

*Charm*

THE CHAIRMAN OF THE  
COUNCIL OF ECONOMIC ADVISERS  
WASHINGTON

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MEMORANDUM FOR MIKE BLUMENTHAL

FROM: Charlie Schultze *CLS*  
SUBJECT: Anti-inflation component of a 1978 economic program.

Without timely and vigorous Federal actions on a number of fronts, the next several years are likely to see:

- o a stagnation of overall unemployment in the 6-1/2 percent area;
- o no improvement, and more likely a worsening of unemployment for blacks and other minorities;
- o a continuation of inflation in the 6 to 6-1/2 percent neighborhood.

Economic growth and progress on the unemployment front in the last half of 1977 is less than we had anticipated. In 1978, without quick action on taxes, the CEA's forecast, based on "realistic optimism" foresees a 4 percent growth rate (fourth quarter to fourth quarter), and little further improvement in the unemployment rate. An alternative forecast, based on "realistic pessimism" suggests that growth could be as low as 3 to 3-1/2 percent, and that unemployment would begin increasing. These forecasts raise the problem of how to secure quick passage of the tax reductions needed to speed up growth and improve the unemployment picture.

The problem of inflation complicates matters further. We could, for awhile, deal with unemployment problems without facing up to inflation. For a year, or perhaps two, inflation might not get significantly worse. But if we are successful

on the unemployment front, then by mid-1979 or 1980, the rate of inflation will begin to grow -- and then it may be too late to address it. Both economic and political consequences would be severe. Unless the political difficulties are absolutely insuperable, we must have a meaningful anti-inflation program.

I believe that the President should consider a comprehensive economic program simultaneously aimed at all three problems. But doing so -- particularly in the case of an anti-inflation program -- requires:

- o a re-thinking of the components of the tax reform package;
- o a program of consultation with business, labor, and Congressional leaders to see if the relatively controversial parts of an anti-inflation program had some chance of passage.

This memo is designed to lay out some options and to suggest a program of consultations within and outside the Administration. It differs, in some specifics, from Barry Bosworth's attached memo, which explores anti-inflationary options in some detail. But I think it highlights the issues that I believe are most important.

#### Anti-inflation program

I think there are three basic options on inflation:

1. Do nothing.

The long-run consequences of this approach were outlined above. It has the short-run advantage of not rocking the boat and not getting in the way of our pursuit of the other objectives.

2. Enunciate a series of voluntary guidelines or standards for private wage and price behavior, and be prepared to "jawbone" in important cases.

A set of voluntary guidelines and standards has been developed by CEA and COWPS which would not rely on rigid numerical guidelines for wages or prices. Essentially the standards for wages and prices would ask for a lower rate of increase this year than last year, subject to specified exceptions. (We call it a "deceleration standard.")

There are few major union contracts coming up in 1978. Hence the guidelines would principally be addressed to employers, in terms of both their price and their wage decisions. If the guidelines worked, they would hopefully set the stage for more moderate wage increases in 1979 when the next round of major union bargaining begins.

Such guidelines might be better than nothing. But they have only a dubious chance of success. And they are likely to involve the President occasionally, and senior Administration officials more frequently, in public confrontations with particular business or labor leaders. ✓

3. Use part of the tax bill as an explicit device to secure moderation of wage and price increases in 1978.

We will need a tax reduction in 1978. Tax reductions, like wage gains, increase workers' disposable incomes. But unlike wage increases they do not add to costs and prices. One way to secure wage and price moderation, therefore, would be to use the tax cuts as an alternative to wage and price increases. Specifically, we could make permanent reduction effective in 1979, but also offer a 1978 reduction along the following line (the numbers and details are still illustrative, but in the ballpark): ✓

- (a) If an employer certifies that the wages and fringe benefits of his employees (excluding government-mandated increases) will increase by no more than 6 percent in 1978 (fourth quarter 1977 to fourth quarter 1978), each employee will receive a 1978 tax reduction equal to 1-1/2 percent of wages, up to wages of, say, \$20,000.
- (b) For each 1 percent that an employer reduces his weighted average price increase in 1978 below 1977, he will receive a 1 percentage point reduction in his 1978 corporate tax rate, up to, say, a maximum of 2 percentage points.

This approach would provide economic stimulus and also give strong incentives for wage and price moderation. It would be entirely voluntary; no one is forced to "join." The objective behind the approach is to break the momentum of the current price-wage spiral in 1978, and lay the groundwork for moderate union settlements and price increases in 1979.

We have examined the administrative problems and most of them seem manageable. We are now running calculations of the likely fiscal, employment and inflation-reduction consequences of various permutations of this approach.

#### Advantages

1. It would give us a concrete, understandable, yet voluntary approach to reducing inflation.
2. It would not require public jawboning of particular price and wage decisions.
3. If successful, it would make it easier for the Fed to pursue a lower interest rate policy -- with lower inflation the existing rate of growth in the money supply would finance a larger growth in real output and employment.
4. It would demonstrate the President's determination to fight inflation, but do so in a way which also promotes lower unemployment.
5. Except for those who favor full-scale price controls or who want to fight inflation by keeping economic growth low and unemployment high, no one can offer an alternative which has any real teeth in it.

#### Disadvantages

1. It is novel, "radical," untested, and would be controversial.
2. It would have to be incorporated as part of the tax bill and its novelty might well delay passage of the bill.

3. The amount of fiscal stimulus it provides would depend on how many people chose to take advantage of the offer. We can estimate the number, but without any kind of precision. (Many workers would get lower wage increases anyway, and would obviously join. Those expecting very high wage increases wouldn't, since it wouldn't give them enough to offset the wage loss. For a large number in the middle, it would be a close calculation.)
4. The Administration might be accused of proposing a "gimmick."
5. Because it incorporates a specific wage standard, the unions might say it was first cousin to the old Kennedy-Johnson guideposts, which they do not like.
6. Unless it is quickly passed, its effectiveness will diminish. For administrative reasons, we have to make the wage and price standards apply to calendar 1978. The longer that passage is delayed the more difficult it becomes for employers and workers whose wage increases are normally made early in the year. (They would have to make contingent agreements.)
7. Even if we got wage and price moderation in 1978, that doesn't guarantee its continuation into 1979. (But it would surely help, and if it proved successful a more modest version could conceivably be tried again in 1979. If both wages and prices come down, everybody gains.)
8. It will seem unfair to many. (Workers or firms who had huge wage increases in 1977 and didn't expect much in 1978 get a windfall; and vice-versa.) But any deceleration of inflation has to be unfair, since the inflation itself was not evenly distributed.

### Conclusion

This kind of a proposal represents a major departure from traditional policy. It would inevitably complicate whatever tax program is decided upon. If proposed, it would become a major element of the Administration's economic program, and its elimination by the Congress would be considered a major defeat.

But on substantive grounds this approach offers the only hope for moderating inflation.

We will need Presidential approval to take some soundings on the Hill and with the business and labor community, to provide some basis for making judgments about the idea. I believe we should see whether it has any chance of success, even at some risk of leaks.

Attachment