

## THE SEVENTIES: INSTABILITY, INFLATION, AND STAGNATION

After more than 25 years of stability, growth, and low inflation following World War II, the U.S. economy ran into trouble in the late 1960s and 1970s. A series of shocks to the economy combined with destabilizing monetary and fiscal policies produced a period that has been characterized as stagflation: high, variable inflation and rising unemployment. Aggravating these problems were disincentives to private investment introduced by the tax system, increased regulation, and reductions in government investment.

The 1970s stand in stark contrast to the 1950s and 1960s. Between 1973 and 1981 the rate of inflation was nearly three times as high as between 1948 and 1973, averaging more than 8 percent and reaching 9.7 percent (four quarter change) at the business cycle peak in 1981. Until 1981 each successive peak exhibited higher inflation and higher unemployment. Higher inflation was not buying lower unemployment, and the unemployment rate reached 7.4 percent at the business cycle peak in 1981 (Chart 1-4). Productivity growth plunged to a scant 0.6 percent per year between 1973 and 1981. Manufacturing's productivity performance was better than overall productivity, but it, too, slowed to a 1.3 percent annual rate of increase.

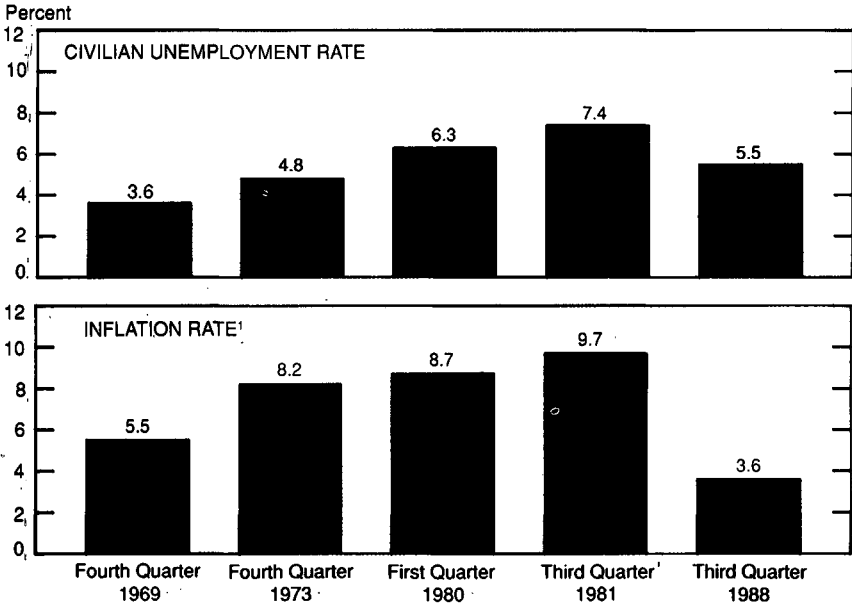
The net result was a stagnation in standards of living. Growth in real GNP per capita was cut to one-half the 1948-73 rate, to a 1.1 percent annual rate between 1973 and 1981. Real median family income showed no growth, despite the growth in the proportion of two-earner families. A real differential began to show up in the 1970s, however, with the lowest groups in the distribution of income faring the worst. The poverty rate increased from 11.1 in 1973 to 14.0 in 1981.

### DESTABILIZING MACROECONOMIC POLICIES

The United States entered the 1970s with rising inflation, a recession, and the collapse of the exchange-rate system. These problems, inherited from the 1960s, were compounded by two supply-related changes in the 1970s: sharp increases in energy prices and rapid labor force growth that injected large numbers of inexperienced workers into labor markets.

Chart 1-4

### Unemployment Rate and Inflation Rate at Business Cycle Peaks, and Current Rates



<sup>1</sup>Four-quarter percent change in GNP implicit price deflator.

Note.—Data are seasonally adjusted.

Business cycle peaks as determined by National Bureau of Economic Research.

Sources: Department of Commerce and Department of Labor, except as noted.

Exacerbating the effects of these exogenous factors were short-term policy responses. Prominent among these policy responses was the mismanagement of mounting inflation and the energy shocks. Instead of pursuing the medium-term goal of gradually reducing the growth rate of the money supply from the rapid pace of the 1960s, policymakers focused on successive short-term responses to the inflation and unemployment problems.

*Price Controls:* In 1971 wage and price controls were introduced, beginning with a 90-day freeze on prices and progressing to weaker controls in later phases of the program. The freeze at first slowed the measured rate of inflation by suppressing the rise, but in doing so it may have encouraged a resumption of monetary stimulus. Between 1971 and 1972, M2 increased at an annual rate of 13 percent. The freeze also distorted relative prices and reduced efficiency.

When the oil "crisis" hit in 1973, the Nixon Administration imposed controls on the price of energy production. The result, howev-

er, was distortions in relative prices and gas lines. Perhaps most damaging was policymakers' failure to recognize that the oil price rise was a one-time increase in the price level, or, depending on monetary policy, a change in relative prices, not a permanent change in inflation. Consequently, policymakers did not confront the fundamental causes of the underlying increase in inflation—rapid monetary growth. Although periodic swings in money growth answered swings in inflation, average money growth remained high.

*Discretionary Policies:* The attempt to use fiscal and monetary policies to smooth the economy produced the pattern of successively higher peaks in inflation at each business cycle peak (Chart 1-4). Higher inflation rates did not produce the reduction in unemployment rates suggested by the Phillips curve tradeoff. (For a discussion of the Phillips curve tradeoff between inflation and unemployment, see Chapter 2 of the 1988 *Economic Report of the President*.) The stop-go pattern had already shown up in the 1960s. In the mid-1960s, there was an acceleration of monetary stimulus, accompanied by fiscal stimulus in the form of the 1964 tax cut, and Vietnam war and Great Society spending. In the latter part of the 1960s, rising inflation led to the 1968 tax surcharge and to the monetary contraction in 1969 that preceded the 1969-70 recession. This pattern became more destabilizing and more volatile in the 1970s, with government responding to short-term fluctuations, first stepping on the accelerator to stimulate the economy and reduce unemployment and later stepping on the brakes to slow inflation.

*Information and Lags:* Fine-tuning proved to be more harmful than helpful because of the inherent difficulties in forecasting business cycle turning points, the long and variable lags in policymaking, the lag between action and its effect on the economy, and the difficulty of distinguishing between permanent and transitory changes.

The first problem confronting discretionary policy was, and continues to be, information. Discerning trends in preliminary data is difficult. With hindsight, peaks and trends are easy to spot. Identifying trends as they occur is more difficult because there are large random components in the data, many changes in monthly data are not statistically significant, and initial data are often revised substantially. These difficulties and the time it takes to collect and disseminate the data make early recognition of trends even more difficult. For example, an analyst using business cycle rules for identifying significant trends in the leading index of economic indicators would not have been able to identify in advance either the 1974-75 or the 1981-82 downturns, the two most severe downturns of the postwar period.

These problems, in obtaining reliable information promptly, present large difficulties when combined with lags in policy. Fiscal

policy takes time to enact, and after enactment often requires 3 to 6 months to take effect. Fiscal policies reach their peak effect on average between 9 and 18 months, with wide variation around the average reflecting in part variations in anticipations and information about the change. Monetary policy has a short administrative lag, but its effect is usually not felt for between 6 to 9 months, and its peak effect may occur as many as 36 months later. Further complicating discretionary policy is the variability of these lags, with the length of the lag partly depending on anticipations—whether the action will be taken and the form it will take. Greater certainty about the action tends to shorten the lag and more uncertainty tends to lengthen it.

Given these lags and the fact that the average postwar contraction lasts only 11 months, to be effective, discretionary policy requires accurate forecasts of turning points at least four quarters ahead. Unfortunately, the record in the 1970s and 1980s indicates that neither Federal Government nor private forecasters has been able to forecast on average whether the economy will be in boom or recession four quarters ahead. The errors in their forecast tend to be largest at turning points, and even on average the range of real GNP growth suggested by the forecasts' standard errors bracket a range from more than twice the mean rate of real GNP growth to negative real GNP growth.

Much of the error in these forecasts involves problems in estimating the course of policy. Some estimates indicate that as much as one-half of the error of forecasts relate to unexpected changes in monetary policy. Much of the rest of the error results from random shocks, such as changes in oil prices or in labor force and productivity, and random fluctuations in decisions of governments and private citizens at home and abroad.

*Stop-Go in the 1970s:* The record of the 1970s graphically illustrates the problem with lags and the destabilizing nature of discretionary policy. Including one-time energy price increases, during 1973 the measured rate of inflation nearly doubled. To reduce the underlying rate of inflation in 1973 and 1974, monetary growth had to be reduced, but the sharp spike in prices related to the transitory energy-related change in relative prices caused the monetary authorities to overreact. Instead of reducing gradually, they cut the growth in M2 by more than one-half, from 13.3 percent between 1971 and 1972 to 6.2 between 1973 and 1974. While the one-time oil price change had a role in the severity of the ensuing recession—by reducing real incomes—monetary policy accentuated the effect. The 1974-75 recession was the deepest downturn that had occurred to that point during the postwar period. Inflation dropped from 8.2 percent at the pre-recession peak to a low of 5.7 percent following the recession,

but unemployment climbed to 9.0 percent. Also, although part of the reduction was attributable to a fall in the underlying inflation rate, much of the drop was traceable to the absence of additional oil price increases.

The 1974–75 recession and higher unemployment prompted a tax cut in 1975 and accelerated monetary growth. The progress in reducing the underlying inflation rate that had been so expensively gained was lost. Between 1975 and 1977, M2 growth averaged 12.3 percent.

The Tax Reduction Act of 1975 was a one-time tax cut designed to stimulate aggregate demand and fight the recession. Unfortunately, it was passed in March 1975, which was the recession trough, and the tax cut probably had its initial effect well after the expansion had begun, and its peak effect at a point well into the expansion, when inflation pressures were already starting to build. The monetary expansion also began in early 1975, with its initial effect probably occurring even further into the expansion and its peak effect as late as 1978, when inflation was approaching 8 percent.

Later in the 1970s a large increase in oil prices combined with the inflationary stimulus of past monetary growth to produce rates of price increases of 7.3 percent in 1978 and 8.9 percent in 1979. The Federal Reserve again shifted policy. In 1978 it started to tighten monetary policy and by 1979 was committed to reduce inflation. A significant slowing in monetary stimulus began.

The periods of rapid monetary growth in the 1970s had a particularly strong effect because of continued increases in velocity (the ratio of nominal GNP to the money supply). Higher inflation and higher interest rates during the 1970s kept velocity rising. From 1973 to 1981 the velocity of M1 (a narrower definition of money than M2) increased from 5.3 to 7.2. The behavior of the velocity of M2 was influenced by Regulation Q, which fixed interest ceilings on commercial bank deposits, and was more cyclical, tracking changes in short-term interest rates, the opportunity cost of holding idle money balances. The velocity of M2 also rose, however, increasing from 1.6 in 1973 to a peak of nearly 1.8 in 1981.

#### THE PRODUCTIVITY SLOWDOWN

Many analyses of the productivity slowdown focus on three exogenous factors that affected the United States in the 1970s: rapid increases in energy prices, rapid labor force growth, and the shift in demand away from goods and toward services.

*The Energy Shock:* Because the first oil shock occurred in 1973 and coincided with the worldwide productivity slowdown and stagflation, it appeared to explain both phenomena. The increase in oil prices raised the price level and measured rate of inflation, lowered real

output, raised unemployment, and lowered real incomes. The rapid increase in energy prices also reduced the optimal use of the existing capital stock, which was designed for low energy prices. Resources that might otherwise have been devoted to producing and purchasing new laborsaving capital equipment and structures were diverted to purchasing new energy-saving equipment and structures.

Some studies in the 1970s attributed a significant share of the decline in productivity to the sharp increase in energy prices; more recent analysis suggests a smaller effect because energy did not constitute a large enough share of total production costs to cause a prolonged decline in productivity.

Although it does not completely explain continuing stagflation, the effect of the energy price increase in some energy-intensive sectors, particularly in manufacturing, may have been significant. Higher energy prices combined with other pressures to cause an even greater reduction in the optimal use of the capital stock in these sectors. Some authors have suggested that a gradual change in energy prices might not have had a significant effect on the productivity of the capital stock because of energy's small relative contribution to total costs, but that the large sudden increase in energy prices presented serious adjustment problems.

Higher energy prices may also have had a large indirect effect on the economy. To the extent that the sudden rise in energy prices helped to contribute to the stop-go policies of the 1970s, it may also have contributed significantly to the period's stagflation.

*Rapid Labor Force Growth:* The growth rate of the civilian labor force in the United States increased from 1.2 percent between 1948 and 1966, to 2.4 percent between 1966 and 1973, and increased further to 2.5 percent between 1973 and 1981. These increases resulted from the maturing baby-boom generation and increasing labor force participation by women. The acceleration in growth shifted the composition of the work force to younger and less experienced workers, which tended to slow productivity growth. In 1966, 39 percent of the labor force were under the age of 35. By 1973 younger workers accounted for 47 percent of employment, and by 1981 they peaked at 51 percent.

This rapid labor force growth also added to the need for an increased rate of capital formation. The increase in labor required an even larger increase in investment to maintain the existing ratio of capital to labor and output per unit of labor. Unfortunately, coinciding with the rise in labor force participation was a slowing of the rate of capital formation.

The increase in labor force growth may have begun to assert its effect in the mid-1960s, when productivity growth dropped from a

rate of 3.3 percent between 1948 and 1966 to 2.1 percent between 1966 and 1973. Between 1973 and 1981, however, productivity growth dropped sharply to a rate of 0.6 percent, even though labor force growth was not much faster during this period than between 1966 and 1973. A more important factor was probably the slowdown in capital accumulation, which contributed to the slowdown in the growth rate of the net capital stock per worker. The productivity literature also suggests a relatively small effect on productivity from rapid growth in the number of young workers between 1973 and 1981.

*Shifts in the Composition of Demand:* Throughout U.S. history shifts in the composition of demand have affected productivity and economic growth. Flexibility in labor markets allows resources to move into expanding sectors. In the past, increases in agricultural productivity freed resources from farming to be used in the expanding nonfarm sectors. The shift raised average productivity as resources left agriculture—a sector with a relatively low level of output per man-hour—to other sectors with higher output per man-hour.

During the 1970s manufacturing productivity increased, although at a slower rate than in the 1950s and 1960s, which allowed manufacturing's share of GNP to remain roughly constant despite an increase in the share of the labor force employed in the expanding services-producing sector. This shift facilitated the employment and training of a large number of young, inexperienced workers.

In contrast to the net boost that the shift out of agriculture gave to average productivity, the shift to service industries lowered measured productivity growth because the faster growing components of the service sector had lower measured levels of productivity. Estimates of the effect of the shift in the composition of output vary widely, but it may have reduced overall measured productivity growth by as much as one-fourth. It is difficult to assess the true effect because part of the difference in productivity across sectors may be the product of problems in measuring output and productivity in the service industries.

In addition to these three exogenous factors, two other factors affected the productivity slowdown that were subject to Federal Government control: inflation and regulation.

*Inflation:* One of the most important changes in the U.S. economy that accompanied the U.S. productivity slowdown was rising inflation. Although analysts have carried out a large number of studies on the productivity slowdown, they seldom discuss or measure the direct effects of inflation—particularly variable inflation—on productivity. Yet the rise and variability of inflation after 1973 clearly paralleled the productivity slowdown. The potential impact of inflation is especially

important because, as the past 8 years have demonstrated once again, inflation is clearly subject to Federal Government control through monetary policy. In contrast, rapid labor force growth and the energy crisis are largely beyond the reach of government policies.

The effect of inflation in the United States in the 1970s and early 1980s, however, was not just to redistribute income. Inflation was high and variable, rising from 4.4 percent during 1972 to 10.1 percent during 1974, dropping to 5.7 percent in 1976, and rising again to 8.9 percent by 1979. Within a structure of unindexed taxes and contracts, high and variable inflation had real effects and pulled down measured productivity in a number of ways.

*Noise and Relative Prices:* During the 1970s high and variable changes in the rate of inflation were accompanied by a significant increase in the variability of relative input prices, as measured by the producer price index for intermediate goods. Not only did relative prices change more frequently, but also relative price changes did not appear to be lasting. For many goods, adjusting prices costs something, and sellers adjust prices infrequently. The result may be that during a period of high and variable inflation, relative prices may for a time be more a function of the pattern of past changes than a reflection of current or future resource cost.

Relative price volatility was important because many price contracts were not indexed for inflation and because changes in resources used in production processes can be costly. When decisions are based on relative price changes that reflect statistical noise and random adjustments rather than on changes in real costs, these rigidities can cause significant inefficiencies in resource allocation and reduce measured output per unit of input.

Even without rigidities, volatility in relative prices imposes two other types of costs. The first is the cost to sellers of adjusting prices, while the second is the cost to buyers and managers of having to learn new information and integrate it into decisionmaking.

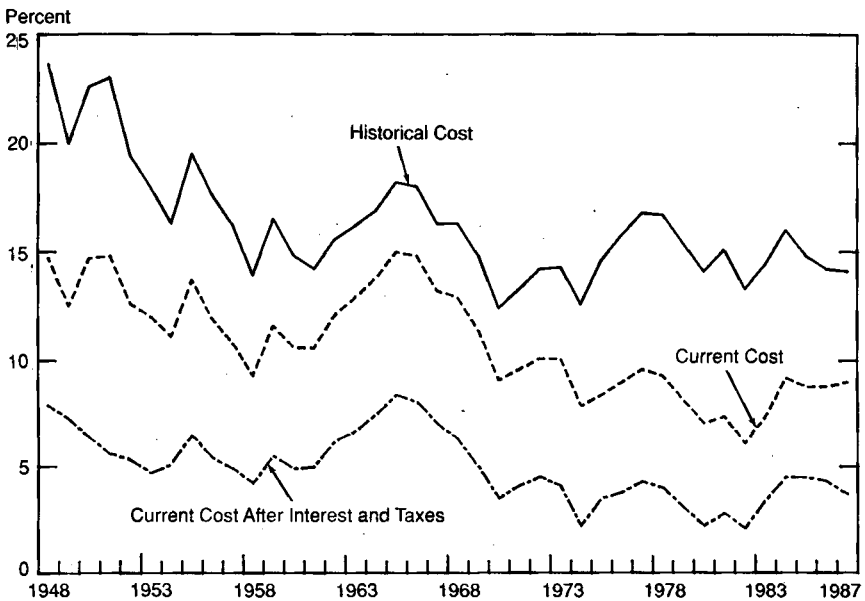
*Managerial Efficiency:* In addition to its effect on resource allocation in the choice of input combinations, inflation had another significant effect on managerial efficiency in the 1970s. Operating decisions about productivity had a smaller impact than inflation on reported profits and rates of return; and managers had an incentive to allocate more time to the latter and less to the former. With input prices and wages rising at 10 percent or more, managers could save more by buying early or trying to win a wage concession than by trying to improve productivity by a percentage point or two.

These labor and material pressures were reflected in the behavior of inventories. Expectations of rising prices and low real interest rates gave managers an incentive to carry more inventories, raising

the inventory input for a given level of output and raising inventory profits. In contrast to today's just-in-time inventory systems, in the 1970s inventory-to-sales ratios reached their highest postwar levels.

The relationship of inflation to incentives is graphically illustrated by its distorting effect on reported profits. Inventory profits came to account for a rising share of reported profits. Inflation also understated the replacement cost of capital assets, which further increased book profits. Reinforcing these effects on profits, inflation caused the value of a firm's capital assets to be understated. The result of all these effects was to cause accounting—or historical cost—rates of return reported to stockholders and upper management to diverge sharply from real rates of return, with nominal rates of return trending upward slightly while real rates trended down (Chart 1-5).

Chart 1-5  
Alternative Rates of Return on Capital Investment



Source: Unpublished data from Department of Commerce.

In the 1960s real operating profits from production accounted for up to 82 percent of accounting rates of return for U.S. nonfinancial corporations; inventory profits and the understatement of capital costs and assets resulting from the effects of inflation-induced profits accounted for the other 18 percent. Rising inflation in the 1970s increased the importance of inflation, and by the early 1980s, inflation accounted for as much as 54 percent of accounting rates of return

and real operating profits from production accounted for only 46 percent. The effect of inflation on returns after taxes and interest payments was even more dramatic. By the early 1980s, inflation's share reached 72 percent of accounting rates of return after taxes and interest payments and real operating profits 28 percent.

In addition to the incentive and time problems related to inflation, managers had the added burden of burgeoning government regulations and of trying to forecast the effect of the stop-go economic policies. Under these uncertain conditions, at the margin, managers were likely to spend more of their time on purchasing and planning decisions—as well as on complying with new regulations—than on basic operating decisions. Training personnel, attending to plant maintenance, or working on improvements in work processes may have received less attention as a result of the increased demands resulting from inflation and regulation and the lower relative returns to time devoted to these activities.

*Investment Incentives and Investment Trends:* In addition to the distorting effect on accounting profits and rates of return, inflation raised effective tax rates on capital investment. Real after-tax rates of return fell, lowering investment incentives. Inflation eroded effective corporate profits by reducing the value of depreciation allowances and measured materials costs, thereby raising effective tax rates on capital that were based on nominal profits. Partly offsetting these effects was the deductibility of nominal interest payments. On average, however, the net effect was an increase in effective tax rates that accompanied the decline in real operating rates of return.

While uncertainty continues among economists as to how much the interaction of inflation and taxes increased effective tax rates and reduced real returns, and how much the rise in effective tax rates reduced the rate of capital formation, it is likely that higher effective tax rates had a significant role in reducing the rate of capital formation. One frequently cited estimate suggests that the interaction of inflation and taxes reduced net investment by as much as one-third.

The effect of inflation and taxes had another distorting effect on nonresidential investment. During the 1970s and early 1980s, inflation and the Tax Code gave large incentives to investment in residential housing while it lowered the net returns to investments in financial markets. Taxation of capital gains that reflect inflation rather than real increases in value also reduce incentives to save and invest. Partly as a result, housing values soared and stock values stagnated while the replacement cost of plant and equipment rose. As might be expected, lowering the stock market value of firms relative to the cost of new plant and equipment raised the firms' cost of capital and lowered the incentive to invest in new capital.

Slower capital formation lowered U.S. productivity in three ways: by failing to keep up with rapid labor force growth during this period, the growth rate of capital per worker slowed dramatically; by slowing down the rate of adoption of new technologies embodied in new plant and equipment, the growth rate of capital productivity was reduced; and the slowing of the rate of adoption of new technologies may have reduced the learning by doing that accompanies new investments and feeds back into the rate of technological change. (Science and technology are discussed in Chapter 6.)

Although considerable controversy surrounds the relative importance of the slowdown in capital formation, most studies have found that slower capital formation had a significant and substantial influence. The range of estimates is wide, with most of the estimates of slower capital formation ranging between 20 and 50 percent of the slowdown. And perhaps most important, in contrast to the rapid growth in labor force or the energy crises, government policies—either through their effect on taxes or inflation—have an important effect on incentives that influence the rate of capital formation.

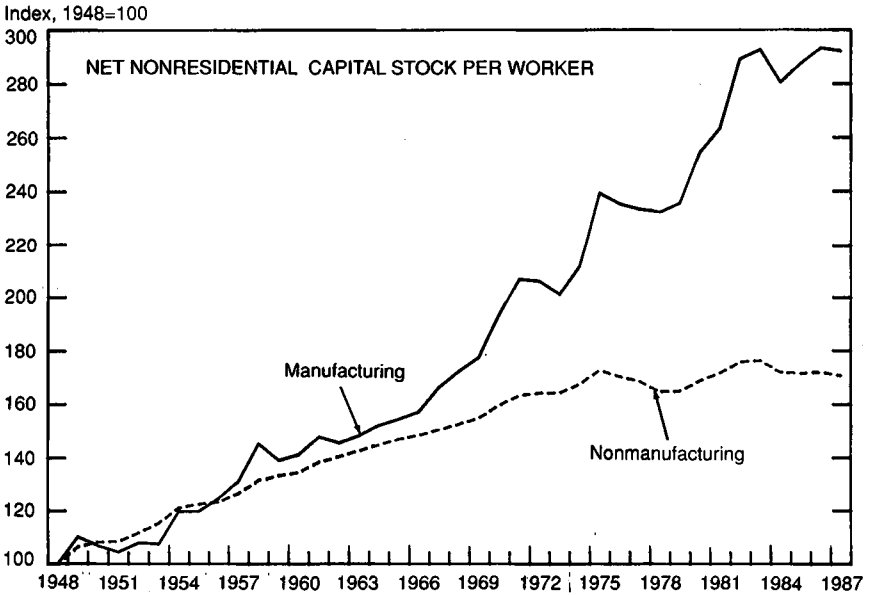
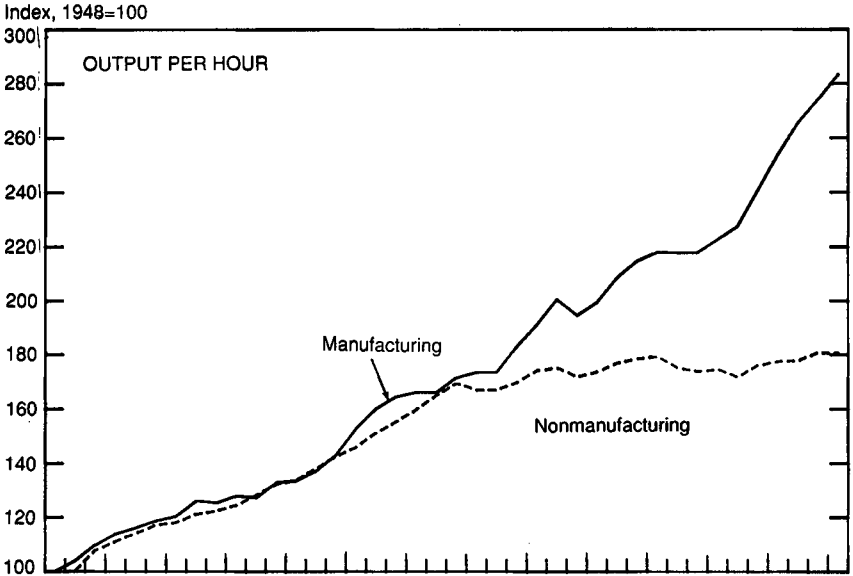
Although some slowing of the rate of capital formation occurred after 1966, the drop in the 1970s was dramatic. The rate of growth in the private real net nonresidential capital stock per worker dropped from 2.2 percent between 1966 and 1973 to 1.4 percent between 1973 and 1981. The trend across industries was not even. Capital formation in manufacturing showed significant growth in the 1970s. Net capital stock per hour worked rose at a 3.4 percent annual rate between 1973 and 1981, while growth in capital per worker in nonmanufacturing slowed between 1973 and 1981, to a 0.7 percent annual rate (Chart 1-6). Partly as a result of the continued growth in capital formation, manufacturing productivity growth did not suffer as much of a slowdown as did productivity in other sectors.

All these factors notwithstanding, one of the most important effects of inflation on private investment incentives was the result of stop-go policies that produced higher inflation and unemployment. Instability reduced incentives to investment, making entrepreneurs more cautious, more concerned about downside risks, and less willing to undertake new investments and projects.

Paralleling the decline in private capital formation was a continued decline in government capital formation as government direct transfers and insurance programs rose. After peaking at 4.1 percent of GNP in the mid-1960s, the ratio of government nonmilitary investment to GNP declined throughout the 1970s, falling to 2.1 percent by 1981. This decline in nonmilitary investment paralleled a decline in military investment, which allowed U.S. defense capability to run down.

Chart 1-6

Output per Hour and Capital Stock per Worker,  
Manufacturing and Nonmanufacturing



Sources: Output per hour, unpublished data from Department of Labor; capital stock per worker, Council of Economic Advisers; based on data from Department of Commerce.

*Incentives to Entrepreneurial and Other Labor Effort:* Just as businesses and investors experienced inflation-induced bracket creep, entrepreneurs and workers also saw bracket creep reduce their returns to extra effort. One-earner families of four with twice the median income—who were more likely to be entrepreneurs and professionals—saw their marginal tax rates increase from 28 to 43 percent, while their real income stagnated. Proprietors' income declined from 10.6 percent of personal income in 1973 to 7.6 percent in 1981.

Wage and salary workers also saw their marginal tax rates rise as their real incomes stagnated. Between 1973 and 1981 nominal median family income for a one-earner family of four increased 92 percent, while the family's real income was little changed and its marginal Federal income tax rates rose from 19 to 24 percent. The impact on married women and other secondary workers was particularly severe, as they faced declining real wages and high marginal tax rates on their labor effort.

*Measurement Problems:* One of the most difficult problems in measuring productivity is separating pure price changes from changes in product price that reflect changes in the characteristics or quality of a product. The difficulty of making this separation is increased when either prices change rapidly or technology changes rapidly. During the 1970s rapid increases in prices increased the complexity of measuring relative versus pure price changes. There was also the added difficulty of distinguishing permanent versus temporary price changes.

In constructing price indexes, producers are asked to estimate the cost of product improvements, and these costs are used to adjust the product's price index so as not to overstate pure price change. If the quality change is costless or the cost is difficult to identify, however, the price index will not capture the improvement and any price increase will be shown as a pure price increase rather than as an increase in output. This problem is especially acute in industries where there is no physical output and where changes in quality are hard to measure or even observe. Interestingly, the decline in productivity growth in nongoods-producing sectors, such as finance, insurance, and real estate, transportation services, and other services, was much more pronounced than in manufacturing.

Rapid and variable increases in input prices during the 1970s probably made the estimation of the cost of improvements more difficult than during the 1960s. As a result, some overestimation of inflation, which resulted in an underestimate of real output growth may have occurred during this period.

Added to the problem of separating relative from pure price changes was the expanding underground economy. Increasing tax-

ation of inflation gains through bracket creep gave extra stimulus to the underground economy. Higher effective tax rates may help to explain the productivity declines in construction and services where there are significant numbers of sole proprietorships and underreporting of receipts is most likely.

Understatement attributable to the underground economy is more likely to show up as an understatement of receipts and income data than as an understatement of employment. As a result, if the statistical agencies did not adequately adjust for increases in the understatement of noncorporate income during the 1970s, they may have permitted a downward bias to enter the productivity estimates.

*Regulation and the Productivity Slowdown:* In addition to its impact on management efficiency, regulation reduces productivity by increasing capital and labor inputs without an increase in measured output. For example, environmental health and safety regulations in certain industries required new capital equipment designed to reduce pollution and produce environmental and health benefits but not measured output. Studies of these added capital and labor costs to industry estimate that, although government regulations improved the environment, they reduced measured productivity by about 15 percent between 1973 and 1981.

As the costs of these regulations became evident, policymakers began to reconsider the costs and benefits of environmental, safety, and other regulations. Questions were raised about the impact of regulations on costs and productivity of even the oldest of regulated industries. Entry and pricing restrictions in these areas resulted in inefficiencies that raised prices and reduced the quality of services. In recognition of these costs beginning in the 1970s, deregulation began in air transportation, trucking, and railroads as well as in other areas. (Regulation is discussed in Chapter 5.)

#### SOCIAL PERFORMANCE

The failure to reduce poverty in the 1970s was a source of social frustration. Part of the poverty problem appeared to be related to the stop-go policies that affected all families. The poverty rate had reached an all-time low of 11.1 percent in 1973, but the 1974-75 recession raised the rate to 12.3 percent. Economic expansion and a reduction in inflation seemed to improve the poverty rate, but shortly thereafter inflation began to rise and the economy moved in 1980 into a mini-recession. The poverty rate rose from 11.4 percent in 1978 to 14.0 percent in 1981 (Chart 1-3).

Part of the poverty problem was probably related to measurement issues because the official poverty statistics are based on the consumer price index, which in the 1970s and early 1980s overstated

housing costs and inflation. The poverty statistics also exclude non-cash income, a growing component of means-tested benefits. The net effect of these factors was probably to overstate the rise in poverty that occurred between 1973 and 1981.

Another part of the poverty problem appears to have been related to diminishing returns to economic growth. During the 1950s and 1960s increases in median income were accompanied by large reductions in poverty. When median income was lower, a significant proportion of the population was near the poverty income level. As median income rose, a large number of persons were lifted from poverty. By the 1970s, however, the poverty threshold was located in the long flat tail of the lower end of the income distribution, and further shifts in the location of the distribution lifted fewer people from poverty.

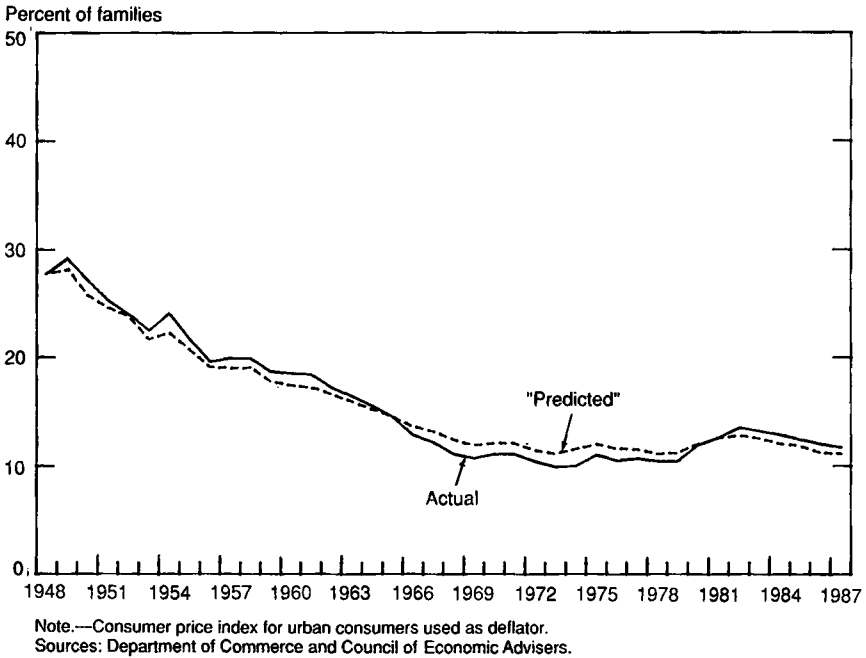
Interestingly, if a fixed distribution of income, such as the 1948 distribution, is used with growth in median income to "predict" the percentage of the population that would have been at low-income levels, it produces a "predicted path" that tracks the actual path quite well (Chart 1-7). Thus, despite the fact that large sums were being redistributed to reduce poverty, the distribution of income was little changed, and the low-income population appears to have been moving along a path that would have been predicted by economic conditions alone. The persistence of large numbers of low-income families and the rise in poverty rates may help to explain why at the time there was a nagging feeling that the effort to invest in people and "to give a hand, not a handout," was failing.

Real spending on public aid increased from \$56.3 billion, measured in 1982 dollars, in 1973 to more than \$87.1 billion in 1981. The programs did benefit some groups. Unrelated individuals and the elderly showed improvement and, despite the poor economic performance over this period, the poverty rate for unrelated individuals fell from 25.6 percent in 1973 to 23.4 percent in 1981 and for those over 65 from 16.3 percent to 15.3 percent.

For other groups a disturbing trend suggested that increased transfers were influencing behavior and fostering dependency. The proportion of births to unmarried women was rising and showed an alarming increase among the most disadvantaged groups. By 1981 more than one-half of all black births were to unmarried women, and for those aged 15 to 24 nearly 70 percent were to unmarried mothers. This development was particularly disturbing because families with the poorest economic outlook were increasing, suggesting that poverty was increasingly becoming a long-run condition for these families. The proportion of the poverty population accounted for by female-headed families grew dramatically, while those headed by a

Chart 1-7

Actual and "Predicted" Proportion of Families  
With Income Below \$10,000 in 1987 Dollars



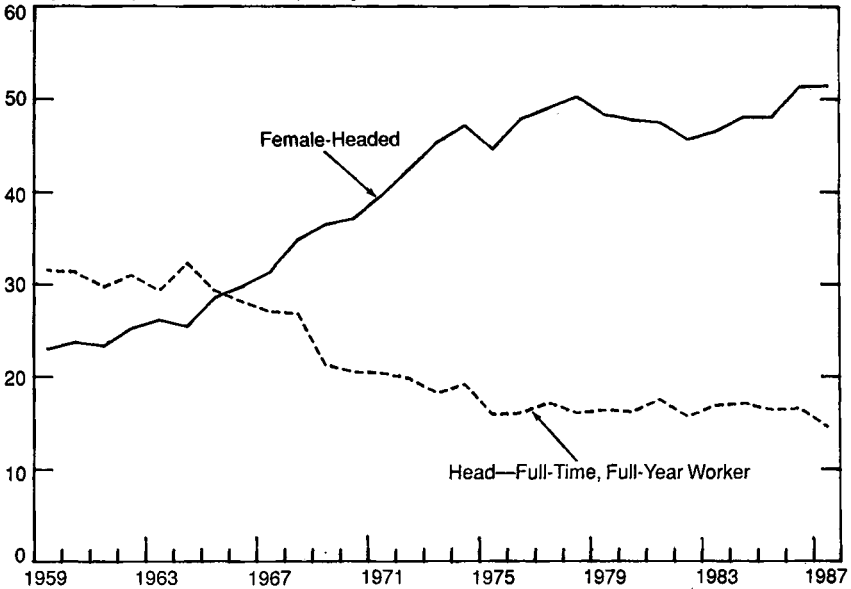
full-time worker declined. The proportion of families in poverty headed by women rose from 23 percent in 1959 to 35 percent in 1968, and rose further to 48 percent by 1981, while those with a full-time, full-year worker as head of the household fell from 31 percent to 27 percent between 1959 and 1968 and to 18 percent by 1981 (Chart 1-8).

An increasing proportion of these families also was headed by women with little or no work experience. With child care responsibilities and expenses and no work experience, job prospects were poor for these women and labor force participation correspondingly low. In 1981 more than 50 percent of black and Hispanic female-headed households were in poverty. Among these poor households only 34 percent of the women worked and only 7 percent worked a full-time, year-round job.

Chart 1-8

### Composition of Families in Poverty

As a percentage of all families in poverty



Source: Department of Commerce.

## THE EIGHTIES: LOWER INFLATION, IMPROVED INCENTIVES, AND IMPROVED PERFORMANCE

This Administration replaced the stop-go interventionist policies of the 1970s with a different view of the role of the Federal Government and of incentives. This view was based on lessons from U.S. economic history: the best performances have been recorded when government has provided stability and relied on the dynamism of the private sector.

The Administration emphasized that government often does best when it improves incentives and encourages private market solutions. The Administration sought to take government back to the basics, delivering the essential services and ensuring the stability that the private sector requires and allowing markets to work, often by providing a framework that gives incentives to private individuals to seek solutions. Desiring not to repeat the failures of short-term discretionary policy in the 1970s, the Administration abandoned discretionary fiscal policy. In its place the Administration has used fiscal policy as a tool for restoring incentives and efficiency, both in the private sector