of this century.