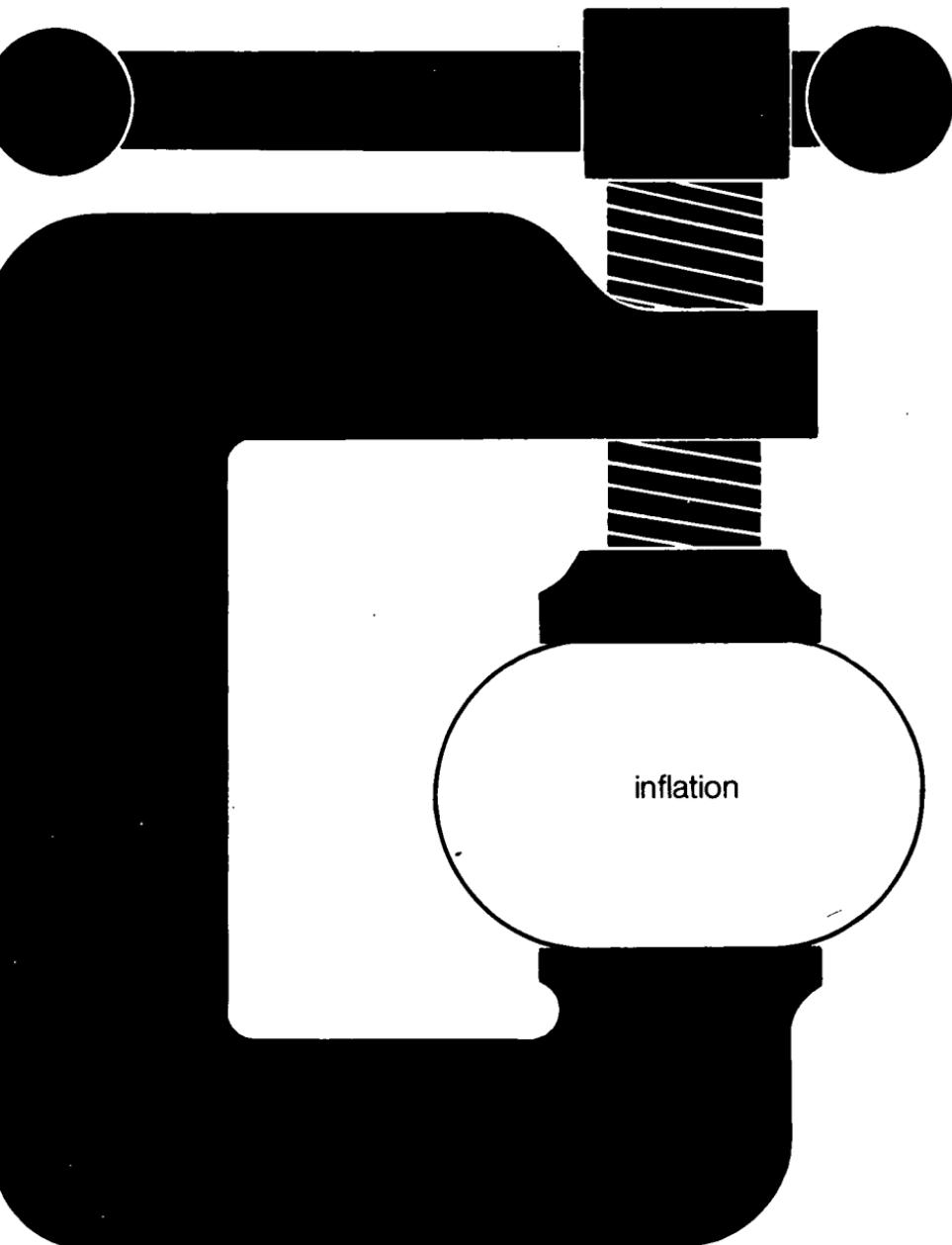


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JOINT ECONOMIC REPORT 1979

Joint Economic Committee/Congress of the United States/Senate Report No. 96-44



96TH CONGRESS }
1st Session }

SENATE

{ REPORT
No. 96-44

THE 1979
JOINT ECONOMIC REPORT

R E P O R T
OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES
ON THE
1979 ECONOMIC REPORT OF
THE PRESIDENT
TOGETHER WITH
SUPPLEMENTARY AND ADDITIONAL VIEWS



MARCH 22 (legislative day, FEBRUARY 22), 1979.—Ordered to be printed

Printed for the use of the Joint Economic Committee

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(Created pursuant to sec. 5(a) of Public Law 804, 79th Cong.)

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¹ Due to the appointment of Senator Sarbanes on Mar. 5, 1979, to the Committee, he was unable to participate in the recommendations and views in this report.

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**REPORT ON THE 1979 ECONOMIC REPORT OF THE
PRESIDENT**

MARCH 22 (legislative day, FEBRUARY), 22, 1979.—Ordered to be printed

**Mr. BENTSEN, from the Joint Economic Committee,
submitted the following**

R E P O R T

together with

SUPPLEMENTARY AND ADDITIONAL VIEWS

[Pursuant to sec. 5(b)(3) of Public Law 304 (79th Cong.)]

This report is submitted in accordance with the requirement of the Employment Act of 1946 that the Joint Economic Committee file a report each year with the Senate and the House of Representatives containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report. This report is to serve as a guide to the several committees of Congress dealing with legislation relating to economic issues.

All statistics appearing in this report were current as of March 7, 1979, when it was sent to the Government Printing Office.

(1)

I. CHAIRMAN'S INTRODUCTION

For the first time in 20 years, the Annual Report of the Joint Economic Committee is a unified report endorsed by both the Majority and the Minority Members of the Committee. Policy disagreements among Committee Members naturally remain and those departures from the Report are spelled out in supplementary and additional views. But this Report illustrates an emerging consensus in the Committee and in the country that the Federal Government needs to put its financial house in order and that the major challenges today and for the foreseeable future are on the supply side of the economy.

The Report focuses on the underlying issue of the capacity of the economy over the long term to increase the standard of living for the average American, to create a job for every American who wants to work and to help hold down the cost of living by increasing the goods on the shelves of the Nation's businesses.

This Report reaffirms the traditional Joint Economic Committee's concern about unemployment. The key to our success as a nation has been freedom, not just political and religious freedom, not just freedom of the press, but the freedom to succeed, the freedom of opportunity. Throughout our history, a job has been the passport to success in America.

We have learned that the problem of inflation does not yield to quick or easy solutions. Policies of excessive restraint and of wage and price controls have both failed. The Report recommends moderate fiscal restraint, endorses the Administration's voluntary guidelines and encourages adoption of incentives to increase savings and investment.

To post World War II economists, the basic economic problem was to insure an adequate level of demand. Insufficient demand was the main economic problem of the depression era. Excessive demand was the main economic culprit during World War II. So it was not surprising that economists were preoccupied for almost 30 years with the problem of maintaining an adequate level of demand in the economy. The Arab oil embargo and the subsequent behavior of the OPEC cartel suddenly and dramatically began to force the attention of the country and its economic experts on the supply side of the economy.

The Report emphasizes the need to stimulate job creating new investment. It recommends consideration of incentives to promote industrial research and development. It calls for a more rational and effective Federal regulatory system. It recommends reducing our reliance on OPEC energy by accelerating research efforts to reduce the cost of coal pollution abatement facilities and to develop secure nuclear waste storage systems. It emphasizes the need to substitute Mexican and Canadian energy supplies for overseas sources. All of these recommendations are designed to advance the theory that expanding the capacity of the economy to produce goods and services efficiently is the most effective policy to combat the major economic ill of our time—stagflation.

The 1979 Annual Report addresses the problem of unemployment, particularly structural unemployment, in detail. The Committee recommends expansion of current Federal manpower training programs. It calls for beefing up the CETA program by improving the link between that program and the private sector. It also recommends significant strengthening of economic development programs to reduce the Nation's unemployment rate, particularly among disadvantaged Americans. The Committee calls upon the Administration to publicize the new jobs tax credit proposal so that it can be an effective employment device. It recommends new incentives for private sector employment and it calls upon the Administration to prepare a standby program for employment in the event that the unemployment rate rises significantly. In addition, the Committee is quite critical of the Administration's assessment of the magnitude of the economic policy changes required by the targets established under the Employment Act as amended last year.

This Committee recognizes that the term structural unemployment is a cold, clinical term which really does not capture the human dimension of the problem. Too many blacks, too many Hispanics, too many young people remain jobless and often without much hope of participating in the economic life of our nation. The recommendations in this Report would not solve the problem completely. But they are sound, solid recommendations that underline the obligation—the economic, moral, and humanitarian obligation—we as a nation have to foster opportunities for employment.

The Report stresses the growing interdependence of the United States and the world economy. It recommends greater international co-ordination of macroeconomic policies to achieve a better United States trade balance. It urges greater emphasis on export assistance for small- and medium-sized firms and scrutiny of the laws and regulations currently inhibiting U.S. exports. It indicates that unilateral measures to encourage surplus countries to meet their international obligations may be necessary. Finally, it endorses the initiative taken by the U.S. Treasury to study a plan to accommodate the changing role of the dollar.

Bipartisanship during critical periods in our history has served this nation well. This is the right time for a great deal more bipartisanship in economic policy as we try to pursue remedies to fight simultaneously high inflation and high unemployment. I would welcome that bipartisanship and I hope this Report contributes to it. The severe economic problems we face require the kind of national unity which has so often been the hallmark of the American people when confronted with difficult challenges.

II. THE ECONOMIC SITUATION AND OUTLOOK

THE ECONOMY IN 1978

Recovery from the recession of 1974-75 continued at a healthy but reduced pace in 1978, with real gross national product (GNP) growing 4.3 percent between the fourth quarter of 1977 and the fourth quarter of 1978. Particularly heartening was the continuation of the long-awaited revival of capital spending, as nonresidential fixed investment registered a gain of 8.5 percent in real terms.

Despite rapidly rising interest rates last year, home construction continued at a pace of over 2 million units started, and our export performance improved in the second half of the year.

The most positive economic development of 1978 was the enormous growth of employment. Between the fourth quarter of 1977 and the fourth quarter of 1978, civilian employment increased by over 3.5 million persons and the unemployment rate dropped from 6.6 percent to 5.8 percent. The Nation's industrial capacity continues to be heavily utilized with manufacturing capacity utilization in December up to 85.9 percent compared with 83.0 percent in December 1977.

With employment growing virtually as rapidly as real GNP, there has been little room for productivity growth. Fourth quarter figures showed that output per hour for all persons in the private business sector of the economy grew only 0.5 percent during 1978.

Last year's results are difficult to explain on the basis of past experience as the growth of employment usually falls below the growth of GNP. It is also hard to estimate how rapidly the employment situation might deteriorate if the economy slows down as it is expected to do in 1979. However, considering the large cushion of employees with which firms appear to be armed, there could easily be large layoffs and a very sharp increase in the unemployment rate if the economy slows substantially.

In addition to the coal strike, the most serious problems besetting the economy in 1978 were the accelerating inflation rate and the precipitous decline in the value of the dollar. Table II-1 shows the inflation rates during the decade of the 1970's. The first four columns show the growth of overall consumer prices and their three major subcategories, and the last two columns trace the growth of compensation per man-hour and unit labor cost.

TABLE II-1.—MEASURES OF INFLATION IN THE UNITED STATES, 1970-78
[Annual rates of change]

	Consumer price index (all items)	Food component	Commodities less food	Services	Compensation per man-hour ¹	Unit labor cost ¹
1970	5.9	5.5	4.1	8.1	7.1	6.4
1971	4.3	3.0	3.8	5.6	6.7	3.3
1972	3.3	4.3	2.2	3.8	6.3	2.8
1973	6.2	14.5	3.4	4.4	8.2	6.2
1974	11.0	14.4	10.6	9.3	9.1	12.5
1975	9.1	8.5	9.2	9.5	9.9	7.7
1976	5.8	3.1	5.0	8.3	8.7	5.4
1977	6.5	6.3	5.4	7.7	8.1	6.0
1978	9.0	11.8	7.7	9.3	9.2	8.9
1978:1	9.3	16.4	6.1	9.1	12.1	17.4
1978:2	11.4	20.4	7.2	11.8	8.1	6.8
1978:3	7.8	3.0	7.8	10.3	10.4	6.7
1978:4	7.9	7.8	10.1	5.7	8.6	6.4

¹ Compensation per man-hour and unit labor cost data are for the private business sector.

Source: U.S. Department of Labor, Bureau of Labor Statistics.

Following the explosive price behavior of 1974, the inflation rate decelerated in 1975 for all categories except services, with further deceleration continuing for all major components into 1976. In 1977 the rate of increase of the Consumer Price Index (CPI) once again increased, and it has continued to rise. Consumer prices increased 9.0 percent between December 1977 and December 1978. Food prices rose at double-digit rates in the first half of the year, and the cost of services was not far behind. Commodities less food remain just above the 10 percent inflation rate, and they are showing a disconcerting tendency to accelerate. Underlying this acceleration is a renewed rise in the rate of increase of employee compensation per man-hour which, in conjunction with the poor productivity performance noted earlier, has been pushing up unit labor costs at steadily increasing rates.

On October 24, 1978, the President promulgated a set of specific standards designed to bring about a deceleration in the rate of wage-price increase. (The standards are discussed in detail in Chapter IV.)

The President's new program was described as voluntary and therefore appeared to be lacking in muscle. However, it did contain the threat that Federal Government contracts would be withdrawn from firms that failed to comply with the guidelines. This aspect of the program produced complaints from those who believe that government procurement should be on the most efficient basis possible, and it also raised concerns among those who felt that a direct price control program had been instituted without congressional authorization.

The immediate reaction to the President's announcement of October 24 was one of disappointment, if a sharp decline in the stock market and a continuing decline of the dollar in international currency markets can be taken as guides. The feeling, evidently, was that the new program was too feeble to make headway against the rising inflationary momentum and that far stronger measures were needed.

Additional measures were invoked on November 1. The President announced that a \$30 billion pool of foreign exchange was being assembled for the purpose of intervening in foreign exchange markets to prevent further declines in the international value of the dollar. Simultaneously, the Federal Reserve increased the discount rate a full

percentage point to 9.5 percent. And finally, the President announced his determination to cut Federal Government spending in the budget to be proposed in 1979 by enough to reduce the deficit for fiscal year 1980 to \$30 billion or less. These measures meant that both fiscal and monetary policies were becoming steadily more restrictive. (The international monetary actions are discussed in Chapter III.)

THE OUTLOOK FOR 1979 AND 1980

As we look ahead into 1979 and 1980, the best characterization is "highly uncertain." The views of professional forecasters range from the optimistic "soft landing" projected by the Administration to the more common "mild recession" predicted by many private economists.

One of the striking features about the private forecasts is that although many project a mild recession, a variety of explanations is offered. Data Resources, Inc. (DRI), for example, forecasts that an automobile strike will topple the economy into a mild recession. Chase Econometrics anticipates that sharp increases in the interest rates and inflation, coupled with tighter monetary policy in the first half of the year, will cause problems later. Some economists argue that low saving rates and heavy debt burdens will cause the consumer to slow his spending, and this will precipitate the slowdown. Others observe that the current recovery is already "old" by most standards, and it is now time for a recession. None of these forecasts include the serious impact which developments in Iran might have on the U.S. economy.

There are at least two possible conclusions to be drawn from the fact that the forecasters predict a recession but disagree about its causes. One is that the U.S. economy may be in such a fragile condition that any one of a wide variety of events could knock it off track. Another possible conclusion is that the private forecasters are wrong about a recession and the Administration's forecast of slow growth without recession is correct.

A convenient way to survey the forecasts is to begin with the various components of the GNP as they are discussed in the *Economic Report of the President*. Although the individual components are each within a reasonable range, the Council of Economic Advisers (Council) projections invariably fall at the optimistic end of the ranges. This approach leaves little room for errors to offset one another. If any part of the Administration's forecast is incorrect, the economy is likely to be weaker than is presently assumed by the Administration. In these uncertain times, it is refreshing to see that one forecaster, Data Resources, Inc., admits that its own forecast has less than a 50-50 chance of being realized. At the same time, the forecast published on February 1 by Wharton Econometric Forecasting Associates notes that while they do not predict a recession, "declines in GNP fall within the normal error bounds."

Consumption

The Council estimates that personal consumption expenditures will rise $1\frac{3}{4}$ to $2\frac{1}{4}$ percent during 1979. This would be consistent with a very slight rise in the saving rate if personal income grows as ex-

pected. Private forecasters are much more modest, generally projecting rates at the low end of a 1 to $2\frac{1}{4}$ percent range.

While many factors must be considered in reviewing the consumption outlook, one which may have been given inadequate attention is the impact of the social security tax increase. This year the taxable earnings base is scheduled to rise from \$17,700 to \$22,900. When this is entered into an econometric projection, the increase is adjusted so that it is spread out smoothly over the entire year. Consumers, however, may view the situation differently. Last year a family with a \$30,000 income stopped paying social security taxes in early August and enjoyed a larger paycheck in the last few months of 1978. This year because of the tax increase, that same family must wait until October before the social security deduction stops. This is likely to have a negative impact on consumer behavior in the last quarter of 1979, the period when many economists are projecting a weaker economy for other reasons.

Business Fixed Investment

The Council's report projects that business fixed investments will grow 4 to $4\frac{1}{2}$ percent during 1979. They note that this is substantially higher than the Commerce Department's survey of investment intentions which forecasts less than 3 percent growth but they also note errors in the Commerce estimates in the past 3 years.

While it is true that the Bureau of Economic Analysis surveys have tended to be low, most of the error can be explained by a higher than anticipated inflation performance. For this reason private forecasters do not hesitate to project lower rates of growth. Data Resources, for example, expects business fixed investment to *decline* by more than 1 percent during 1979, and other forecasters expect even larger declines.

Much of the disagreement about the likely path of investment stems from differing estimates of the anticipated growth in business profits. The Administration projects an increase of over 12 percent, while some private forecasters consider 3 to 4 percent growth more likely. The Administration's projection depends on economic growth remaining firm in 1979 and on a very successful wage and price guidelines program. If wages grow more rapidly than the Administration hopes, this would reduce profits and lower investment.

Housing

As noted earlier, housing has remained an area of substantial strength in the current economy. There is widespread agreement that residential construction will slow from its current level of over 2 million units started, and it began to slow early in 1979. But no one expects the sort of crash which would have been experienced in earlier years. The new money market certificates are widely credited with this improvement. Forecasters are generally agreed that housing starts will average $1\frac{1}{2}$ to $1\frac{3}{4}$ million units in 1979.

Inventories

If there is a single reason for expecting any possible slowdown to be a mild one it is the behavior of inventories. While previous reces-

sions have been preceded by an unwanted buildup of stocks, businessmen in recent years have become quite cautious. Inventory-to-sales ratios have remained relatively low, and therefore, large corrections do not appear likely.

Net Exports

During 1978 exports grew faster than imports causing our net deficit to decline. The reduction in the deficit provided support for the expansion in 1978, and this can be expected to continue this year. This is true despite the large deficit in the U.S. merchandise trade account. Forecasters are generally agreed that the combination of the dollar depreciation and the slow growth of the U.S. economy relative to the slow growth of the U.S. economy relative to the rest of the industrial world will result in a further improvement in our net export balance during the coming year.

We must note, however, that these forecasts were made prior to the recent developments in Iran. The disruption of Iranian oil production and the change of government means that Iran will export less petroleum and consequently will be able to pay for fewer U.S. imports. The magnitude of these changes is unknown at this time. It is possible that other oil exporting nations will offset some of the slack and correspondingly increase their purchases of U.S. goods. Unfortunately, it is now clear that developments in Iran will cause larger oil price increases than had been anticipated, producing a negative impact on the U.S. economy.

Government Demand

According to the President's budget recommendations, Federal purchases will increase very little in real terms following a small decline in 1978.

The Administration expects a substantial decline in State and local government activity from the 3½ percent growth rate experienced last year, the more so if the State share of revenue sharing were reduced or eliminated.

There can be little doubt the Government will exercise a restraining force on economic growth in 1979 and well into 1980. According to the Council's projections, fiscal policy as measured by the full- or high-unemployment surplus will move some \$8 to \$10 billion in the direction of restraint from 1978 to 1979. The movement from 1979 to 1980 will be an even larger \$15 to \$16 billion. If, as has often been the case, the Council has underestimated the rate of inflation by 1 to 2 percentage points, then the movement toward restriction would be some \$10 to \$13 billion in 1979 and another \$24 to \$30 billion in 1980. The Committee's recommendations outlined in this Report would produce little change in this general move toward fiscal restraint although, as we discuss later, it may be necessary to eliminate some of the additional restraint planned for 1980 if weakness develops later this year.

Employment-Unemployment

As we noted earlier, the high increases in employment in 1978 were unanticipated and difficult to understand. If the economy slows later this year, it is possible that layoffs and a sharp increase in unemployment could occur very quickly.

Further complicating any effort to project an unemployment rate consistent with any real growth forecast is the newly revised potential GNP. Forecasters normally use Okun's law to relate the gap between actual and potential GNP to the unemployment rate. As the gap narrows, unemployment falls. This is true, however, only if the gap is narrowing because actual GNP moves up closer to potential. The Council's report revises potential GNP downward so that it is closer to the actual level expected. Only because of these revisions is the Council able to project a substantial slowdown in economic growth with very little deterioration in the unemployment rate. As discussed in Chapter VI, there are serious doubts about the validity of these revisions, and therefore, we would not be surprised to see an unemployment rate somewhat higher than the Council has forecast.

Wages, Prices, and Productivity

A final and most important factor in the economic outlook is the behavior of wages, prices, and productivity. The Administration has placed great emphasis on the importance of its anti-inflation program, and we endorse most of these efforts. Nevertheless, we are quite concerned that price increases in goods not covered by this program—imported oil and farm products for example—could create the impression that the program had failed despite compliance with the guidelines. In addition, wage and price increases in the areas not covered could produce high inflation even if the guidelines succeed. As discussed later, we feel that additional policies are needed to supplement the anti-inflation program.

In evaluating any inflation forecast, we must always remember that this is the area where forecasters have the poorest track record. In recent years, errors of 1 to 2 percentage points have not been unusual.

The Council has estimated that total employee compensation per hour will increase about 8½ percent in 1979. When combined with their projection of less than one-half percent increase in productivity, this leads to a projection of unit labor costs increasing about 8 percent. If unit labor costs do increase by this amount, it would be very unusual for price increases to slow to a 7-percent rate as the Council expects. This is especially perplexing when combined with the healthy profit forecast noted earlier. A variety of witnesses, including the Chairman of the Federal Reserve Board, testified before this Committee that the Council's inflation forecast is probably too low.

To summarize our general views on the economic outlook, we agree with the Council that there was substantial strength in the U.S. economy in 1978. While the Council's forecast is more optimistic both in the aggregate and its components than the forecasts we have reviewed, we do not believe it is unrealistic. Nonetheless, because there are so many areas of potential weakness, the possibility of a mild recession cannot be ruled out.

III. MONETARY, FISCAL AND EXCHANGE RATE POLICY

INTRODUCTION

When most of the economic news is good, the art of monetary-fiscal policy design is relatively simply. When most of the economic news is bad, policy design becomes more difficult and challenging. However, when policymakers are confronted with substantial amounts of both good news and bad news, the challenges they face are truly formidable. The good news-bad news scenario is the one we face today.

The economy continued its expansion in 1978 although at a somewhat slower pace than that experienced during the earlier years of recovery from the 1974-75 recession. The fourth quarter to fourth quarter growth rate of real GNP was 4.6 percent in 1976 and 5.5 percent in 1977. The growth rate moderated in 1978 to 4.3 percent. This slowdown, while not substantial, was due in part to the tightening of monetary and fiscal policy during 1978.

Despite the slower real growth, the economy continued to exhibit considerable momentum in 1978. Employment rose by 3.5 million and the unemployment rate dropped by more than a full percentage point. Real income gains were experienced in all sectors of the economy, although with the exception of the farm sector, the gains were more modest than those obtained over the previous 3 years. Corporate profits also rose moderately in 1978, and this combined with the continued rise in capacity utilization helped to spur a further 8.3 percent increase in real nonresidential fixed investment.

The growth in real personal consumption expenditures moderated in 1978. Nevertheless, they continued to be a source of stimulus in 1978.

The growth of housing activity slowed to a near zero rate last year, accounting for much of the slowdown in the growth of real GNP over previous years, but the level of housing remained extremely high with housing starts running at an annual rate of about 2 million units. The slowdown in the growth of housing starts is not alarming in view of the fact that the building industry is currently operating at close to capacity. The reason for the continued strength lies in the fact that the availability of mortgage credit has remained high.

The bad news was the acceleration of inflation during 1978 and the weakness of productivity growth. The continued acceleration of inflation in the first month of 1979 (as reflected in the 1.3 percent January increase in the Wholesale Price Index and the 0.9 percent increase in the Consumer Price Index) is the most disturbing development of all. Part of the deteriorating inflation picture can be explained by special factors such as the sharp increase in food prices in the early part of the year and the substantial depreciation of the dollar on foreign exchange markets. However, the accelerating rate of inflation was not due to these special factors alone. On the contrary, during 1978 there

was a marked increase in the underlying rate of inflation—the rate excluding the influence of special factors—of 2 percent or more. This rapid increase in the underlying rate of inflation is what poses the most serious challenge for U.S. policymakers.

In the present situation, the chief objective of monetary and fiscal policy is clear. Reducing inflation must be the top priority of policy for 1979-80. The failure to bring inflation under control will mean jeopardizing the progress we have made in the past several years in extricating ourselves from the worst recession in our post World War II history. Monetary and fiscal policy must be set in a manner that is conducive to a slowing of our inflation rate without triggering a recession.

There is an overwhelming consensus among economists that severe demand restriction is not the appropriate response to the current inflation. Any sharp reduction in dollar GNP under present circumstances would barely put a dent in the present inflation rate but would result in a huge loss of real output, an increase in unemployment, and a reduction in the utilization of capacity. This view was emphasized by the Council of Economic Advisers in last year's *Economic Report of the President* and was reemphasized again by the Council in this year's report. We concur with that assessment.

In the implementation of policies designed to achieve demand restraint, it is essential that we do not ease up on our economic development assistance program or our structural employment programs. On the contrary, these programs must be strengthened.

Additionally, we need to achieve restraint in a manner consistent with an increase in capital investment spending in plant and equipment in order to raise productivity. Productivity growth is essential to our long-run objective of significantly slowing our inflation rate.

The Committee is optimistic that the varied objectives of monetary and fiscal policy can be reconciled under the current circumstances. It should be possible to sustain moderate economic growth with reduced inflation and lower interest rates, while addressing the international difficulties of the dollar. The key is moderation, a policy of gradualism.

We anticipate that interest rates and credit availability to the private sector will ease significantly if the Committee's recommendations for monetary and fiscal policy are followed. As the recovery continues, a gradual reduction of Federal spending, as a percent of GNP and the accompanying move toward budget balance will relieve pressure on the credit markets, freeing funds to meet expanded loan demand without a sharp increase in the rate of money creation.

It is the purpose of this chapter to examine these issues in detail. We begin with a brief review of monetary and fiscal policy during 1978. We then attempt to assess the monetary-fiscal policy outlook for 1979. This is followed by a number of important Committee recommendations regarding the conduct of monetary and fiscal policy. Next, we will review briefly and make recommendations concerning both the revenue sharing and economic development assistance program and our structural employment programs. In the final section of this chapter, we examine the circumstances surrounding and the economic implications of the Administration's November 1 dollar support program.

MONETARY POLICY

In response to the acceleration of inflation and the deteriorating position of the dollar on foreign exchange markets, monetary policy became more restrictive during 1978. There is some dispute among economists concerning the degree of restraint that was applied during 1978, but there is absolutely no dispute over the fact that monetary policy was significantly tighter at the end of 1978 than it was at the beginning. The first 2 months of 1979 provide us with conflicting signals with respect to the direction in which monetary policy is now moving.

Because of the accelerated pace of inflation, movements in interest rates have produced conflicting signals. Nominal interest rates rose dramatically in 1978. The magnitude and pace of the change in the prime rate and the Federal funds rate are documented in Table III-1. Thus, between January 1978 and January 1979, the prime rate and the Federal funds rate increased by 4 percentage points. The most dramatic of those increases occurred in the final months of 1978. This was caused in large measure by the severe tightening of monetary policy occasioned by the November 1 dollar support program and the midyear accelerated pace of inflation. In February 1979 these interest rates remained virtually unchanged from their January 1979 highs.

TABLE III-1.—SELECTED INTEREST RATES, 1975-79

[Percent per annum]

Year or month	Prime rate charged by banks ¹	Federal funds rate ¹
1975.....	7.86	5.82
1976.....	6.84	5.05
1977.....	6.83	5.54
1978:		
January.....	7.93	6.70
February.....	8.00	6.78
March.....	8.00	6.79
April.....	8.00	6.89
May.....	8.27	7.36
June.....	8.63	7.60
July.....	9.00	7.81
August.....	9.01	8.04
September.....	9.41	8.45
October.....	9.94	8.96
November.....	10.94	9.76
December.....	11.55	10.03
1979:		
January.....	11.75	10.07
February.....	11.75	10.06

¹ Average effective rate.

Source: Board of Governors of the Federal Reserve.

Although nominal interest rates are high, real interest rates are much lower. In spite of the fact that nominal interest rates have been rising rapidly, it is not at all clear that real interest rates have been rising as rapidly, if at all. In order to compute real interest rates, it is necessary to subtract from nominal interest rates a value that reflects the influence of inflationary expectations. Whether the expected inflation rate should be subtracted fully is a matter of some dispute. In any event, real interest rates represent the real cost of funds to the borrower and the reward to the lender. The inflation component of the interest rate simply makes up for the declining real

value of the principal. Borrowers are willing to pay this premium because the items to be purchased with the borrowed funds are also rising in nominal value with inflation. Federal Reserve Board Chairman G. William Miller, in testimony before the Committee in December 1978, explained that short-term interest rates have followed the inflation rate very closely over the last several years, including the period since the dollar support program began on November 1. Long-term rates, however, have actually fallen relative to inflation. For example, Chairman Miller stated that the excess of the average mortgage rate over inflation was 3.9 percent from 1955-65, 3.2 percent from 1966-72, just under 1 percent from 1973-78, and barely above zero in 1978. Thus, inflationary expectations and relatively low real interest rates are one reason for the continued relatively strong activity in the housing market and for the moderately strong showing of real nonresidential fixed investment.

The monetary aggregates are also producing conflicting signals. In general, the growth of the monetary aggregates slowed during 1978. From the fourth quarter of 1977 to the fourth quarter of 1978, M-1 (demand deposits and currency) grew at an annual rate of 7.3 percent, down from the 7.9 percent growth rate experienced in 1977. The reduction in the growth of M-2 (consisting of M-1 plus time and savings deposits other than negotiable certificates of deposit at large commercial banks) was somewhat larger. From the fourth quarter of 1977 to the fourth quarter of 1978, M-2 grew at an annual rate of 8.5 percent, down from the 9.8 percent rate registered in 1977. With respect to the growth of M-3 (which consists of M-2 plus deposits at mutual savings banks, savings and loan associations, and credit union shares) the fourth quarter to fourth quarter drop was 2.3 percent—from 11.7 percent in 1977 to 9.4 percent in 1978.

The quarterly pattern of monetary growth during 1978, however, was very uneven, as is made clear in Table III-2. What is noteworthy are the very sharp declines in M-1 and M-2 reported for the fourth quarter of 1978 and the further precipitous declines registered in the first month of 1979. M-3, on the other hand, declined only marginally in the fourth quarter of 1978 and actually increased by 3.7 percent at a seasonally adjusted annual rate in January.

TABLE III-2.—GROWTH RATES OF SELECTED MONETARY AGGREGATES, 1977-78

(Seasonally adjusted at annual rates)

	1977				1978				1979 January
	QI	QII	QIII	QIV	QI	QII	QIII	QIV	
M ₁ ¹	7.4	7.4	8.6	7.4	6.6	9.2	8.1	4.4	-5.0
M ₁₊ ²	(³)	(³)	(³)	(³)	5.0	7.2	6.0	2.5	-----
M ₂	10.9	9.0	10.1	7.9	7.0	8.4	9.9	7.1	-1.1
M ₃ ³	12.4	10.5	11.8	10.1	8.1	8.4	10.4	9.4	+3.7
Monetary Base ³	7.6	8.5	9.7	9.5	10.3	7.8	10.2	9.9	6.1

¹ Revised.² Not available.³ The monetary base consists of member bank reserves and currency held by the public and nonmember banks, with adjustments for reserve requirement changes and shifts in deposits among classes of banks, as computed by the St. Louis Federal Reserve.

Sources: Board of Governors of the Federal Reserve and the St. Louis Federal Reserve.

Although nominal interest rates have been rising rapidly, and the growth of the aggregates has slowed, there is no convincing evidence that a credit crunch is occurring. Part of the reason for this is that loan demand is not inordinately high despite relatively low real rates of interest. This seeming paradox, a moderate demand for investment goods and funds in spite of relatively low real interest rates, may be due in part to inflation's direct effects on investment. Inflation reduces the real value of the nominal depreciation allowances and inventory expenses deductible for tax purposes. This understatement of real expenses causes profits and taxes of corporations and partnerships to be overstated and reduces the real rates of return to, and quantities of, investment and output. In 1978, the capital consumption adjustment and inventory valuation adjustment, a measure of the understatement of depreciation and inventory replacement costs, were in excess of \$18 billion and \$24 billion, respectively, for the corporate sector alone. This \$42 billion was in excess of 20 percent of unadjusted profits. In addition, inflation, especially at high and variable rates, leads to great uncertainty in the calculation of expected returns on future activity. Even activities which still look profitable after inventory and depreciation adjustments may be shelved because of fears that the rate of inflation may shift or that anti-inflation policies may trigger a recession or price controls. As inflation can retard investment, monetary policy ought to take into account both inflation and interest rates and the link between them.

The subject of depreciation allowance adjustments is discussed at greater length in the fiscal policy section of this report.

Problems in the Interpretation of Monetary Policy

As a result of the financial reform measures introduced in 1978, it is now difficult to predict the impact of monetary restraint on the economy. During previous periods of credit restriction, savings and loan associations and mutual savings banks sharply reduced their mortgage lending activity in response to reduced deposit inflows. In earlier periods of rising interest rates, many depositors diverted funds from accounts in these institutions to market securities—usually government securities—which offered interest yields higher than the low ceiling rates available on deposit instruments. The resultant slowing in the growth of deposits to these institutions necessarily led to a contraction in their levels of mortgage lending. Housing credit dried up and home building collapsed.

Because of rising interest rates during 1977 and the first half of 1978, the typical pattern of deposit growth began to emerge. Indeed, by the end of the second quarter of 1978, total deposit growth at savings and loan associations and mutual savings banks declined to the lowest rates since the very low rates attained in 1974. However, with the introduction of the variable ceiling money market certificate on June 1, 1978, deposit growth since the second quarter has accelerated to very strong levels. The adjustment in deposit-rate regulations on June 1 allowed depository institutions to issue 6-month certificates on which the ceiling rate varies weekly according to 6-month Treasury bill rates. This change bolstered the ability of thrift institutions to compete for funds

during periods of high interest rates. By the end of January, the volume of funds in these new certificates for all depository institutions amounted to \$105 billion.

The introduction of these money market instruments does not mean that the housing market will be completely insulated from credit tightening. In the first place, home buyers are sensitive to the higher cost of credit and it is reasonable to assume that high and rising interest rates will lead to at least some softening in the demand for housing. Secondly, the money market certificates are a very expensive source of funds for depository institutions. And since mortgage rates do not rise as rapidly as the short-term rates payable on these certificates, the spread between the cost of new deposits and the return from new mortgages narrows. This has led some people to conclude that any prolonged period of very narrow spreads will cause the depository institutions to restrict the availability of these new certificates. There is some dispute, however, over the likelihood of such an occurrence.

In any event, we do expect some modest slowdown in housing activity in 1979 as a result of the likelihood of continued high interest rates this year and the projected slowing of the economy generally. However, we see no evidence to suggest that home building will be severely hampered. On the contrary, we expect housing starts to remain at the relatively high level of 1.5–1.75 million units in 1979.

The real significance of the new money market certificate lies in the fact that home building will no longer be forced to bear as much of the burden of adjustment caused by credit restraint as it has in the past. The burden of adjustment will now be spread more evenly. A greater share of the reduction in aggregate spending caused by tighter money may now fall on investment spending in plant and equipment. This raises a new question. In view of the apparent relative insensitivity of investment spending and consumer installment spending to changes in interest rates, does it follow that much higher interest rates will be needed in our current economic environment in order to achieve a given reduction in aggregate spending? Unfortunately, we do not as yet have the answer to this question. However, one conclusion does seem apparent. If the reduction in aggregate spending occasioned by tight money does take the form of a sharp slowing in nonresidential capital formation, this will limit our ability to contain future price increases because of the adverse effects that such a development will have on productivity growth. For this reason, a case can be made for the adoption of a change in the monetary-fiscal policy mix to make more capital available for nonresidential fixed investment, a subject we will examine at length later.

The interpretation of monetary policy is made more difficult for two additional reasons. The first has to do with the introduction on November 1, 1978, of yet another financial reform—the automatic transfer of funds. For banks that offer this new service, and for customers who elect to take advantage of it, funds can be automatically transferred from customers' savings accounts to cover the needs for funds in their checking accounts. The growth in the use of this service has been relatively modest to date, but it is expected to grow. The problem this creates is in the interpretation of movements of M-1. Savings accounts are not included as part of M-1. Thus, declines in M-1 could

partly be the result of depositors shifting funds to savings accounts to take advantage of the interest paid on balances in these accounts. Some additional shifting is also likely in view of the recent authorization of Negotiated Order of Withdrawal (NOW) accounts in New York State.

As a result of these new regulations, the Federal Reserve defined a new monetary aggregate, M-1+. It includes M-1 plus all passbook savings accounts at commercial banks and all checkable deposits at nonbank financial institutions (negotiable orders of withdrawal, demand deposits at mutual savings banks, and share draft accounts at credit unions). The quarterly annualized 1978 growth rates of this new aggregate are shown in Table III-2. However, movements in this new monetary aggregate are also an ambiguous indicator of monetary change. As a consequence, the Federal Reserve is in the process of redefining all of its monetary aggregates.

The final development that makes the interpretation of monetary policy more difficult concerns the heightened use of "repurchase agreements"—so-called RPs—during periods of monetary restraint. A repurchase agreement involves the sale of a bank asset—usually, a government or corporate security—to a corporate depositor with an agreement to repurchase it after a short period of time (usually a day or two). This is frequently advantageous to corporate depositors who have temporary "idle" funds. It is also advantageous to the bank since the reduction in deposits occasioned by the sale of the asset frees up reserves, on the basis of which new loans can be made. In other words, an increase in the use of RPs can result in an expansion in the volume of credit even though the money supply has not changed. During periods of high and rising interest rates, banks have an obvious incentive to make greater use of RPs. We have no precise idea of the magnitude of these RPs, but Federal Reserve officials suspect that they were "substantial" in 1978, and of growing importance as the year progressed. As a result, changes in all the monetary aggregates are now less reliable indicators of monetary change than before.

Because of all the problems associated with the interpretation of movements in the monetary aggregates *and* interest rates, we do not feel particularly comfortable making recommendations with respect to either the aggregates or interest rates. We are hopeful that the monetary authorities will conduct their policy in a manner that is consistent with a slowing of inflation, a lowering of interest rates, and a sustained level of economic activity. In this regard, the Federal Reserve in its *Monetary Policy Report to Congress* (pursuant to the Full Employment and Balanced Growth Act of 1978) issued on February 20, 1979, listed its targets for the monetary aggregates as follows: from the fourth quarter of 1978 to the fourth quarter of 1979, M-1 is projected to grow between 1.50 and 4.50 percent; M-2, 5 to 8 percent; and M-3, 6 to 9 percent. These figures represent a modest reduction in the Federal Reserve Board's previous targets. After adjusting for the expected shifts of funds to savings accounts with automatic transfer services (ATS) and to NOW accounts, the 1.50-to-4.50 range for M-1 is estimated to be equivalent to a 4.50-to-7.50 range by former standards. Thus the targeted growth for M-1 is not that much lower than the earlier target.

In the eyes of the Board of Governors of the Federal Reserve, these targets are viewed as being "reasonably consistent" with the Administration's economic goals. If the Administration's economic goals are achieved with this monetary policy in 1979, we believe it is reasonable to expect that there will be some moderation of inflation and interest rates in the current year.

Recommendation No. 1

We believe that the sharp dip in the growth rates of the monetary aggregates over the past few months was larger than desirable. It is our conviction that the Federal Reserve should allow the aggregates to grow in the ranges of their targets for at least the next several months. Such a policy would be in conformity with the Federal Reserve's goal of a gradual reduction in money supply growth.¹

FISCAL POLICY

Fiscal policy also shifted toward restraint during 1978. This is evidenced most clearly in the sharp decline of the high employment budget deficit between 1977-78 and its continuous decline during 1978. The high employment budget is a measure of what the budget would have been had the economy been operating at its potential, assuming unchanged expenditure and tax policies.

The magnitude of the decline in the high employment budget deficit was partly accidental. The higher than expected rate of inflation, which moved individuals into higher tax brackets during the year, and the slower than expected growth in government spending, which the Administration made no attempt to offset, were important contributing factors. The rest of the decline can be explained by four factors that had been anticipated: (1) real growth which shifted individuals into higher tax brackets; (2) the slower growth in public service employment which peaked in the spring of 1978 at about 725,000 jobs; (3) the cessation of antirecession fiscal assistance to State and local governments; and, (4) legislated increases in social security taxes.

A relevant fiscal measure both for questions of economic activity and for the capital market is not the Federal budget alone but the consolidated budget of the entire government sector—the Federal sector and the State and local sector combined. Accordingly, the large surpluses of State and local governments must be netted against the Federal deficit. Thus, on the basis of the consolidated budget of Federal, State, and local governments in the national income and product accounts, the budget was nearly in balance in 1978. The consolidated budget deficit was only \$1.5 billion in 1978, down sharply from the combined deficit of \$18.6 billion in 1977. Fiscal restraint at the Federal Govern-

¹ Senator Proxmire states: "The dip in growth rates of M-1 in the past few months probably reflects, in large part, the transfer of demand deposits to automatic transfer savings accounts and other types of money substitutes such as NOW accounts, security repurchase agreements, and money market mutual funds. The dip in growth rates for M-2 also reflects financial innovations, particularly transfers of time and savings deposits into 6-month money market certificates at thrift institutions. We should avoid preoccupation with short-run changes in growth rates of the monetary aggregates, particularly now when the proper definitions of those measures is open to serious doubt, questioning, and review. The Federal Reserve should seek to achieve its goal of gradually reducing the growth of the monetary aggregates in a manner that is consistent with restraining inflation and achieving the moderate rates of growth in real GNP that President Carter has proposed."

ment level was partially offset by the fact that State and local governments had a much smaller surplus than they had in the previous year.

On a unified budget basis, the Federal budget deficit increased from \$45 billion in fiscal year 1977, which began in October 1976, to \$48.8 billion in fiscal year 1978. However, the magnitude of the increase in the unified budget deficit was dramatically lower than the \$61.8 billion deficit projected a year ago. Virtually all of this \$13 billion decline was the result of the fact that Federal Government spending in fiscal year 1978 grew by \$12.5 billion less than had originally been anticipated. The remaining \$0.5 billion is accounted for by the higher than expected rate of inflation and the somewhat slower than expected real growth for fiscal year 1978.

On a unified budget basis, the budget deficit is expected to decline to \$37.4 billion in fiscal year 1979. Converting this to a national income and product account basis, the Federal budget deficit is expected to decline from \$36.8 billion in fiscal year 1978 to \$32.0 billion in fiscal year 1979. Thus, the fiscal drag stemming from changes in effective tax rates caused by inflation, real growth, and increased social security taxes will more than offset the effective net revenue losses occasioned by the Revenue Act of 1978 for fiscal year 1979. Fiscal policy, therefore, will be modestly contractive during fiscal year 1979.

The budget proposals handed down by the Administration in January of this year imply a projected further reduction in the Federal budget deficit in fiscal year 1980 to a level of \$29 billion on a unified budget basis. On a national income and product account basis, this translates into a budget deficit of \$25.4 billion for fiscal year 1980, \$6.6 billion less than the projected deficit for fiscal year 1979.

The 1980 budget proposed by the Administration constitutes a marked shift in the direction toward greater fiscal restraint. Moreover, the Administration's budget projections also imply that Federal outlays will decline from 22 percent of GNP in fiscal 1978 to 21 percent in fiscal 1980. But all of these budgetary projections are heavily dependent on the economic assumptions made by the Administration concerning the future inflation rate and the future rates of growth of actual and potential GNP. Thus, assuming projected tax and expenditure policies, a higher than expected inflation rate will raise both actual and high-employment tax receipts relative to expenditures, therefore reducing both the actual and the high-employment budget deficit. The opposite effects will result from a lower than expected inflation rate. A higher rate of real GNP growth will reduce both the actual budget deficit and the ratio of federal outlays to GNP. The reverse will occur if GNP growth declines.

On the basis of these considerations, it is apparent that the budget figures for 1979-80 could well differ—and perhaps, substantially—from those projected by the Administration even though tax and expenditure policies as planned remain unchanged.

Recommendation No. 2

The Joint Economic Committee strongly endorses the adoption of budgetary policies designed to achieve the reduction in the deficit projected by the Administration for fiscal year 1980.

In our view, the Administration's outlook and the attainment of a reduced deficit for fiscal year 1980 are consistent economic goals. If economic events unfold as the Administration expects for 1979-80, these policies will result in a substantial budget deficit reduction for fiscal year 1980. If, on the other hand, economic events unfold differently, these policies could yield a budget deficit that is higher or lower than projected by the Administration. Barring very dramatic departures of the economy from its projected path, we feel it is appropriate to maintain austere budgetary policies.

Recommendation No. 3

The Committee supports the basic trend of the President's budget, both for fiscal year 1980 and projected into future years, toward a reduced share of Federal outlays in the gross national product. Further reductions in the share of the Federal sector can be attained by additional reduced Federal spending and tax cuts.

It is the Committee's view that the Administration's current budget proposals do not provide for sufficient improvements in incentives for capital formation and saving. We are persuaded that a very high rate of capital formation is needed if we are to succeed in reversing the disastrous course of productivity growth in the American economy. We are also persuaded that a high rate of productivity growth is essential to the success of our long-run goal of significantly slowing inflation.

Additional paring of government expenditures would not be easy, of course. Further savings are possible in the fiscal year 1980 budget if the Administration fails to win congressional approval for some of its newly proposed programs. In addition, savings amounting to \$2.28 billion could be made if the States were excluded from the revenue sharing program. We also believe that efforts to reduce Federal spending should not be limited only to direct expenditure programs. Tax incentives should be examined to make sure they are effective in meeting their objectives.

Finally, we are convinced that other savings are possible through the elimination of waste and the attainment of greater economy throughout the Federal Government.

Over the past several years, we have witnessed a dramatic change in our monetary-fiscal policy mix that has contributed to our sluggish productivity growth and our unacceptably high rate of inflation. Many witnesses appearing before our Committee have noted with alarm the change in the mix adopted over the last decade. Thus, we have pursued a policy that favored tighter money whenever the inflation rate accelerated, followed by budgetary policies designed to offset the negative employment effects of tighter money. As a consequence, there has been a decided change in the composition of output away from capital investment toward higher levels of consumption. This has contributed significantly to our sluggish productivity performance, which in turn has exacerbated our underlying rate of inflation. The policy mix needs to be changed. Our recommendations in this regard follow:

Recommendation No. 4

If aggregate demand pressures continue to mount in the months ahead, and if it is determined that these pressures are contributing to our inflation problem, therefore requiring a further policy-induced restraint on demand, the additional restraint should come about through a tightening of fiscal policy, not through a tightening of monetary policy. Fiscal policy must shift to the forefront in the fight against inflation.

Recommendation No. 5

If the growth rate of real GNP in the months ahead falls below the rate projected by the Administration and if it is determined that this shortfall needs to be offset by further stimulus, the additional stimulus should come about through an easing of monetary policy, or a tax cut, or both.²

If the inflation rate continues to accelerate and the growth of real GNP falls below the rate projected by the Administration, it would be inappropriate to offset the accelerating inflation with a further tightening of monetary policy. Tighter money would have little immediate effect on inflation but would exacerbate the losses in output and employment. If the source of such "stagflation" is caused by a "supply shock", such as an unexpectedly large increase in oil prices, it should be accommodated by a one-shot increase in the growth of the money supply. If, on the other hand, the source of the problem lies elsewhere, policy-makers will need to consider fiscal or monetary policy changes, or both, designed to slow inflation and raise real growth.

Recommendation No. 6

From a longer run perspective, we need improved incentives to foster savings and investment and job creation.

Rationale for Committee Recommendations

In our view, sluggish productivity growth is the most important factor contributing to our present economic malaise. We agree with the Administration that reducing inflation must be the top policy priority for 1979 and 1980 and for the years beyond as well. However, if we are to make any real headway in the fight against inflation, we must reverse dramatically our recent disastrous productivity slump. Widespread compliance with the Administration's wage and price standards will take us part of the way toward our goal. Reducing the

² Congressmen Moorhead and Reuss state: "If in the months ahead the growth of real GNP falls below the rate projected by the Administration, our first line of defense should be an easing of monetary policy in order to provide additional stimulus for capital formation and housing, both of which will be standing in need of assistance. If monetary easing is insufficient, supplementary fiscal stimulus may be required. In that case, we should be prepared to consider both tax and expenditure policy changes. We do not feel that we should lock ourselves into a policy recommendation that favors a tax cut only, as this Committee recommendation does, no matter what the source of the real GNP shortfall. As future economic events unfold an increase in government spending directed, perhaps, at alleviating the problems of the structurally unemployed might be more appropriate, either by itself, or in addition to some kind of tax cut. The nature of future fiscal policy changes should be determined by what is then most desirable economically and socially."

costs of governmental regulation will also be of assistance. But these programs, in conjunction with an overall policy of demand restraint, may still leave us with an unacceptably high rate of inflation which, barring some fundamental policy changes, could persist well into the future. A continuation of our past productivity performance will virtually guarantee a continuation of inflation.

The connection between our productivity problem and our inflation problem is much more complicated and fundamental than is frequently recognized. Appeal is often made to the fact that the growth in unit labor costs and the underlying inflation rate move virtually in tandem with one another. Thus, since the growth in unit labor costs is defined as the difference between the growth in employee compensation and the growth in productivity, one conclusion becomes self-evident. Had the growth in productivity been more rapid, the underlying rate of inflation increase would have been less rapid. All too often the analysis ends there, punctuated by a plea indicating that more ought to be done to improve productivity.

More probing questions need to be asked. What effect does inflation have on capital formation directly? Does inflation retard capital investment spending, and if so, how? What effect does sluggish productivity growth have on the growth of employee compensation? Does it reduce the compensation offered to labor by business? Does it lead to an acceleration of wage demands, and if so, why?

What effect does sluggish productivity growth have on the design of overall macroeconomic policy? Is such a policy design consistent with a rapid rate of capital formation? In the discussion that follows, we will attempt to provide at least partial answers to these questions. (The subject of productivity is discussed in more detail in Chapter IV.)

With respect to the question of the direct effect of inflation on capital formation, the evidence is mounting that inflation significantly retards capital investment spending. The main reason given for this adverse effect is simple. Present law requires firms to expense their plant and equipment purchases on a "historic cost" basis only, even though inflation raises their replacement costs. If firms were permitted to depreciate assets on a "replacement" rather than a historical cost basis, depreciation charges would be raised, nominal profits would be lowered, and so would corporate income tax liability. If there were no inflation, the method of accounting would make no difference. Thus, under presently required accounting practices, a rise in the inflation rate lowers real after-tax profits and, therefore, reduces the real after-tax rate of return on fixed investment. This means that there is a direct adverse link between the rate of inflation and the level of capital spending. Even if demand is high, capital spending and the supply of output in general may be low if the after-tax real rate of return is inadequate.

A quantitative estimate of the adverse effect on profits of current depreciation rules was provided by Dr. Martin Feldstein who testified before the Committee as follows:

We estimate that the historic cost method of depreciation caused corporate depreciation in 1973 to be understated by more than \$25 billion. This understatement increased cor-

porate tax liability by \$12 billion, a 20 percent increase in corporate taxes. This extra inflation tax reduced net profits by 23 percent of the total 1973 net profits of \$53 billion.

Dr. Feldstein concluded by stating that he thought this was the single most important adverse effect of inflation on capital formation.

The evidence respecting the influence of sluggish productivity on the growth in employee compensation is less conclusive and more qualitative. When productivity growth is rapid, sizable increases in real per capita income are possible. And when these gains are realized year after year, as they were in the 1950's and 1960's, people come to expect their realization in future years. The mechanism for achieving these expected gains takes the form of wage demands significantly in excess of the expected rate of inflation. Of course, in an environment characterized by weak productivity performance, the expected real gains cannot possibly be realized. The higher rate of employee compensation is simply whittled down in real size through a higher than expected actual inflation rate and by higher tax rates levied on higher nominal incomes. Low productivity and rising marginal tax rates then become contributing factors to the all too familiar wage-price treadmill.

Because of the effect that inflation has on the real after-tax rate of return on investment, and because of the further effect that slow productivity growth, rising inflation, and higher tax rates have on the growth of employee compensation, it becomes apparent why a high rate of capital formation is essential to our eventual success in the fight against inflation.

Our dismal productivity performance has also had a decided impact on the design of overall macroeconomic policy in the United States. This is evidenced most clearly in the monetary and fiscal policies that were adopted in 1978 and in the policies the Administration and the Federal Reserve intended to pursue in 1979-80 in line with the economic outlook. It is important to examine carefully the case made by the Administration because the implications of its proposed demand restraint program could be significant in terms of future capital investment spending and productivity growth.

At the outset, it must be recognized that one of the main requirements of a program to raise the rate of capital formation is to ensure that the growth of the economy is sustained at a high level and not interrupted by a recession. New capacity will not be installed if there is no reasonable assurance that it will be regularly used. The generation of excess capacity frequently results in the postponement or cancellation of capital projects.

In the 1979 *Economic Report of the President*, the Council of Economic Advisers went to great pains to explain their justification for a demand restraint program. The Administration was concerned that in the absence of a demand restraint program, demand pressures would mount and add to our inflation problem. The Council concluded that demand pressures were not an important contributing factor to the accelerated pace of inflation in 1978. Capacity utilization in manufacturing, as measured by the Federal Reserve Board index, had increased during 1978, but by comparison with earlier periods of high demand,

it was not inordinately high. Capacity utilization was somewhat below the highs experienced in the 1972-74 period and significantly below the highs of the early 1950's and mid-1960's. Additionally, on the basis of the ratio of unfilled orders to shipments, no evidence could be found to support the contention that industrial capacity generally was under severe pressure in 1978.

A similar conclusion emerged from the Council's careful and detailed examination of labor market developments during 1978. The speed of the decline in unemployment did cause some acceleration of wages in the first half of the year, and some marginal additional inflation was caused by the 1978 minimum wage increase. On balance, however, labor market demand pressures were not a significant source of inflation in 1978.

On the basis of these statistical measures, then, the Council was apparently hard pressed to make a strong case for a tough demand restraint program. Indeed it is possible to interpret the Council's evidence in a way that would suggest that there still exists a comfortable margin of safety. It can be argued that a further moderate rate of expansion, a further lowering of the unemployment rate, and a further increase in the rate of capacity utilization would not run the risk of generating much excess demand.

When the Council turned its attention to the study of the implications of our productivity slowdown, however, its case for demand restraint was made much easier. The Council concluded that the long-term trend of productivity growth was now significantly below even the estimated trend they believed was reasonable when they wrote their reports in 1977 and 1978. As a consequence of this downward revision of the long-run trend of productivity growth, the Council was forced to revise downward its estimate of potential GNP. The Council stated its case in its report in the following terms:

It no longer seems reasonable to assume that the exceedingly poor productivity growth in 1973-74 and 1977-78 represented statistical aberrations or one-time events, implying no reduction in the long-term trend. Downward revisions of our estimate of long-term productivity growth and of potential GNP are clearly necessary (p. 73).

The downward revision was dramatic. Thus, on the basis of the methods employed by the Council just a year ago in calculating potential GNP, our actual GNP in 1978 was about 5.6 percent below its potential level. The revisions calculated by the Council this year imply that actual GNP last year was only about 2.7 percent below its potential level and in the fourth quarter of 1978 it was only 1.8 percent below its potential. As stated by the Council:

* * * the economy has approached the point where the overall margin of unused resources is very slim (p. 77).

In view of this "very slim" margin of unused resources, and in order to ensure that demand pressures do not add to existing inflationary forces, the Administration has proposed a demand restraint program designed to slow the rate of growth of real GNP to $2\frac{1}{4}$ percent over the four quarters of 1979, down sharply from the 4.3 rate realized in 1978. For the four quarters of 1980, its projected growth rate is $3\frac{1}{4}$

percent. Given the Council's revised estimated long-term growth potential of 3 percent, the Administration's program is designed to increase somewhat the margin of slack between our actual and potential GNP over the next 2 years. According to the Council's report, this increased margin of slack is deemed appropriate in order that "market forces can work together with the pay and price standards announced by the President on October 24 to moderate inflation." Slack is to be achieved by restraining demand and the growth of actual GNP rather than by a more rapid expansion of the potential supply of goods and services, that is, by a faster rate of growth of productivity and potential GNP.

The demand restraint program could have significant implications for the rate of capital investment spending in the months and years ahead. The problem we face is this: there is no single unambiguous measure of the margin of slack which exists in the United States economy. On the basis of the Federal Reserve Board's index of capacity utilization in manufacturing and the ratio of unfilled orders to shipments, one could easily draw the conclusion that the current margin of slack is still sizable. On the basis of the Council's revised estimate of our potential GNP, one could draw the equally plausible conclusion that the margin of slack is very small. Unfortunately, all of these statistical measures offer us only imperfect guides to the degree of slack that actually exists. Capacity utilization measures are subject to wide margins of error, as are estimates of productivity growth. The Administration decided to place greater reliance on its productivity growth estimates. This led it to conclude that the margin of unused resources is very slim.

We do not quarrel with the Administration's proposed level of demand restraint. There is considerable uncertainty over the degree of slack that actually exists in the economy. We therefore believe it is appropriate to exercise considerable caution in the design of overall macroeconomic policy in order to guard against the possibility that excess demand pressures will add to our inflation problem.

Even under the best of circumstances, however, there will probably be only a modest increase in real capital spending in 1979 with the Administration's program. At present, the Administration is projecting only a 4 percent real growth in business fixed investment in 1979, measured from fourth quarter to fourth quarter. In view of the uncertainty surrounding the forecast, real business fixed investment could grow much less rapidly. This is all the more likely if the reported capacity utilization figures turn out to represent the actual degree of economic slack, as the proposed level of demand restraint will lower capacity utilization, lower the share of profits in GNP, and raise unemployment. In short, the economic environment might not be conducive to even a modest rate of capital formation. This would hurt our productivity performance.

For all of these reasons, we feel it is appropriate not to change the overall level of restraint, but to accomplish that degree of restraint in the context of a program designed to improve incentives for capital formation. Not only are we anxious to prevent a possible slowdown in real capital investment spending in 1979-80, we are hopeful that tax incentives can be devised to bring about an increase in real business

fixed investment in excess of the Administration's projected 4 percent growth for 1979.

Several tax-incentive options are available to stimulate capital investment spending. Those options that have received the greatest attention include liberalized depreciation allowances, an expanded investment tax credit, and a corporate tax rate reduction. One other option that is in need of further study is to allow firms to shift from a historic cost accounting basis to a replacement cost basis in the computation of depreciation allowances. In the final analysis, however, we leave it to the tax writing committees to devise the appropriate tax incentive policies.

In an effort to put our sluggish productivity performance in perspective, it needs to be recognized that there is a direct link between the growth in productivity and the growth in the capital-labor ratio. The alarming reduction in the growth of the capital-labor ratio over the past several years has been matched by a corresponding alarming deterioration of labor productivity.

The problem, simply, is that the U.S. economy is putting too few of its resources into the expansion of its capital stock. Although the ratio of real business fixed investment to real GNP was close to 10 percent in the early 1970's, as it was in the 1960's, it was well below 10 percent for most of the period since 1975. In addition, the labor force has grown much more rapidly during the 1970's. The growth of the capital-labor ratio has suffered for both reasons. Our capital expansion performance since 1973 has been exceedingly poor. Real capital spending fell sharply during the recession of 1974-75 and revived less rapidly than in preceding recoveries. Fortunately, it showed stronger signs of life in 1977-78, growing at an annual rate of 9.1 percent in 1977 and 8.3 percent in 1978, measured in real terms from fourth quarter to fourth quarter. For the year as a whole, investment rose to 10 percent of GNP, close to the share it maintained from 1960-73.

Despite this stronger performance, real business fixed investment must grow more rapidly still. The cumulative loss of capital stock due to the recession, combined with projections for continued rapid labor force increase, strongly suggests that special measures to promote capital spending are needed if productivity growth is to recover even to the modest levels of 1967-73. Policies that would raise the ratio of investment to GNP to the 11 percent range or more for the next several years would be extremely beneficial. Productivity growth would be restored; inflation would be moderated; our international competitive position would be improved; and productive new employment opportunities would be created.

It should be obvious why we feel it is necessary to gradually change the direction of the monetary-fiscal policy mix. The improper mix adopted in the past has caused interest rates to be substantially higher than they would otherwise have been. The supply of credit to the private sector was depressed, even as low after-tax yields stifled the demand for investment goods. This has also been a contributing factor to the long-run decline in the stock market. Low real economic profits, high interest rates, and low bond prices have attracted funds to the bond market, exerting downward pressure on stock prices. As we emphasized in our *1978 Joint Economic Committee Report*:

The combination of high interest rates and low stock prices creates an environment that is exceedingly inhospitable to

capital spending. High interest rates make borrowing costly, and low stock prices make the flotation of new capital issues difficult and unrewarding. As measured by stock and bond prices, the market value of firms' physical assets is now very low relative to their physical replacement costs. As long as that continues to be the case, the incentive to construct *new* capital facilities will be very weak.

On the basis of the data presented in Table III-3, we reaffirm the position we took a year ago. Moreover, in our view, the clearest way to alleviate this situation is through a change in the direction of the monetary and fiscal policy mix and through improved tax incentives.

TABLE III-3.—DETERMINANTS OF BUSINESS FIXED INVESTMENT

Year	Ratio of market value to replacement costs of assets	Rate of return on equity	Share of invest- ment in GNP
1964-69.....	1.24	7.9	10.3
1975-77.....	.77	5.4	9.5
1977.....	.77	6.2	9.7
1978 ¹70	8.9	10.1

¹ Preliminary.

Source: 1979 Economic Report of the President.

General Revenue Sharing

The General Revenue Sharing Program distributes \$6.9 billion to State and local governments annually. Intergovernmental grants have been among the largest growth sectors in the Federal budget in recent years. Between 1960-80, Federal grants to State and local governments have increased from \$7 billion to the \$82.9 billion proposed in the fiscal year 1980 budget.

TABLE III-4—Federal grants-in-aid outlays

Year:	Millions
1960	7,020
1965	10,904
1970	24,018
1975	49,832
1976	59,094
1977	68,415
1978	77,889
1979 (est.)	82,129
1980 (est.)	82,937

Source: Special Analyzes, Budget of the U.S. Government, Fiscal Year 1980.

Overall budget restraint, hospital cost containment initiative, and the phase-down of the economic stimulus programs (Anti-Recession Fiscal Assistance, Public Service Employment, and Local Public Works) are largely responsible for the relatively slow growth in grants between 1978-80. The funding for the economic stimulus programs, enacted to offset the effect on State and local economies of the recession as well as to stimulate the national economy, has been reduced from \$9.2 billion in fiscal year 1979 to \$2.9 billion in fiscal year 1980.

The recovery of the national economy has been accompanied by record State and local surpluses in 1977-78 in the aggregate, as well

as in the general government surpluses (aggregate minus social insurance funds), although some portion of the surpluses may be attributable to the budget methods used by the States and localities.

While current National Income and Product Accounts (NIPA) data disaggregating the State and local sector into its component parts are not available, the National Governors Association Center for Policy Research and the National Association of State Budget Officers' Fiscal Survey of the States projects a fiscal year 1978 State government budget surplus of \$8.9 billion and a \$4.3 billion surplus in fiscal year 1979.

TABLE III-5.—SURPLUS OR DEFICIT IN STATE AND LOCAL GOVERNMENT OPERATING ACCOUNTS (NATIONAL INCOME PRODUCT ACCOUNT (NIPA))

[In billions of dollars]

Calendar year	Aggregate surplus	Social insurance	General government
1960	0.1	2.3	-2.2
1961	-0.4	2.5	-2.8
1962	0.5	2.6	-2.1
1963	0.5	2.8	-2.4
1964	1.0	3.2	-2.2
1965	0.0	3.4	-3.4
1966	0.5	4.0	-3.5
1967	-1.1	4.8	-5.9
1968	0.3	5.3	-5.0
1969	2.1	5.9	-3.7
1970	2.8	6.8	-4.0
1971	3.7	7.5	-3.8
1972	13.7	8.1	5.6
1973	13.0	8.9	4.1
1974	7.6	10.5	-2.9
1975	5.9	12.1	-6.2
1976	20.7	15.2	5.5
1977	27.8	18.0	11.6
1978:			
Estimated	27.9	21.2	6.6
I	31.5	19.9	11.5
II	29.8	20.5	9.3
III	23.4	21.6	1.8
IV	27.0	22.8	4.0

Source: Survey of Current Business.

According to the data in Table III-6, State government expenditures increased 25 percent between fiscal years 1977-78 and 14 percent between fiscal years 1978-79, an annual average more than double the average annual rate of inflation as measured by the CPI for the same years, and 5 percent above the increase in Federal expenditures.

TABLE III-6.—STATE GOVERNMENT REVENUES AND EXPENDITURES, FISCAL YEARS 1977-79

[In billions of dollars]

	1978			1979, estimated
	1977	Estimated	Actual	
Total funds available.....	88.5	96.6	113.0	123.0
Expenditure.....	83.6	92.5	104.1	118.7
Surplus.....	4.9	4.1	8.9	4.3

Sources: National Governors' Association Center for Policy Research and the National Association of State Budget Officers' "Fiscal Survey of the States."

Table III-7 indicates that between 1977-78, State governments realized a 14 percent increase in adjusted per capita tax revenue exclusive of tax rate increases. In fact, for each year 1975-78, the percentage increase in per capita tax revenue has well outpaced the combination of inflation and population growth. The conclusion is that since the percentage increase in State own-source tax revenues has continued to rise and has kept well ahead of inflation even when the revenue from tax rate increases has been discounted, States appear to be in sound fiscal health. The need for additional Federal funds, i.e., General Revenue Sharing, is therefore reduced.

TABLE III-7.—STATE OWN-SOURCE TAX REVENUES

	State tax revenue per capita	Annual increase (percent)	Percent increase from economic factors ¹	Adjusted per capita increase ²
1975.....	\$376.....	90.....
1976.....	415.....	10.4.....	76.....	8.0.....
1977.....	466.....	12.3.....	85.....	10.4.....
1978.....	532.....	14.2.....	100.....	14.2.....

¹ Excludes tax rate increases.

² Adjusted for population growth and tax rate changes.

³ For year ending September 1978.

Sources: Advisory Commission on Intergovernmental Relations; Bureau of the Census.

States have become increasingly dependent on Federal funds over the years. In 1977 (the most recent year for which data are available), Federal grants to State governments were equal to 46 percent of all State-generated taxes. In other words, for every dollar State governments raised in taxes, they received \$.46 from the Federal Government. It should also be noted that the increase in the size of the Federal sector in the national economy is due principally to domestic transfer payments and grants-in-aid to State and local governments.

TABLE III-8.—STATE REVENUES FROM THE FEDERAL GOVERNMENT AND FROM OWN-SOURCE TAXES

	Federal grants (billions) ¹	State tax revenues (billions) ²	Per capita State tax revenue (dollars) ³
1960.....	6.0.....	18.0.....	\$100.....
1965.....	9.9.....	26.1.....	134.....
1975.....	40.0.....	80.2.....	376.....
1976.....	43.3.....	89.3.....	415.....
1977.....	45.9.....	101.1.....	466.....
1978.....	NA.....	116.0.....	532.....

¹ Survey of Current Business.

² Quarterly summary of State and local tax revenue (Bureau of the Census).

³ For year ending September 1978.

TABLE III-9.—FEDERAL SECTOR EXPENDITURES AS A PERCENT OF GNP

Description	1948-50 average actual	1958-60 average actual	1968-70 average actual	1978-80 average estimated
Defense purchases.....	4.5	9.6	8.4	4.7
Nondefense purchases.....	2.3	1.7	2.4	2.6
Domestic transfer payments.....	3.6	4.1	5.4	8.7
Foreign transfer payments.....	1.5	.4	.2	.2
Grants-in-aid to State and local governments.....	.8	1.3	2.2	3.4
Net interest paid.....	1.6	1.3	1.3	1.8
Subsidies less current surplus of Government enterprises.....	.3	.5	.5	.4
Total expenditures.....	14.6	18.8	20.5	21.8

Source: Office of Management and Budget. "The Budget of the United States Government, Fiscal Year 1980."

Eliminating State governments from the General Revenue Sharing program would be a step in the direction of reducing the dependence of State governments on the Federal Treasury.

Recommendation No. 7

Congress should evaluate the General Revenue Sharing Program and should consider the possibility of reducing or eliminating the portion going to the states.³

Recommendation No. 8

The Committee believes that in the event of a recession in the national economy, State and local governments may need to be provided with assistance to prevent interruption of vital services and reduced employment.

Economic Development Assistance

The programs of the Economic Development Administration (EDA) are designed to reduce substantial and persistent unemployment in economically distressed areas and to react to economic adjustment problems that may arise abruptly. So too, the Urban Development Action Grant Program in the Department of Housing and Urban Development has been effective in fostering economic rejuveniation. The Committee is cognizant of the important mission of domestic economic development programs and recommends expanding and strengthening them.

The vehicles for providing economic development assistance are already in place, though they remain underfunded. For example, the Economic Development Administration has the tools necessary to assist local governments in their development efforts: capacity building programs, business loans and guarantees, and flexible grants. However, in fiscal year 1980, the budget request for the entire Economic Development Administration is \$759 million. The apparent increase over 1979 is somewhat misleading. The fiscal year 1980 budget request

³ Congressman Hamilton states: "The current revenue-sharing program has helped to shift decisions on local projects out of Washington and back to the State and local level. The Federal government should continue to support that trend. I understand the reasons for the current political pressures generated by the contrast between State budgetary surpluses and the large Federal deficit, but I do not feel that either general revenue sharing or the block grant programs are the places where spending cuts should be made."

includes \$150 million for a new energy impact assistance program. Funds for economic development assistance have actually been reduced.

Of the projected fiscal year 1980 EDA funding for existing programs, \$163 million is estimated to be spent on cities and \$178 million on rural areas. Funding for both urban and rural programs has been reduced by 12 percent from fiscal year 1979.

TABLE III-10.—EDA BUDGET

	Fiscal year 1979	Fiscal year 1980	Change
Total budget authority.....	\$628	\$759	+\$131
Energy impact assistance program.....		150	+150
Budget authority minus energy impact assistance.....	628	609	-19

Source: Office of Management and Budget, "The Budget of the United States Government, fiscal year 1980.

Recommendation No. 9

The committee recommends a modest increase in the EDA budget authority of the economic adjustment assistance, planning and technical assistance, and business loan programs of the Economic Development Administration. The Committee also recommends that additional funds from the Economic Development Revolving Fund be transferred to Title II again in fiscal year 1980. These funds represent the repayments and interest from EDA business development loans made in previous years and should be used to enhance the business development programs.

EDA programs offer great potential for the revitalization of urban and rural areas because they encourage greater private sector investment. EDA's business development program provides loans and loan guarantees to businesses for a wide range of capital needs. These include long-term, low-interest loans for fixed assets, financing for businesses willing to establish or expand operations in economically distressed areas, working capital loans, working capital guarantees, interest subsidies, guarantees of fixed asset loans made by private institutions, and guarantees of lease payments for building and equipment.

The budget authority for Title II of the Public Works and Economic Development Act authorizing the business development activities, was \$95.4 million in fiscal year 1979. However, during fiscal year 1979, \$75 million from the Economic Development Revolving Fund was transferred to Title II, resulting in an actual fiscal year 1979 repayments and interest from earlier loans. The administration is proposing an increase in the fiscal year 1980 budget authority for budget authority of \$170.4 million. The revolving fund is made up of Title II to \$176.4 million.

Title IX of the Public Works and Economic Development Act should also be strengthened. The program can fund virtually any development activity, has been used in varied and innovative ways, and can be used to bring multipurpose projects under one grant.

Economic adjustment assistance includes grants to help areas resolve problems related to actual or threatened long-term unemployment or low income. It also provides assistance to help localities adjust to a sudden and severe disruption to their economies. In addition, assistance may be provided to facilitate long-term community adjustments to such situations as the loss of a major employer in the area.

Its maximum potential has not been realized, because its funding has never exceeded \$100 million. The fiscal year 1980 budget proposes a reduction in Title IX funding to \$78 million, down from \$88.5 million in fiscal year 1979. If it were funded adequately, Title IX would have the potential of providing uniquely adaptable assistance to meet the needs of distressed areas. The aid it provides is flexible, comprehensive, and most important, rapid.

Title III of the Public Works and Economic Development Act of 1965, as amended, provided funds for planning and technical assistance for economic development purposes. This program provides the crucial link for putting together local development organizations, strategies, and projects. The administration, however, is proposing a reduction in both the planning and technical assistance programs from a total of \$72.8 million in fiscal year 1979 to \$64.1 million in fiscal year 1980.

Finally, the Section 204 program of Title IX of the Public Works and Economic Development Assistance Act of 1965, as amended, was designed to capitalize local revolving loan funds for businesses. This concept provides maximum local discretion, flexible eligible activities, predictable amounts of money, and maximization of limited resources through a recycling mechanism. Despite an authorization of \$125 million, Section 204 has never been funded at more than \$15 million, and the program is now designated as a small set-aside in the Title IX program. This program offers great flexibility and potential activities and should be given consideration as a separate grant program with adequate funding.

The economic development programs provide valuable assistance to jurisdictions of all sizes—large and small cities as well as rural areas—in adjusting to and improving their local economic circumstances. The Committee believes that these important programs remain under-funded. With an adequate budget, EDA could provide business assistance, and flexible grants for public and private initiatives, and local capacity building. These are the essential elements of economic development. Utilizing these programs to rebuild local tax bases and generate jobs is consistent with the goal of achieving greater efficiency in the use of each Federal dollar.

Structural Unemployment

The spectacular growth in the number of jobs created by the economy in 1978 was the best economic news in what was in many ways a difficult and troubling year. Over 3 million Americans found work last year. That was the silver lining in the dark clouds which seemed to hang over the economy in 1978.

Accompanying the employment growth was a substantial drop in the unemployment rate from 6.6 percent in the fourth quarter of 1977 to 5.8 percent in the final quarter of 1978. But in spite of this

progress, far too many Americans remained jobless. For 6 million Americans who wanted to work, 1978 was a bitterly disappointing year.

As discussed in some detail earlier, the economy is approaching its fifth year of expansion. Although strong economic growth is a vital precondition in providing employment opportunities, many economists believe we are at the point where further reductions in unemployment through conventional macroeconomic policies will be inflationary.

The arguments for fiscal and monetary restraint in light of the increasing rate of inflation have also been discussed. But this policy of restraint does not address the issue of structural unemployment. Special measures are needed to assist the structurally unemployed—those who remain jobless when the economy reaches its potential output. The problem, then, is to devise policies and programs to reduce unemployment without resorting to stimulative actions that could be inflationary.

The severity of the problem can be demonstrated vividly by a recount of the unemployment rates for some unemployed people.

By comparison with an unemployment rate of 4.0 percent for adult men in January 1979, the unemployment rate for adult women was 5.7 percent, and for teenagers was 15.7 percent. The unemployment rate for blacks and other minorities was 11.2 percent, more than double the white unemployment rate of 5.1 percent.

A more detailed breakdown of the unemployment statistics in January reveals even greater discrepancies between some groups. Thus, although the overall white unemployment rate was 5.1 percent, for white adult males the unemployment rate was a modest 3.6 percent. For white adult women, the unemployment rate was 5.0 percent; and for white teenagers, the unemployment rate was 13.7 percent. The unemployment rate for blacks and other minorities was more than double that of whites in each of those categories: 7.8 percent for adult males, 10.6 percent for adult females, and 32.7 percent for teenagers. The figure for all Hispanic workers was 8.9 percent.

These cold statistics mask the human cost of unemployment to jobless Americans and their families. For example, the one sharp difference between female and male heads-of-households is that the former are poor. In 1978 a record one in seven families was headed by a woman. The proportion of these families who live in poverty—one in three—far outnumbers the proportion of husband-wife families in poverty—one in eighteen.

The cost of unemployment also may have greater implications for other groups. For instance, much of the job switching experienced by white teenagers generates labor market information. Unemployment for black teenagers tends to last longer and to affect adversely their earnings potential and long-term employment patterns.

As Chairman Benten said during the Committee's annual hearings:

The structurally unemployed are Americans who cannot find work in bad or in good times. They are forgotten Americans. They do not want welfare, they want only the opportunity to become full participants in our economic life. We can't afford to waste the energy, the intelligence and the ingenuity of these people.

Congress already has taken some initial legislative steps directed toward addressing the structural unemployment problem. The Comprehensive Employment and Training Act (CETA) has been refocused to provide a greater proportion of jobs and training to structurally unemployed persons. In Title II and Title VII, public service employment programs (PSE) for the structurally unemployed will expand to 57 percent of all PSE by the end of 1980, compared to 43 percent in 1979.

The Title VII program includes the new private sector program, for which a 1979 supplemental appropriation of \$400 million is requested. These funds will be provided through States and localities for training, placement, implementation of the new targeted employment tax credit (described below), and other services, such as on-the-job training, designed jointly with Private Industry Councils.

Several observations should be made about the public service jobs programs and the private sector initiatives. The Committee has no doubt that the reorientation of the public service jobs program toward the structurally unemployed was appropriate and necessary in light of our present economic circumstances. Although there has been some congressional disenchantment with some of the more visible problems of CETA, public sector jobs continue to fill certain functions which cannot be implemented through the private sector. Evidence, although tentative, has shown public jobs can enhance both earnings and employment potential of structurally unemployed workers.

Because structural unemployment is a composite of factors rather than attributable to a single cause, approaches to solve the problem must be multifaceted. The public sector programs must go in tandem with initiatives developed by the private sector. Because the ultimate aim of any structural employment program is to assist the transition of unemployed workers into jobs in the private economy, the involvement of the private sector is vital. The exposure to the "real" world imposes a type of job discipline and provides actual knowledge of job opportunities. In addition, private employers will be sure to train workers with skills necessary to their business operations. This results in reenforcement of the acquisition of additional skills with the exercise of those skills.

The Committee gives wholehearted endorsement to the objectives proposed in Title VII. Initial efforts by concerned public and private parties have caused businessmen to be greatly interested in special training and employment efforts. It would be tragic not to provide funding for such a fundamentally promising approach.

Recommendation No. 10

Congress and the Administration should assure funding for programs to combat structural unemployment including effective private sector jobs programs under the CETA Act. This assurance is necessary to avoid stop-and-go policies for the structurally unemployed. The \$400 million appropriation request for the CETA private sector jobs programs should be enacted.

Because many businesses have neither the time nor the initial inclination to seek out structurally unemployed workers, intermediate

organizations that provide essentially a matchmaking service between employers and structurally impaired workers have evolved. The Private Industry Councils are one example.

Recommendation No. 11

Private, nonprofit intermediate organizations, which have proven to be highly successful in providing placement and support services to the structurally unemployed, offer a unique source of aid in solving the problem. Their role in public and private sector initiatives should be expanded.

A major theme stressed by witnesses appearing in the annual hearings before the Committee was the importance of training for structurally unemployed workers. Training for unskilled and low-skilled workers in order to prepare them for jobs was deemed absolutely essential. Training is also a crucial factor in achieving renewed productivity growth. Furthermore, upgrading the skill levels of average workers in order to reduce the labor bottlenecks present in our high-technology society was given a high priority.

Recommendation No. 12

The current Federal manpower training programs should be significantly expanded in order to equip unemployed workers with skills to meet entry level requirements.

Training can be implemented by the private or public sector, either through jobs programs or through direct or indirect subsidies to employers. One of the key measurements of a training program's success should be whether it gives the individual needed work skills.

Dr. Bernard Anderson said in his testimony before the Joint Economic Committee:

I think my preference would be (for) * * * a training subsidy or investment in human capital account or something of that type. But, the purpose would be to reduce to the private sector the cost of hiring the structurally unemployed, specifically youth. I think we should do that and we should do it for the purpose of providing specific training to the young people.

Others have emphasized the value of on-the-job training. As was stated by G. William Miller, Chairman of the Federal Reserve Board:

* * *. On-the-job training is one of the most effective ways to deal with the problem (structural unemployment problem). There is no question about that. * * * I think you're absolutely correct, that this is something that needs far more emphasis because of a greater probability of a trainee staying with a company where he has been getting his experience on the job. There is a greater probability of his moving into continuing employment than there is when he has to be moved from whatever kind of institution to the work site." (Testimony before the Joint Economic Committee.)

One initiative for private sector involvement in the hiring of the structurally unemployed is the new Targeted Employment Tax Credit

proposed by the Administration, designed to increase private sector employment opportunities for target groups of disadvantaged individuals, primarily youth. This credit is generally equal to 50 percent of the first \$6,000 of first-year wages of such an employee and 25 percent of the first \$6,000 of second-year wages. The Revenue Act of 1978 also revised the Work Incentive (WIN) Tax Credit, which is available to employers of recipients of Aid to Families with Dependent Children (AFDC), to pattern it more closely after the new targeted tax credit.

The targeting aspect is new, but the proposed employment tax credit as a method of wage subsidization is a modification of the Employment Tax Credit passed by Congress in 1977. While the Council of Economic Advisers was careful to qualify the introduction of the new targeted credit, there have been indications by witnesses before the Committee, based on the previous experiences with tax credits, that credits potentially could be very successful. However, it was noted that one of the major drawbacks with previous credits was the lack of publicity accompanying their introduction. Many employers found only after their accountants prepared their annual tax returns that they qualified for the credit. It is obvious that an unknown tax credit cannot be utilized by business.

Recommendation No. 13

We recommend that the Administration undertake a major effort to inform businessmen and women about the new targeted Employment Tax Credit Program.

The Committee believes different methods should be considered which would reduce the cost to the employer for training a structurally unemployed individual. The Targeted Employment Tax Credit should provide valuable experience as a certain type of job subsidy. However, we believe that other types of subsidies with a training component should be explored. This training should be centered primarily in the private sector.

Recommendation No. 14

The Committee urges development of legislation to provide targeted incentives to private sector employers—particularly small business—to effectively train and hire the structurally unemployed. Training subsidies or other incentives for training should be provided to employers. The Committee wishes to emphasize this support should be paid only for training and not wages.

Policymakers have long since recognized that youth unemployment is a critical national issue. Although the unemployment rate for teenagers has fallen 3.6 percentage points in 1978 from 1975, their unemployment rate averaged 16.3 percent in 1978. Teenagers account for nearly a fourth of the unemployed, and persons under age 25 represent almost one-half of the unemployed. The rate of unemployment among teenagers is two and one-half times the overall rate. Two-fifths of black teenagers in the labor force are without jobs. This latter figure does not count discouraged youth, who have dropped out of the labor force because they perceive no available job opportunities.

Although the aggregate statistics are fairly clear, numerous studies into the dynamics of youth unemployment reveal often conflicting and inconsistent characteristics of the youth unemployment problem that make it especially difficult to apply conventional aids for the unemployed.

Youth unemployment is different from adult unemployment in several ways. For example, the number of teenage unemployed who are students has risen from less than 25 percent in the early 1960's to 50 percent today. Teenagers usually seek part-time rather than full-time employment and, as may be expected, their employment and unemployment patterns are seasonal. In addition, few youths are heads of households and less than a tenth of 16-19 year olds in the civilian labor force are married, compared to two-fifths of the 20-24 year olds. Obviously, this lack of family responsibilities translates into looser labor market attachments than is true for older workers. The frequency of entry and exit from the labor force as a result of these combined factors is a major factor in youth unemployment.

Because early employment and unemployment experiences make such a long-lasting impression on adult employment patterns, the Committee believes that linkages between the business world and teenagers are crucial at an early stage. Moreover, the connection between school and work should be strengthened.

Although we have devoted our discussion primarily to the structural unemployment, the Committee recognizes that the expected slower economic growth in 1979 may well result in a higher level of unemployment. Therefore,

Recommendation No. 15

The Administration should prepare a standby program to increase the number of CETA public sector jobs to be proposed to Congress in the event that the slower economic growth forecast for this year results in a significant rise in unemployment. A large portion of these jobs should be targeted to the structurally unemployed.

Finally, the Committee regards the above recommendations as the preliminary stage to a more comprehensive look at the problem of structural unemployment. Because so many aspects of the newly formulated legislation was considered experimental, the 1978 amendments to the CETA legislation require the Joint Economic Committee to issue a report by March 31, 1979, responding to the following questions:

1. Can targeted structural employment and training programs reduce the unemployment rates of those segments of the labor force having special difficulties in obtaining employment?
2. Can targeted structural employment and training programs achieve and sustain a decrease in the national unemployment rate without exacerbating inflation?
3. What private incentives can induce employers to hire the structurally disadvantaged?

The Committee's report on CETA, therefore, will detail additional recommendations as well as an in-depth analysis of structural unemployment and its effects on inflation.

The Joint Economic Committee intends to continue its traditional role of attempting to develop new and innovative proposals to deal with the tragic problem of unemployment.

INTERNATIONAL PAYMENTS IMBALANCES AND THE SYSTEM OF FLOATING EXCHANGE RATES

1978 was a year characterized by several sharp disturbances in foreign exchange markets marked by substantial realignments of exchange rates and by heavy official intervention. The real story, however, was the dramatic plunge in the foreign exchange value of the dollar. After nearly 2 years of remarkable stability, the trade-weighted average value of the dollar against the currencies of the ten largest industrial countries plus Switzerland fell by 5 percent in the fourth quarter of 1977, 3½ percent in the first quarter of 1978 and ½ percent in the second quarter. In the summer of 1978, the dollar came under renewed downward pressure, falling in value by 5½ percent in the third quarter. And in October the dollar nose-dived, declining at an accelerated pace until its decline was sharply reversed by the widely heralded dollar-support program announced on November 1. The trade-weighted average value of the dollar declined by 19.2 percent between September 1977 and the end of October 1978.

By the time the dollar-support program was initiated, it was very clear that exchange rates had moved further and much more rapidly than could be justified by any change in "economic fundamentals." The exaggerated decline in the value of the dollar had to be stopped since it was tending both to exacerbate inflationary pressures domestically and to force sharp and unwarranted adjustments in the export industries of a number of our trading partners. The dollar-rescue program, therefore, was justified. To date, this program appears to have been successful. The precipitous decline in the foreign exchange value of the dollar has been arrested, and foreign exchange markets are once again functioning in a relatively orderly manner. At present, the trade-weighted average value of the dollar stands about 6.2 percent higher than its value at the end of October.

The decline of the dollar over the past year or so has caused a great deal of understandable concern both here and abroad. Two fundamental questions are raised in the wake of the disturbances experienced last year. First, in view of the present international payments system, what is the prospect that the current success of the dollar-support program will be short-lived and that the dollar will come under renewed pressure in the months ahead? And, second, is it advisable to retain our present international payments system, or should it be reformed in some fundamental way?

Recommendation No. 16

On the basis of our study of floating exchange rates, it is the view of this Committee that the system of floating should be retained. Floating may not be the best of all conceivable exchange rate regimes, but under present world conditions, it is the only viable approach.

Floating is *not* a panacea for the world's economic ills; it will not by itself ensure world prosperity. That goal will only be attained when the world's economies pursue policies specifically aimed at the achievement of prosperity; when each country pursues sound macro and microeconomic policies designed to foster growth, high employment,

and reasonable price stability; and when restrictions on the international movement of goods, services, and capital are substantially diminished. Floating can facilitate the process of achieving world prosperity by providing sufficient price flexibility to help correct payments imbalances and by providing time for governments to correct fundamental domestic imbalances without resorting to the imposition of trade and capital restrictions or the use of restrictive macroeconomic policies to cure their exchange rate and trade problems. Floating has survived because of its remarkable resilience in the face of disturbances of the sort that had produced repeated financial crises between 1966 and 1973 under the old Bretton Woods arrangements. The shock-absorbing capacity of the exchange markets and the effective recycling of the Organization of Petroleum Exporting Countries (OPEC) funds by the Eurobanks after 1973 have convinced us that the floating system has served the world economy more effectively in a difficult period than the Bretton Woods system could have done.

Since late in 1977, however, the managed floating system has exhibited much less stability. Not only have there been marked realignments of exchange rates, as noted earlier, but there has also been a sharp increase in foreign exchange market intervention. Gross foreign exchange market intervention in 1978 amounted to \$114 billion, of which an estimated \$50 billion went to support the dollar, and much of that occurred in the last two months of 1978 after implementation of the dollar-support program.

On the surface at least, floating exchange rates do not appear to have functioned as smoothly as they did between 1973-77. In our view, however, the instabilities evident in foreign exchange markets and the failure of balance-of-payments equilibrium to be restored among the major trading countries were not the fault of floating rates. Rather, they were largely the result of the fact that the major trading countries were unwilling or unable to coordinate their macroeconomic policies and performances.

The leading industrial countries have divided into "weak" and "strong" currency blocs, characterized respectively by large payments deficits and large surpluses. The primary source of these payments imbalances was the domestic economic policies pursued by the countries constituting the respective blocs. The "strong" currency countries, such as Germany and Japan, adopted sluggish growth policies in an effort to combat inflation; the "weak" currency countries, such as the United States, adopted rapid growth policies. The resultant payments imbalances were reflected in an appreciation of the currencies of the surplus countries, and a depreciation of the dollar. As a result of these exchange rate changes, wage and price advances were slowed in the appreciating currency countries, and the accelerated in the United States.

In the long run, exchange rate changes such as those witnessed last year should result in a narrowing of the respective payments imbalances. In the short run, however, little improvement can be expected. Payments imbalances may continue to widen in the short run, to be followed by a narrowing only in the long run.

There are several reasons why there may not be any immediate narrowing of the payments imbalances, but rather may be widening.

The first reason has to do with what has been called the J-curve effect. In response to a depreciation of the domestic currency on foreign exchange markets, the current account of the balance of payments may change in a manner that looks like a J-curve: first down, then ultimately up.

Currency appreciation or depreciation has both price and quantity effects. The price effects occur immediately, but the quantity adjustments take place after some time. In the case of a depreciating dollar, the dollar value of our imports rises by more than the dollar value of our exports, causing the current account to deteriorate. Ultimately, however, traders adjust to the price changes with the result that the volume of imports decreases and the volume of exports increases. When these lagging quantity effects begin to predominate, the current account begins to improve and the upward sloping point of the J-curve is reached. The opposite sequence of events takes place in those countries whose currencies appreciate. Empirical studies of the timing of quantity adjustments suggest that it may take two or more years before much of an improvement in the current account can be expected. It needs to be recognized, however, that there is some dispute over the empirical significance of the J-curve effect, and therefore over how much of an improvement can be expected in the current account as a result of exchange rate changes.

A second important consideration derives from the fact that exporters in surplus countries are willing to absorb for a while their loss in relative competitiveness caused by an appreciating currency through a reduction in their profit margins. For example, as the value of the dollar falls against the yen, a Japanese producer of autos might reduce the yen price of his exported cars so that the dollar price would rise by less than that implied by the change in the exchange rate. The exporter is willing to accept lower profits in an effort to maintain his share of the auto market in the hope that the fall of the dollar will turn out to be only temporary. When it becomes clear that the change is permanent and profit margins can be squeezed no further, the dollar price will rise to reflect the changed exchange rate. At the same time, American exporters may attempt for a while to raise the dollar price of their exports in an effort to expand their profit margins.

As a result of the operation of these forces, the payments imbalances, which were the initial cause of the exchange rate realignments, will be widened which, in turn, will magnify movements in the exchange rates themselves.

Another caveat is in order. Some observers believe that insofar as the devaluation has an effect on prices and cost-of-living adjustments in the United States, it may increase U.S. wages and production costs, diminishing the expected surge in exports, and restricting the improvement in the balance of payments, which in turn may cause further depreciation of the dollar. The net effect is an open question.

The lesson to be learned from all of this is straightforward: balance-of-payments adjustments and relative exchange rate stability necessitate the synchronization of macroeconomic policies and performances. In the face of policy disharmony the burden of rectifying payments imbalances falls on the exchange rate. And because of the J-curve

effect (among other things), there is caused, at first, even are more disparate payments imbalances and further exaggerated movements in exchange rates. In the absence of the required degree of coordination, there can be little hope of greater exchange rate stability.

We believe that the Committee's recommendations for monetary and fiscal policy will work to raise the U.S. trend rate of growth of productivity toward levels achieved overseas, while reducing inflation in the United States to the levels achieved by some other major trading nations. These steps, coupled with faster growth rates abroad, will bring about the harmonization required for greater exchange rate stability.

It needs also to be emphasized that in the face of huge payments imbalances and in the absence of policy coordination, foreign exchange market intervention can constitute, at best, only a temporary solution to the problems caused by exchange rate realignments. None of this is to deny the appropriateness of intervention to counter disorderly market conditions. However, the magnitude of the market disorders is caused by the disharmony of economic policies and performances. This creates instabilities and uncertainties, exaggerated movements in exchange rates, J-curve effects, and speculative pressures which have exacerbated international economic difficulties.

It is in this context that the restrictive monetary policy pursued since November 1 gives rise to some apprehension. Restrictive monetary policy can prop up the dollar in several ways. First, by creating interest rate differentials between the United States and foreign financial markets, it can induce an inflow of capital. However, recent empirical evidence suggests that such inflows are only temporary, with no permanent rise in the exchange rate. Interest rates, however, will be higher, the money supply will be lower, and the rate of economic activity therefore will be slowed.

The second effect on the value of the dollar comes about because the slowing of the economy will improve the current account. There may be less inflation, and the slower real growth will dampen the demand for imports. However, it was precisely to avoid the need for this method of dealing with a balance-of-payments deficit that made the abandonment of fixed rates of exchange an attractive option.

According to the monetary approach to the balance of payments, a third effect on the value of the dollar comes from a reduction in anticipated dollar creation and inflation, implying a reduction in the supply of dollars in circulation and a strengthening of demand for dollars as a reliable store of value.

We should not sacrifice domestic expansion for the purpose of maintaining the dollar. Nor does it make any sense for us to protect the export industries of Western Europe and Japan by deflating our economy when these countries could bring about a slower decline in their relative competitiveness by undertaking internal policies to step up their real rates of growth.

Recommendation No. 17

The Committee has consistently opposed diversion of monetary policy from domestic goals to secure international objectives other than in truly exceptional circum-

stances, and we reaffirm that position now. Monetary policy should be based primarily on the needs of the domestic economy.

This does not mean we are ignoring our international problems. The gradualist monetary policy and fiscal measures we have recommended are ideally suited to both domestic and international requirements and to efforts to coordinate policies among major trading nations. The reduction of inflation is the key to stronger investment and productivity growth domestically, while lower inflation and higher productivity are both required to strengthen the dollar.

In view of recent and prospective developments in the world economy, the system of floating rates should exhibit greater stability in 1979. Both the European countries and Japan seem to have achieved about $\frac{1}{2}$ percent faster growth in 1978 than in 1977. Furthermore, the Organization for Economic Cooperation and Development (OECD) is now forecasting that their growth will accelerate by another $\frac{3}{4}$ percent in 1979. At the same time, U.S. economic growth has been slowing from 5.5 percent in 1977 to 4.3 percent in 1978 to a projected 2 to 3 percent in 1979. On the other hand, it is not as clear that there will be much of a convergence of inflation rates in 1979. We can hope for some abatement of inflationary pressures in the United States in 1979, and there is likely to be some slight increase abroad; but we suspect that the inflation differential will be narrowed only negligibly. There will undoubtedly be some improvement in the pattern of international payments imbalances in 1979. The \$17 to \$18 billion deficit in the U.S. current account is expected to drop by some \$8 billion as the combined effects of the dollar depreciation, slower growth at home, and somewhat faster growth abroad take hold. This forecast does take account of higher oil prices planned for 1979 but does not allow for reduced exports to Iran. In view of the recent cancellation of military contracts by Iran, the magnitude of the offset to the projected \$8 billion improvement could be substantial, though increased sales to Saudi Arabia might negate at least part of this effect.

The Iranian situation could well nullify the expected gains in the U.S. current account for yet another reason. As far as oil supplies are concerned the United States is in a much better position than Europe or Japan. In view of the possibility of oil shortages, it may not be possible for Europe and Japan to achieve a greater rate of economic expansion without offsetting stimulus initiatives—actions which, at this point, are not being contemplated. Indeed, it is conceivable that Europe and Japan will tighten credit in an effort to counter the inflationary effects of higher oil prices. And there is some indication that oil prices could rise dramatically. Recently, the spot price for crude oil exceeded \$20 a barrel, considerably higher than the OPEC reference price of \$13.34.

We believe there should be some improvement in our competitive position in the world economy, a factor that will contribute to an improved current account balance in the future.

The Role of the Dollar

Although coordination of economic policies and performances is essential to the attainment of exchange market stability, coordination

by itself may not be sufficient to ensure the smooth functioning of our international payments system. Additional measures may be required to deal with another possible source of instability caused by the fact that the dollar continues to play a role in world currency markets that is far out of line with the economic position of the United States in the world economy. In our view, we must begin to give serious consideration to proposals designed to supplement the reserve role of the dollar with that of other currencies.

At the moment, there is no workable alternative to the dollar in the world economy. No other country wants its currency to assume that role. In the eyes of many international monetary experts, exclusive reliance on the dollar is itself a threat to the smooth functioning of our system of managed floating.

One possibility that deserves consideration is the establishment of a Substitution Account in the International Monetary Fund whereby foreign central banks who wish to diversify their reserve portfolios may turn in some limited portion of their disproportionately large holdings of dollars for Special Drawing Rights (SDRs) or some other currency composite. The existence of such a Substitution Account, of course, would not solve the dollar problem; but it would aid in the removal of one source of instability. If they have more broadly diversified portfolios, foreign official institutions might be more willing to absorb private unloadings of dollars in the interest of exchange market stability. Thus, a Substitution Account could facilitate the unloading of private dollars without the usual crisis atmosphere that at present characterizes such actions.

Moreover, a willingness on the part of the United States to accept a changed role for the dollar would convince world leaders that we are willing to shoulder greater responsibility in international monetary affairs since the existence of a Substitution Account would virtually guarantee that the United States would no longer be able to meet its international obligations exclusively through the issuance of dollars. At the same time, it could have the beneficial effect of causing the surplus countries, such as Germany, Japan and Switzerland, to shoulder greater responsibilities to ensure a smoothly functioning international payments system.

Until very recently, the Administration looked with disfavor on proposals to establish a new parallel key currency as a partial substitute for the dollar. That has changed. In testimony before our Committee on January 31, Secretary Blumenthal stated that the Administration was currently studying the Substitution Account proposal with an eye toward its possible implementation in the future.

Recommendation No. 18

In our view, the United States must express a willingness to give serious consideration to proposals designed to facilitate a changed role for the dollar in world currency markets. We endorse the initiative taken by the U.S. treasury to study carefully the proposal to establish a Substitution Account within the International Monetary Fund (IMF) with an eye toward its possible implementation in the near future.

IV. INFLATION, GOVERNMENT REGULATION, AND PRODUCTIVITY

INFLATION

During 1978 inflation was the Nation's major economic problem. Between the end of 1977 and the end of 1978, the Consumer Price Index (CPI) rose 9.0 percent. This represented a significant and disturbing acceleration of inflation. Following the explosive price behavior of 1974 when prices increased 12.2 percent, the inflation rate decelerated during 1975 to 7.0 percent, followed by a further decline to 4.8 percent during 1976. In 1977, however, the rate of increase of the CPI rose again to 6.8 percent on a December to December basis, and it has gone up even faster since then. During the first half of 1978, inflation was paced by an almost 20 percent rise in food prices, measured at an annual rate, with the cost of services not far behind. During the second half, inflation in these two areas moderated significantly, but the price increases of commodities less food showed a disconcerting tendency to accelerate, after a long period of only moderate increases. The Producers' Price Index also continued to rise rapidly during the year, promising further increases in consumer prices during 1979.

The acceleration of inflation during 1978 caught many observers by surprise. At the beginning of the year, most forecasters expected prices to rise in 1978 at about the same rate as they had during 1977, or even slightly lower. The *1978 Economic Report of the President* was based on the prediction of price increases in the $5\frac{3}{4}$ to $6\frac{1}{4}$ range; the revenue and outlay estimates in the President's fiscal 1979 budget were computed on the assumption of a 6.1 percent inflation rate during 1978.

These optimistic forecasts were unceremoniously laid to rest by mid-year as the CPI climbed in the first half of 1978 at an annual rate of more than 10 percent—a frightening return to the double-digit inflation of the early 1970's which followed supply cutbacks stemming from the oil embargo and poor food harvests. In response, on October 24, 1978, President Carter announced an anti-inflation program consisting of three main elements: Voluntary wage and price guidelines, budgetary restraint, and an attack on excessive regulatory costs. One week later, under pressure from foreign exchange markets, the President and the Federal Reserve Board indicated that a tighter monetary policy would also be pursued.

Our comments on this policy mix, and our recommendations, are made with the recognition that monetary and fiscal restraint should be supplemented with other anti-inflation programs designed to ease the transition to lower inflation. In the previous chapter, we indicated our broad agreement with the restraint in the President's recommendations on the fiscal 1980 budget and with the effort to reduce the

size of the Federal sector. This is consistent with our position that the Federal budget should provide economic stimulus during periods of reduced output and high unemployment, while providing restraint when the economy approaches a high level of resource utilization and nears the zone where demand pressures begin to cause inflation.

Inflation, however, cannot be dealt with as quickly as we would like through demand restriction alone without exacting intolerable costs in terms of lost output and high unemployment. This has been a major problem for economic policy throughout the last decade. Twice—in 1970 and 1974—monetary and fiscal restraint was relied on to cool inflation. In both cases, the inflation rate moderated but only at the cost of enormous unemployment and lost output. In neither instance was inflation cured, however. The lost output actually hurt matters by reducing supply. The devastating impact of unemployment on millions of workers who lost jobs, particularly during the 1974–75 recession, made it imperative that expansionary policies be taken long before the inflation had been wrung out of the economy. This illustrates the major problem of demand restriction: the costs in terms of lost output and higher unemployment show up very quickly, whereas the benefits measured by reduced inflation are much slower in coming.

As we stated in the previous chapter, reliance on fiscal and monetary restraint as the *sole* weapon against inflation would be particularly inappropriate today. Clearly, demand restriction does not address supply-related inflation triggered by rising energy and food costs, increases in government regulation, substandard productivity gains, and a declining international value of the dollar—which is propelled onward by subsequent spirals of wages and prices attempting to keep up with each other. Although much of the enormous slack in the economy caused by the 1974–75 recession has by now disappeared and economic policy has appropriately shifted from providing stimulus to restraint, these other important sources of our current inflation will not be altered by fiscal and monetary restraint alone.

Supply has been badly neglected as a way of fighting inflation. Increasing our productive capacity so that producers can put more goods on the shelves is a highly desirable method of holding prices down. In the 1970's, years of rapid inflation have been years of low real growth or recession. Years of lower inflation have been years of more rapid growth of real output. One explanation is that inflation discourages production. However, it is also true that a decline in production can contribute to price increases.

Instead of allowing these negative factors to feed on each other, the situation can be reversed. We can alter the policy mix to encourage supply, which will dampen inflation, which in turn will reduce disincentives and raise the reward to production. This Report has suggested reducing tax and regulatory burdens. The greater the burden on a factor of production, the smaller the quantity of that factor that will be offered to the market. The greater the burden placed on production, the less production there will be. Reducing these tax and regulatory burdens may encourage the supply of labor, capital, and output. This may weaken inflation and lessen the prospect that steps taken to manage demand will produce a slowdown.

Restrictive policies must be supplemented by measures designed to control the other sources of inflation—including voluntary wage and

price guidelines, regulatory cost controls, and measures to stimulate productivity increases and the output of goods and services.

Voluntary Wage and Price Guidelines

The voluntary wage and price guidelines announced by President Carter during his October 24 anti-inflation message aimed at moderating wage and price increases and breaking the inflationary psychology built into the system during the past decade. Faced with persistent inflation, labor and business have developed a number of ways of maintaining their real income, making the current inflation a self-sustaining spiral of rising wages and prices. During the 1960's American workers became accustomed to annual increases in their real wages of about 3 percent. These gains were made possible by annual productivity increases of about the same amount. During the 1970's, for reasons we will explore later, productivity gains deteriorated significantly. In addition, increases in Organization of Petroleum Exporting (OPEC) petroleum prices drained off a significant amount of real income into foreign hands. Wage demands escalated as workers tried to maintain rising real incomes or simply to keep from losing ground.

Cost-of-living adjustment provisions have become increasingly prevalent in labor contracts, automatically increasing wages in step with rising prices, and a number of government income support programs tie benefits in increases in the CPI. In addition, last year Congress provided for periodic increases in the minimum wage to compensate for cost-of-living increases. The lack of productivity gain meant that most of the nominal wage increases were simply passed on to consumers in the form of higher prices, stimulating another round of higher wage demands.

Inflationary expectations have become firmly entrenched. The psychology of the wage-price spiral must be broken to control inflation. This fact is the rationale for voluntary wage and price standards, as explained in the *1979 Economic Report of the President*:

General macroeconomic policies can create an appropriate market environment for unwinding inflation. However, 10 years of inflation preclude achievement of a given deceleration of prices solely through aggregate demand policy without much more demand restraint and loss of growth than would have been the case in earlier periods. Unless ways are found to brake the momentum of self-perpetuating wage and price increases that have acquired a prominent place in our private behavior, inflation will continue at an unacceptably high rate (p. 80).

The wage guidelines announced on October 24 would limit the increase in hourly wages and private fringe benefits to a maximum of 7 percent for each employee group in a firm. Increases above 7 percent in the costs of maintaining existing health benefits are not included in the limit, nor are pension fund contributions designed to maintain existing benefit levels. Because of significant exemptions that would permit some increases above the 7 percent target—for those earning less than \$4.00 an hour, to preserve historically close tandem relation-

ships between employee groups, and to retain employees in job categories where acute labor shortages exist—only three-fourths of all workers are covered by the pay standards.

The rate of increase of total private wages and fringe benefits in 1979 would be limited to about 8 percent if there is substantial compliance with the pay standards, according to the President's *1979 Economic Report*. Total employee compensation per hour, including employer payroll taxes, would increase by about 8½ percent in 1979, compared to 9¾ percent in 1978.

The price guidelines aim at keeping price increases in 1979 to one-half percentage point below the average for the past 2 years, with the price increase for an individual firm limited to no more than 9.5 percent. In instances where compliance with the price standards would impose a substantial hardship, a profits test may be substituted. The Administration has forecast an increase in the CPI for 1979 of 7.4 percent, on a December to December basis, and believes that the rate of price increase will fall to 7.0 percent by year's end.

Although some members of the Joint Economic Committee have strong reservations concerning their legality, we support voluntary wage and price guidelines as part of an overall program to bring inflation under control. We are concerned, however, about specific aspects of the guidelines.

The increase in productivity in 1979 necessary to reconcile the 8.5 percent increase in total employee compensation per hour, and the 7.4 percent increase in the CPI is inconsistent with other Administration productivity forecasts. For most policy purposes, the Administration predicts a productivity gain in 1979 of about 0.4 percent, the same as in 1978. But the gap between the projected increase in labor compensation and price increases under the guidelines implies a productivity increase of 1.1 percent. If actual productivity fails to rise by this figure and the wage goal is met, prices will rise by more than 7.4 percent unless a reduction in profits also occurs. The latter, however, is also inconsistent with other Administration projections, including a forecast of a \$10 billion increase in corporate profits taxes in 1979 and a 4-percent increase in real investment.

In addition, important commodity groups are not covered by the price guidelines, including raw agricultural products, housing, and most imports. Interest rates and State and local taxes, both important elements in the CPI, are excluded from any guidelines. The Administration expects food prices to rise substantially less in 1979 than they did in 1978. Interest rates are not expected to change substantially. If the dollar stabilizes in response to current policies, the cost of imports should stop rising as rapidly, and many State and local governments are under intense pressure to hold taxes down in light of Proposition 13. However, an unexpected increase in any of these areas could cause inflation to exceed the Administration's forecast, thereby weakening the impact of the guidelines and adding steam to the wage-price spiral.

The Committee recognizes that progress has been made in securing agreements with some businesses to comply with the guidelines. Whether or not these promises, in fact, do result in slower price increases, the guidelines should not be regarded as the Nation's sole

effort to reduce inflation. Fiscal and monetary restraint is still essential, even if all employers and employees comply with the guidelines. As one witness testified :

The temptation to pursue more expansionary demand policies than would otherwise be considered prudent is strengthened not only by the tendency to rely on wage-price standards to offset their inflationary effect, but also by the possibility that such standards may temporarily mask, by shifting into the future, some of the symptoms of excess demand that would be evident in the market. Yielding to this temptation is a prescription for higher inflation instead of reduced inflation. (Testimony of Marvin H. Kosters.)

Recommendation No. 19

Voluntary wage and price guidelines can be effective policy for winding down persistent long-term inflation when they are part of an overall anti-inflation program that includes fiscal and monetary restraint and other anti-inflation policies. We urge Congress and the President to conduct economic policy during 1979 in a manner that will contribute to the success of the guidelines. We oppose any attempt to transform the guidelines into mandatory wage and price controls.¹

Comprehensive wage and price controls have appeal because it is thought that such controls can stop inflation without at the same time necessitating the demand restriction that brings recession. That may be correct in theory, but in practice it has not worked that way. A review of the controls episode of 1971-74 is instructive in showing why they failed to control inflation.

In 1970 Congress provided President Nixon with the authority to impose comprehensive wage and price controls. In August 1971, and as part of his "New Economic Policy," the President imposed a 90-day freeze on wages, prices, and rents. After the 90 days, the freeze was followed by Phase II which continued until January 1973. Under Phase II the Cost of Living Council, the Price Commission, and the Pay Board were created to administer mandatory controls for prices, wages, rents, dividends, and profit margins.

Phase III began in January 1973. It was designed to be a strategic retreat back to the free market although the Government continued to set standards for price changes that required only voluntary compliance. Phase IV brought a return to mandatory controls in August 1973. Phase IV ended on April 30, 1974.

How effective were the controls? A recent econometric study by Dr. Otto Eckstein, President of Data Resources, Inc., demonstrated that while price controls reduced inflation during the control period, the subsequent catch up after the elimination of controls put the price level right back where it would have been in the absence of the controls. Furthermore, the elimination of the controls probably contributed to the recession of 1974-75.

¹ Senator McGovern states: "I believe if extraordinary inflationary pressures continue to grow in the months ahead, selected mandatory wage and price controls may be necessary and desirable."

The next controls episode, of course, would differ radically from the 1971-74 experience. There is a widespread belief that President Carter would use the authority to impose controls, whereas President Nixon was not expected to use his authority. President Carter at present does not have the authority to impose controls, and a proposal to impose them would entail a lengthy congressional debate. Such a debate would very likely produce an acceleration in the rate of wage-price inflation at those with market power would probably exercise their power to attain the highest wages and prices possible prior to the control period. This would put additional pressure on the Congress to grant price-fixing authority to the President. He, in turn, would probably be forced to use the authority whether he wanted to or not because of the deteriorating inflation situation. Finally, and perhaps worst of all, the accelerating inflation would force the Federal Reserve Board to pursue an even more restrictive monetary policy.

Thus, the adoption of direct and comprehensive wage-price controls would be unwise. Controls will not produce a permanent reduction in the inflation rate; they will not prevent recession although they may affect its timing and magnitude; and they will produce undesirable bottlenecks and administrative costs. We wish to make clear our opposition to wage and price controls.

GOVERNMENT REGULATION

During the past decade and a half, the Federal Government has increasingly relied on regulation of the private sector to channel resources toward such public goals as a cleaner environment, safer workplaces, less hazardous consumer products, and equal employment opportunities. These important programs usually require that businesses incur significant compliance costs which are then passed on to consumers through higher prices.

Many government regulations, particularly those affecting health, safety, and the environment, have contributed significantly to the overall well-being of the vast majority of American consumers and workers. We would not turn back the clock because many regulatory policies have produced substantial benefits for the public.

Although it would be very difficult at this time to measure the impact of Federal regulations on the rate of inflation, largely because techniques for measuring the private sector costs of regulations and their benefits are still being developed, there can be little doubt that this rapid growth of regulation, and the growth of unnecessary, conflicting, and duplicative regulations in particular, has been a substantial contributor to our current inflation. The growth of such regulatory costs must be brought under control as part of a comprehensive anti-inflation program.

Until the mid-1960's government regulation aimed primarily at achieving strictly economic objectives, such as control over monopoly or stabilization of an industry, and did so through intervention in the marketplace in the form of controls over prices, entry requirements, or other aspects of economic activity. In specific industries, primarily transportation, banking, and communications, the effect of economic regulation has generally been to raise the level of consumer prices or

rates above the level that would have prevailed in the absence of regulation.

Deregulation can help cut inflation by permitting increased competition and lower prices. The recent airline deregulation resulted in more price competition, lower fares, and higher airlines profits during 1978. This example demonstrates that deregulation can generate substantial consumer and business benefits. Deregulation, however, should be carefully planned so that it does not harm consumers or cause a crippling decline in available services to regions or localities.

A more recent source of inflation pressures is the rapid growth of Federal *social* regulation. During the past 15 years, Congress has enacted numerous measures dealing with clean air and clean water, more healthful workplaces, fair credit practices, toxic substance control, highway and auto safety, strip mine controls, interstate land sales, and consumer product safety, as well as other important social concerns. In contrast with economic regulations which affect few industries, social regulations aim at achieving specific objectives across a broad range of industries. It should be noted that many of these social regulations have been directed at having private industry internalize the costs generated by the industry itself and previously borne by society as a whole.

As with many new and rapidly growing government programs, problems have developed with social regulations that have to be dealt with in order to improve their efficiency and effectiveness. One major problem involves the measurement of benefits and costs. Most economists would agree that the marginal costs of regulatory programs should be balanced. But this is very difficult in practice, since the current techniques for measuring benefits and costs are not very sophisticated and need further development. There are other significant problems which we will discuss later. As a result, the benefit goals of many regulations are set with little regard to cost. Much of the fault for this lies with Congress, as some laws allow regulations without requiring that costs or benefits be weighed, while other laws prohibit the consideration of costs.

In addition, the recent proliferation of regulations and lack of coordination among regulatory agencies have often resulted in regulations which are duplicative, conflicting, and excessive. Witnesses appearing before the Committee have provided examples of instances where compliance with one regulation requires violation of another. This not only puts businesses in unnecessary jeopardy, both legally and financially, it also reduces respect for the law and the Federal Government. Small businessmen are often hardest hit by the morass of conflicting and duplicative regulation because they cannot afford the necessary legal advice.

We are pleased that President Carter recognizes the inflationary impact of government regulations and has taken measures to improve the regulatory process. The creation last year of the Regulatory Analysis Review Group has subjected selected major regulations to economic analysis. An Executive Order issued in March 1978 requires each Executive agency to review its major regulations periodically with a view toward eliminating unnecessary regulations and simplifying others. The order requires that each agency head approve major

regulations personally and that each agency conduct a sunset review each year. The Executive Order, however, does not apply to the independent regulatory agencies. We believe it should.

A Regulatory Council, composed of Executive and independent regulatory agency heads, was created in October 1978 to coordinate regulatory activities and eliminate duplication and conflict. The Council will publish a regulatory calendar semiannually, listing the timetable for new regulations along with data on their objectives and potential costs.

We support the President's efforts to make the regulatory process more effective and efficient. There are other measures that Congress and the President could take to improve government regulations and eliminate duplicative, conflicting, and unnecessary regulations.

Congressional Analysis

As we have said, much of the blame for excessive regulatory costs lies squarely on the shoulders of Congress. If regulatory costs exceed benefits and regulatory programs are not coordinated, it is often because new regulatory programs are inadequately examined before they are enacted. At the beginning of the 95th Congress, the Senate adopted Senate Rule 29.5 requiring all legislation to be accompanied by a regulatory analysis. The regulatory analysis, which would be part of the committee report on the legislation, would look at the number of individuals or businesses to be regulated, the burden imposed by the new program, the impact on personal privacy, and the new paperwork that would be created.

During the 95th Congress, one-third of all legislation passed by the Senate failed to be accompanied by the required regulatory impact analysis. For many other bills, the analysis was perfunctory. This is a weak link in the regulatory reform process and should be rectified in the 96th Congress.

Recommendation No. 20

Senate Rule 29.5 requiring all legislation to be accompanied by a regulatory impact analysis should be vigorously enforced, and the House of Representatives should adopt a similar measure.

Cost Effective Regulation

As we have pointed out, regulatory programs should attempt to systematically consider costs and benefits whenever possible. A cost-benefit test for government regulations, as desirable as it might be in theory, would create many problems in practice.

First, it is often impossible to measure the benefits of regulatory programs. One of the most enduring and illuminating examples of this problem is the debate over how to value lives saved as the result of different highway and auto safety expenditures. The estimates range from just over \$270,000 to more than \$2 million per life, depending on the method and data used. For most other regulatory programs, the data would be less precise and more open to controversy. In addition, while some regulatory costs can be measured, including necessary

investment, paperwork and recordkeeping requirements, and additional wages, the techniques for measuring costs still need much development. Second, the imprecise nature of the data needed for accurate benefit-cost analyses of regulations would make it easy for such studies to be manipulated to achieve a predetermined result. Third, there is the distinct possibility that regulatory decisions made solely on the basis of cost-benefit analyses would be morally repugnant. For example, if lives are valued on the basis of earnings potential, as they are in many cost-benefit analyses studies, highway safety programs would be concentrated in wealthy neighborhoods, as the economic value of a life saved would exceed the economic value of lives saved in poorer neighborhoods.

For most regulatory programs, such computations are not necessary to reduce regulatory-imposed waste and inefficiencies. Congress, in enacting regulatory programs, generally presumes or sets a level of benefits to be achieved, just as it does with spending programs. The benefit level is not, and should not be, determined by the administering agency. Rather, the agency should be charged with achieving the congressionally mandated goals at the least cost. This eliminates the need to measure benefits and instead focuses on costs which can be more accurately measured.

We believe that a cost-effectiveness requirement would be the simplest way of assuring that regulatory goals are achieved at the lowest possible cost and with the least waste of resources. We believe a cost-effectiveness rule for all regulations would be a more effective way of controlling regulatory costs without reducing the benefit of regulatory programs than would a cost-benefit test, as some have proposed.

Recommendation No. 21

All government regulations should accomplish the statutory objective in the most cost effective manner. When alternatives exist, each of which clearly would achieve a particular regulatory goal, the least costly way should be adopted unless an overriding statutory goal requires the adoption of a less cost effective alternative.

Regulatory Budget

The current regulatory process fails to recognize that the goals of regulatory programs must be balanced rationally with other national objectives. The achievement of any objective, public or private, involves resources that could be used for several purposes. The more resources that are devoted to one purpose, the less available for others. Even if all regulations were cost effective, the problem of balancing resources for regulatory purposes with resources for other purposes would still exist. This balance could best be accomplished through a regulatory budget.

Prior to the rapid growth of social regulatory programs, the present fiscal budget was generally adequate to show the impact of government on the economy. Almost all the activities of the Federal Government involved direct spending, in the form of purchases or transfers or direct taxation, and these showed up in the budget. There were very few regulatory programs.

By showing the level of total spending and the amounts to be spent by each agency, the Federal budget has been a powerful tool for limiting the Government's command over public resources and facilitating their allocation among competing uses. One could have a fairly clear picture of the Government's influence in the economy by reading the budget. But with the rapid growth of the new regulatory agencies—the Occupational Health and Safety Administration, the Environmental Protection Agency, the Highway and Traffic Safety Administration, and many others—the Federal budget no longer conveys a complete picture of the Government's economic impact.

The annual budget understates the proportion of the Nation's resources that are used for public purposes. Government spending for national defense, welfare, job training, revenue sharing, and other programs, as well as revenues lost through tax incentives, do appear in the budget. Spending in the private sector for auto safety, mine safety, pollution control, and consumer protection, plus the attendant government-required paperwork, do not appear in the budget. Nor do the possible higher prices paid by consumers because of economic regulation by such agencies as the Interstate Commerce Commission, the Civil Aeronautics Board, and the Federal Communications Commission. The costs and benefits of both social and economic regulations should be more clearly available to policymakers.

If these costs were minor, their omission from the budget would not be a problem. But they are not minor. The costs are significant and appear to be growing. On the other side of the ledger, benefits are also significant but do not appear anywhere.

Although the measurement of the private sector costs of compliance with government regulations is still at the development stage, a number of studies have recently been performed which give an indication of their magnitude. According to these studies, businesses and individuals are currently spending perhaps as much as \$100 billion annually, or even more, to comply with government regulations, and the costs are growing substantially each year. Spending by State and local governments is also heavily influenced by Federal regulations, as will be shown by a study to be issued by this Committee later this year. In addition, there have been numerous studies determining the costs of individual regulations or regulatory programs.

The Federal Register, where all new regulations are printed, provides evidence that the burdens imposed by regulation are growing substantially. In 1955 the Federal Register contained only about 10,000 pages. By 1970, 15 years later, the number of pages had doubled to 20,000. In the next 7 years, however, the number of pages more than tripled to 70,000. Much of this growth has been the result of new social regulatory programs.

To get a good grip on these regulatory costs, the Budget Act of 1974 should be amended to require that Congress annually establish a regulatory budget, along with the fiscal budget, to set a limit on the costs of compliance each agency could impose on the private sector.

What we are dealing with here is essentially a third aspect of our budget process. The present budget is essentially an administrative budget containing the "on-budget" items. There are also 14 "off-budget" agencies not now included in the budget, such as the Federal

Financing Bank, with total expenditures of about \$12 billion in fiscal 1979. President Carter has proposed developing a budget for these off-budget agencies. The "off-off-budget" spending, the costs of compliance with Federal regulations, should also be shown in the budget. These costs have a financial impact on businesses just as a tax would, and an impact on the economy just as Federal spending would.

While a regulatory budget would provide an incentive for the regulatory agencies to limit the compliance costs of their regulations, it would have other important purposes as well. A regulatory budget, along with the fiscal budget, would provide a more accurate picture of the Federal Government's total impact on the economy. It would provide an effective tool for determining what percentage of the Nation's output should be devoted to public uses and what percentage should be devoted to private uses. It would make possible a better balance between regulatory programs and traditional spending programs. It would enhance the protection of the public's health and safety by requiring that the Federal Government establish priorities in pursuing regulatory objectives. The fiscal budget alone can no longer be used for these purposes, since regulations have recently become a substantial factor in government resource command. The semi-annual regulatory calendar, the first of which was published by the Regulatory Council on February 28, 1979, could prove to be an important step toward a regulatory budget.

Although some regulatory costs will be hard to measure with current techniques, many costs are measurable, including the costs of required investment, paperwork, and changes in product quality. The Joint Economic Committee will issue a report during 1979 that will discuss procedures for implementing a regulatory budget, including the gradual phasing in of such a budget. It took more than a century to develop a fiscal budget for the Federal Government, but with the Budget Act of 1921 a fiscal budget was finally developed. With the recent rapid increase in government regulation, a regulatory budget is also needed.

Recommendation No. 22

The Committee believes that the Congress and the Executive branch should begin to work on developing the methodology necessary to make a regulatory budget a reality in the future. A regulatory budget could be used to encourage government agencies to reduce the costs of regulations and could provide an additional incentive for agencies to develop cost effective regulations. In addition, a regulatory budget would supplement the annual fiscal budget to give the public, Congress, and the President a more comprehensive view of the Federal Government's command over resources for public purposes.

PRODUCTIVITY

An increase in productivity is the key to improvement in our economic standard of living and to the reduction of inflation. Since the late 1960's, the growth rate of productivity has been well below that attained over the previous years since World War II; the performance

of productivity has been even worse since the early 1970's and, especially, over the last year.

In the past year many statements of concern about our lagging productivity growth have been made. The Council of Economic Advisers, in their 1978 report, termed the productivity slowdown "one of the most significant economic problems in recent years"; further discussion was contained in their 1979 report. Numerous magazine articles discussing the subject have appeared, and "adequate productivity growth" is one of the goals of the Humphrey-Hawkins Act. But in spite of the talk, few specific actions have been taken.

The lower rate of productivity growth in recent years is one of the causes of today's inflation, worker dissatisfaction, the deficit in our balance of payments, and the weakening of the international position of the dollar. Productivity gains provide the means by which historically disadvantaged minorities can increase their economic welfare. Thus, the adverse effects of a low rate of productivity growth extend far beyond economic issues.

A variety of factors contribute to inflation, but over a period of years the most important determinant of the overall price level is the level of unit labor cost (labor cost per unit of output). In any one year, the percentage change in unit labor cost is equal to the difference between the percentage change in compensation per hour and the percentage change in output per hour. Thus, for any given rate of change in compensation per hour, each decrease of one percentage point in productivity increases unit labor cost by 1 percentage point. In the short run, changes in unit labor cost might be offset by reductions in the cost of other inputs, or by decreases in profit margins, but such offsetting adjustments cannot continue indefinitely. Continued increases in compensation per hour in excess of the rate of productivity growth are inflationary and self-defeating, since such gains are offset by higher prices.

The recent rates of productivity growth in the United States have lagged behind those of many of our foreign trading partners, contributing to the deficit in the balance of payments and the decreasing value of the dollar.

The lack of major new proposals to stimulate productivity may arise from a feeling that little can be done to raise productivity in the short run. While there may be some truth to this, such a view may become a self-fulfilling prophecy. In the early 1960's, significant gains were made with the rate of productivity growth in the private business sector rising from 2.3 percent per year for 1955-60 to 3.9 percent per year for 1960-65.

Measurement and Recent History of Productivity Growth

Productivity may be defined generally as output per unit of input. But because output depends on several inputs, there are a variety of measures of productivity. That is, labor productivity is output per unit of labor input; capital productivity is output per unit of capital input; energy productivity is output per unit of energy input materials productivity is output per unit of materials input.

In spite of a number of theoretical and empirical difficulties, several private economists and the Department of Agriculture have combined

these various inputs to produce an indicator of total factor productivity. No such measure is currently published by the Bureau of Labor Statistics.

Recommendation No. 23

We recommend that the Bureau of Labor Statistics study the feasibility of the development and publication of measures of total factor productivity.

The broadest measures of labor productivity growth—for private business, nonfarm business, farms, manufacturing, and nonfinancial corporations—are published quarterly by the Bureau of Labor Statistics, and are summarized in Table IV-1. Productivity growth in the private business sector has fallen steadily, from an average annual rate of increase of 3.2 percent for 1947-67, to 2.2 percent for 1967-72, 1.0 percent for 1972-78, and only 0.5 percent between the fourth quarter of 1977 and the fourth quarter of 1978. For any one year the difference between productivity growth rates of 3.2 percent and 1.0 percent may seem small, but over time this gap becomes sizable—24 percent after a decade, 54 percent after two decades. Thus, if the 1947-67 productivity growth rate had continued to 1978, at 1978 employment levels, gross domestic product in the private business sector would have exceeded the actual level attained by \$342 billion.

TABLE IV-1.—PRODUCTIVITY GROWTH FOR MAJOR SECTORS

[Average annual rates of change]

Sector	1947-67	1967-72	1972-78	1977:4-1978:4
Private business.....	3.2	2.2	1.0	0.5
Nonfarm business.....	2.6	1.9	.9	.8
Farm.....	5.7	5.2	2.1	-9.1
Manufacturing.....	3.0	3.0	1.8	3.7
Durable.....	2.7	2.5	1.4	3.4
Nondurable.....	3.3	3.6	2.6	4.3
Nonfinancial corporations.....	*3.2	2.0	1.1	.6

¹ Short-run changes in the BLS measure of farm productivity may not be significant.

² 1958-67; data not available for years prior to 1958.

³ 1977:3 to 1978:3.

Source: Department of Labor, Bureau of Labor Statistics.

Some of the overall productivity gains have resulted from the shift of resources out of lower productivity sectors into higher productivity sectors.

Productivity in manufacturing rose at the same annual rate (3.0 percent) over the 1967-72 period as it had over the previous two decades but fell to approximately half this rate for 1972-78. However, over the past year manufacturing productivity has risen by a rate slightly above that achieved over the 1947-72 period. Thus, while the 1972-78 performance is a cause for concern, the major sources of the decline in overall productivity growth lie outside the manufacturing sector.

In a recession, productivity tends to increase less rapidly or, in a few instances, actually decreases. Several studies of the cyclical performance of productivity have been made; they differ in some conclusions, but they agree that the recent lagging performance of produc-

tivity cannot be explained by cyclical factors. The cyclical performance of productivity shows that in a recession the effects on unit labor costs of reductions in the rate of increase in compensation are partially offset by lower productivity growth.

In Table IV-2 we have analyzed the recent productivity levels and growth rates of the major industrial sectors. Over the last three decades major shifts of labor have taken place—out of agriculture and, to a lesser degree, nondurable manufacturing and transportation, and into government, other services, and finance, insurance, and real estate—affecting the overall level of productivity performance. Contrary to popular opinion, the shift to services has actually increased the average level of private productivity. Output per hour in the private sector in 1977 was nearly 7 percent higher than the level which would have prevailed with the 1948 relative labor patterns; for the economy as a whole, this was offset partly by the increase in the share of total labor input in the lower productivity government sector. It should be noted that measurement of productivity within government and some private services is difficult.

TABLE IV-2.—SUMMARY OF PRODUCTIVITY MEASURES BY SECTOR

Sector	Share of total hours worked, 1977	Levels of productiv- ity, 1977 ¹	Average annual growth rates of productivity			Production shortfalls, 1977 ²
			1948-67	1967-72	1972-77	
Private goods...	33.1	7.72	3.7	2.4	1.3	67.5
Agriculture, forestry and fisheries	4.4	5.06	5.1	3.3	2.4	9.3
Mining	1.0	11.26	4.4	1.4	-5.1	17.1
Construction	5.3	6.26	3.2	-2.7	-1.0	37.0
Nondurable manufacturing	9.1	8.44	3.1	4.0	2.4	-2.5
Durable manufacturing	13.2	8.42	2.5	3.1	1.3	6.6
Private services...	50.1	8.33	2.6	2.3	1.1	65.7
Transportation	3.3	9.09	2.9	2.6	2.1	2.9
Communication	1.3	19.02	5.3	4.5	6.5	-7.7
Electric, gas and sanitation ser- vices	.8	21.21	6.1	3.1	1.0	14.4
Wholesale trade	5.6	10.06	3.0	4.3	-7	12.2
Retail trade	14.3	5.08	2.6	1.6	1.4	14.7
Finance, insurance and real estate	5.0	23.59	1.8	.8	1.2	17.2
Other services ³	18.9	4.92	1.2	1.6	.2	5.0
Total private	83.2	8.09	3.2	2.4	1.2	133.2
Government and Government enterprise	16.8	5.74	.2	1.0	.2	-6.0
Total	100.0	7.70	2.8	2.2	1.1	127.2

¹ GNP in 1972 dollars per hour worked by persons engaged in production.

² Production shortfall is projected production in billions of 1972 dollars less actual production; projected production is the product of 1977 hours and projected 1977 productivity, which was obtained by projection to 1977 of the average annual rate of productivity growth over the 1948-67 period.

³ Health, business services, household, education, hotels, professional and social services.

Source: Department of Commerce.

The drop in productivity growth has been widespread, but the greatest reductions have occurred in mining; construction; electric, gas, and sanitary services; and wholesale trade. Communications is the only sector which showed an improvement in the 1972-77 period over the 1948-67 period.

The Bureau of Labor Statistics publishes annual productivity indexes for a number of specific industries. The general conclusions are similar. The declines were particularly sharp in coal mining, utilities, air transportation, retail food stores, and petroleum refining.

In response to a 1970 request from the Joint Economic Committee, the Bureau of Labor Statistics also measures productivity in 28 activities (functional groupings) of the Federal Government. Data have been developed retrospectively back to fiscal year 1967. Currently, 319 organizations participate in the Federal productivity measurement program. They produce 1,919 products and services which form the bases for the 28 categories. Indexes are not published for each organization; thus within any functional grouping, the overall averages may mask wide variations between organizations in the productivity levels and trends.

As of fiscal year 1977, these productivity indicators covered 1.8 million employee-years, 64 percent of the Federal civilian total. The results show a positive rate of productivity growth in each period, both overall and for more than three-fourths of the activities. And the total rate of productivity growth was higher for 1972-77 than for 1967-72, though this was true for only half of the activities. However, the total rates and the rates for most activities are less than the 3.2 percent achieved in the private business sector for 1947-67.

No productivity measures are available for State and local government, which account for approximately 80 percent of total government employment. Thus, only about one-eighth of all government workers are covered by the productivity measurement program.

Trends for Productivity Growth: United States and Other Countries

Differences between countries in the levels and trends in productivity have major impacts on foreign trade, the balance of payments, and exchange rates. Policies to deal with these international economic questions also have effects on the domestic economy.

A number of difficulties arise in making international comparisons of productivity levels, reflecting differing patterns of output, prices for various goods and services, variations in exchange rates, and other factors. But estimates have been made; the results of one recent study by the Bureau of Labor Statistics are presented in Table IV-3. In 1977 the United States still had the highest overall level of productivity among these seven countries.

TABLE IV-3.—RELATIVE PRODUCTIVITY, AVERAGE ANNUAL PERCENT CHANGE IN PRODUCTIVITY, AND CAPITAL FORMATION, RELATIVE TO GROSS DOMESTIC PRODUCT

	Relative productivity, 1977 ¹	Average annual percent change in productivity ²				Fixed capital formation as a percent of GDP, 1962-76
		1950-67	1967-72	1972-77	1950-77	
Japan.....	62.2	7.4	9.2	3.5	7.0	33.0
West Germany.....	79.1	5.0	4.8	3.5	4.7	24.3
Italy.....	54.3	5.3	5.0	1.0	4.4	21.0
France.....	84.7	4.7	4.5	3.1	4.3	23.2
Canada.....	91.6	2.5	2.8	.8	2.3	22.2
United Kingdom.....	55.1	2.2	3.0	1.2	2.2	18.6
United States.....	100.0	2.4	1.1	.6	1.8	17.8

¹ Measured by real gross domestic product per employed civilian, using international price weights, relative to the United States.

² Measured by growth in real domestic product per employed civilian, using own country's price weights.

The greatest concern is over the trend of productivity growth rates. The growth rate of productivity in recent years has generally been higher in other industrial countries than in the United States. Productivity growth in the United States was lower than that for each of the six countries shown in Table IV-3 for 1950-77, and for each of the subperiods 1967-72, 1972-77, and (with the exception of the United Kingdom) 1950-67. Over the past few years, this may reflect the more rapid reduction unemployment in the United States; over a longer period some of the foreign trends may be due to their "catching up" by adopting (or adapting) U.S. technology. But other more basic factors, such as the higher rates of capital formation in the other countries (shown in the last column) play an important role.

If the 1967-77 trends should continue, productivity in France and Germany would exceed that in the United States by 1985; shortly thereafter this would also be true for Japan and Canada. In the steel industry, the level of productivity in Japan has already surpassed that in the United States.

For 1979 the Council of Economic Advisers has forecast a rate of productivity growth (private business sector, fourth quarter to fourth quarter) in the 0.25-0.75 percent range; the midpoint of this range is identical with the rate achieved for 1978.

As discussed above, in an economic slowdown (whether or not it formally qualifies as a recession), the rate of productivity growth normally declines. But because the rate was so low in 1978, the Administration may be correct that this will not happen in 1979.

For the longer run the Administration forecasts that the gap between potential and actual GNP will shrink, and that productivity growth (measured by the change, fourth quarter to fourth quarter, in real GNP per hour worked) will be 1.1 percent in 1980, 1.8 percent in 1981, and 2.0 percent in 1982 and 1983. The Administration also believes that the long-term trend rate of productivity growth along the potential GNP path is now 1.5 percent per year. We appreciate the candor of these forecasts, but these rates of productivity growth are simply inadequate.

Recommendation No. 24

We urge the Administration and Congress to develop specific proposals to stimulate productivity growth. In our view an underlying rate of productivity growth of 1.5 percent per year does not constitute the "adequate productivity growth" called for by the Humphrey-Hawkins Act.

Impacts of Lagging Capital Formation

One factor cited in virtually all studies of the productivity slowdown as a major or paramount cause is the low capital stock due to the recent inadequate levels of investment. If the capital stock-labor force ratio is to rise, net investment (gross investment less depreciation) must be sufficiently large so that the capital stock grows more rapidly than the labor force. This was the case until 1974, when the capital stock-labor force ratio peaked at \$10,604 (in 1972 dollars) per person. Since then investment has been inadequate relative to

the rapid labor force growth, and the ratio has fallen by nearly 3 percent. This will adversely affect economic growth for several years in the future.

Real gross private nonresidential fixed investment peaked in 1973, fell slightly in 1974, and declined sharply in 1975. Investment increased in 1976 and 1977, but did not exceed the 1973 level until 1978. Spending for structures has been especially weak; in 1978 this was still below the 1973 peak. Relative to real GNP, investment averaged 10.4 percent for the 1965-74 decade, but fell to 9.3 percent for 1975-77. This ratio rose to slightly more than 10 percent for 1978, but this is not adequate to make up for previous years.

Further, a significant share of investment in recent years has been for the installation of pollution abatement equipment which, however beneficial in reducing pollution, does not contribute directly to the production of measured output. In 1977, such outlays totalled \$6.9 billion, more than 5 percent of the total expenditures for new plant and equipment for the industries surveyed. In several industries the percentage was much higher: primary metals (15.7 percent), paper (13.8 percent), electric utilities (10.4 percent), and chemicals (10.2 percent). These figures do not consider the addition to annual operating costs from pollution abatement regulations.

Some of the recent performance of investment may be attributable to the usual cyclical pattern in a recession: economic activity falls, firms have little incentive to add to capacity, as profits and utilization of existing capacity fall. But even after allowance for cyclical patterns, investment (especially in structures) has been below desired levels.

The determinants of investment spending have been analyzed in detail by economists, but no consensus has arisen concerning the relative importance of the various factors. Some of these are:

1. Rate of capacity utilization. While there has been substantial improvement in the past 3 years, as of December 1978, 14 percent of manufacturing capacity was unutilized, a deterrent to spending for new plant and equipment.

2. Level of interest rates and availability of credit. High interest rates and restricted availability of credit deter investment. However, the real rate of interest, net of the allowance for current and anticipated inflation, is a major factor.

3. The "roller coaster" performance of the economy. It is difficult for business to plan and undertake investment with uncertainty about the future path of the economy. This is particularly true for economy. This is particularly true for cyclically sensitive businesses.

4. Inflation and tax provisions. Some of the provisions of the corporate income tax code which were designed in a noninflationary economy, act as a deterrent to investment in the current inflation. Depreciation allowances based on historical cost do not allow sufficient deductions to recover replacement costs. Similarly, profits on inventory in one sense may be illusory, because inventory must be replaced at current costs. On the other hand, in inflationary periods corporations benefit from reductions in the real value of outstanding debts.

Some of the tax changes in the Revenue Act of 1978 will stimulate investment. But these are not sufficient. We believe that per dollar of revenue loss, liberalization of depreciation allowances would be the most effective stimulant.

Recommendation No. 25

We agree with the Council of Economic Advisers that further steps to strengthen investment are needed. We favor policies that will raise real business fixed investment to 12 percent of real GNP.

Other Causes of the U.S. Productivity Slowdown

In addition to basic demographic/economic factors, lagging capital formation, and the diversion of investment to pollution abatement, several other possible causes of the productivity slowdown have been cited. These include government regulations in general, insufficient spending for research and development (R. & D.), possible changes in work attitudes, and the increase in crime. In the opinion of business leaders Federal regulation is the most important cause of the productivity slowdown.

Research and development are essential to the growth of productivity, although more needs to be known about how R. & D. influences productivity in specific industries. The decline of real spending for R. & D. in recent years has undoubtedly had an adverse impact on growth. Spending for R. & D. peaked in 1968 at \$31.1 billion (in 1972 dollars); in 1977, real R. & D. was \$28.5 billion, although some of the drop reflected reductions in space and military-related R. & D. Relative to GNP, R. & D. fell from 3 percent in 1968 to approximately 2 percent in 1977.

Various proposals to stimulate R. & D. generally involve either more direct government support or tax incentives. One drawback to the latter is that there might be some difficulty in defining R. & D. sufficiently narrowly to distinguish it from design, styling, and marketing/manufacturing startup costs. But we believe that this would not be an insuperable problem—considerable analysis on the definition of R. & D. has been carried out by the National Science Foundation and others.

Recommendation No. 26

We urge consideration of additional tax and other incentives to promote industrial R. & D.

The importance of investment should be emphasized again; many of the benefits from R. & D. must be embodied in new capital plant and equipment.

Some social observers have suggested that there has been a change in work attitudes since the late 1960s, and that this change has adversely affected productivity. In the Chamber of Commerce-Gallup survey of business leaders, 83 percent listed this as a cause of the slowdown—this was the third most commonly cited factor. In order to improve morale, more productivity-sharing programs might be established.

Recommendation No. 27

We support Federal policies which encourage the establishment in industry of joint labor-management committees to identify opportunities for productivity gains and the improvement of worker morale.

Finally, one study has discussed the effects of rising crime and dishonesty on productivity. This involves both loss of output and the need to devote inputs (e.g., store guards) to the prevention of crime. The overall impact is not major.

One offset to these negative factors is the increase in average educational attainment of the labor force. According to one study, this has made a steadily increasing contribution to productivity growth.

There appears to be a consensus among researchers over the list of possible causes of the productivity slowdown. There are differences of opinion on the relative importance of these various causes. Disagreements also exist about the most appropriate policies. But all agree that this is one of our most pressing national economic problems.

V. ENERGY, FOREIGN TRADE, AND AGRICULTURE

ENERGY

Review and Outlook

Led by sharply higher spot petroleum prices in December, energy prices rose 8.1 percent from December 1977 to December 1978. As shown in Table V-1, energy prices to consumers have more than doubled in the last decade, outstripping the rise in prices for food, housing, apparel, transportation, or entertainment. Only the cost of medical care has kept pace with energy inflation. This striking price behavior reflects the role of petroleum as the worldwide marginal energy source and the continuing existence of an international petroleum cartel practicing monopoly pricing.

TABLE V-1.—*Price increases for urban consumers, 1967-78*

<i>Item</i>	<i>Percentage price increase</i>
All Items.....	103
Energy	128
Housing	112
Apparel and upkeep.....	63
Transportation	93
New cars.....	60
Medical care.....	128
Entertainment	81
Personal care.....	87
Commodities	94
Services	119

Source: Consumer Price Index for Urban Consumers, Department of Commerce, December 1978.

These forces and supply shortfalls from the cessation of Iranian petroleum production will force sharply higher prices on consumers during 1979. Last December, the Organization of Petroleum Exporting Countries (OPEC) dictated a 14.5 percent (\$1.92 per barrel) price rise during 1979 for benchmark light Saudi crude petroleum. The Commerce Department estimates that this alone will add .3 of 1 percentage point to consumer prices in 1979. Private analysts are projecting all energy prices to rise 13 percent in 1979. These projections will be low. Unless Iranian petroleum production is rapidly restored to near-full capacity, petroleum price hikes this year could approach the level recorded in 1973.

Tighter markets in recent weeks have sent spot crude and product prices soaring; heavy fuel oil has been selling well in excess of \$15 per barrel, FOB Rotterdam, and premium gasoline in excess of \$25 per barrel. These prices have met virtually no buyer resistance as suppliers scrambled to fulfill contracts. OPEC members are switching exports from longterm contractors to spot markets in order to capture

these sharply higher spot revenues now flowing to middlemen. A number of members, including Abu Dhabi, Algeria, Iraq, Kuwait, Libya, Qatar, and Saudi Arabia have announced higher prices. And OPEC ministers at their March 26th emergency meeting in Geneva will face pressure to formalize these *ad hoc* price increases. The remainder (9.5 percent) of the 14.5 percent OPEC price hike schedule throughout 1979 could well be imposed entirely in the second quarter.

Of more immediate threat to the economy than sharply higher inflation in energy prices is the prospect of supply shortfalls arising from disrupted Iranian petroleum production. Since this disruption began in December, world oil reserves have declined by over two million barrels daily; the U.S. portion of this shortfall is some 500,000 barrels per day. Continued turmoil could prevent a significant resumption of Iran oil exports before summer. The resulting stock depletion could necessitate petroleum use restrictions by mid or late spring unless Saudi Arabia permits production to rise above its current 9.5 million barrels per day ceiling. Since the Iranian production curtailments in December, the Saudi's have been content to let petroleum markets tighten. They cut production for the first quarter of 1979 from the 10.25 million barrels per day recorded in November and December. The Saudi's have already imposed the entire 14.5 percent price hike on about 1 million barrels of daily output months earlier than scheduled.

Saudi Arabia may not be willing or able, due to technical constraints in their fields, to rectify the present global petroleum shortfall.

The President has adequate standby authority to implement petroleum allocation schemes designed to spread supply curtailments evenly. In the event the President concludes that stronger measures are needed he would have to seek speedy approval from Congress of measures such as a standby emergency gasoline rationing program and of energy curtailment plans, including proposals to limit service station hours. Such action may also be necessary to comply with International Energy Agency agreements designed to minimize OPEC price increases. Presumably, interregional price inequities that result from the implementation of emergency measures would be eliminated.

These conservation steps alone may not prevent spot petroleum shortages later this year if Iranian production is not fully restored and Saudi Arabia does not provide substitute volumes. Consequently, the President should be prepared to take these additional steps before instituting gasoline rationing or petroleum allocation:

Recommendation No. 28

Encourage a switch of oil-fired boilers at the numerous utilities and major fuel burning installations to natural gas for those firms that can speedily make the adjustment. Utilizing the temporary domestic gas bubble of one trillion cubic feet annually in this manner would reduce petroleum imports by up to 500,000 barrels daily.

Recommendation No. 29

Establish a contingency program to wheel electricity from the Midwest to the East Coast. This would replace oil-fired electric generation capacity using up to 100,000 barrels of fuel oil daily with comparable coal-fired gen-

eration capacity. Substantial quantities of electricity were wheeled in the opposite direction during the coal strike in the winter of 1977-78.

Recommendation No. 30

The President should expedite the installation of pumps and associated hardware for the withdrawal of petroleum from the Strategic Petroleum Reserve.

Beyond 1979

The prospect facing consumers in 1979 of oil shortages and sharply escalating gasoline and fuel prices is not a transitory phenomenon. Despite optimistic reports of new petroleum finds, particularly in Mexico, global spare capacity of that key fuel at about 10 percent (including Iran) is dangerously small. As a major oil importer, the United States will remain subject to supply disruptions from insecure foreign energy sources into the foreseeable future. It must aggressively act to reduce that dependency through energy conservation, increased domestic energy production, and the development of relatively more secure foreign energy supplies.

Conservation

The United States uses energy relatively inefficiently. This in part reflects the traditionally low energy prices in this country. Energy use per capita, for example, is some 50 percent higher per dollar of product than in West Germany. As shown in Table V-2, both Sweden and West Germany are much more modest consumers of energy on a per capita basis for a variety of residential tasks.

TABLE V-2.—PER CAPITA RESIDENTIAL ENERGY USE RELATIVE TO THE UNITED STATES
[Percent of U.S. levels]

	Sweden, 1972	West Germany, 1972
Space heating.....	74	67
Water heating.....	105	37
Air-conditioning.....	Nil	Nil
Clothes drying.....	Nil	Nil
Refrigeration and cooking.....	70	—
Lighting.....	31	28
Total.....	76	48

Sources: Lee Schipper and A. S. Lichtenberg: "Efficient Energy Use and Well-Being, The Swedish Example," *Science*, 194, p. 1001, Dec. 3, 1976, and, Richard L. Goer and Ronald K. White: "Comparison of Energy Consumption Between West Germany and the United States," prepared for the Federal Energy Agency by the Stanford Research Institute, June 1975.

Similar findings exist for a variety of manufacturing activities. For example, paper manufacturing requires only 77 percent as much fuel per unit of output in Sweden and 57 percent in Germany compared to the United States. Comparable figures for steelmaking are 85 percent in Sweden and 68 percent in Germany.

While relatively low, energy efficiency in the United States increased steadily from the 1920's to 1960. For example, in 1960, energy use per (constant) dollar of Gross National Product was 45,000 Btu's versus 75,000 Btu's in 1920. This trend was reversed briefly in the

1960's, but the economy's energy efficiency began to improve once again in 1970 and was later reinforced by energy price hikes associated with the 1973 petroleum embargo. In real terms, GNP grew about 15 percent between 1973 and mid-1978, while energy use grew only 5.5 percent.

Provisions of the National Energy Act, enacted last fall, as well as legislation enacted earlier, should accelerate the trend toward energy efficiency. But additional actions to improve the long-term efficiency of energy use are appropriate, including an emphasis on conservation initiatives which directly reduce petroleum imports and an assessment of the effectiveness of the present voluntary appliance efficiency standards. An aggressive information program for homeowners, including the training of energy productivity specialists through energy extension services and the development of an energy performance index for buildings, is also appropriate.

These relatively minor steps will promote the Administration's goal of saving through conservation 5 million barrels of petroleum equivalent daily by 1985.

Increased Domestic Energy Supply

Recommendation No. 31

We should reduce our dependence on foreign energy sources by encouraging domestic production.

PETROLEUM

Imported petroleum constituted 21 percent of domestic energy consumption in 1978, up from 14 percent in 1972. Since 1972, domestic petroleum production has fallen over 10 percent, domestic petroleum reserves have fallen nearly 20 percent and oil imports have jumped 50 percent. Yet, domestic petroleum demand has risen over 10 percent and is projected to rise 2.5 percent annually through at least 1981.

The decontrol of domestic petroleum prices is one effective step to reduce petroleum demand and raise domestic production, thereby reducing the volume of insecure imports. Improved energy efficiency will also reduce petroleum imports. Under provisions of the Emergency Petroleum Allocation Act, the President has authority to propose price decontrol this spring. However, abrupt price decontrol will excessively burden consumers already confronting a minimum 14.5 percent OPEC price hike this year. At the same time, some price action by the President is appropriate to avoid the premature shut-in of high-cost wells and for the application of expensive tertiary oil recovery techniques.

Federal petroleum price regulations permit price relief for high-cost properties on a case-by-case basis. This exceptions process has proven too expensive for owners of small-volume properties subject to relatively high production costs. They have plugged wells or restrained production to less than ten barrels daily in order to qualify their properties for free-market stripper-well prices. Some price relief for low volume marginal properties could yield up to 700,000 additional barrels of oil daily by 1985 from 75,000 marginal wells.

Primary and secondary waterflood oil recovery techniques widely used today obtain only one third of the petroleum from producing fields. A variety of tertiary chemical and thermal techniques are available to increase that yield by five to 10 percent. But they are expensive and have lengthy lead installation times of three years or more. Yet the application of these tertiary recovery techniques would add from 25 billion to 40 billion barrels to proven domestic petroleum resources (now estimated at 30 billion barrels) and raise production by up to 2 million barrels daily by 1990.

Recommendation No. 32

The President should reduce oil imports by providing incentives through administrative action and otherwise to achieve maximum additional domestic production from small volume marginal wells which hold the greatest promise of additional supplies and to stimulate the application of tertiary petroleum recovery techniques.

RENEWABLE ENERGY

Renewable energy, including solar energy, wind, biomass, ocean thermal, geothermal, hydroelectric energy for small dams, and gasohol, is the most environmentally attractive long-term energy form for the economy.

The Federal renewable energy research program has grown sharply in recent years. Including tax credits, total outlays are \$730 million in Fiscal Year 1980. This aggressive program is designed to reduce the cost of renewable energy through a rapid buildup of technology. It must continue if the Administration's target of renewable energy supplying 10 percent of our energy by the year 2000 is to be met.

The rapid application of renewable energy is inhibited because consumers still see it as a relatively immature and expensive technology. That perception is not accurate for selected applications including, in particular, the production of low temperature heat. This application is both mature and cost-competitive with electricity. Yet, despite the availability of recently enacted tax benefits, its widespread adoption may not occur rapidly without further stimulation to overcome high initial system costs. Potential applications are enormous. Twenty-two percent of the fuel consumed in the United States is used to provide low temperature heat for water and space heating in commercial and residential buildings. Complete substitution of renewable energy systems over time for these purposes is impossible due to architectural, cost, and other barriers. But if even half of the low temperature heat demand is replaced with renewable energy, petroleum imports would be reduced significantly.

Recommendation No. 33

To overcome the high initial costs of renewable energy systems which are presently cost-competitive, a Federal Energy Bank should be created to provide low-cost loans for such systems, including solar energy systems.

The operation of an energy Bank could be extended, as well, to cover relatively expensive renewable energy applications such as gas-

ahol. The production of petroleum supplements or gasahol from agricultural products and by-products is a promising option for minimizing petroleum imports. Cost barriers to the widespread use of gasahol are rapidly being diminished by OPEC action and research. Federal research efforts on ethanol alcohol fuel technology should be intensified.

COAL AND NUCLEAR ENERGY

The substitution of oil with coal has not approached the expectation created by the President in early 1977 when he announced his energy program. The government was expected to mandate a doubling of coal use by 1985, which alone would reduce petroleum imports by up to 6.6 million barrels of oil daily. Coal's share of domestic energy supplies would rise to 29 percent from 18 percent. But the 1978 strike, reduced and uncertain future electricity demand, and ineffective Administration policies have caused coal use to stagnate. Output in 1978 at 661 million tons was only 1 percent above 1975 and well below the 695 million tons produced in 1977.

The coal industry has the ability to expand output rapidly, but demand is lacking. Utilities use two of every three tons of coal mined. In 1977, they were projected to construct 259 new coal-fired plants by 1986, doubling their demand for coal. Projections now are for only 219 new plants by then, and the Administration's target will not be hit.

The remaining one-third of domestic coal consumption is by industry. The Administration originally projected a quadrupling of industrial coal use by 1985. With a few notable exceptions, such as the cement industry, that target also will not be hit. The conversion of boilers to coal from oil is financially impractical for smaller sized plants. And larger ones face expense in complying with clean air standards.

The coal incentive provisions of the National Energy Act prohibit oil and gas use in big, new industrial boilers, grant additional coal conversion authority to the Department of Energy and authorize funds to upgrade coal transport facilities and to minimize the negative impact of increased coal production. Taken together, these steps should produce petroleum imports by 300,000 barrels daily within 5 years. Voluntary conversions would buttress these savings. And such conversions will occur if pollution abatement facility costs are reduced through further Federal research.

The contribution of nuclear energy to domestic electricity supplies reached 13 percent last year, reflecting the continued start-up of facilities licensed in past years. That figure will more than double over the next decade if the 133 nuclear plants with construction permits granted or pending supplement the 71 operating plants. But utilities are increasingly concerned with uncertainty both in licensing procedures and costs of nuclear power. These capital intensive facilities are particularly subject to disfavor during periods of high interest rates. And no definitive conclusion exists yet on the cost of nuclear *versus* coal power. Regulatory uncertainty will persist, as well, as issues of nuclear waste management and low-level radiation hazards increasingly enter the licensing process. Only two nuclear reactors were ordered in 1978, both by Commonwealth Edison in Chicago. These orders were deferred early in January. Prospects are little different for 1979.

Recommendation No. 34

The Federal Government should accelerate research efforts to reduce the cost of coal pollution abatement facilities, to develop secure nuclear waste storage systems, and to clarify low-level radiation hazards.

International Energy Sources

Currently 45 percent of United States crude petroleum imports are from relatively volatile Arab producers (OAPEC) who participated in the 1973 embargo against the Western economies and Japan. Libya and Algeria alone are the source of 20 percent of crude petroleum imports representing almost 10 percent of total domestic petroleum supplies (See Table V-3). We import no crude petroleum from the United Kingdom or Norway, and less than 10 percent of such imports come from Mexico and Canada—a proportion that will decline as Canadian domestic energy policies are fully implemented.

Eventually, conservation, added domestic energy production, and further research on coal technologies will reduce the economy's excessive dependence on foreign petroleum. More aggressive action is called for, however, to reduce the possibility of temporary petroleum import disruptions in the near term.

Recommendation No. 35

A major emphasis of the Administration's long-term international energy policy should be the substitution of Mexican and Canadian supplies for overseas sources. Mexico and Canada's proximity as neighbors offers the United States the opportunity to substantially backout OPEC petroleum imports with pipeline natural gas as well as petroleum, and the Administration should expedite efforts to acquire such gas and petroleum at a competitive price to complement domestic supplies.

TABLE V-3.—CRUDE OIL IMPORTS BY SOURCE, UNITED STATES

Sources	Percent of total	
	September 1973	October 1978
OPEC:		
Arab OPEC.....	30.8	45.3
Algeria.....	3.6	10.4
Iraq.....	.5	2.2
Kuwait.....	1.3	—
Libya.....	4.4	10.3
Qatar.....	1.2	.7
Saudi Arabia.....	17.3	17.7
United Arab Emirates.....	2.5	6.2
Non-Arab OPEC.....	37.5	34.8
Ecuador.....	.9	.5
Gabon.....	—	2.2
Indonesia.....	7.2	7.9
Iran.....	5.9	9.4
Nigeria.....	11.8	14.3
Venezuela.....	11.7	2.5
OPEC total.....	68.3	80.1

TABLE V-3.—CRUDE OIL IMPORTS BY SOURCE, UNITED STATES—Continued

Source	Percent of total	
	September 1973	October 1978
Non-OPEC:		
Canada.....	28.8	3.6
Mexico.....	.2	6.1
United Kingdom.....		
Norway.....		
Other, Untraced ¹	2.7	10.2
Total.....	100.0	100.0

¹ Includes Abu Dhabi, Bahrain, Dubai, Sharjah, and Syria.

Note: Imported petroleum products in 1978 constituted 23 percent of total petroleum imports. The distribution of product supplier source mirrors that for crude petroleum. Most imported products are processed at Caribbean refineries.

Source: "International Energy Statistical Review," Central Intelligence Agency, Feb. 7, 1979.

Of these three neighboring sources, Mexico offers the greatest prospect. It is soon to be a major force in international energy affairs, as reflected by the President's recent visit to that nation.

A staff report released in January for the Joint Economic Committee's Subcommittee on Energy highlighted prospective Mexican energy resources: its oil reserves are huge, rivaling those of Saudi Arabia; its natural gas supplies are equally impressive and already approach those of the United States. The report stressed the need for Mexico to export gas in order to maximize oil production. It will be shutting in at least 800,000 barrels of oil per day by 1988 unless associated gas can be exported.

Mexico considers its newly discovered energy reserves a national patrimony and negotiations for use are a subject of intense pride. Consequently, the Administration must conduct its efforts with sensitivity to issues of bilateral trade and immigration and in the context of a spirit of understanding and cooperation between the two nations.

Vast areas of the globe have not been intensively explored for fossil fuel deposits. Developments in Mexico suggest that a much more thorough assessment of prospective deposits, especially in developing countries, is needed.

Recommendation No. 36

The United States should encourage the diversification of world energy sources and world energy supplies by encouraging an increase of exploration and production in the developing nations.

FOREIGN TRADE

The relative decline of the United States as a world trade force has occurred at the same time that the United States has become more involved with and dependent on the rest of the world. The growing dependence can be seen most clearly in the field of energy. From the position of a net exporter of petroleum and petroleum products, the United States has shifted to becoming an importer of about 50 percent of its petroleum needs. But the growing dependence can be seen in other spheres as well. The United States relies on imports for high percentages of a number of vital raw materials including chrome, tin, and platinum.

The growing involvement of the United States in the world economy is not limited to a sharp increase in the import of oil or other raw materials. Almost *one-third* of U.S. agricultural production is exported. Major industries such as computers, aircraft, farm implements, and machine tools are heavily dependent on export markets. Exports and imports accounted for about 7.7 percent of U.S. GNP in 1968. The figure for 1977 was almost twice as high, 14.4 percent. If the export and import of services (including such items as licensing agreements, royalties, and dividend) are included trade in goods *and* services equals about 19.2 percent of total U.S. output.

U.S. direct investments abroad now total more than \$150 billion. A large number of our leading corporations draw a substantial percentage of their total earnings from foreign operations.

The growing importance of the non-oil producing developing countries as a market for our manufactured goods has not received enough attention. In 1977, U.S. exports of manufactured goods to the non-OPEC developing countries were four times larger than our exports to Japan and almost equalled manufactured exports to all of Organization for Economic Cooperation and Development (OECD) Europe. Developing countries are entering the international markets in traditional manufactured items, while competition in high-technology goods is likely to become intense as Japan and Europe challenge the American position.

A new era of slow growth rates in many industrialized countries, the shifting pattern of trade, and growing American dependence on international markets will require continuing structural adjustments both in the United States and in other major industrial powers. The United States will have to become a more efficient producer at home and a tougher competitor abroad if it is to maintain a leadership role in the forging of a stable international monetary system and a more liberal trade order. The United States must also insist that restrictive trade barriers—tariff and nontariff alike—be reduced worldwide.

The Trade Deficit: Causes, Consequences, Cures

The United States has had a troubled trade performance for much of this decade. In 1971, the United States experienced a deficit in merchandise trade for the first time in this century. The deficit jumped from 2.3 to 6.4 billion in 1972. Dollar devaluation in 1971 and 1973 helped push merchandise trade back into a modest \$911 million surplus in 1973. Another deficit in 1974 was followed by a recession-born surplus of \$9 billion in 1975. As the United States started to recover from the recession, the trade account swing by \$18 billion back to a \$9.3 billion deficit in 1976.

Throughout the 1970's, however, the United States has achieved steady and substantial surpluses in services—reflecting the flow of fees, royalties, and dividends from U.S. overseas investments. In most years, the U.S. performance in services has been strong enough to more than offset the merchandise trade deficit and assure the United States of a surplus on its current international transactions or current account. That was not the case in 1977. The \$15 billion U.S. surplus on

all current transactions excluding trade was more than offset by a record \$31 billion deficit in trade.

THE PERFORMANCE IN 1978

The trade deficit worsened in 1978, rising to \$34.2 billion. The current account was also larger at around \$17 billion, despite another strong performance in services.

Coupled with a rising rate of domestic inflation, the larger trade and current account deficits precipitated a rapid drop in the international value of the dollar, especially relative to other major currencies. From October 1977 through the end of October 1978, the dollar fell more than 12 percent on a trade weighted basis. During the same period, the dollar fell by 27.9 percent relative to the German mark and by more than 42 percent relative to the yen.

Despite exchange market volatility and record trade and current account deficits, 1978 did contain some promise that the international economic fortunes of the United States would begin to improve in 1979. The size of the trade deficit in the first quarter was considerably larger (\$11.2 billion) than the fourth quarter (\$7.4 billion). Agricultural exports remained high and there was some improvement in the manufactures trade balance.

THE PROSPECTS FOR 1979

Based on the economic situation at the close of 1978 (after the December OPEC meeting but before the more recent increases in the price of oil) the U.S. trade deficit for 1979 should fall somewhere in the \$25 to \$30 billion range. Although still very large by historical standards, that would be a definite improvement over 1978. The deficit in the current account was also expected to fall below \$10 billion.

There are still several reasons to expect a smaller trade deficit—slower economic growth at home coupled with faster growth abroad, reduction in domestic demand as the Federal deficit falls, increased competitiveness because of dollar depreciation, and increased gold sales.

The year should also see a better distribution of current account deficits and surpluses among the industrial powers that are members of the Organization for Economic Cooperation and Development (OECD). Recent developments in oil markets, however, could offset these trends.

FASTER GROWTH ABROAD

During the 1960's and early 1970's, the 3.6 percent real growth rate for the United States lagged well behind the 5.8 percent real growth rate recorded by other major industrial powers. In 1976-77, this relationship was reversed, with the United States growing at an average rate of 5.3 percent while the rest of the industrial powers grew at only 4.3 percent. The United States grew faster than any of the major industrial powers relative to long-term trend growth rates. 1979 should see some movement back toward the pattern of the 1960's. Official forecasts now put U.S. real growth at around 2 percent for 1979. Some private forecasters believe that even 2 percent is overly optimistic. Although growth in Japan is expected to fall, the rest of the OECD group is expected to grow somewhat faster than in 1978.

INCREASED U.S. COMPETITIVENESS

Between September 1977 and November of last year, the U.S. dollar depreciated about 12 percent on a trade weighted basis. Adjusting for the higher inflation at home than abroad still left the United States with nearly a 10 percent improvement in its *real* competitive position.

Following the announcement of the President's dollar support plan in November 1978, the dollar appreciated against both major foreign currencies on a trade weighted basis. Despite some competitive loss, the dollar remains just about 4 percent below the September 1977 level in real terms. It generally takes from 1 to 2 years for an exchange rate change to be reflected in an improvement in actual trade figures. Trade gains from dollar depreciation could be somewhere between \$5 and \$10 billion next year.

Some observers feel, however, that insofar as the excess depreciation triggers further price increases and cost-of-living adjustments to wages in the United States during the period, this competitive gain will be partially offset.

Ultimately, U.S. competitiveness will be increased by improving productivity and reducing tax and regulatory burdens.

ENERGY AND TRADE

At the end of 1978, the impact of energy imports on the U.S. merchandise trade account was fairly clear. The higher than expected oil price increase has already caused forecasters to revise their estimates of the U.S. 1979 oil import bill upward by some \$4 billion and to raise the expected trade deficit by about \$2 billion. Recent developments will require further revisions.

The political turbulence in Iran and the subsequent disruption of Iranian oil production has already begun to cloud the economic outlook for the United States and the other industrialized countries. The stoppage in Iranian oil exports eliminated about 16 percent (or 5 million bbls. a day) of free world trade in oil. Thus far, additional production by other OPEC members has kept the net shortfall to 6 percent (2 million bbls.) of noncommunist oil trade. In the wake of reduced world oil supplies, a number of OPEC countries have already raised prices on all or part of their oil exports. Further price increases may follow the March 26 meeting of OPEC. Nor will the resumption of Iranian oil exports necessarily remove the pressure for oil price increases. In announcing the Iranian Government's intention to resume oil export in early March, an Iranian spokesman indicated that oil would be sold at between \$18 and \$19 a barrel, some 30 percent above the current OPEC price levels.

Rising oil prices have a fairly clear message for domestic inflation. Their impact on the trade account, however, is not nearly as clear. The sharp drop in the OPEC current account surplus (from \$31.5 billion in 1977 to \$11.0 billion in 1978) suggests that larger OPEC revenues will now be matched by an increase in OPEC imports. Moderately higher oil prices would definitely add to the U.S. import bill, but the impact on the trade account would be offset by a rise in U.S. exports. The magnitude of recent OPEC price increases, however, could upset that relatively sanguine view. If sharply higher oil prices slow growth in Western Europe, Japan, and the developing world, U.S. exports

will suffer. The impact on the trade account has been compounded by the decision of Iran to cancel billions of dollars in American contracts. In sum, the oil situation could seriously reduce the hoped-for improvement in the U.S. trade and current accounts.

It is hoped that the President's energy bill and other energy-related legislation will encourage energy conservation. It is often overlooked that the United States has made some progress on the energy front. Prior to the early 1970's, the use of energy actually grew a bit more rapidly than did GNP. It has fallen relative to GNP since that period.

The growth of Mexican oil exports could also benefit the long-term trade account. Mexico is already a major trading partner and its growing oil revenues could create a natural market for U.S. exports of machine tools and other high technology items.

In the longer term, there may be some dividends for the United States from the new World Bank policy of providing seed money to encourage oil exploration in various developing countries. Anywhere outside the Arabian Peninsula, greater oil exports will be matched by greater imports.

GOLD SALES

For 1978, total gold sales will amount to about \$800 million. The program announced by the Treasury Department on November 1 will boost the level of gold sales to at least 1½ million ounces per month, starting in December 1978. If sales continue at that level throughout 1979, there should be an increase in gold sales of about \$3 billion, at current market prices.

Improving the U.S. External Position

The projected improvements in U.S. trade and current accounts do not necessarily assure long-term stability in the international trade or monetary systems. Rising domestic inflation and growing uncertainty over the price and security of energy supplies could lead to renewed instability later in 1979.

The precipitous decline in the international value of the dollar against major foreign currencies was a product not only of the large U.S. trade and current account deficits but also of a general imbalance in international payments among the OECD countries. While the United States experienced a record current account deficit of \$17 billion in 1978, Japan was in surplus by \$20 billion and Germany by another \$6 billion.

In part, the trading imbalance among major industrial powers reflects structural problems in the United States as well as the lag between the fall in the international value of the dollar and an increase in U.S. exports. But far more than an economic lag or laggard behavior in export markets is involved.

As noted above, much of the U.S. trade deficit has been caused by higher growth rates in the United States than is true for many of our traditional trading partners. For instance, comparing the 1977 growth rates of the United States, Canada, Japan, France, and Germany to the average growth rates achieved in the 1960 to 1973 period, only the United States exceeded (4.9 percent to 3.9 percent) its 1960 to 1973 growth rate. The best performance in the remaining countries was less

than half its 1960 to 1973 average rate of growth. In many cases, the slow growth rates were the result of conscious slow-growth policies that sent thousands of European guest workers back to their home countries.

The prospects for greater current account balance among OECD countries stems not so much from high growth abroad as from low growth in the United States coupled with past dollar depreciation. Although growth rates in Europe will be generally higher than in 1978, they remain below their 1964-1973 average. Japanese growth for the year is expected to slow slightly (as a result of slow export growth) and will be at a little over half of the rates achieved in the 1964-1973 period.

The OECD community has not yet adjusted to the changed economic circumstances that have come in the wake of the four-fold increase in the price of oil in 1973. Previously, high domestic savings rates in parts of Europe as well as Japan were translated into business fixed investment and high growth rates. Since the OPEC mandated rise in the price of oil, savings rates in many OECD countries have remained high, but investment and growth both have fallen. The result has been a tendency to accumulate trade and current account surpluses and to enlarge public deficits.

The U.S. balance-of-trade and current accounts deficits also reflect the imbalance in the rules that govern international trade and monetary affairs. As part of a broad-based effort to reconstruct the war damaged economies of Western Europe and Japan, the United States accepted more restrictive behavior in the part of its trading partners than it applied to itself. The hope was that as recovery progressed, the restrictions on trade and payments would be reduced. They have been. But the pace of economic recovery has been more rapid than the pace of trade liberalization.

U.S. trade has also been affected by the workings of the floating exchange rate system. In assessing the system, it is important to keep in mind that the world does not have a textbook example of a generalized floating system. Many countries have chosen to peg their currencies to the dollar or another leading currency. Government purchase of foreign currencies and other practices have also reduced the degree of floating. However, the major European currencies, the dollar, and the yen have varied considerably in value since 1971.

The oil shock of 1973 and the widely divergent inflation rates in the leading industrial countries made some form of floating necessary.

It is important to remember that a system of floating or flexible exchange rates does not in and of itself assure balance in either trade or current accounts. Capital flow, the desire to hold national reserves, or speculative pressures will also affect the value of a currency. When OPEC ran a substantial current account surplus with the rest of the world, several countries were bound to experience current account deficits.

The current system is flexible, but it is not pure floating. Countries can and do intervene in foreign exchange markets to keep the value of the currency from rising or falling. The precipitous fall in the value of the dollar relative to the yen was partly caused by earlier heavy Japanese purchases of dollars in 1976. If the Japanese had not inter-

vened, the dollar would have declined earlier but more gradually. American goods would have become more competitive sooner, and the U.S. trade deficit would have been smaller.

Throughout the two years of the Carter Presidency, the United States has sought to deal with trade and current account deficits through international discussions and multilateral negotiations. At the London Summit in May 1976, and again at the Bonn Summit in July 1977, the United States urged major surplus countries to stimulate their economies to increase their level of imports and reduce pressures to increase exports. To a limited extent, the United States has been successful. Germany pledged a substantial increase in fiscal stimulus and Japan agreed to seek a 7 percent growth rate in fiscal 1978 (March 1978 to March 1979). Both pledges have been followed by concrete action. Although Japan has recently abandoned hopes of achieving a 7-percent growth rate, it did adopt a supplementary budget in September 1978 that will provide some stimulus through the first half of 1979. However, these modest increases in fiscal stimulus have had little effect on correcting the current imbalances among the major industrial powers.

The United States has also sought to limit the ability of surplus countries to intervene in exchange markets to preserve export markets. Recent amendments to the International Monetary Fund (IMF) Articles of Agreement gave the IMF powers of surveillance over exchange market intervention. It is not yet clear how effective the IMF can or should be in controlling exchange market behavior. Although in some sense there is a system of surveillance, the IMF still has relatively little power over surplus as opposed to deficit countries.

The Carter Administration has put considerable emphasis on achieving a satisfactory conclusion to the current (Tokyo) round of trade negotiations. Under the able leadership of Ambassador Robert Strauss, the United States negotiating team appears to have broken new ground in attempting to bring a wide range of government subsidies as well as some aspects of government procurement policy under international supervision.

Recommendation No. 37

In past reports, the Committee has supported the Administration's attempts at international coordination of macroeconomic policies and efforts to build a more flexible international monetary system and a more open trading regime. The Committee continues to support Administration efforts to achieve a better trade and current account balance through international discussions and multilateral negotiations.

The multilateral approach to trade and current account imbalances has not been entirely successful. The economic summits are probably a necessary step toward greater macroeconomic coordination among the major industrial powers, but they remain more prelude than policy. For some time to come, domestic pressures, not international responsibilities, are likely to dictate most fiscal and monetary decisions around the world.

The Administration's dollar support plan, to some extent, has muted the question of exchange rate surveillance. The Administration has stressed its intention to pursue intervention only to avoid disorderly

exchange market conditions. But the temptation to avoid the inflationary repercussions of dollar depreciation may reduce the pressure on our economic allies to make the kind of domestic adjustments that would support international economic stability. On the other hand, if widening inflation differentials between the United States and its trade partners and persistent payments imbalances precipitate another round of dollar depreciation, the conditions will be ripe for renewed exchange market intervention to preserve their export markets in the United States. There is as yet no indication that the IMF efforts at surveillance will prevent the kind of distortions that took place in 1976.

The results of the latest round of multilateral trade negotiations will be available when final agreement is reached and the terms of the agreement are made public. The United States has attempted to bring under control a number of trading practices that have had the effect of reducing U.S. exports (and allegedly increasing U.S. imports). A preliminary assessment of the nontariff measure codes negotiated at Geneva promises some progress in such areas as government procurement and export subsidies. The short-term impact of the multilateral trade agreement should not be overestimated. In testifying before the Committee, Ambassador Strauss emphasized how limited the immediate gains for U.S. exports would be. He noted that the trade agreement would provide not so much a solution as a framework within which continued U.S. initiatives could lead to smaller trade deficits and greater balance among the OECD members and several advanced developing countries.

Unilateral Measures May Be Necessary

What should the United States do if international consultations or negotiations fail to move the international system back toward stability? In the course of our annual hearings, the Committee heard a wide variety of suggestions ranging from the need for more rapid productivity growth to the importance of a national export policy. Two witnesses spoke in terms of unilateral U.S. actions that would slow import growth.

In his testimony before the Committee, Edward M. Bernstein traced the recent dollar instability to a pattern of growth in Europe and Japan that has come to depend "...on a very large surplus on current account." Bernstein finds that only a portion of the U.S. deficit can be attributed to cyclical factors and links the high deficit to the economic policies followed in Europe and Japan. Bernstein concluded his testimony by noting that "...the strength of the dollar in the exchange market will depend on restoring an acceptable trade balance." If that proves to be impossible in the next few months, Bernstein suggested that "...it may be necessary to reduce the deficit by limiting imports from the surplus countries."

A similar suggestion was made by William Miller, Chairman of the Board of Governors of the Federal Reserve System, during his appearance before the Committee. Chairman Miller was asked what he would do if the dollar renewed its sharp fall on foreign exchange markets. In response to a hypothetical choice between higher domestic interest rates and an across-the-board import surcharge, Chairman Miller opted for the surcharge.

The Bernstein-Miller position did not reflect the sole or even the majority position of the witnesses who appeared before the Committee. There remained a strong current of hope that by putting its own economic house in order and by continuing its commitment to a multilateral approach, the United States could achieve reasonable trade and current account balance.

Recommendation No. 38

The Committee strongly supports the multilateral approach, but realizes that appropriate unilateral measures to encourage surplus countries to meet their international obligations may be necessary.¹

Appropriate Domestic Policies

Trade negotiations and greater international coordination of macroeconomic policy are no substitute for the adoption of appropriate domestic policies. Elsewhere in this Report, the Committee has pointed to the need for greater productivity growth and higher rates of business fixed investment. The rate of inflation must be brought under control. Failure to control domestic inflationary pressures will either lead to ever-widening trade deficits or precipitate yet another fall of the dollar, or both.

With the largest, integrated market in the world, U.S. firms have understandably concentrated on the American market. Those firms that have entered the export market are generally large multinational firms that have mixed foreign direct investment and domestic exports. The country as a whole has been a "better mousetrap country"—waiting for high technology items to lure the world to its export door. The United States has compounded its export problems in recent years by using foreign trade as one of the elements in foreign policy.

The President has already announced (on September 26, 1978) the first phase of his new export policy. The policy emphasizes assistance to domestic exporters as well as reducing existing barriers to U.S. exports. The President's budget for 1980 includes increases for a variety of Export-Import Bank programs and a modest boost for the export programs in the Departments of State and Commerce. The President's program also embraces the provisions of the Agricultural Trade Act of 1978 and some tax relief for the overseas earned income of Americans working abroad.

The President indicated that Executive agencies would be directed to examine the export implications of their regulatory decisions. In late November, the Office of Management and Budget issued such instructions to the Executive agencies. As part of the new export program, the Justice Department will give expeditious treatment to business requests for guidance on international antitrust matters and the application of the Foreign Corrupt Practices Act.

The Committee's Subcommittee on International Economics has begun a series of hearings to assess the problems with U.S. export policy and the prospects for reform. The Committee is convinced

¹ Congressman Reuss states: "I disagree with the Committee view 'that appropriate unilateral measures to encourage surplus countries to meet their international obligations may be necessary.' The holding out of a thread of unilateral action violates the spirit of multilateralism that has been the hallmark of the U.S. approach to American and world trade problems. We can contemplate unilateral action, but why threaten retaliation before we need to?"

that the United States is in the midst of a structural transformation of its economy toward greater export (and import) dependence.

Recommendation No. 39

The President should speed the completion of the second phase of his national export policy. In formulating the second phase of his export policy, the Committee urges the President and Congress to seriously consider a greater emphasis on export assistance for small and medium-sized firms, and further scrutiny of the law and regulations currently inhibiting exports.

AGRICULTURE

In 1973 American farmers got a taste of prosperity. Net income to farm operators increased 78 percent in one year; from \$18.7 billion in 1972 to \$33.3 billion in 1973. Net income per farm rose to an all-time high: \$11,813 per year in current dollars and \$8,875 in 1967 dollars. The adjusted parity ratio rose to its highest level since the early 1950's.

Unfortunately, the farmers' prosperity was short-lived. By 1976 it all fell apart. Net income to farm operators dropped to \$18.8 billion in 1976, with net income per farm falling to \$6,848 per year in current dollars and \$4,016 in 1967 dollars. The parity ratio fell to its lowest level since the Great Depression.

Since 1976 there has been some recovery. Net income to farm operators last year increased by 40 percent but still stands well below its 1973 high. When the figures are adjusted for inflation, a truer picture emerges. Although net income per farm rose to \$10,780 last year in current dollars, in real dollars it was 38 percent lower than it was in 1973: \$5,520 per farm versus \$8,875. The farmers' protests are understandable.

The reason for the farmers' dilemma is that since 1974 payments by farmers for land, seed, fertilizer, wages, interest, and family living items have gone up much faster than prices received by farmers for their products. Since 1974 prices paid by farmers have increased 34 percent, while prices received by farmers have increased a mere 9 percent.

The bright spot in this otherwise sad farm picture is the increase in farm real estate values. Since 1967 the average value of land and buildings per acre for farm real estate has increased three-fold. Of course, farm debt has also escalated, but nevertheless there has been a substantial increase in proprietor's equities in the farming sector. Unfortunately, this increase in equity can only be translated into cash by either selling the farm or by going further into debt—at a time when interest rates are at a 5-year high. Thus, the critical problem becomes one of cash flow until such time as agricultural profits are again on the upswing.

The plight of farmers has brought forth many proposals for solving the problems—some good, some bad. This Committee leaves to others the analysis and recommendations on specific agricultural legislation. However, we do urge the Congress to seriously consider programs that would raise farm income through a steady expansion of farm exports. The emphasis must be on creating new foreign markets in conjunction with a gradual increase in domestic farm income. With a balanced

expansion of new markets and domestic production, farmers should be able to secure larger incomes without adding to domestic inflation through higher farm prices.

The major vehicle presently available for aiding exports is the Multilateral Trade Negotiations. It is not altogether clear at this point what the total effect on the U.S. trade balance will be from enactment of a new trade agreement, since the U.S. must make some concessions that may increase imports. Nevertheless, it appears that a reduction in barriers on agricultural products was a major focus of the negotiations. Ambassador Strauss told the Joint Economic Committee that the reduction in trade barriers on agricultural products alone will amount to about \$3 billion.

In addition to passage of a new trade agreement, however, there are some important things that can be done. The Administration should increase farm marketing efforts. Actually, farmer organizations have been more aggressive in promoting and marketing American farm products than has been the Government itself.

From Government we need better information, research, regulatory reform, and general improvement in the functioning of the marketplace. Government must ease onerous paperwork and other regulatory burdens to aid exports.

Examples of useful actions the Government could take include the provisions of short- and immediate-term credit (through the Commodity Credit Corporation) to other countries for the purchase of U.S. farm products, an expansion of Export-Import Bank financing of loans for farm commodity exports commensurate with agriculture's share of total U.S. exports, promotion of steady and regular annual sales instead of wide yearly fluctuations, and an expansion of agricultural trade missions. If such actions were coupled with the easing of trade barriers which limit the flow of agricultural exports, and if importing countries understood that we are able to provide a dependable supply of farm commodities, the increase in U.S. exports could result in major benefits for farmers and the entire Nation.

The goal for U.S. farmers is rising real incomes. Most farmers would agree that the Government should not be the dominant force in the marketplace. Free markets should be a goal of agriculture policy. The Government can make a major contribution by promoting exports aggressively and effectively.

To enable the United States to continue to exercise its traditional leadership in international affairs, the increasing dependence on uncertain foreign sources of supply must be reversed. For specific difficulties in international trade or payments, the United States should continue to emphasize a multilateral approach, but must not shrink from unilateral action where it proves necessary. In his State of the Union speech, the President emphasized the need to build a new foundation for future growth. We must harness the unruly forces of inflation, stimulate business fixed investment, and further reduce the link between growth in GNP and energy use. America's international economic fortunes are closely tied to an effective energy program. Economics has become a seamless web of domestic policies and international consequences. America's ability to contribute to a more stable and more open international order will depend on just such a new economic foundation.

VI. THE HUMPHREY-HAWKINS ACT GOALS AND THE CURRENT SERVICES ESTIMATE

SHORT AND LONGER TERM GOALS

Under the provisions of the Humphrey-Hawkins Act, the Joint Economic Committee is required to review and analyze the short- and medium-term goals set forth in the President's Economic Report. We have already presented our views on the Administration's forecast for 1979 and 1980. Because unemployment is expected to increase in 1979 and remain stable in 1980, real progress toward achieving the unemployment goals set forth in this Act is being postponed until 1981. This short-term drift away from meeting the goals of the Act and the Administration's lack of effort to combat this drift through increasing emphasis on employment programs is disappointing. A far greater commitment will be necessary if the goals are to be achieved. Congress may want to explore short-term ways in which the goals of the Act might be more closely met. The remainder of this discussion will therefore focus on the medium-term goals.

The Humphrey-Hawkins Act spells out quite clearly the President's responsibilities with respect to the budget recommendations and the medium-term goals. The act says:

The President's Budget shall provide five-year projections of outlays and receipts consistent with the medium-term goals of section 4(b).

Unfortunately, the President's budget does not comply with this requirement. The discussion in the Council's Economic Report explains that the large surpluses shown in the medium-term projections in the budget are inconsistent with achieving the Humphrey-Hawkins goals. The existence of such large surpluses means that fiscal policy would be so restrictive that unemployment would rise instead of fall.

Instead of answering the question about the budget policy consistent with the economic goals, the *Economic Report* only asks the question: "What kind of budgetary policies would be required over the next several years to achieve this kind of economic growth?" (p. 110). The partial answer suggested, "Large government surpluses would tend to make that task more difficult," (p. 112) is in direct contradiction to the large surplus projected in the budget.

Recommendation No. 40

We are well aware of the difficulties involved in trying to make economic and budget projections several years into the future. However, if the targets we establish for the next 5 years are to be useful, we must have a realistic assessment of the magnitude of probable economic policy changes required to reach those targets. The Council has not provided that assessment, and accordingly we recommend that this requirement of the Employment Act be better observed in the future.

In order to assist the Administration in its future work under the Humphrey-Hawkins Act, we suggest that the following approach would be helpful to Congress: the Act states that its goals are to be achieved through a combination of macroeconomic policies designed to provide the appropriate overall environment of economic growth and structural policies designed to solve specific problems. A logical starting place would be to examine a set of fiscal and monetary policies consistent with achieving our long-term potential growth rate. Economists are generally agreed that such a set of macroeconomic policies would produce an economy with relatively stable unemployment and prices. Once this set of policies is clearly defined, it can be compared to current services projections to determine the minimum policy change which is to be expected over the next 5 years.

For example, the Council has argued that the economy will be operating reasonably close to potential GNP in 1979 and fiscal 1980. Therefore, a fairly neutral fiscal policy would be consistent with maintaining economic growth near the potential growth rate. In other words, in 1980 when the unemployment rate is expected to be 6 percent, we will be operating very close to potential GNP. This analysis implies that reductions in unemployment below 6 percent will depend upon structural programs because demand stimulus would be inflationary. This would imply a stable budget deficit which could be achieved by tax reductions of roughly \$30 billion in 1981, \$65 billion in 1982, \$100 billion in 1983, and \$135 billion in 1984. But no matter how a stable deficit is achieved, the growing surpluses in the Administration's projections are inconsistent with the Humphrey-Hawkins goals.

The second step in the analysis would be to examine the gap between the final goals and the economy expected from the minimum policies described above. This gap would have to be filled by some combination of additional macroeconomic stimulus and structural programs. An analysis by the Council of the appropriate amount of additional macroeconomic stimulus consistent with all goals of the Humphrey-Hawkins Act would be most helpful. When combined with the minimum policy described earlier, this should outline the total progress toward the goals which could be expected from macroeconomic policies. Any remaining gap would need to be filled by structural programs. Until the magnitude of the problem to be solved through structural policies is clearly defined, it will not be possible to determine whether existing and proposed policies are sufficient.

The Federal Reserve Board also plays an important role in achieving the economic growth targets set forth in the Humphrey-Hawkins Act. Accordingly, it is the Fed's responsibility to report to Congress on the relationship of its "objectives and plans to the short-term goals set forth in the most recent Economic Report of the President." The report submitted on February 20, 1979, is an important first step in satisfying that requirement.

We say this report is a first step because in our view, several things are lacking in the Federal Reserve Board's effort. The report states, "At this juncture, the monetary growth ranges and the Administration's 1979 economic goals appear reasonably consistent." Unfortunately, the Fed's report does not explain how the goals can be consistent with the ranges. And by focusing on nominal GNP, the report says little about the mix between real output and price. In fact, in

Chairman Miller's testimony before the House Banking Committee, he indicated that he expected real growth in 1979 to be somewhat below the Administration's forecast and inflation to be somewhat worse. It is unclear whether the Fed's monetary policy is intended to be consistent with the Administration's view of the economic outlook or its own more pessimistic view. If the latter is the case, we do not have the degree of fiscal and monetary policy coordination envisioned in the Humphrey-Hawkins Act.

While we consider the Fed's discussion of policy targets in 1979 incomplete, the three paragraphs devoted to 1980 are even less satisfactory. The Federal Reserve Board only repeats the well-known difficulties of making longer range forecasts. We understand the uncertainty surrounding these forecasts and take that into consideration as we use them. Nevertheless, Congress concluded that the Fed's comments were sufficiently valuable to write this requirement into the law. Since 1980 is included in the short-term goals, we would urge that the Federal Reserve Board comply with this requirement of the Humphrey-Hawkins Act in the future.

As mentioned above, the appropriate way to begin an evaluation of the goals set forth in the Humphrey-Hawkins Act is to relate these goals to the economy's productive capacity. The Council has begun this process by providing new estimates of potential GNP. These estimates revise the projected growth rates down from the $3\frac{1}{2}$ percent estimated 2 years ago to 3 percent. The Council explains that the reason for this revision is that the productivity decline experienced in 1973 and 1974 has not been corrected. They argue that the poor performances of 1973-74 and 1977-78 cannot be regarded as statistical aberrations or one-time events, and therefore, the estimate of the long-term trend must be revised downward. The Council explains that an optimistic view of the situation could justify a potential growth rate of $3\frac{1}{2}$ percent per year, whereas the pessimistic view is that the growth rate should only be $2\frac{1}{2}$ percent. The Council has merely chosen the midpoint of these views, estimating that potential GNP will grow about 3 percent per year. This estimate assumes annual growth rates of about $1\frac{1}{2}$ percent for productivity and 2 percent for the labor force. Offsetting this growth is a decline in hours worked of about one-half percent per year.

We understand the difficulties and uncertainties surrounding these potential GNP estimates. Our discussion in Chapter III explores many of these difficulties and illustrates that the Council's revisions cannot be accepted without further evaluation. Implications of basing policy decisions on erroneous estimates are so serious that we do not find the Council's discussion of this subject reassuring.

Suppose the Council's estimates of potential economic growth are too low. If we tailor policy to achieve a growth rate lower than necessary, we will maintain an unnecessarily low level of labor and plant capacity utilization, producing lower profits, incomes, and investment. The lower level of investment, in turn, will reduce future potential growth. Thus, over time, the acceptance of potential GNP growth rates that are unnecessarily low will become a self-fulfilling prophecy.

Consider the alternative of accepting estimates of potential growth which are too high. Policies aimed at reaching the unreachable will create excess demand pressures which will be translated into acceler-

ating prices. This will prevent the high objectives from being reached or maintained for very long; and to the extent that the expectation of high inflation reduces profit expectations, raises interest rates, and reduces investment, it may also mean that the long-term growth of potential is lowered.

Clearly, if estimates of potential GNP are to be useful in the formation of economic policy, they must be as accurate as possible. In this context we find the Council's uncertainty about the prospects for further productivity growth disturbing. This uncertainty is seen in the optimistic-pessimistic discussion in the *Economic Report*. Further, as we mentioned earlier, the productivity projection consistent with the wage-price guidelines program is substantially greater than the projection discussed in the *Economic Report*. Finally, there is no explanation of why the Council chose to use a productivity estimate which is near the lower end of their estimated $1\frac{1}{4}$ to $2\frac{1}{4}$ percent range.

The second major factor contributing to the growth of potential GNP is labor force growth. As the Council notes, the labor force grew roughly $2\frac{1}{2}$ percent per year between 1973 and 1978. According to their projections, this should slow to about 2 percent in the future. Again, this is an area of substantial uncertainty, but a soon-to-be-released study prepared for the Committee indicates that a continuation of labor force growth rates near $2\frac{1}{2}$ percent is most likely. If the Committee study is correct, this would raise the estimate of potential GNP growth.

When all of this evidence is combined, we conclude that a reasonable range for a potential growth rate projection is moderately higher than the Council has proposed. This is not to say that the Council's potential GNP growth rate is unreasonable or obviously wrong, but we do think the revision was premature and we reemphasize the consequences of adopting erroneous estimates as a guide to economic policymaking.

Lowering the estimate of potential GNP growth has important implications for hitting the Humphrey-Hawkins targets discussed above. For the short-term goals, it means that a somewhat slower growth rate is required to prevent increases in the unemployment rate. For the longer term, it means that less reliance can be placed on using fiscal and monetary policies to achieve the Humphrey-Hawkins employment goals because of the increased danger of creating excess-demand inflation. The effect of fiscal and monetary policy on the achievement of the goals should be kept in mind. Such policies should also remain in the full employment arsenal when they prove helpful to meeting the goals of the Humphrey-Hawkins Act. However, structural policies must carry a greater share of the burden. At the same time, reducing our expectations of fiscal and monetary policy makes the balanced budget objective easier to achieve.

THE CURRENT SERVICES BUDGET

Section 605 of the Congressional Budget Act of 1974 requires the Office of Management and Budget (OMB) to submit "the estimated outlays and proposed budget authority which would be included in the budget * * * for the ensuing fiscal year if all programs and activities were carried on during such * * * year at the same level

* * * and without policy changes." It further requires that the Joint Economic Committee "shall review the estimated outlays and proposed budget authorities so submitted, and shall submit to the Committee on the Budget of both Houses an economic evaluation thereof." In an experiment begun last year, the timing of these reports was moved from November and December to January and March.

As we noted in our report last year, there are several advantages to having the President submit the current services estimates simultaneously with his budget proposal. The primary advantage is that the current services estimates are based on the same set of economic assumptions as those used in the President's budget. This eliminates the need to update any changes in the economic assumptions made between November 10 and the date the President's budget is submitted in late January or February.

A second advantage is that the later submission date allows the Joint Economic Committee to review these estimates in the context of its Annual Report. It allows a more complete evaluation of the economic analysis underlying both the current services estimates and the President's recommendations.

Although the reporting procedures employed by OMB in the preparation of the current services budget have been improved, the treatment of inflation is completely inadequate and misleading. The current practice is to include an allowance for anticipated inflation in the current services estimates for those programs whose inflation adjustments are mandatory under existing law or those programs included in the Department of Defense. Programs which are not military or are not linked by law to the cost of living include no inflation allowance.

This unequal treatment of inflation means that the current services estimates are often misleading and deceptive. For example, if one compares the current services outlay estimates for the Department of Defense (military \$125.5 billion) with President Carter's request (\$125.8 billion), one could correctly conclude that the President has requested that military expenditures be held roughly constant in real terms. A similar comparison for the Veterans' Administration (a current services estimate of \$20.4 billion) compared to a Presidential request of \$20.5 billion would lead one to the same conclusion. This is incorrect. If the Veterans' Administration estimate had included an inflation allowance, as the Defense estimate did, the current services figure would have exceeded the Administration's request by a substantial amount. By the Administration's own estimates, if an inflation adjustment had been made for all programs not limited by statutory ceiling, the current services outlay total would have been about \$8 billion higher than the estimates presented. Because this \$8 billion figure is not shown in the early tables of the budget where current services numbers are used, we consider this misleading.

Recommendation No. 41

The Administration's treatment of inflation in the current services estimates is misleading. All programs in the budget should receive comparable inflation treatment in the current services estimates.

At the time that the Chairmen of the Joint Economic Committee, the House and Senate Budget Committees, and the House and Senate Appropriations Committees agreed to a change in the timing of the current services budget submission, they noted the deficiencies in the manner in which OMB has always treated inflation in the current services budget and suggested that these should be corrected. The Director of OMB responded:

We believe that it is desirable that inflation be treated comparably in the two sets of estimates. However, guidance to the agencies for the preparation for the 1979 budget estimates has already been issued, and there is insufficient time to reach final decisions on possible changes in handling the inflation in the budget estimates and incorporate those changes in the 1979 budget. As we complete our review of this issue, we plan to discuss our views with the interested committees of Congress.

Since there has been no change in the Administration's treatment of inflation in the 1980 estimates, and since this has not been discussed with the Joint Economic Committee in the past year, it is clear that no further progress has been made. Last June, in a joint letter to OMB Director James McIntyre from the Chairmen of the five previously mentioned committees, we stated:

In order to admit the easy identification of Presidential recommendations that deviate from a current services base, all programs included in that base must be treated consistently with respect to inflation. The absence of a uniform presentation of the effects of inflation in the OMB current services estimates reduces their value by inadvertently introducing activity level and policy changes which affect the various functions in uncertain ways. The intent of the Congressional Budget Act, which requires outlay and budget authority estimates for maintaining programs "at the same level as the fiscal year in progress without policy changes" will be more fully satisfied by presenting the effects of inflation in a uniform manner and by identifying other adjustments in the estimates, such as those made for maintaining orderly procurement in construction activities.

In view of the fact that the Administration has made no progress toward resolving this problem in the past 2 years, we are forced to conclude that the disadvantages of presenting current services estimates in a misleading way more than offset the advantages of having them made on an economic basis that is consistent with the President's budget estimates. We therefore conclude that the 2-year experiment concerning the submission of the current services estimates should be suspended until such time as these problems can be resolved.

Recommendation No. 42

Until the Office of Management and Budget is able to resolve satisfactorily the problems associated with incorporating inflation in the current services budget estimates, these estimates should be submitted to Congress on November 10 as required by law.

SUPPLEMENTARY VIEWS OF THE MINORITY MEMBERS

INTRODUCTION BY CLARENCE J. BROWN, RANKING MEMBER

The Minority Members of the Joint Economic Committee are pleased to join with the Majority Members of the Committee in this consensus Report on the economy, the first such consensus JEC Report in 20 years.

The general theme of the Report is to stimulate economic growth through investment and productivity gains. The Report correctly cites inflation as the country's No. 1 economic problem and a major road-block to economic growth. To deal with this persistent problem, the Report calls for spending restraint, moderate monetary policy, and reduced tax and regulatory burdens. These steps will encourage supply and restrain excess demand—and will greatly aid the faltering dollar.

Timing is as vital in the exercise of macroeconomic policy as it is in microeconomic decisions of individuals. Much of the demand-oriented approach, which became so fashionable in the Great Depression of the 1930's, is now outdated by the economic evolution of the past four decades. Modern economists have rediscovered the supply side of the economic model. The recommendations in the Report reflect this by calling for increased capital formation, labor productivity and output for the fight against inflation and unemployment.

We live in a complex society, made more so by our free form of government, in which diversity is still a basic source of economic strength. This diversity causes problems for policymakers in trying to arrive at clear-cut policy recommendations. That is why this consensus Report of the Majority and Minority Members of the Joint Economic Committee is all the more important, and is a real accomplishment. The underlying message of the Report is clear, and the Minority restates its belief in that message through this consensus Report.

Areas of disagreement in the Report are few and relatively specific. Most of the comments relate to emphasis rather than direction. Therefore, the supplementary views that follow arise from what we believe to be gaps in the Report as well as a few points of genuine disagreement.

MINORITY SUPPLEMENTARY VIEWS

MONETARY POLICY

The major compromise which made this joint Report possible involves monetary policy. In the past, the Majority has frequently called for more rapid money creation to reduce nominal interest rates. The

Minority has been, and continues to be, concerned about the role of money creation in fueling inflation, and emphasizes real interest rates rather than nominal interest rates, and the importance of the availability of credit for private investment after government borrowing. These concerns are now reconciled and discussed in the main Report.

In the current environment, a common recommendation was possible. We emphasize the following section of the text:

The Committee is optimistic that the varied objectives of monetary and fiscal policy can be reconciled under the current circumstances. It should be possible to sustain moderate economic growth with reduced inflation and lower interest rates, while addressing the international difficulties of the dollar. The key is moderation, a policy of gradualism.

We anticipate that interest rates and credit availability to the private sector will ease significantly if the Committee's recommendations for monetary and fiscal policy are followed. As the recovery continues, a gradual reduction of Federal spending as a percent of GNP, and the accompanying move toward budget balance, will relieve pressure on the credit markets, freeing funds to meet expanded loan demand without a sharp increase in the rate of money creation.

In the long run, monetary conditions and credit availability for private investment will ease naturally, without sharp increases in the money supply. New Federal Government borrowing will decline as the budget moves toward balance, and more of the Nation's flow of saving will be available to private borrowers. Then, as growth accelerates, even more saving will be generated.

We support the Federal Reserve's goal of a gradual reduction in the growth rates of the monetary aggregates in order to eliminate inflation without recession. In pursuit of that goal, the Federal Reserve should avoid sudden contractions or expansions of the aggregates for any significant length of time. Thus, the recent dip in the growth rates of the monetary aggregates may have been larger than desirable. If so, the Federal Reserve should allow the aggregates to grow within their target ranges, to maintain a policy of gradual adjustment.

However, we wish to stress that the lack of adequate statistical information on nondeposit sources of funds for the banking system (such as repurchase agreements) clouds our view of monetary data. In addition, the spreading use of money market certificates by thrift institutions may also be distorting the monetary aggregates and clouding our view of the current posture of monetary policy. In short, the recent dip in the aggregates may well not be as sharp as it appears. We urge the regulatory agencies to obtain now, and on a continuing basis, all the information needed from all depository institutions to determine, communicate, and implement an effective, constructive, anti-inflationary monetary policy.

THE FEDERAL BUDGET

We applaud the philosophy in the Report's Recommendation No. 2, to reduce the Federal deficit. We are concerned, however, that the recommendation is tied to the deficit projected by the Administration; namely, \$29 billion.

We believe an additional \$10 billion cut in the deficit, to \$19 billion, would put us on a more certain track toward a balanced budget by fiscal 1981. There are sufficient controllables in the budget to accomplish this.

In Recommendation No. 3, the Report calls for a reduction in the ratio of Federal outlays to gross national product. The trouble with this recommendation is that it is not specific. It should clearly spell out the specific ratio. We recommend 20 percent by 1981, unless an economic or other emergency makes the goal unattainable.

The reduction in Federal spending can be attained by elimination of waste, and by economy and efficiency in government.

This policy will move us toward a balanced budget while reducing Federal outlays as a share of GNP. This avoids the potential problem of raising taxes to balance the budget, a solution which might discourage investment and the growth of productivity.

We are pleased to see the emphasis in the Report on policies to encourage the supply of goods and services. This is a departure from the usual heavy reliance on demand management, where higher spending or lower taxes increase the Federal deficit to supposedly "stimulate" total "spending," which is magnified by a "multiplier," and so forth.

In this Report, business taxes are correctly viewed as barriers to production. High tax rates mean fewer goods on the shelves. Fewer goods on the shelves mean higher prices. It is time to lower the tax and regulatory burdens on labor, capital, and output as part of the fight against inflation.

Effective tax rates on business have been increased by inflation and regulation. We pointed out in the Minority Views in the *1978 Joint Economic Annual Report* that inflation has increased the effective tax rate on real profits from about 40 percent in 1965 to between 50 and 60 percent, on average, in the last few years. When the true cost of depreciation is counted, some industries pay heavy taxes when they are really losing money on continuing operations.

As the after-tax rate of return on investment has fallen, investment has been reduced and productivity growth has slowed. This has cost us jobs and real wage increases.

This rate of return analysis is crucial. It means that tax rates can alter incentives in ways that are independent of the quantity of money directly involved in the tax change itself.

Thus, a two-point drop in the corporate tax rate may leave businesses between \$3 and \$4 billion a year in added profit. However, it may increase the rate of return on output to such an extent that firms desire to increase the employment of all factors of production. Firms may step up investment by several billion dollars a year, add other billions to inventory, and provide more billions for new manpower training for the work force. The tax cut may be far less in dollar terms than the change in desired investment in physical and human capital it produces.

If the tax cut does not fully pay for the expansion it encourages, where does the money come from? There are three sources. First, the Government may reduce its own borrowing, freeing up private saving for loans for investment. Second, private domestic saving may rise. Third, foreign capital may be attracted by the improved return on U.S. investments.

The most important source of funding for business is saving, including personal saving and retained earnings. Only if saving increases in response to the increased investment demand can the full benefit of a change in business taxes be realized. Therefore, as the Minority has recommended in previous reports, steps should be taken to provide incentives for personal saving. Also, as the current Report points out, the Government can help by reducing its spending as a share of GNP and moving toward budget balance.

As for investment incentives, several are available. The corporate tax rate can be cut to increase the rate of return on all factors of production in a nondistorting fashion. Depreciation allowances can be speeded up or adjusted for actual replacement cost to offset the distortion created by inflation. The double taxation of dividends can be ended to eliminate the discrimination against equity financing in favor of debt. The investment tax credit, though restricted to certain types of physical capital, may be useful. The important thing is to increase desired investment and hiring and to provide the saving to fund the process.

PERSONAL TAXES

The major analytical breakthrough in the main Report is that taxes influence investment and growth by affecting rates of return on capital investment, not just by adding or subtracting money from the spending stream. Unfortunately, the full Report does not carry this concept over into the area of personal taxes. The Report does not contain a recommendation to reduce personal taxes to increase the rates of return to labor and saving.

As inflation pushes personal incomes into higher tax brackets, leisure is substituted for labor at the margin, because the after-tax reward to labor falls. Consumption replaces saving and investment for the same reason. Saving is discouraged, and tax shelters divert increasing amounts of the remaining saving into inefficient uses. The supply of labor and saving is curtailed.

Inflation is pushing taxpayers into higher brackets at the rate of about \$10 to \$12 billion per year. Coupled with Social Security tax hikes, the annual burden on individual taxpayers is due to grow by \$15 to \$25 billion per year in each of the next several years. In 1984 alone, tax payments will be \$100 billion higher than would be due under current tax rates. This increased tax burden acts to lower the after-tax income of labor, which must then demand increases in pay in excess of the cost of living, just to stay even.

We see little chance for success for the President's wage insurance program because a 1-year rebate cannot offset a permanent increase of prices relative to wages. Nor will wage restraint be possible if tax rates are increased by inflation.

The only way to encourage lower wage increases and protect workers from inflation is through permanent adjustments in the tax brackets or tax rates. The figures show that large tax increases are occurring each year, and there is room for significant bracket adjustment or rate reduction while moving toward a balanced budget. Some of our Members favor annual tax-rate adjustment or bracket widening to offset inflation on a discretionary basis. Others would make it auto-

matic by indexing the personal exemption and the tax brackets to bring down higher tax rates produced by cost-of-living increases, or would reduce tax rates across the board and then index them. Regardless of the method chosen, this is an urgent matter if work incentives, savings incentives, and real after-tax wages are to be maintained, and inflation is to be reduced.

SAVINGS

The main Report is seriously deficient in its failure to discuss saving.

Saving is the key to the fundamental budget constraint of the whole economy: only that part of our national income which goes into savings is available to cover private investment and the public deficit. Once the Government chooses a deficit, the only way to get more private investment is to increase saving.

One way of encouraging saving is to lower personal income tax rates across the board. This would allow every taxpayer to keep a higher percentage of the *additional* interest or dividends earned from *additional* savings, and thus would make saving more attractive.

Another approach was strongly recommended by a panel of capital formation experts who testified before the Committee on July 14 and 19, 1977. To correct the tax code's bias against saving, they recommended that income be taxed only when it is spent, thereby not taxing net savings. That is, they advocated the substitution of an expenditure tax for the personal income tax we have now.

A marginal savings tax credit along these lines has been introduced, providing a tax credit of 50 percent of any addition, above certain threshold levels which rise with income, to bank savings accounts, purchases of stock and taxable bonds, and investment in small businesses. This credit would double the after-tax rate of return to saving.¹

There are other approaches to increased saving that are worthy of study, but one thing is clear: *saving is essential to investment and growth, and ought to be encouraged.*

Foreign countries are out-saving and out-investing the United States by wide margins, and they have enjoyed growth rates and real wage increases well in excess of those in the United States.

	Wage Increases, investment, and saving			
	1965-75 percent change in real wages and fringe benefits ¹	Investment as percent of GNP-averages 1960-73		Household savings ratios ² 1976 estimate (percent)
		Total	Total minus home building	
United States.....	15.7	17.5	13.6	6-8
Canada.....	48.5	21.8	17.4	10-12
Japan.....	137.9	35.0	29.0	24-26
France.....	77.4	24.5	18.2	16-18
Germany.....	78.1	25.8	20.0	14-16
Italy.....	116.4	20.5	14.4	22-24
United Kingdom.....	53.9	18.5	15.2	12-14

¹ Includes pension programs and other fringe benefits.

Source: Bureau of Labor Statistics, OECD.

² Senator James A. McClure prefers this approach over proposals to create interest or savings deductions. He points out that a 50 percent credit is more progressive than a deduction. A credit for all savings above progressive threshold levels encourages additional saving at all income levels, rather than saving up to a limited sum. The bill referred to has been introduced by Senator McClure (S. 18) and by Representative Brown of Ohio and Representative Rousselot (H.R. 169).

ENERGY

The energy section of the main Report suggests several substantive long-run steps for securing adequate energy supplies for the United States. These include oil and gas purchases from Mexico and Canada, encouragement of exploration in non-OPEC countries, and price incentives for domestic U.S. producers who undertake tertiary recovery methods and who maintain or increase production from marginal wells. That section also recommends a general reduction in U.S. dependence on foreign energy sources. Unfortunately, it then breaks down into a discussion of shortrun stop-gap measures for sharing shortages.

Because of the Administration's failure to use the authority available to it since 1975 to encourage restoration of domestic U.S. energy production, production which was lost as a result of U.S. price controls on energy since 1973, we are now faced with the problem of sharing the shortages resulting from the loss of Iranian oil supplies. Surely now it is time to face facts.

The only practical way to reverse the decline in oil and natural gas production in the lower 48 states is to move gradually to terminate Federal price controls on oil and gas. We need market incentives for production from all wells, not just marginal old ones. Otherwise, the call for more domestic output and energy conservation in the interest of the balance of payments and national security is a hollow cry.

Oil production in the lower 48 states is down by nearly 2 million barrels per day, from 1973 to October 1978. Marketed production of natural gas is down from 22.5 trillion cubic feet per year in 1973 to 19.7 trillion cubic feet in 1978. After almost 6 years of allocation and price controls, the United States now imports more than twice the amount of foreign petroleum that it imported in 1972. This growing dependency on foreign imports for our petroleum needs, coupled with record OPEC and spot prices, and the curtailment of Iranian oil production, creates a potentially serious situation for the United States economy. The outflow of dollars to pay for our petroleum imports has reached staggering proportions.

We do not see how this Committee can deny domestic producers of natural gas the same price which we are contemplating paying to Mexico for the purchase of natural gas for the same pipelines. This is especially true in view of the negative balance of payments impact which is clearly being produced by a similar split price system (a foreign price and a domestic price) in the case of oil. A fundamental reappraisal of our entire energy policy is clearly in order.

We have comments on two other recommendations.

Forcing the conversion of oil-fired burners back to natural gas is the third policy flip-flop in 10 years. First, coal was too dirty, so boilers had to switch to oil and gas. Then, gas was scarce, so boilers had to switch to oil and coal. Now, oil is scarce, so boilers have to switch back to gas. This is as expensive as it is absurd. We must not let the existence of a temporary "bubble" of natural gas divert attention from our need for increased energy availability on a permanent basis.

The wheeling of electricity from the Midwest to the East Coast in the event of a shortage of boiler fuel oil for East Coast generators may become necessary on occasion, but this practice cannot possibly

be more than a temporary expedient. Under no circumstances should it become a foot in the door for a national power grid.

INTERNATIONAL PROBLEMS

The Report is much too hopeful about the value of the dollar on the foreign exchange markets and the improvement in the trade balance we can expect from last year's decline of the dollar.

It should not be government policy to encourage the erosion of real wages, either through deliberate dollar devaluation or domestically produced inflation. If the Government wishes to encourage domestic production, it should do so by reducing the tax and regulatory burden on the use of American labor and capital. That is the real solution to the trade problem.

The exchange rate of the dollar will respond to this real approach to improvement in the trade balance. It will also respond as the public perceives a change in the direction of policy in the United States toward less deficit finance, slower money growth, and less inflation. In this sense, the value of the dollar domestically and the value of the dollar compared to other currencies reflect the confidence of U.S. and foreign holders of dollars in the policies of the Government of the United States.

The Report correctly points out that currency intervention by Central Banks to protect the dollar is only a temporary expedient. It must be supplemented by the policies cited above to increase U.S. productivity and to increase our ability to compete abroad.

The Report also refers to the sale of U.S. gold as a positive factor in next year's payments accounts. The Report fails to point out that this too is only a temporary expedient. Gold sales must not be used to delay the fundamental tax and regulatory changes needed to improve our trade performance, or we will be in worse trouble when the gold runs out.

Unless confidence is restored in the dollar, it may be necessary to provide for some other asset to serve as an international reserve for the world's central banks. The Report commends the Treasury for its ongoing study of the possibility of the establishment of a substitution account at the IMF for the large dollar balances now held, somewhat grudgingly, by foreign central banks.

Also deserving of study is the feasibility of bringing the Eurodollar market under some form of control. One approach, the imposition of reserve requirements on Eurodollar creation, could help reduce worldwide dollar creation, stabilize the dollar and restore confidence. This step would reduce the threat of the so-called dollar overhang, which is due as much to lack of faith in the dollar's value as it is to the quantities being held.

The traditional "J-curve" approach to the trade balance is seriously deficient. It states that a dollar devaluation increases import prices at once (which worsens the trade balance) and lowers the price of U.S. goods, which eventually boosts exports (which finally improves the trade balance). This is a gross simplification.

Devaluation does not work simply by lowering U.S. export prices. Eventually, U.S. exporters tend to adjust their quoted prices to get the world price for their products. A more significant reason devaluation encourages exports is that it lowers the cost of production in the

United States. Wage contracts are fixed in dollar terms. Devaluation lowers U.S. costs relative to world prices, increasing profit margins on exports. Exports are encouraged.

This spurt in exports depends heavily in the devaluation of wages and other costs. Insofar as workers react to the devaluation by demanding wage increases, the benefits of devaluation are undone. They last only until automatic cost-of-living adjustments are triggered or old contracts expire.

Workers do tend to react in this way, because devaluations are inflationary, more so than is commonly realized. The price of imports and exports tends to rise to the world price. Even domestically consumed export-type goods (wheat) and domestically produced goods which compete with imports (steel and autos) tend to rise to the world price. (Wheat bound for Boston and wheat bound for Bombay sell for the same price in Chicago.) The price increases contribute to a rise in the consumer price index, which triggers cost-of-living adjustments to wages in all sectors of the economy, which help to push up prices even in sectors that are not related to imports or exports. The net effect is that cost increases tend to follow the devaluation, and undo, at least in part, the increased profit margin on exports.

GENERAL REVENUE SHARING

We strongly favor continuation of the General Revenue Sharing Program beyond its scheduled expiration in October 1980. This program is the cornerstone of the Federal grant structure.

We realize that many of our colleagues have expressed serious reservations about whether the Federal Government should continue revenue sharing at a time when the inflationary effects of continued Federal deficit spending are of great concern to the American taxpayer. The suggestion has been made that we could save about \$2.3 billion by eliminating States from the revenue sharing program (Recommendation No. 7).

In 1978, the aggregate State budget surplus with \$8.9 billion, providing an 8.6 percent positive balance. However, more than half of that surplus was lodged in just three States—Alaska, California, and Texas. The situation in the remaining States was relatively tight. In the event of recession, these surpluses would fade rapidly. In 1979, the projected total State surplus will be cut in half, to \$4.3 billion, only a 3.6 percent positive balance. Congress would make a mistake to generalize a conclusion from the inflated 1978 State budget picture.

Furthermore, real general revenue sharing has actually declined since 1972. Calculations by the Brookings Institute indicate that the purchasing power of the program has declined by 17 percent since 1972. We only need contrast the budgetary stability of the general revenue sharing program with the uncontrollable Federal spending in other areas, to realize that revenue sharing is indeed a bargain for the taxpayer.

The Federal administrative cost of distributing general revenue sharing funds is only one-tenth of 1 percent of the funds distributed—lower than the cost of administering any other Federal program.

Far better candidates for budget cuts could be found, among others, in some of the Federal categorical grant programs, particularly those which are restrictive and narrow, and, in some cases, downright useless to the States.

General revenue sharing is superior to many other forms of financial assistance. It achieves the goals of decentralization and efficiency in government. It provides flexibility and emphasizes local responsibility. State and local officials can better determine their needs and priorities than can Federal policymakers far removed in Washington, D.C.

We should resist the temptation to tamper with one of the few Federal programs which works well.

WAGE AND PRICE GUIDELINES

The Minority believes that the President's wage and price guidelines might be effective, but only if they are surrounded by a meaningful anti-inflation program of monetary and budgetary restraint. Unfortunately, they are not, and the Minority believes that they provide only rhetoric to the inflation fight.

Indeed, the guidelines are under attack from legal as well as economic sources. Several labor unions, joined by Members of Congress, have sought the courts' decision on the legality of the compulsory compliance forced on government contractors. While the Minority eschews comment on the legal entanglements of the guidelines, we believe that the Administration is attacking the symptoms of inflation rather than getting at the real causes of inflation.

STRUCTURAL UNEMPLOYMENT

The Report stresses that the private sector has an important role to play in the unemployment problem. Unfortunately, the Report's recommendations, while generally sound, have a few substantial problems.

The conspicuous absence of a recommendation calling for a youth differential in the minimum wage law undermines the integrity of the structural unemployment section. The economics profession is united in the belief that minimum wage increases have a serious effect on the employability of youths. The structurally unemployed are in critical straits, and should not be held hostage by narrow political interests that prevent a youth differential.

The Minority strongly supports the training subsidies referred to in Recommendation No. 14, but finds the recommendation's specific prohibition against wage subsidies in the private sector ironic. We have spent billions of dollars subsidizing wages through the public sector. Widespread waste, impropriety, and inefficiency in such spending is well documented. Can we seriously recommend that not one penny be spent on well targeted wage subsidies in the private sector, when the Report itself stresses the efficiency and importance of greater usage of the private sector? The structurally unemployed and the taxpayers of this country both would have their needs better addressed if we were spared this bizarre political logic.

Recommendation No. 15 is misdirected. The section clearly points out that the problem of structural unemployment demands a variety of solutions. Yet, the recommendation stresses the advancement of CETA alone to help the structurally unemployed in the event of a recession. CETA is a countercyclical program, with some successes and some well documented problems. It does not always address the problems of the structurally unemployed. This recommendation fails to offer real help to the structurally unemployed.

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

I would go further than the Report to reduce Federal spending and I would oppose efforts to increase spending programs at this time. The Report does not go far enough to restrain inflation in these respects.

I am, however, in general agreement with the Report and most of the recommendations. It is a well-reasoned response to the statutory requirement that the Joint Economic Committee evaluate the President's Economic Report and make its findings known to Congress. I commend it to my colleagues and urge that it be fully considered in deliberations over the budget and other economic matters.

I especially approve of the recommendations to hold down Federal spending and the deficit, to reduce the Federal sector as a share of the Gross National Product, and to change the mix of fiscal and monetary policy in order to encourage capital formation. I also agree that positive steps need to be taken to improve productivity, to encourage savings and investment, and to solve the problem of structural unemployment.

I would like to see the budget balanced in fiscal year 1980, and I believe it can be done.

The Report properly calls attention to the high costs of the General Revenue Sharing Program and suggests that it can be cut back. I would eliminate it entirely and I would make cuts in many other civilian and defense programs.

I would not approve an increase in the Economic Assistance, Man-power Training or CETA programs because much as I agree with the objectives of those programs, the temptations to spend more in any area, or to provide tax benefits, has to be resisted if we are to balance the budget. I oppose the establishment of an Energy Bank for the same reason. This is also the wrong time to signal State and local governments that special assistance will be made available by the Federal Government in the event of a recession. Whether such aid is necessary or appropriate will depend entirely on the situation.

ADDITIONAL VIEWS OF REPRESENTATIVE PARREN J. MITCHELL

With a great deal of hesitancy, I support the adoption of the Joint Economic Committee Annual Report. My reticence is based on (1) the Report's inability to provide the appropriate analysis and alternatives to the Economic Report as stated in the provisions of the Full Employment and Balanced Growth Act of 1978 (Humphrey-Hawkins Act); (2) the endorsement of the President's budget policy of reductions in spending and tax cuts to reduce Federal outlays as a proportion of the Gross National Product; and (3) the Report's focus on inflation and the precipitous decline in the value of the dollar, to the exclusion of unemployment, as the most serious problems of the economy.

The President's Economic Report of 1979 poses serious problems for me. I am greatly concerned by the Administration's policy and program suggestions and the economic assumptions upon which they are based. In my opinion, they run directly counter to the goals, requirements, and legislative intent of the Humphrey-Hawkins Full Employment and Balanced Growth Act of 1978, and directly counter to what is the most effective way of combatting both inflation and unemployment simultaneously. In addition, while I agree with many of the analyses and recommendations which have been made by this Report, I unfortunately, must disagree with some of the basic economic assumptions. My major objection is particularly that they acquiesce to the erroneous assumptions of the President's Economic Report, as in the case of the short-term and medium-term economic goals.

The Employment Act, as amended by the Humphrey-Hawkins Act, requires policies to be used which will reduce unemployment and inflation simultaneously, by "mutually reinforcing" means, and with the stipulation that, ". . . policies and programs for reducing the rate of inflation shall be designed so as not to impede achievements of the goals and timetables . . . for the reduction of unemployment." This is not the case in the President's Economic Report. The Economic Report calls for and endorses programs and policies which will result in a short-term unemployment goal of 6.2 percent (a rise in the current rate), and endorses the "trade-off" theory by deliberately following policies which increase unemployment to reduce inflation. Simulations done by the Congressional Budget Office suggest that five years of unemployment at about 7 percent would be necessary, in the absence of outside shocks, to bring inflation down to the neighborhood of 4 percent. The short-term goals, as set forth in the Economic Report, clearly violate the intent of the Act as specified on Page 8, Section 3, in the House Report which states: "The Committee urges strongly that the Executive Branch exert every practical effort to reduce the rate of unemployment more rapidly during the first year or two under the Act than later on in moving toward the targeted levels for the

fifth year, instead of spreading the rate of reduction equally over the entire period." While the fundamental message of the Humphrey-Hawkins Act is that a properly balanced expanding economy will both produce jobs and limit inflation, the President's Economic Report suggests policy that imposes a severe economic restraint, which in the words of several economic forecasters will result in a slowdown and possible recession next fiscal year. The provisions of the Act, as well as the legislative history, is very explicit in its repudiation of the economic "trade-off" theory. Historically, these goals have not been outside the range of our economy.

There is economic consistency in the full list of goals contained in the Humphrey-Hawkins Act. Goals such as "full employment and production; increased real income; balanced growth; a balanced Federal budget; proper attention to national priorities; achievement of an improved trade balance through increased exports; improvement in the international competitiveness of agriculture, business and industry; reasonable price stability and adequate productivity growth," are not mutually exclusive in their attempt to provide adequate real growth in the economy. I understand the Committee's concern for increased productivity and support the recommendation for "adequate productivity growth" as called for by the Humphrey-Hawkins Act." I also support the recommendation for additional tax and other incentives to promote industrial R. & D., hoping this will spur increased productivity. I comprehend, even though I do not support, or agree with the economics, the Committee's recommendation to reduce the Federal deficit and share of Federal outlays in the Gross National Product in an attempt to address the goals of inflation in the Humphrey-Hawkins Act. What I fail to understand, comprehend and support is the Committee's reluctance to "include findings, recommendations, and any appropriate analyses with respect and in direct comparison to each of the short-term and medium-term goals (full employment) set forth in the Economic Report." I would be totally remiss if I did not identify the full employment goal as an omission, oversight or at minimum, low priority of the Committee Report. This is one factor that has provoked my apprehension to support the Committee Report.

Another factor that conjures my reservation is the fact that the Federal budget is objectified as a culprit for inflation. The Committee makes a recommendation to reduce the deficit, reduce Federal spending as a proportion of GNP and supports "the basic trend of the President's budget." Of the \$581.6 billion included in the President's budget request, \$316.2 billion or 59.5 percent of total Federal outlays result from permanent authority already made available through permanent appropriations or appropriation entitlements.¹

Another \$87.9 billion or 16.5 percent of total outlays result from prior year contracts or other obligations. Therefore, only \$132.9 billion or 24 percent of gross outlays is discretionary. Of this discretionary amount, \$77.1 billion or 58 percent is requested for the military budget. Discretionary programs which have been reduced 49 percent, as a share of Federal outlays, in the last 10 years amount to \$55.8 billion or 10.5 percent of the total outlays. At the same time tax expenditures, in the

¹ Permanent authority includes permanent appropriations, which are accounted for largely by the social insurance trust funds, interact on public debt and revenue sharing. Appropriated entitlements cover payments for food stamps, veterans benefits, AFDC, Medicaid, Supplemental Security Income, and other programs.

form of credits, deductions, and exclusions now amount to \$146 billion, more than two and one-half times the amount of discretionary program funds and 28 percent of gross outlays. The Report identifies specific discretionary programs as contributors to the deficit and increased government spending never identifying the fact that increases in tax expenditures, which are entitlements that once enacted seldom suffer the rigors of Congressional review, are the basic contributors to the deficit and loss in Federal revenue.

Under existing legislation, I could not support recommendations that call for reductions in discretionary spending, reductions in the deficit and at the same time increases in tax expenditures. The culmination of the three policies are destined to render deleterious effects on the under developed economic sectors of our country. The prototype of these sectors are the black, Spanish speaking inner-city communities; the poor less-skilled rural communities, particularly in the South; the 16-19 year old sector who need initial training and skill development and the elderly who, though protected by the entitlements of social security, medicaid, and others, are increasing in number and need the resources of additional housing and social services. This is my expressed reservation in endorsing a recommendation to achieve the reduction in the deficit projected by the Administration for fiscal year 1980.

My policy decisions are based on the fact that continuing high rates of unemployment take enormous toll in human, emotional, physical, and social terms. Economics has a tendency to discount personality and treat people as a homogeneous subculture. It is very difficult for me to endorse a policy when I fear those who comprise the 13 percent adult unemployment, 40 percent teenage unemployment, the unskilled worker who cannot find training or the handicapped elderly person who needs special provisions, in my district might possibly be victimized by the policy.

Again, with sincere reservation, I opted to support this Committee Report. I do feel, however, that this Committee must make every effort to provide to the Congress those specific program alternatives that render these recommendations viable in accordance with the provisions of the Full Employment and Balanced Growth Act of 1978. The Economic Report did not make "a realistic assessment of the magnitude of probable economic changes required to reach the targets," as requested by the Employment Act. It, therefore, becomes the responsibility of this Committee to do so.

ADDITIONAL VIEWS OF SENATOR JACOB K. JAVITS

I am especially pleased that this year's Annual Report of the Joint Economic Committee is a unified Report endorsed by both Majority and Minority Members of the Committee. For the threat to our democratic institutions and economic well-being posed by the serious economic problems that we face today may very well be as acute as any we face from foreign complications.

I join in the Report's emphasis on the disastrous effect that inflation is having on America's institutions and the primacy of developing long-term structural solutions in the areas of productivity improvement, increased capital formation, energy, and international trade and finance.

While I share many of the concerns contained in the Minority's Supplementary Views, there are a number of concerns which need to be particularly presented:

THE FEDERAL BUDGET

On a number of occasions I have expressed my view that while I endorse the President's recommendation to cut Federal spending in fiscal year 1980 by \$14 billion below current policy levels and to reduce the Federal budget deficit by over 20 percent, from \$37.4 billion to \$29 billion or less, and while my priorities for expenditure reductions may not be the same as the President's priorities, I intend to do all I can to get the budget deficit as scheduled. As a case in point, during the recent Human Resources Committee consideration of its budget report to the Senate Budget Committee, I moved to reduce the CETA program—one I consider vital—by \$1 billion below the fiscal year 1980 current policy levels.

If U.S. economic conditions permit, I am in favor of having the Federal budget reduced by an additional \$10 billion and then eliminated entirely. But I do not believe the present and projected economic situation in the United States and the world permits a precipitate 50 percent reduction in the Federal budget deficit as the Minority has proposed.

As the Committee Report makes clear, our country is heading into a very uncertain and perilous era, economically, politically, and internationally. Such dangers require that U.S. Federal budgetary policy be kept flexible in the period immediately ahead. Obedience should not be pledged, therefore, to a single numerical standard which could hamstring policymaking next year and thereafter. I believe we can balance the Federal budget by fiscal year 1981; but this objective can only be reached by a prudent course of action, not by precipitous changes in Federal fiscal policy.

Accordingly, I am unable to subscribe now to the Minority position that the Federal budget deficit should be reduced by nearly 50 percent in fiscal year 1980.

Beyond these considerations, I do not think the American people seriously believe they can have it both ways, to wit, a balanced Fed-

eral budget soon, and immediate large tax reductions. Restraint of Federal spending growth, as is made feasible by economic conditions, is the surest route to achieving our goal of a balanced Federal budget. But we cannot also have precipitate tax reductions. These objectives are simply not compatible in the relatively short time frame of the next 1 or 2 fiscal years particularly with the present resurgence of inflation to nearly 10 percent per year. I, therefore, cannot share the view that our goal of a balanced budget by fiscal year 1981 can be achieved through both large spending cuts and tax cuts in fiscal year 1980.

STRUCTURAL UNEMPLOYMENT

I do not agree that a youth differential in the minimum wage law would have a significant effect in reducing structural unemployment in the United States. Many of those who focus upon this particular approach to improving the job prospects of unemployed youth seems to miss the essential point, to wit, that our objective should be to reduce total structural unemployment, not just youth structural unemployment. Most economists who have concluded that a youth differential would open the job doors to a greater number of unemployed youths acknowledge also that it would close those same doors to the adult unemployed and even some presently employed. The net effect on employment, therefore, is difficult to measure; and until we have better estimates of the net employment effect, I do not believe we should take this drastic step.

Furthermore, we now have in law a number of provisions which are designed to reduce the net first year cost of hiring unemployed youth. First, Congress has enacted, along the lines of a bill I introduced early last year, a Targeted Jobs Tax Credit, which provides for a tax credit equal to 50 percent of the first year's wages paid to certain target groups, including disadvantaged youth. Second, the Department of Labor is presently experimenting with two programs authored by Senate Republicans last year: a job voucher program proposed by Senator Chafee and a social bonus program proposed by Senators Hayakawa and Hatch. Both of these programs are aimed at providing employers with some subvention of wages in the first year of employment of disadvantaged youth. And, finally, under the provisions of the new Title VII of CETA, the Private Sector Initiative Program, local private industry councils will promote the placement of disadvantaged youth in jobs in private business. Reimbursement with Federal funds of up to 50 percent of the first year's wages is permitted under the provisions of Title VII.

Each of these new provisions—all enacted last year for the first time—will help to reduce the cost of employing and training disadvantaged youth, particularly minorities, and will provide us with a better understanding of the labor market interactions of wage subsidization in the private-for-profit sector. Until these have been evaluated, I cannot agree that a youth subminimum wage is justified.

CETA

With respect to the CETA program, while it is true that there have been abuses in the past, Congress completely rewrote the Act in 1978, including, among other things, very tight new restrictions on wages, eligibility and duration of participation; as well as placing new em-

phasis on training, employability development, and transition to unsubsidized employment. Given the very perilous outlook for the U.S. economy for 1979 and 1980—and most observers are predicting significant increases in layoffs in the private sector of the economy in 1980—we may very well conclude that CETA, while it may not be the optional approach, may be our best weapon in the fight against renewed widespread unemployment.

ENERGY

While I believe that it is indeed essential to continue to review the adequacy of price incentives for new energy production, it is important that considerations of the potential inflationary effects of any proposed policy and of the impact on various income groups and geographic regions be a factor in any decision. Significant new energy production will occur only when the Nation has reconciled new competing economic, technological, and public health goals so as to end the uncertainty facing investors, which is now the principal obstacle to new energy investment.

Also, U.S. energy policy choices should be made with far greater awareness of the international implications of our choices. These considerations include not only short and midterm trade considerations but also the size of our claim upon the world's common heritage of natural resources and the military security implications of our limited supply base. Thus, I feel it is impossible to overstate the urgency of rapidly reducing U.S. demand for oil to demonstrate our determination to break the grip of the OPEC cartel on world energy markets.

INTERNATIONAL TRADE AND FINANCE

I endorse the Report's recommendation that the President speed the completion of the second phase of his national export policy including a review of the laws and regulations currently inhibiting exports and special emphasis on export assistance for small- and medium-sized firms.

Government must be aided in this endeavor by the private sector, which has an important supplementary role to play in improving our export performance. Groups such as the Business Roundtable should organize seminars and fora to educate smaller firms not already in the export business on how to exploit opportunities overseas.

The role of the dollar as the primary reserve asset in the international monetary system imposes on the U.S. a responsibility to take into consideration international factors in the management of our economic policy. In this regard, while monetary policy should be responsive in the first instance to the needs of the domestic economy, we may very well have to be prepared to consider more frequently the effect of monetary policy on the international strength of the dollar.

The recommendations made in the Report to support implementation of a Substitution Account in the IMF and in the Minority's Supplementary Views to consider international regulation of the Euro-currency market have my support. To facilitate this process towards a multiple reserve system, strong currency countries, such as Germany and Japan, must overcome their concern that open money and capital markets would make domestic financial management more difficult and permit their currencies to play an expanded international role.

ADDITIONAL VIEWS OF REPRESENTATIVE JOHN H. ROUSSELOT

Chairman Bentsen and Ranking Minority Member Brown should be commended for bringing together this consensus Report, the first in over 20 years. While I am not entirely in agreement with several of the consensus recommendations, which were arrived at in the spirit of compromise, and although the Report is sprinkled with such Keynesian expressions as "demand restraint" and "economic slack", on the whole, I am pleased that Members on both sides of the aisle are now focusing on the need for greater production incentives in the marketplace. Not long ago, the idea that the supply side of the economy, as opposed to the demand side, had a place in policy analysis was little more than an emerging concept. It was espoused by those few of us who had, for many years, been advocating steep cuts in personal income taxes, and cuts in the corporate and capital gains taxes as a way of promoting increased growth and prosperity in the economy.

Although the Majority has recognized the need for greater production incentives in the marketplace to foster supply increases, it appears still to be wedded to the ancient Keynesian idea that economic growth can be demand-managed and fine-tuned. In contrast, it is my view that the most the government can do to stimulate the economy is to foster a favorable business climate, and sponsor basic research that might not otherwise be undertaken by the private sector. Federal spending programs not related to R. & D. and defense may be considered necessary for social-political reasons, but such programs do little or nothing to stimulate growth in the economy. Economic growth is not rooted in targeted spending programs, it is rooted in the private sector's desire to gain aftertax income or profits. This desire is the motivating force behind all of today's business and individual investment decisions.

Our understanding of this desire, an understanding that we hope will soon be shared by all Members of Congress, has, in the past, led us to recommend a substantially different mix of tax and spending policies from those usually offered by the Majority. The Majority's views differ from our own on this subject, particularly in the area of tax reform. They pay so little attention to individual tax cuts that it appears as if they believe that our steeply progressive tax code is not yet sufficiently biased against individual savings, work and investment incentives to require attention. Unfortunately, such a view totally disregards how the tax code discourages saving and encourages consumption and consumer indebtedness. Interest earned is heavily taxed, while interest paid is tax deductible. Instead the tax code should be encouraging saving through a similar tax concession. With this objective in mind, I have introduced H.R. 745, a bill that would exclude the first \$2,000 of interest earnings from taxable income, and H.R. 169, a bill to provide a 50 percent tax credit on certain types of eligible saving.

The tax code is also biased against work in the economy. A worker's after-tax pay bears little resemblance to his pre-tax salary. In fact, in many instances, a worker's after-tax earnings may be less than the amount available through social welfare. For this reason I urge enactment of the Kemp-Roth Bill, a bill that would restore incentives to all workers in the labor force. So too, the tax code is biased against individual investment in market securities. Capital gains taxes are still so prohibitively high that the small investor has not yet returned to the stock market. His return after taxes is usually too low to risk his savings in equities. Further cuts in capital gains taxes are needed.

It is time that we all realized that the economy's greatest gains have come, not from Federal spending programs, but from the private sector of the economy, a sector which is in desperate need of tax cuts to spark human capital and machine capital formation. Therefore, it must be our objective to stimulate growth by advocating and adopting tax policies which will promote economic incentives and opportunities in the marketplace.

ADDITIONAL VIEWS OF REPRESENTATIVE CHALMERS P. WYLIE

The Joint Economic Committee's Report on the President's Economic Report and the Minority's supplementary views are both thoughtful, interesting documents with which I am pleased to be associated. I am submitting separate additional views because my own emphasis in terms of national priorities differs on some issues from that of the Administration and the Majority and Minority views of the Joint Economic Committee.

The Administration's *Economic Report* says that its basic program is designed to reduce inflation through budgetary austerity and moderation of economic growth in a manner that avoids waste and misplaced priorities while both protecting the poor, the elderly, and the structurally unemployed from the effects of restraint and maintaining our obligations in an interrelated world economy. I am generally supportive of this policy statement, although I would have preferred an explicit mention of our commitment to national defense.

THE MONETARY AUTHORITIES' NEED FOR BROADER LEGISLATION

The proliferation of deliberate mechanisms for avoiding the impact of monetary policy, such as repurchase agreements, and less intentional avoidance through institutional change in response to worldwide inflation, such as money market funds, the Eurocurrency markets, and the growth of multinational banking institutions, needs to be addressed by better legislation than we now have. I agree that no matter what we do to try to stop inflation legislatively, the creative efforts of the avoiders of taxes and the will of Congress can be depended upon to render our efforts obsolete in a few years time. In my opinion, the probability that we will have to do our duty again in a few years should not deter us from doing what is required now as well.

The correct conduct of monetary policy requires several essential ingredients. First and foremost, we need to have a balanced Federal budget year in and year out. Next, the monetary authorities need timely, accurate data on all elements of the financial sector which monetary policy seeks to stabilize for the whole economy of the United States.

Lastly, the monetary authorities need to be able to treat alike all factors in our economy which perform monetary functions. Money market funds, nonbank securities dealers, and foreign based banks do, indeed, seem to be competing with commercial banks in providing domestic banking services. I, therefore, feel that regulatory institutions created by Congress to assure a stable currency should be empowered to require from competitors of commercial banks the same information and other contributions which we require of commercial banks. This

will provide a more realistic treatment of financial institutions, be constructive for the conduct of monetary policy and responsive to the just demands of our constituents that we do something about inflation.

WAGE-PRICE GUIDELINES VERSUS POSITIVE POLICY MEASURES

I do not think the Administration's wage-price guidelines approach to containing inflation will work. We need positive measures, not negative ones, to solve the country's economic problems. Sound fiscal and monetary policies together with targeted programs for the structurally unemployed and additional creative steps to deregulate the American economy will do the job. Wage-price controls, whether voluntary or otherwise, will not, and they cannot be depended upon.

THE ADMINISTRATION'S FISCAL POLICY

I am glad to see the Administration advance its timetable for reducing Federal outlays as a percent of GNP to 21 percent, although I have a strong personal preference for 20 percent and believe the ratio should be stabilized at 20 percent except in time of war or economic necessity declared by substantially more than a majority vote of both Houses of Congress.

I very much regret that the Administration has slipped a year in its timetable for balancing the Federal budget. In my opinion, Table 24 on page 114 of the President's *Economic Report* shows that the Administration is not serious about balancing the budget in fiscal 1981. It presents a program with an \$8.4 billion reduction in the deficit for fiscal 1980 (from \$37.4 billion to \$29.0 billion) which is to be followed by a \$27.8 billion reduction in the deficit in fiscal 1981 (from \$29.0 billion to \$1.2 billion). I feel the Administration should have programmed a deficit of \$18.1 billion or less for fiscal 1980 ($\$8.4 + \$27.8 \div 2$) if it is serious about having a negligible deficit in fiscal 1981 (\$1.2 billion).

My own guess is that domestic and worldwide developments will have substantial effects not included in the only scenario given by the Administration. I, therefore, regret that the Administration neglected to give us alternative scenarios with alternative policy prescriptions. If inflation increases substantially while the prime rate is near or above 12 percent, further strain in the markets could well force additional policy measures on the Administration. If industrial production should decline as an election year approaches, the Administration might abandon fiscal restraint for political objectives with different policy prescriptions. I, for one, would like to have had some inkling of what these alternatives might be under conditions of worsening in either inflation or recession and, especially, a worsening in both simultaneously.

THE PERSONAL INCOME TAX BURDEN OF INTEREST ON THE NATIONAL DEBT

Interest on the national debt is already the third largest item in the Federal budget after outlays for income security and for national defense. The Administration's forecast for interest needed to be paid

on the national debt out of our Federal budget for fiscal 1980 is now \$57 billion. That \$57 billion is just interest on the debt; the debt itself is now almost \$800 billion and rising strongly. The growth rate of the interest portion of the Federal debt is roughly 18 percent per year which is roughly 1.5 times the growth rate of personal income in this country. From a long-run point of view, taxation for the payment of interest on the national debt is closing fast on total wages and salaries. The people feel this in their bones, but neither the Administration nor the Congress seem responsive to the problem.

FISCAL POLICY AND INFLATION

Financing an \$800 billion debt creates an unprecedented demand on the credit markets. Each and every consumer, business, school district or local government that seeks to borrow money pays the price in higher interest rates. In short, fiscal policy (budget deficits and an ever growing national debt) is the prime source of inflation in this country, and inflation is the No. 1 problem. With the spreading call for a Constitutional Convention to amend the Constitution, Congress has been placed on notice by the American people that we must put our fiscal house in order.

It is clear to me that we have to stop inflation, and we have to stop adding to the national debt. That means we have to balance the budget and keep it balanced except in time of war or economic necessity declared by substantially more than a majority vote of both Houses of Congress.

ADDITIONAL VIEWS OF SENATOR WILLIAM V. ROTH, JR.

I commend the Committee endorsement of restrained Federal budget policies though I firmly believe further reductions can be achieved. The Committee's call for tax cuts and further spending reductions is a significant policy decision which I wholeheartedly endorse.

Unless taxes and spending are reduced, the economy faces continued inflation and the prospect of a deep recession. The growing Federal tax burden is strangling economic growth, retarding the savings and investments needed to create jobs, and holding productivity down to its lowest level in four years.

Federal spending restraint and tax rate reductions will ease inflationary pressures, expand the production of goods and services and increase productivity, savings and investment.

Unless taxes are reduced in fiscal 1980, taxpayers in all brackets face substantial tax increases. Under the present tax laws, the Federal tax burden will increase to unprecedented levels over the next few years, both as a percent of gross national product and as a percent of personal income.

Unless taxes are reduced, Federal taxes as a percent of gross national product will exceed 20 percent in fiscal year 1980 for the first time in a decade. In fact, only twice in the past 35 years—during the Vietnam tax surcharge—was the tax burden as high as it will be during fiscal 1980.

According to the Joint Committee on Taxation and the Congressional Budget Office, Social Security and inflation will increase taxes by at least \$19 billion in fiscal 1980, \$36 billion in fiscal 1981, and \$58 billion in fiscal 1982, as the following table shows:

	Fiscal year (billions)—				
	1980	1981	1982	1983	1984
Tax increase:					
Bracket creep.....	\$8	\$19	\$33	\$51	\$71
Social security.....	11	17	25	28	29
Total tax increase.....	19	36	58	79	100

The President has proposed what he calls a lean and austere budget for fiscal 1980. But the real reduction in his proposed fiscal 1980 deficit comes from a significant increase in the Federal tax burden.

By opposing tax cuts, the President is trying to balance the budget on the backs of taxpayers.

I do not believe we should attempt to reduce the deficit by allowing taxes to increase on the American people. I believe Congress should reduce the tax burden on working Americans and reduce the budget deficit by curbing the growth rate of Federal spending.

The Tax Reduction and Spending Limitations Acts (S. 33 and S. 34), which Congressman Jack Kemp and I call Roth-Kemp II, combine limits on Federal spending as a percent of GNP with across-the-board tax rate reductions of 10 percent a year for 3 years, followed by tax indexing to avoid future tax increases.

TAX RATE REDUCTIONS

Roth-Kemp II would reduce tax rates across-the-board by 10 percent a year over the next 3 years. When fully effective, individual tax rates would be reduced to rates ranging between 10 and 50 percent. These tax cuts are needed to offset the substantial Social Security and inflation-induced tax increases facing the American people. Once tax rates are reduced, a tax indexing system would go into effect to keep tax rates down and avoid future automatic tax increases caused by inflation. The following table shows the static revenue impact of the tax cuts and the net tax cuts after offsetting the Social Security and inflation tax increases:

	Fiscal year (billions)—			
	1980	1981	1982	1983
Roth-Kemp tax cuts.....	\$16.1	\$42.4	\$77.5	\$102.9
Tax increases.....	18.6	36.7	58.0	79.0
Net tax cuts.....	+2.5	-5.7	-19.5	-23.9

SPENDING LIMITATIONS

Roth-Kemp II would restrain the growth rate of Federal spending by limiting spending to specified percentages of the Gross National Product. Under this bill, Federal spending as a percent of GNP would be limited to 21 percent in fiscal 1980, 20 percent in fiscal 1981, 19 percent in fiscal 1982, and 18 percent in fiscal 1983. These spending limitations would restrain the growth of Federal spending to less than 7 percent a year. The following table compares the administration's proposed spending levels with the spending levels under Roth-Kemp II:

	Fiscal year (billions)—			
	1980	1981	1982	1983
Administration spending.....	\$532	\$578	\$615	\$646
Roth-Kemp II spending.....	522	560	595	628
Spending cuts.....	-10	-18	-20	-18

The enactment of this legislative package would signal an end to the high taxes and big government spending policies of the past decade. If Roth-Kemp II is enacted, taxes will be substantially reduced, the growth of Federal spending will be curbed, and the Federal budget will be virtually balanced by fiscal 1982 and have a surplus by fiscal 1983. The following table shows the estimated spending and revenue levels under Roth-Kemp II. The revenue levels assume a feedback of only 20 percent in the first year and 30 percent in the following years.

	Budget under Roth-Kemp II			
	1980	1981	1982	1983
Spending.....	\$522	\$560	\$595	\$628
Revenue.....	492	547	597	645
-Def/+surplus.....	-30	-13	-2	+17

As these figures show, substantial tax cuts can be enacted and the budget can be balanced if the growth rate of Federal spending is restrained. Roth-Kemp II would allow us to fight inflation and recession at the same time. It would combine the tax cuts needed to stimulate real economic growth with the spending restraints needed to curb inflation.

COMMITTEE ACTIVITIES DURING THE 95TH CONGRESS, 1977-78

The Joint Economic Committee was created by the Employment Act of 1946 and directed to (1) make a continuing study of matters relating to the President's Economic Report; (2) file an annual report to Congress containing its findings and recommendations with respect to each of the main recommendations made by the President in the Economic Report, and make other reports as the Committee deems advisable; and (3) study means of coordinating programs in order to carry out the policy of the Employment Act.

A joint resolution in 1949 authorized the Committee to issue a monthly publication entitled "Economic Indicators," containing information relating to the state of the economy. This publication was revised and expanded during the 94th and 95th Congresses to improve its usefulness.

Other recent actions by Congress have added to the Committee's responsibilities. The Congressional Budget and Impoundment Control Act of 1974 requires the Committee to set forth in annual reports its views with respect to the Federal budget and recommendations as to the fiscal policy appropriate to the goals of the Employment Act, and to perform an economic evaluation of the current services budget estimates transmitted to Congress by the President each year.

The Full Employment and Balanced Growth Act of 1978 (known as the Humphrey-Hawkins Act) requires the Committee to analyze the short-term and medium-term economic goals with the President is directed to set forth in the Economic Report under the Act, and to report its findings and recommendations.

The 1978 amendment to the Comprehensive Employment and Training Act directs the Committee to analyze the problem of structural unemployment and report its findings and recommendations by March 31, 1979.

The Committee's activities consists of full Committee and Subcommittee hearings, reports and staff studies. In 1977 and 1978 the Committee issued annual and semiannual reports on the State of the Economy, and issued other reports required by law.

The Committee has traditionally been concerned with the problems of policy coordination, economy in Government and long term economic issues. In the past, Committee recommendations led to statutory provisions requiring the President to submit 5-year budget projections and current services budget estimates. The Committee also played a role in the development of the budgetary procedures contained in the Congressional Budget and Impoundment Control Act.

In the 94th and 95th Congresses, under the leadership of the late Senator Hubert H. Humphrey, the Committee helped formulate the new economic short-term and medium-term goal-setting procedures incorporated in the Humphrey-Hawkins Act. The Committee's recom-

mendations for improvements in fiscal and monetary policy coordination were also substantially incorporated in the same Act.

Other recent Committee activities which have influenced policies were in the areas of regulatory reform, government waste, structural unemployment, and energy. The following discusses briefly the highlights of the work of the Joint Economic Committee and Subcommittees during the 95th Congress.

FISCAL AND MONETARY POLICY

Concern was expressed in several hearings over the mix of monetary and fiscal policy. In the 1977 Midyear Report, 1978 Annual Report, and the October 1978 Review of the Economy, the Committee recommended changing the policy mix in order to increase capital formation. The Administration's and the Federal Reserve's present policies reflect a shift in the mix in the direction urged by the Committee.

The Committee, led by Senator Jacob Javits and Congressman Reuss, has urged the Department of the Treasury to consider proposals to develop a new parallel currency as a partial substitute for the dollar in world currency markets. The Department of the Treasury is now studying possibilities for establishing such a substitution account.

REGULATORY REFORM AND THE REDUCTION OF PAPERWORK

A wide-ranging hearing on the cost of Government regulation was initiated by Chairman Bentsen (then Vice Chairman) in April 1978 to assess the regulatory and reporting burden placed on the Nation's business community and consumers by Federal agencies. As a result of these efforts a series of recommendations were developed in consultation with the Chairman of the appropriate legislative Committees. These included:

An amendment to the Housing and Urban Development Department authorization bill to require the Federal Housing Administration and the Veterans' Administration to use the same forms in processing residential mortgage loan applications. The effect of the amendment is to reduce by an estimated 50,000 the number of forms FHA and VA single-family housing loan applicants required to fill out each year.

An amendment to the Comprehensive Employment and Training Act to reduce the paperwork burden imposed by Federal regulations on State and local governments in order to qualify for assistance under the CETA program.

An amendment to the proposed Sunset Bill to eliminate duplication and conflicting regulations among various Federal agencies in the conduct of their programs. This proposal was enacted in the Senate but was not taken up in the House.

UNEMPLOYMENT AND INFLATION

The Full Employment and Balanced Growth Act of 1978 is largely the product of a concept explored and developed by the late Senator Hubert Humphrey as Chairman of the Joint Economic Committee, and Representative Augustus Hawkins, Chairman of the Subcommittee on Employment Opportunities of the House Education and Labor Committee.

The legislation for the first time commits the Federal Government to the goal of achieving full employment for persons 16 years and older who are able and willing to work, and to reduce the rate of inflation. The full employment goal is defined as 4 percent overall unemployment to be reached by 1983. An anti-inflation goal of 3 percent, to be reached by the same year, is also contained in the Act.

The new law requires the President to annually present to Congress numerical interim targets for employment, unemployment, production, productivity, real income, and prices, together with the fiscal and monetary policy and program proposals designed to reach these objectives.

The National Commission on Employment and Unemployment Statistics was formed in 1978 partly in response to recommendations by the Joint Economic Committee. The Commission is reevaluating the adequacy of the Federal and State and local employment and unemployment statistics.

Hearings were held by the Subcommittee on Priorities and Economy in Government on Women in the Military, showing job discrimination and other unfair practices. Following the hearings a number of initiatives were taken by the Defense Department to increase women's employment and career opportunities.

A number of the provisions of the Youth Employment Act of 1977 and Title IV of the Comprehensive Employment and Training Act amendments of 1978 were shaped by findings and recommendations developed during hearings held by Senator Humphrey as Chairman of the Committee and Cochairman of the Subcommittee on Economic Growth and Stabilization. Several recommendations in the 1976 Joint Economic Committee Annual Report are incorporated in provisions of the Youth Employment Act authored by Senator Humphrey and Senator Javits and in the provisions of Title IV of the 1978 CETA legislation providing youth employment and training programs.

ECONOMIC DEVELOPMENT POLICY AND ANTIRECESSION ASSISTANCE

Ideas about economic development contained in testimony presented at hearings held in 1977 and 1978 by the Fiscal and Intergovernmental Policy Subcommittee, under the Cochairmanship of Representative Moorhead, are reflected in the Administration's proposed fiscal year 1980 budget. The hearings concerned the financial needs of municipalities. The idea of a National Development Bank and alternative mechanisms being considered by the Administration, are intended to increase the level of investment and expand job opportunities in private sector areas experiencing lagging growth or increasing unemployment.

Hearings on antirecession assistance focused on the expiration of the existing program in October 1978, the need to extend this program and to concentrate its resources on localities having the greatest problems. The Administration's fiscal year 1980 budget proposes a "transitional fiscal assistance program carefully aimed at cities with the greatest need in 1979 and 1980."

ECONOMY IN GOVERNMENT

Extensive hearings in 1977 and 1978 by Senator Proxmire's Subcommittee on Priorities and Economy in Government on shipbuilding

claims against the Navy led to an amendment of the Military Authorization Act limiting the use of funds paid by the Navy to settle close to \$2 billion in claims. The amendment also directs the General Accounting Office to conduct audits of the contracts that were the subject of claims. Earlier work by the Subcommittee in the Government claims area led to enactment of an amendment to the Defense Appropriations Act of 1977 requiring the Defense Department to fully evaluate all contract claims before their settlement.

The Subcommittee's work is also reflected in a number of provisions in the Contract Disputes Act adopted in 1978. The Act is intended to prevent abuses of the Government claims process and to require complete evaluation and swift resolution of contract disputes.

Congressional enactment of the Foreign Corrupt Practices Act in 1977 largely stemmed from the work of the Subcommittee on Priorities and Economy in Government during the 94th Congress. These Subcommittee hearings focused attention on bribes and other improper payments made by U.S. corporations in foreign countries.

The Commerce Department's Bureau of Economic Affairs in 1978 established a defense deflator index based on price changes for the purchase of defense items. This project had its roots in a Subcommittee proposal first put forward in 1969.

ENERGY

A series of hearings conducted by Senator Kennedy's Energy Subcommittee produced recommendations that were incorporated in provisions of the National Energy Act of 1978 and the Comprehensive Employment and Training Act of 1978. Subcommittee recommendations also influenced expansion of World Bank support of efforts to discover new reserves of natural gas and oil in the developing countries.

The Subcommittee's industrial energy conservation hearings recommended expanding industrial energy user reporting of energy consumption levels and plans and progress to reduce those levels.

A Subcommittee recommendation led to enactment of CETA amendments requiring the Department of Labor to estimate the employment effects of Federal energy expenditures and authorizing the assignment of CETA employees to work on solar energy projects.

The Subcommittee's hearings contributed to the World Bank's decision to make some \$32 million available in low-cost loan funds for exploration of natural gas and oil in developing countries.

Full Committee hearings produced recommendations which influenced the establishment of a 4-year program within the Department of Energy to explore application and use of solar cells through installation on Government buildings.

SELECTED COMMITTEE PUBLICATIONS

U.S. Economic Growth From 1976 to 1986: Prospects, Problems and Patterns. Volume 9—Technological Change. Studies prepared for the use of the Joint Economic Committee. January 3, 1977.

Some Questions and Brief Answers About the Eurodollar Market. A staff study prepared for the use of the Joint Economic Committee. February 7, 1977.

The United States Response to the New International Economic

- Order: The Economic Implications for Latin America and the United States.* A study prepared for the use of the Subcommittee on Inter-American Economic Relationships. February 23, 1977.
- The 1977 Joint Economic Report.* Report of the Joint Economic Committee on the January 1977 Economic Report of the President. March 10, 1977.
- The 1977 Economic Report of the President.* Hearings before the Joint Economic Committee: Part 1. January 19 and February 2 and 3, 1977. Part 2. February 7, 8, and 9, 1977. Part 3. February 10, 23, and 24, 1977. Part 4. Invited Comments.
- Foundations for a National Policy To Preserve Private Enterprise in the 1980's.* A study prepared for the use of the Subcommittee on Economic Growth and Stabilization. April 8, 1977.
- The Profit and Price Performance of Leading Food Chains.* A study prepared for the use of the Joint Economic Committee. April 12, 1977.
- Issues at the Summit.* Report of the Joint Economic Committee together with additional and supplemental views. May 4, 1977.
- Toward a National Growth Policy: Federal and State Developments in 1975.* A report prepared for the use of the Subcommittee on Economic Growth and Stabilization. May 19, 1977.
- Youth and Minority Unemployment.* A study prepared for the use of the Joint Economic Committee. July 6, 1977.
- Soviet Economic Problems and Prospects.* A study prepared for the use of the Subcommittee on Priorities and Economy in Government. August 8, 1977.
- The Macroeconomic Goals of the Administration for 1981: Targets and Realizations.* A study prepared for the use of the Joint Economic Committee. August 5, 1977.
- The Current Fiscal Condition of Cities: A Survey of 67 of the 75 Largest Cities.* A study prepared for the use of the Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy. July 28, 1977.
- Allocation of Resources in the Soviet Union and China—1977. Part 1.* Hearing before the Subcommittee on Priorities and Economy in Government. Executive Session. June 23, 1977.
- East European Economies: Post-Helsinki.* A compendium of papers submitted to the Joint Economic Committee. August 25, 1977.
- Recent Developments in Mexico and Their Economic Implications for the United States.* Hearings before the Subcommittee on Inter-American Relationships. January 17 and 24, 1977.
- Energy Independence or Interdependence: The Agenda With OPEC.* Hearings before the Subcommittee on Energy. January 12 and 13, 1977.
- American Women Workers in a Full Employment Economy.* A compendium of papers submitted to the Subcommittee on Economic Growth and Stabilization. September 15, 1977.
- The Economics of the Natural Gas Controversy.* A staff study prepared for the use of the Subcommittee on Energy. September 19, 1977.
- Financing Municipal Needs.* A joint hearing before the Subcommittee on Economic Growth and Stabilization and the Subcommittee on Fiscal and Intergovernmental Policy. July 28, 1977.
- Work, Welfare, and the Program for Better Jobs and Income*

- study prepared for the use of the Joint Economic Committee. October 14, 1977.
- Economic Problems of Rural America.* Hearings before the Subcommittee on Economic Growth and Stabilization. June 7 and 15, 1977.
- Employment-Unemployment. Part 10.* Hearings before the Joint Economic Committee. May 6, June 3, July 8, and August 5, 1977.
- Five-Year Budget Projections: Fiscal Years 1979-83.* Hearing before the Joint Economic Committee. December 5, 1977.
- Economics of Defense Procurement: Shipbuilding Claims, Part 1.* Hearings before the Subcommittee on Priorities and Economy in Government. June 7 and 25, 1976, and December 29, 1977.
- S. 1726, Small Business Economic Policy and Advocacy Reorganization Act of 1977.* Subcommittee on Government Regulation and Small Business Advocacy of the Select Committee on Small Business and the Subcommittee on Economic Growth and Stabilization of the Joint Economic Committee. Joint Hearings, June 29, July 21, and November 21, 1977.
- The Costs of Government Regulation of Business.* A study prepared for the use of the Subcommittee on Economic Growth and Stabilization. April 10, 1978.
- The Role of Federal Tax Policy in Stimulating Capital Formation and Economic Growth.* Hearings before the Subcommittee on Economic Growth and Stabilization. July 13, 14, and 19, 1977.
- The Trade Deficit: How Much of a Problem? What Remedy?* Hearing before the Subcommittee on International Economics. October 11, 1977.
- Western Perceptions of Soviet Economic Trends.* A staff study prepared for the use of the Subcommittee on Priorities and Economy in Government. March 6, 1978.
- The Economics of the President's Proposed Energy Policies.* Hearings before the Joint Economic Committee. May 20 and 25, 1977.
- Industrial Energy Conservation.* Hearing before the Subcommittee on Energy. July 28, 1977.
- The 1978 Joint Economic Report.* Report of the Joint Economic Committee on the 1978 Economic Report of the President together with Minority and Additional Views. March 15, 1978.
- The 1978 Economic Report of the President, Part 1.* Hearings before the Joint Economic Committee. January 31, February 1, 3, and 6, 1978.
- A Comparison of Econometric Models.* A study prepared for the use of the Joint Economic Committee. July 28, 1978.
- Keeping Business in the City.* Hearings before the Subcommittee on Fiscal and Intergovernmental Policy. March 6 and 7, 1978.
- Structural Unemployment and Urban Policy.* Hearing before the Subcommittee on Economic Growth and Stabilization. March 17, 1978.
- Anticipating Disruptive Imports.* A study prepared for the use of the Joint Economic Committee. September 14, 1978.
- Energy in the Eighties: Can We Avoid Scarcity and Inflation?* Hearings before the Subcommittee on Energy. March 8, 9, and 21, 1978.
- Public Hearings Before the National Commission on Employment and Unemployment*
- Statistics, Volume 1.* Report of the Joint Economic Committee. October 3, 1978.

Creating Jobs Through Energy Policy. Hearings before the Subcommittee on Energy. March 15 and 16, 1978.

The Cost of Government Regulation. Hearings before the Subcommittee on Economic Growth and Stabilization. April 11 and 13, 1978.

Multifamily Housing Demand: 1975-2000. A study prepared for the use of the Subcommittee on Priorities and Economy in Government. November 14, 1978.

Local Distress, State Surpluses, Proposition 13: Prelude to Fiscal Crisis or New Opportunities? Hearings before the Subcommittee on the City, Committee on Banking, Finance and Urban Affairs and the Joint Economic Committee. July 25 and 26, 1978.

Chinese Economy Post Mao: Volume 1. Policy Performance. A compendium of papers submitted to the Joint Economic Committee. November 9, 1978.

Special Study on Economic Change, Part 1. Hearings before the Joint Economic Committee. May 31, June 1, 6 and 7, 1978.

The 1978 Midyear Review of the Economy, Part 1. Hearings before the Joint Economic Committee. June 28 and 29, and July 11, 1978.

Mexico's Oil and Gas Policy: An Analysis. Prepared for the Committee on Foreign Relations and the Joint Economic Committee. December 1978.

CHANGES IN COMMITTEE MEMBERSHIP 95th CONGRESS, 2d SESSION

Senator Lloyd Bentsen (D-Tex.) was named Vice Chairman of the Joint Economic Committee in January of 1978, following the death of the previous Vice Chairman, Hubert H. Humphrey of Minnesota. In early February, Senator George McGovern (D-S.D.) became a Member of the Committee. Following the resignation from the Committee in February 1978 of Representative Otis G. Pike (D-N.Y.), Representative Parren J. Mitchell (D-Md.) joined the Committee.

CHANGES IN COMMITTEE STAFF

The following professional staff members left the Committee during the second session of the 95th Congress: Timothy Barnicle, G. Thomas Cator, William A. Cox, and Robert D. Hamrin, all economists; and Richard D. Boltuck, Research Assistant. Administrative personnel who left during this session were staff assistant Beverley M. Park, and secretaries Margaret M. Akra, M. Kathleen Danforth, Imogene Holmes, and Jody L. Reed.

Joining the professional staff during the year were John M. Albertine, David Allen, Lloyd C. Atkinson, William R. Buechner, and Paul B. Manchester, Majority Economists; Robert H. Aten, Minority Economist; and James L. McIntire, Research Assistant. Administrative personnel joining the staff were Barbara L. August, Receptionist; and secretaries Lynda A. Mersereau, Patricia Ann Redmond, and Lennea G. Tinker.

The staff of the Special Study on Economic Change was comprised of: Robert A. Wallace, Research Director; George D. Krumbhaar, Jr., Counsel; Douglas N. Ross, Senior Economist; Richard D. Bartel, Economist; Albert A. Sayers, Jr., Professional Staff Member; Cathy L. Pennock, Clerk; Lorren V. Roth, Secretary/Clerk; Sandra K. Blake, Secretary; and Research Assistants Carolyn H. Crowley and Michael J. Lockerby.

The following lists the present staff economists who contributed to the 1979 *Joint Economic Report*:

Majority:

John M. Albertine
 David Allen
 Lloyd C. Atkinson
 William R. Buechner
 Kent H. Hughes
 Richard F. Kaufman
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 Deborah N. Matz
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Lynda A. Mersereau
 Lennea G. Tinker

