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95th Congress, 1st Session

House Report No. 95-652

THE 1977 MIDYEAR REVIEW  
OF THE ECONOMY

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REPORT  
OF THE  
JOINT ECONOMIC COMMITTEE  
CONGRESS OF THE UNITED STATES  
TOGETHER WITH  
MINORITY AND ADDITIONAL VIEWS



SEPTEMBER 30, 1977.—Committed to the Committee of the Whole House  
on the State of the Union and ordered to be printed

Printed for the use of the Joint Economic Committee

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*1st Session* } { No. 95-652

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## THE 1977 MIDYEAR REVIEW OF THE ECONOMY

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SEPTEMBER 30, 1977.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

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Mr. BOLLING, from the Joint Economic Committee,  
submitted the following

### REPORT

together with

Minority and Additional Views

(Pursuant to sec. 5(b) of Public Law 304, 79th Congress)

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This Report is submitted in accordance with the continuing responsibility of the Joint Economic Committee to apprise the Congress of economic circumstances and make such recommendations as it deems advisable.

## GENERAL NOTES

Senator Sparkman states: "Because of the pressure of other responsibilities, I was not able to participate fully in the hearings and discussions underlying this report. For this reason I do not consider it appropriate for me to identify myself with all of its conclusions and recommendations. However, I support the general tenor of this report and am pleased to join my colleagues in presenting this report to the Congress as a valuable and useful analysis of our current economic situation and its implications for public policy."

Statistical data used in this Report were the most accurate available on September 19, 1977. Information released between September 19 and September 26 could not be incorporated in this Report. However, it would not change either the analysis or the conclusions.

## I. INTRODUCTION

The sub-par condition of the American economy continues to be a source of serious concern to the Joint Economic Committee. We are alarmed by the continuation of unacceptably high rates of unemployment more than two years after the bottom of the recent recession, and by the failure of inflation to slow to a tolerable rate. For this reason, this report pays particular attention to the sources of our economic difficulties and to measures that would make it possible to combine a reduction in inflation with increases in production and employment.

In "The 1977 Joint Economic Report" a number of proposals designed to improve the state of the economy were set forth. We recommended vigorous measures to raise youth employment. We also expressed concern over the economic outlook and stressed the possible need for more stimulus than could be expected from Administration proposals. A standby jobs fund was recommended as a countercyclical measure. Although Congress has enacted a major new youth employment program, most of the Committee's earlier recommendations are as relevant to the present situation as to the one that prevailed at the beginning of the year. Indeed, the danger of a new interruption of recovery is now greater than at the time the 1977 Joint Economic Report was issued, and it is therefore entirely appropriate to reiterate that stimulative measures that go well beyond the budget for fiscal year 1978, or that are contained in present monetary policies, are very likely to be needed in the near future.

The Congress recently directed the Joint Economic Committee to undertake an extensive study of economic change, past and prospective, and to provide the Congress with recommendations for meeting the future economic policy requirements of the Nation. In so doing, the Congress has cited the "numerous and profound changes in the United States and world economies" since the passage of the Employment Act in 1946. These changes have reduced the relevance of traditional economic doctrine to the problems of today. More knowledge and better insight are needed. The JEC will be addressing these matters in the months ahead.

This Report begins with a review of the progress, and lack thereof, of the recovery from our deepest post-war recession. It moves from there to the presentation of our rather pessimistic forecast for the remainder of 1977 and for 1978. Chapter III of the Report identifies the continuation of rapid inflation as the chief obstacle to speedy recovery. However, the view that inflation must be stopped at all costs -- including the cost of higher unemployment and slower growth -- is firmly rejected as primitive and ineffective. Instead, we propose an agenda for study and action that is intended to shift the burden of inflation control away from those persons -- the poor, minorities, teenagers, the aged -- who have tended to be the principal victims of the traditional method of slowing inflation by restricting demand.

### The Recovery to Date

The recent recession is by far the deepest of the post-World War II era. It began in late 1973 and reached bottom in the spring of

1975. However, more than two years later unemployment still hovers at about 7 percent of the labor force. Prior to this recession, the year 1958 was the worst year of the post-war era; yet unemployment that year was only 6.8 percent as compared with the 7.7 percent of 1976 -- a year of recovery -- and the 7 plus percent that will be registered this year.

Meanwhile, inflation has failed to respond either as hoped or as predicted to the slack in the economy. Although the 9.1 percent increase in the Consumer Price Index (CPI) of 1975 gave way to a more modest 5.8 percent in 1976, this rate is still alarmingly high by historical standards, and it jumped once again to an annual rate of 8.9 percent in the first half of this year.

That recovery from a recession as deep as the recent one should take several years does not come as a surprise. Raising output to its past peak only gets us a small part of the way back to full employment. The inexorable arithmetic of labor force and productivity growth keeps pushing up potential output at a rate between 3.5 and 4.0 percent a year. Recovery requires actual output to grow faster than potential output -- about 3 percent faster to reduce unemployment by 1 percentage point in a year. And this must be kept up for as many years as it takes to reduce the unemployment rate to tolerable levels.

Had real growth proceeded rapidly and steadily, full recovery would have taken about four years. However, actual growth has been uneven and not firmly based and the economy has therefore fallen far short of the targets that the JEC set forth in "The 1975 Joint Economic Report." The Carter



Administration's present long-range goal of a 4-3/4 percent unemployment rate by 1981 is far less ambitious than the goal established by the Committee. Yet the halting progress of the recovery, combined with the bleakness of the outlook for the immediate future, makes even this modest target seem remote and overly optimistic.

The economy rebounded rapidly in the last half of 1975 and early 1976. But in the spring of 1976 the Federal budget began showing an expenditure shortfall that continued throughout 1977 in an amount likely to produce outlays that are approximately \$15 billion below the approved budget for fiscal year 1977. This expenditure shortfall, inventory over-building in early 1976, the persistent failure of business fixed investment to revive, and the constant drag caused by the failure of other industrial countries to expand, stalled the recovery and produced a slowdown in the last half of 1976 that brought the unemployment rate to a level exceeding that of the beginning of the year. Thus, 1976 proved to be a throwaway on the road to recovery, and this is one of the reasons why it will take longer to return to full employment than had originally been expected.

The recovery again picked up momentum in the first half of 1977 as the real growth rate rose from the 2.5 percent of the second half of 1976, to a rate of 6.8 percent. This very rapidly reduced the unemployment rate from the 7.8 percent of last December to an average rate of 7.0 percent in the second quarter of 1977. Unfortunately, the rate of inflation has also accelerated. After rising at a rate of 5.3 percent in 1976, the GNP deflator moved along at a 6.2 percent annual clip during the first half of this year.

The current recovery is lagging behind the progress of recovery of previous recessions in most relevant respects. Table I-1 shows that during the recent recession real final sales -- the best measure of overall demand in the economy -- fell much more than in the earlier recessions. Although real final sales have actually risen at about the average rate for recovery periods, the gap caused by the original greater than normal decline of 1974-1975 has not been made up.

Similarly, when measured as a percent of the levels achieved at the cyclical peak prior to recession, the current recovery lags the average of the past four recessions in all expenditure components except personal consumption and single-family home construction. As shown in Table I-2 non-residential fixed investment is still 95 percent of its previous peak, whereas by this time in four previous cycles it had recovered to over 100 percent. The most serious shortfall has been investment in nonresidential structures. State and local purchases have not been nearly as great a source of stimulus as in earlier recoveries. And the failure of other industrial countries to achieve rapid expansion has caused the growth of our exports to be sluggish.

TABLE I-1. Change in Real Final Sales  
(percent)

<u>Period</u> <u>1/</u>	<u>Change During Recession</u>	<u>Recovery Above Previous Peak</u>
1953:3 - 1956:3	- 1.8	6.8
1960:2 - 1963:2	0.9	11.3
1969:4 - 1973:1	- 0.2	13.8
1973:4 - 1977:2	- 2.9	8.2

Source: Department of Commerce, Bureau of Economic Analysis

1/ The recovery above the previous peak is calculated using the nine quarter period following the economic trough as defined by the National Bureau of Economic Research. The 1957-60 experience is omitted because the recovery was so short.

TABLE I-2. Real Nonresidential Fixed Investment  
 Nine Quarters Following Economic Trough as a  
 Percent of Previous Peak

<u>Period</u>	<u>Total Real Nonresidential Fixed Investment</u>	<u>Structures</u>	<u>Producers Durable Equipment</u>
1953:3 - 1954:2 - 1956:3	115.8	127.1	108.7
1957:3 - 1958:1 - 1960:2	100.0	100.7	99.5
1960:2 - 1961:1 - 1963:2	108.5	109.9	107.5
1969:4 - 1970:4 - 1973:1	112.5	100.2	120.3
1973:4 - 1975:1 - 1977:2	95.5	83.6	101.6

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Source: Department of Commerce, Bureau of Economic Analysis

As shown in Table I-3, industrial production now exceeds its previous peak level. Nevertheless, this performance lags previous recoveries. In addition, the unemployment rate remains at 7 percent of the labor force whereas at the same stage of four previous recoveries it had fallen to an average of less than 5 percent. Finally, and although it has declined very substantially from its recession trough, the gap between actual and potential output is still from 6 to 8 percent of potential GNP, and it remains much larger than the average gap at the same stage of earlier recoveries.

The response of the unemployment rate to the forces of recovery has been particularly disheartening. More than two years after the recession trough, the unemployment rate still exceeds the 6.8 percent rate recorded in 1958, the worst post war year our economy experienced prior to the recent recession.

Some would attribute our unemployment miseries to changes in the composition of the labor force. Because of rising labor force participation rates and the baby boom of the 1940s and 1950s, the proportion of the civilian labor force composed of teenagers and young adults has increased from 15 percent in 1955 to 24 percent in 1976. At the same time, labor force participation rates for adult women have risen sharply.

It is an established fact that teenagers and women suffer higher unemployment rates than adult males. Therefore, the change in the composition of the labor force has tended to pull up the overall unemployment rate, and it has caused the degree of labor market tightness associated with any given unemployment rate to increase.

LETTER OF TRANSMITTAL

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SEPTEMBER 30, 1977.

HON. THOMAS P. O'NEILL, JR.,  
*Speaker of the House of Representatives,*  
*Washington, D.C.*

DEAR MR. SPEAKER: Transmitted herewith is a report from the Joint  
Economic Committee.

Sincerely,

DICK BOLLING.

(iii)

One of the most discouraging results of our forecasting exercise is the likelihood of a continued high rate of inflation. As indicated earlier, inflation decelerated between 1974 and 1976, but has picked up again in the first half of 1977. The implicit price deflator for GNP increased at a 5.3 percent annual rate in the first quarter of 1977, and at a 7.1 percent annual rate in the second quarter.

Although the real spendable earning of a typical wage earner has risen very little, unit labor cost continues to rise rapidly, and it is unit labor cost that represents the basic cost-push force that underlies the ongoing inflation. Table II-1 shows that real spendable earnings actually declined in three of the last four quarters, despite a rapid rise in money wage rates. Once allowance is made for payroll taxes, employer contributions to private benefit plans, and adjustments for inflation, the wage increases translate into almost no gain at all in real earnings.

Table II-1 also shows that much of the rise in unit labor cost is attributable to a slowdown in the rate of growth of productivity. In the second quarter of 1977, unit labor cost in nonfinancial corporations was 7.2 percent above its level of a year ago. Because unit labor cost has continued to rise at an annual rate in excess of 6 percent, it is difficult to foresee any speedy abatement in the rate of price inflation.

There is no particular reason to expect productivity developments in the near future to deviate much from their longer term trends. In addition, we anticipate that money wages will continue to rise at rates

TABLE III-1  
(Dollars in Billions)

Quarter	Full Employment Surplus	Growth of Real M <sub>1</sub> at Annual Rate
1973-IV	\$ 8.6	-1.3
1974-I	16.6	-3.8
1974-II	22.9	-5.7
1974-III	30.4	-8.0

Source: Council of Economic Advisers, Board of  
Governors of the Federal Reserve System, and  
Department of Commerce.



Table I-3. Change in Total Index of Industrial Production  
(percent)

<u>Period</u> <sup>1/</sup>	<u>Decline During Recession</u>	<u>Recovery Above Previous Peak</u>
July 1953 - August 1956	9.4	7.5
January 1960 - June 1963	8.6	11.8
October 1969 - March 1973	6.8	14.2
November 1973 - July 1977(p)	15.1	5.6

Source: Federal Reserve Board

<sup>1/</sup> The recovery above the previous peak is calculated using the 28-month period following the trough in industrial production. The 1957-60 experience is omitted because industrial production peaked after only 21 months then began to decline.

Although the changing composition of the labor force probably means that it will be more difficult to achieve a 4 percent unemployment rate than in the past, it does not follow, as some now find it fashionable to contend, that the change in the composition of the labor force makes it more difficult to lower unemployment by the use of expansionary fiscal and monetary policies. In "The 1976 Joint Economic Report" we noted that applying 1956 unemployment rates for the three major demographic groups -- adult men, adult women, and teenagers -- to the present day labor force, would only raise the overall unemployment rate by 0.3 percent. Our present 7 percent unemployment rate cannot, therefore, be explained by changes in the composition of the labor force.

The unemployment rate for teenagers reached 17.5 percent in August -- almost 3-1/2 times the rate for adult males. This very high unemployment rate for all teenagers obscures the even higher rates for certain categories of the teenage population and for teenagers in many large cities. The unemployment rate for black teenagers is now about 40 percent, whereas the rate for all teenagers is just over 17 percent. In many urban areas the deviations from the average are even more pronounced.

### Lessons of the Recent Past

The experience of the last two years has made several very hard facts clear:

First, recovery is still a problem that extends well beyond the next fiscal year even though three and one-half years have passed since the recession began, and more than two years have passed since it touched bottom.

Planning for full employment still requires looking ahead four or five years.

Second, one of the principal reasons for the anemia displayed by the recovery is the continuation of a rapid rate of inflation. For reasons that will be explored in detail in Chapter III, it is the inflation, more than any other factor, that sucks the lifeblood of expansion out of the economy and that continues to cause the road back to full employment to be so long and so difficult.

Third, and also explored in Chapter III, attempting to control inflation by restricting aggregate demand has proven to be an abysmal and costly failure. The main consequence of such policy has been to reduce production, to increase unemployment, and to cast doubt upon the ability of policy makers to manage a free economy effectively. Alternative methods of slowing inflation -- methods that do not place the entire burden of inflation control on production and employment -- are urgently needed. Chapter IV of this report explores some possible ways of accomplishing this end. In fact, the Committee has instructed its staff to give careful attention and high priority to this very chronic and stubborn problem as it plans programs of hearings and study in the near future.

## II. THE ECONOMIC OUTLOOK

### The Short-Term Outlook

The outlook for the remainder of 1977 and for 1978 is unfavorable. We expect the economy to slow down in the last half of 1977, and we would consider ourselves fortunate if we were able to sustain a real growth rate in 1978 high enough to prevent unemployment from rising. Specifically, we project a year-over-year increase in real GNP of from 5 to 5-1/2 percent in 1977, and an increase in 1978 of from 4 to 4-1/2 percent. The unemployment rate may fall to the 6.5-6.8 percent range by the fourth quarter of this year, but only because of recently enacted job creation programs. Thereafter little improvement is to be expected.

Although the forecast is pessimistic, the assumptions that underpin it are, for the most part, reasonably optimistic. For example, we have assumed that the personal saving rate will remain below 6 percent during 1978, even though this is well below the 7.4 percent average of the first half of this decade, and even though consumers depleted their savings and increased their debt, partly in anticipation of the income tax rebate that never materialized. We have also assumed that housing starts will remain in the 1.7-1.9 million range over the forecast period even though we expect the cost and availability of mortgage financing to move adversely in response to monetary policies that have been dominated by an obsessive concern with inflation. We have also assumed that Federal Government purchases of goods and services -- which have been flat in real terms for the last year and

a half -- will pick up as the 1978 budget goes into operation.

A certain amount of stimulus may result from the spending of State and local governments, although it is very difficult to be certain about this. According to data for the first half of 1977, State and local governments are running a surplus of about \$26 billion at an annual rate in 1977. However, some \$15 billion of this surplus represents social insurance funds that are not available to finance capital projects or operating deficits. Further, much of the remaining \$11 billion consists of surpluses in only two States -- Texas and California. With negligible surpluses in most of the States, any Federal grants to State and local governments are likely to result in speedy increases in government spending.

The areas of greatest uncertainty in the economic outlook are business fixed investment, the rate of inflation, and the foreign sector. We have projected a rise in business fixed investment in real terms of about 10 percent for 1977 and 8 to 9 percent for 1978. If we achieve growth rates in capital spending of this magnitude, we will have done very well by historical standards. Unfortunately, there are a number of uncertainties that becloud this projection.

On the sunny side, many forecasters have been predicting the imminent arrival of a capital spending spree. While this boom has not as yet materialized, there are reasons for supposing that a pickup in capital spending may come along soon. First of all, there is some new evidence which suggests that capacity utilization measures overstate the amount of unused plant and equipment currently available. Writing in the May and

June 1977 issues of the Monthly Review of the Federal Reserve Bank of St. Louis, Robert Rasche and John Tatom reported their estimates that higher energy costs have caused potential GNP to drop about 4 percent relative to trend. It follows from their analysis that capacity utilization indices are too low by a similar proportion. Peter Clark, a staff economist for the Council of Economic Advisers, has arrived at much the same conclusion in a recent paper. In addition, Clark reported a 4 to 5 percent decline in productivity, although he attributed only about one-half of this to restricted energy supplies. Curiously, none of these researchers seem to have incorporated the effect of rising labor force participation rates on potential output. The changing relative price of energy has clearly produced an incentive to substitute labor for capital intensive technologies. But whether this will raise capital spending in the near future is not at all clear.

Environmental legislation is accelerating the rate at which our capital stock is becoming obsolete, and the conversion of oil and gas fired facilities to coal-burning facilities will require some investment of a one-shot nature. But whether this will happen quickly or drag on over a period of years is anyone's guess.

Although the factors above make for an optimistic investment picture, there is at least as much reason to be pessimistic. Revisions of capacity utilization and potential output indices notwithstanding, it is clear that the productive facilities of the economy are still badly underutilized. Until increased demand raises operating rates to near full capacity levels, hopes for a capital spending boom are apt to be in vain.

Second, the acute depression of the stock market does not bode well for capital spending. Stock prices are now very low relative to the replacement costs of the physical assets of business enterprise. To say the same thing differently, the cost of raising new capital in financial markets relative to the cost of the physical assets is extremely high. This is a situation that could, perhaps, be corrected by more expansionary monetary policy. However, as long as depression of the stock market persists, it will tend to keep the level of capital spending below desirable levels.

Finally, there is a group of unique negative factors to be considered. Uncertainties surrounding the tax policy changes which Congress will be considering next year could easily cause investment decisions to be delayed until these uncertainties are eliminated. Similarly, investment associated with the energy conservation program are not likely to be undertaken until it is clear what the terms of that program are. In addition, these investments could be stretched out over several years, thereby minimizing their immediate impact.

Surveys of investment intentions are pessimistic about the prospects for capital spending in 1978. We take these surveys seriously, but also are sufficiently impressed by the arguments that predict expansion to project a growth rate in the 8-10 percent range in real terms. As mentioned earlier, and as will be emphasized throughout this report, such ambitious levels of activity will require the active support of monetary policy.

TABLE II-1 NONFINANCIAL CORPORATIONS

(Percentage Change From Corresponding Quarter of Preceding Year)

<u>Quarter</u>	<u>Money Wages and Salaries</u>	<u>Real Spendable Weekly Earnings</u> <sup>1/</sup>	<u>Productivity (Output per Hour)</u>	<u>Unit Labor cost</u>
1976 - I	9.7	4.4	6.6	1.3
II	11.4	1.5	4.1	4.2
III	11.1	-0.2	2.2	6.5
IV	10.6	-0.1	2.1	6.9
1977 - I	10.4	-0.1	2.4	6.9
II	11.2	1.1	1.6 p	7.2 p

Sources: Bureau of Labor Statistics and Department of Commerce

p = Preliminary

<sup>1/</sup> Computed for worker with average earnings and three dependents.



that attempt to make up for past losses in purchasing power. In combination, these trends suggest that unit labor costs and prices will continue to rise at the 6 to 8 percent trend that has come to be denoted as the "underlying rate of inflation."

As explained in Chapter III, a high rate of inflation has a seriously dampening effect on real expenditures in various sectors of the economy. For example, personal income and personal consumption are expected to increase at about 10 percent next year; but when adjusted for the anticipated inflation, these increases will come to only 3.3 percent in real terms. Thus, while growth in nominal terms may be quite substantial, the level of real activity will not proceed at a rate nearly rapid enough to reduce unemployment. Indeed, a "growth recession," -- a situation in which real growth remains positive but yet is so slow that unemployment rises -- is quite a distinct possibility in the near future.

One of the greatest unknowns which will affect the outcome is the conduct of monetary policy. Our view is that monetary policy in the past three years has been too restrictive; that this has severely impeded recovery; and that it is past time to reverse this posture and to support economic growth. Our present forecast is based on the assumption that monetary policy will accommodate the limited growth that is being projected. This implies rates of growth in M1 in a range of 7.0 to 8.0 percent. If monetary policy fails to provide such accommodation, as we and several of our witnesses fear may happen, interest rates will surely rise, and this will slow investment spending, especially in the presently strong housing sector. As

explained below, it will also add an additional deflationary impulse by further weakening the current account of our balance of payments.

As indicated earlier, the foreign sector has become a very serious question mark in the outlook for the American economy. Foreign demand for U.S. goods can provide an important stimulus to our economy. On the other hand, when our consumers purchase foreign rather than domestic automobiles and TV sets this employs foreign workers rather than our own workers. An excess of exports over imports provides a net stimulus in employment to our economy, whereas an excess of imports over exports does the opposite.

During the present economic recovery the foreign sector has been a burdensome drag. The reason is that recovery in the United States began sooner and proved to be brisker than in other industrial countries. The effect has been to cause our imports to grow much more rapidly than our exports. The differential growth rates have, in fact, been so huge that we are very likely to run up a record trade deficit of \$25-\$30 billion in 1977.

A deterrent to our own recovery is the circumstance that recovery remains sluggish in the major industrial countries, especially West Germany and Japan. Neither of these countries is likely to achieve the growth targets that they announced earlier this year. Although Japan has recently indicated its intention to stimulate its economy, this can hardly be expected to have much impact on our massive trade deficit.

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The United States is very likely to continue to have substantial trade deficits in the next two or three years. Petroleum imports are sure to continue at high levels. And much will depend on the movement of international capital. A large part of the trade deficit has been financed by reinvestment of OPEC surpluses and by other capital movements. Although these inflows helped to finance our oil bill, they have held up the value of the dollar in relation to foreign currencies and this has made our exports relatively expensive, our imports relatively cheap, and has therefore prevented our trade gap from narrowing. If these capital inflows persist, as may happen if tight money raises interest rates or the political situation abroad deteriorates, the dollar will continue to be strong, but at the same time this will perpetuate the trade deficit and therefore have a depressing effect on our economy.

Although it is pessimistic, our forecast lands us roughly in the middle of the various readers of the economic tea leaves. Most of the testimony received by the Committee has been on the down side. Dr. Alvin Karchere of the IBM Corporation told the Committee that he expected real growth to be no more than 2-1/2 percent at an annual rate during the last three quarters of 1978. His inflation projections were similar to ours, coming to 6-1/2 percent to the end of 1978. Another witness, Professor Ronald Teigen of the University of Michigan, projected a declining rate of real growth commencing in the last half of 1977. His forecast implied a slump in the growth rate down to 2.7 percent by the fourth quarter of 1978. At the same time he expected the inflation rate to proceed at a more or less steady rate of 6-1/2 percent in 1978.

The main elements of the JEC forecast are shown in Table II-2. To summarize: Our forecast anticipates significantly lower growth in 1978 than in 1977 and no improvement in the rate of inflation. It should be noted that our forecast incorporates the budgetary assumptions of the Second Concurrent Resolution for FY 1978, and that it does not anticipate any further fiscal policy changes.

### Long Range Projections

The Joint Economic Committee has stated on many occasions that the way to achieve optimal economic progress is to begin by setting forth clearly defined economic targets with respect to employment, growth, and the rate of inflation. We have gone on to say that policy should be designed in a way that attempts to attain those goals. Two and a half years ago the Committee recommended that policy be redirected in an expansionary manner so as to reduce the unemployment rate below 6 percent by the end of 1977. That advice was not heeded, and the failure to adopt expansionary policies has resulted in an unemployment rate that is expected to remain well above 6 percent at the end of the year.

The Carter Administration's targets for 1981, as amended in its Mid-Year Review of the Budget, are as follows:

- reduction of the unemployment rate to 4-3/4 percent;
- reduction of the inflation rate to 4-3/10 percent;

Table II-2. Economic Outlook

	<u>1977:4</u>	<u>1978:4</u>
<u>Gross National Product</u>		
current dollars	1982.5	2169.9
percent change	12.9	9.5
constant (1972) dollars	1373.5	1418.7
percent change	6.7	3.3
<u>GNP deflator</u>		
(perent change)	5.9	6.3
<u>Unemployment rate</u>	6.5-6.8	6.5-6.8

-- balance of the Federal budget at expenditure and revenue levels equal to 21 percent of GNP.

As indicated earlier the JEC has always supported the idea of establishing economic targets toward which policy should strive. Furthermore, our bias has been to adopt targets that are relatively ambitious because we have felt that only by working toward ambitious goals could we hope to sustain sufficient momentum to maintain real growth and employment at high levels. President Carter's decision to establish targets and his determination to look into the economic future are therefore entirely commendable decisions that are wholly in tune with the type of approach that this Committee has long been urging.

Although we have urged the delineation of clear but ambitious goals, we have also stressed that these goals must be achievable in response to reasonable policies. Unfortunately, our recent staff study, "The Macroeconomic Goals of the Administration for 1981: Targets and Realizations," found that only a very unusual combination of extremely good luck such as bumper harvests and cheap and plentiful new energy supplies, combined with rapid expansion of the money supply, would allow all of these goals to be achieved simultaneously. The major conclusions of the study were as follows:

(1) To reach the inflation target of 4.3 percent by using fiscal and monetary policies would necessitate such restrictive policies that the unemployment rate would rise well above its present level of 7 percent. The Administration's present anti-inflation program is not nearly powerful enough to change this picture in any significant way.

(2) To reach the full employment and balanced budget targets, nonresidential fixed investment would have to grow by 10 percent per year in real terms for five consecutive years. This target is beyond reach unless monetary policy becomes sharply more expansionary and this would make it most unlikely that the inflation target could be reached.

(3) The balanced budget and full employment targets are very likely to be incompatible because of structural changes in the economy that have weakened aggregate demand and that will make it necessary to run a budget deficit if the economy is to achieve full employment. The report singled out the foreign sector and State and local spending as sectors that were apt to be particularly weak.

The testimony of witnesses before the Committee generally confirmed the conclusions of the staff report. We commend the Administration for focusing attention on the longer term horizon but feel that Congress should revise these targets in a way that makes them more realistic goals at which to aim policies.

### III. INFLATION AS A DETERRENT TO RECOVERY

#### Introduction

Recovery from the present recession has been seriously hampered because the recession has been accompanied by an alarmingly rapid and seemingly intractable rate of inflation. Other recovery periods were not marred by the confusion and indecision caused by the difficulty of knowing whether to pursue expansionary policy to spur recovery, or restrictive policy to slow inflation. This confusion is but one of the reasons why inflation is showing itself to be the principal impediment to speedy recovery. It is this theme that provides the subject matter for the remainder of this report.

#### Inflation and Recovery

The conventional view of the relationship between unemployment and inflation is that expansionary policies which reduce unemployment will also add to inflation. This is because such policies raise total demand in the economy and cause a price pull effect. Simultaneously, there is a tightening of labor markets which raises wages and unit labor costs and tends, therefore, to cause an upward price push. In this view there is a trade-off between unemployment and inflation. The economy can enjoy lower unemployment, but only at the cost of a higher rate of inflation; or it can reduce the rate of inflation, but only at the cost of higher unemployment.



Once the rate of inflation rises, this increase tends to become entrenched. Higher prices are observed by workers as a cut in their real wages, and they attempt to make up for this by raising their wage demands. If they expect prices to continue to rise, they may demand still more in response to the anticipated inflation. Since wage increases raise unit labor costs, prices are again pushed up, and the merry chase of wages after prices continues.

The extent to which this process is automatic has increased significantly. At present, 60 percent of all workers covered by major labor contracts have an automatic cost of living adjustment clause, in contrast to the 28 percent that enjoyed such clauses in 1971. Social security benefits are automatically indexed to the inflation rate and, according to a Congressional Budget Office study, "The Effect of Inflation on Federal Expenditure" (Background Paper No. 9), over 60 percent of all Federal outlays are effectively indexed for inflation.

Although the policies that begin the inflation may initially reduce unemployment, the continuation of a high and rapid rate of inflation may tend, in subsequent years, to have the opposite effect. Some economists are of the opinion that these adverse effects may be so strong and pronounced that the unemployment rate may exhibit a higher average value over a number of years than would have been the case had the temptation to lower the unemployment rate during the early part of the period been resisted.

The validity of the foregoing proposition is, of course, a subject of considerable dispute. However, persons of all persuasions can certainly agree that a rapid rate of

inflation has very adverse effects upon the economy's ability to generate growth of real output and reduce its rate of unemployment. The reasons for this are very important for the rational conduct of economic policy, and a review of these reasons is therefore appropriate.

### Restrictive Policy Bias Due to Inflation

The most important restrictive effect caused by inflation is the conservative bias that it imparts to budgetary and monetary policy. Stagflation, as the simultaneous existence of excessive unemployment and an excessively high rate of inflation is sometimes called, creates a genuine dilemma for stabilization policy. Excessive unemployment calls for expansionary policy, but this risks renewed inflation, while a high rate of inflation calls for restrictive policy, thereby risking higher unemployment. The sad truth is that since 1974 inflation has provided, and continues to provide powerful motivation to suspend the Employment Act in favor of restrictive economic policies that slow economic growth and increase unemployment.

The inflation of 1974 had very little connection with excessive overall demand, and its magnitude was greatly exaggerated by the Wholesale Price Index. 1/ Nevertheless, it

1/ Dr. Richard Ruggles, author of the recent report "The Wholesale Price Index: Review and Evaluation," which was prepared at the

was the inflation that permitted public officials to pursue monetary and fiscal policies that greatly exacerbated the economic collapse and that caused the present recession to be so deep.

Prices rose rapidly in 1973 due to increases in world food and materials prices, to the export boom that followed the devaluation of the dollar, and to expansionary monetary policies that had been pursued during the previous year. Concerned over the mounting inflation, the Federal Reserve slowed the rate of growth of M1 drastically in the third quarter of 1973. This caused a new credit crunch and, as had happened in 1966, sent profound shockwaves through the housing industry. This time the number of new housing units started crashing down about 60 percent between the first quarter of 1973 and the first quarter of 1975.

(Footnote 1/ continued)

request of the Council on Wage-Price Stability, appeared before the Committee on August 5, 1977, and testified that the WPI greatly exaggerated the rate of inflation in 1974. He also volunteered the opinion that this helped to panic public officials into a switch to excessively restrictive policy. The main reason for the bias in the WPI is that primary and manufactured products are lumped together in the index. Since many primary products also appear as an input in manufactured products, there is duplication that causes the primary products to be double counted. As a result of this, a rise in the prices of such primary inputs as oil and agricultural raw materials causes a very greatly upwardly biased rise in the WPI.

Although the inflation of 1973 could in large measure be attributed to demand factors, the added inflation imparted to the economy in 1974 most certainly could not. Most of the 1974 inflation was directly attributable to the quadrupling of oil prices by the OPEC cartel and the poor harvests that plagued the world's agriculture in the first half of the 1970s. Both events raised the domestic price level for reasons that were unrelated to excessive domestic aggregate demand. Since crop prices for basic staples are largely determined by world market conditions, it is senseless to impose restrictive monetary-fiscal policies to prevent the domestic price level from rising when world food prices increase. Such policy deflates the rest of the economy, creating unemployment and lost production without having any favorable price level effect to show for it. Similarly, the rise in the price of oil added to our import bill and gave an upward shove to our price level. The inflation this produced was comparable to the effects of a massive excise tax on oil. Excise taxes raise consumer prices, and in this sense are inflationary, but because they simultaneously act as a drain on consumer real income, the result is a reduction in real consumer outlays and a restriction of economic activity.

Because the inflationary shocks came primarily from supply restriction, it would have been appropriate for monetary policy to finance a substantial fraction of these price level increases with accommodative measures. Alarmed over inflation, without showing awareness of its cause, monetary policy did the opposite, opting instead for restrictive policies.

Fiscal policy, too, performed perversely. Expenditure growth was held down, taxes were permitted to rise, and the full employment surplus increased sharply. Aware of the deteriorating situation, the Joint Economic Committee in its 1974 Joint Economic Report recommended a \$10 billion tax reduction. However, as late as October of that year President Ford proposed to raise taxes, a misguided proposal that Congress, to its enormous credit, did not take seriously.

Table III-1 shows what happened in 1974. The full employment surplus, as estimated at that time by the Council of Economic Advisers, increased from \$8.6 billion in the fourth quarter of 1973 to \$30.4 billion in the depressed third quarter of 1974. Meanwhile, the rate of monetary growth, although positive in nominal terms, was sharply negative in real terms. From the fourth quarter of 1973 when the recession began, to the fourth quarter of 1974, the real value of M1 decreased by more than 6 percent. As a consequence, interest rates climbed precipitously, and this greatly worsened the recession.

Although policy since 1974 has shown some improvement, it is still characterized by excessive caution, a caution conditioned by the fear that aggressive measures to eliminate unemployment will lead to a reacceleration of inflation. The consequence of such policy is that an enormous drag is placed on recovery.

Simple arithmetic combined with a famous economic truism show how restrictive monetary policy has retarded recovery. An eminent economist from an earlier generation, Irving Fisher, developed the "quantity equation" which states that the quantity of money, multiplied by the number of times this money turns over during a year (velocity), must equal the nominal GNP for that year. The nominal GNP, in turn, must equal the product of the level of real output (call it  $Q$ ), and the level of prices (call it  $P$ ). Consequently, Fisher's famous equation simply states that  $MV = PQ$ .

There are different definitions of the quantity of money, but any one can be used provided the definition of velocity is consistent. For example,  $M_1$ , defined as currency plus demand deposits, has exhibited a secular rise in velocity of about 3 percent a year over the last 25 years. This implies that under ordinary circumstances the rate of growth of  $M_1$  should be about 3 percent less than the rate of growth of nominal GNP ( $=PQ$ ). However, between the second quarter of 1975 and the second quarter of 1977, real GNP grew at an annual rate of 5.8 percent, while the GNP deflator grew at an annual rate of 5.6 percent. The sum of these two growth rates (11.4 percent) adds up (roughly) to the growth of nominal GNP. However, the growth of  $M_1$  over the same interval proceeded at a rate of only 5.2 percent. Thus,  $M_1$  growth was not sufficient to finance the growth of GNP without the kind of rise in the velocity of  $M_1$  that normally occurs only in response to monetary tightness. Such tightness forces up interest rates and raises velocity by causing money holders to reduce the volume of idle cash balances they hold. However, the rise in interest rates also reduces the

growth of expenditure, and this is what brings PQ into line with MV.

As indicated earlier, real growth of 7 percent a year was needed to lower unemployment by 1 percentage point in a year. Because the fastest period of recovery should have been the initial period, there is very little doubt that the failure to achieve a 7 percent real growth rate in the eight quarters following the bottom of recession is very much the consequence of the exceedingly restrictive monetary policies that the Federal Reserve has pursued.

One of the reasons for the pessimistic forecast presented in Chapter II is the judgment that monetary policy will probably continue to be restrictive. This belief was strongly confirmed by Professor Ray C. Fair of Yale University who used his econometric model of the economy to perform several simulations of the effects of alternative monetary policies for the use of the Committee. Professor Fair simulated the effects of three policies -- a fully accommodative monetary policy that held the bill rate constant, a harshly restrictive policy that held the growth of M1 at the upper value of the Fed's present target range (6.5 percent), and an intermediate policy that was characterized by Professor Fair as the Fed's traditional policy of "leaning against the wind." Since the assumptions about the budget were identical in each case, the experiment served to isolate the effects of these alternative monetary policies. Finally, it is the "leaning against the wind" policy that Professor Fair thinks will actually be followed.

To describe the results, it is best to let Professor Fair speak for himself:

If the Fed behaves by keeping the bill rate unchanged, full employment and a balanced Federal budget are reached by 1980. If, on the other hand, the Fed behaves as I predict it will, the expansion is aborted near the end of 1978 and the Federal budget deficit in 1980 is \$32.4 billion. The expansion is aborted because the Fed causes the bill rate to rise in response to the expanding economy. In this case the unemployment rate never falls below 6.1 percent, and by the end of 1980 it is back up to 6.5 percent. If, finally, the Fed behaves by keeping the growth rate of M1 at 6.5 percent, the expansion is aborted almost immediately. The bill rate rises to 13.1 percent in the third quarter of 1977 and stays roughly at this level throughout the period. By the end of 1980 the unemployment rate is 9.8 percent and the Federal deficit is \$86.8 billion.

More rapid growth creates the risk of more rapid inflation. However, Professor Fair's model includes the beneficial effect of faster growth on productivity and unit labor costs that the Committee has emphasized (for example, "Achieving Price Stability Through Economic Growth," 1974), and he therefore finds that the extra inflation will be modest.

In the full employment, balanced budget case, inflation is about 1.0 percentage points higher by the end of 1980 than it is in the case in which the Fed behaves as I predict it will. The inflation rate in this latter case is about 4.5 percent by the end of 1980, compared to about 5.5 percent in the former case. In the case in which the Fed keeps the



growth rate of M1 at 6.5 percent, the inflation rate is about 0.2 percentage points less by the end of 1980 than it is in the case in which the Fed behaves as I predict it will.

Professor Fair concludes with the following dismal prognosis:

It is thus my conclusion ... that the Administration's goals ... will not be achieved if the Fed behaves as it has in the past. The model predicts that the Fed will cause the bill rate to rise from its present level as the economy expands and as inflation continues to be higher than its historic average. (italics supplied)

Professor Fair's results imply that the maintenance of a constant bill rate will require M1 to grow at a rate between 10 and 11 percent in 1978 and 1979. Although the last six months have witnessed an acceleration of M1 growth, the Fed has not raised its announced targets, and monetary growth has been so erratic from month to month that it is difficult to pinpoint the direction in which monetary policy is headed. Short-term interest rates have increased 80 basis points since February, and the events of August have made it appear as if Professor Fair's predictions are already coming true. In that month the Federal funds rate, which had averaged about 5-3/8 percent in July, was rapidly pushed up to 6 percent. This pressure was felt in financial markets and has led to a rise in the prime and other interest rates. The month ended with a rise in the rediscount rate from 5-1/4 percent to 5-3/4 percent.

Fiscal policy, too, has been hampered by the constant fear that tax and expenditure measures designed to raise economic activity will merely contribute to inflation. As noted earlier, both monetary and fiscal policies performed disastrously in 1974. Since that time, there have been a number of stimulative fiscal measures enacted. Tax reductions were enacted in 1975, 1976, and 1977, and accelerated public works and anti-cyclical revenue sharing programs have also been introduced. Nevertheless, the overall performance of fiscal policy cannot be described as particularly adventuresome.

The First Concurrent Budget Resolution under the new Congressional Budget and Impoundment Control Act of 1974 was passed in April 1975. The Resolution approved unified budget outlays of \$367 billion and revenues of \$298.2 billion for fiscal year 1976. In combination, the two figures implied a deficit of \$68.8 billion. The final recorded deficit was remarkably close to the approved amount, coming to \$66.5 billion and was the largest deficit ever recorded in a single fiscal year.

Despite the enormous size of the deficit, this was not a reflection of expansionary fiscal policy. The budget for fiscal year 1976 contained hardly any new spending initiatives, and the deficit was entirely the passive consequence of the recession. Had GNP been at a level commensurate with 4 percent unemployment, as opposed to the 8 percent actually recorded in fiscal year 1976, taxable income would have been so much higher that an additional \$50 billion in revenue would have flowed into the Treasury. Similarly, had unemployment been 4 percent, transfer outlays for unemployment compensation, food stamps, welfare, and

temporary recovery programs would have been \$17.3 billion less. This means that the recession cost the Treasury \$67.3 billion in fiscal year 1976. Since the actual deficit was about the same as this amount, the budget would have been roughly in balance had the economy been at full employment. Therefore, despite the massiveness of the deficit, it is clear that fiscal policy was not, in fact, expansionary during the worst fiscal year that the economy has ever suffered. The budget did, of course, help to cushion the decline in the economy since the various automatic stabilizers prevented after-tax income from falling as much as pre-tax income. But this is a far cry from providing the kind of positive lift that the economy very badly needed at that time.

President Ford's initial budget proposals for fiscal year 1977 would have raised revenues by about 18 percent to \$351 billion, expenditures by about 5.5 percent to \$394 billion, and in combination these changes would have reduced the deficit to \$43 billion. These proposals involved a swing into surplus of some \$20 billion in the full employment budget, and therefore a far more restrictive budget than in the preceding year.

Most observers regarded the President's proposals as unrealistic. He had recommended a tax reduction but had made this contingent on congressional observance of a spending ceiling. However, because the expenditure recommendations were so low it seemed as if Congress were being forced either to have to forego the tax reduction or to widen the deficit -- both politically unpopular options. As it turned out, Congress bit the bullet rather too hard and chose the former option. Thus, the restrictive Ford budget

became the law of the land as the Second Concurrent Resolution for Fiscal Year 1977 was agreed to in September 1976. The Resolution approved revenues of \$362.5 billion, outlays of \$413.1 billion, and implied a deficit of \$50.6 billion, only about \$6 billion higher than the President had recommended.

The promising recovery of early 1976 began to falter during the third quarter of 1976 and then continued to deteriorate sharply through the fourth quarter. Alarmed by this situation, President-elect Carter asked the Budget Committees to provide a Third Budget Resolution for fiscal year 1977 that would make room for additional stimulative measures. Among these measures was an income tax rebate of \$50 per person, or \$200 for a family of four. The proposal ran into some heavy weather on Capitol Hill, and when the economic indicators brightened slightly, the proposal was quickly withdrawn.

The Administration's decision to abandon the rebate may well have been influenced by its nervousness about inflation. The very cold winter had raised fuel demands and destroyed winter crops, and these factors caused the inflation rate to rise during the first quarter. Hopefully, this decision does not reflect an inclination on the part of the Carter Administration to repeat the mistakes of 1974.

The decision to withdraw the rebate without replacing it by an alternative form of fiscal stimulus may turn out to have been shortsighted. Consumers, expecting the rebate, raised their spending levels, helping to bring about the unexpectedly strong performance of the economy in the first half of 1977. However, because of the failure of

the rebate to materialize, households have depleted their savings, and when they begin attempting to make up for this depletion, the attendant reduction in consumption will contribute to the slowdown that is now widely expected.

The Second Concurrent Resolution for FY 1978 has just been passed by the Congress. Approved were outlays of \$458.3 billion, revenues of \$397.0 billion, and a deficit of \$61.3 billion. According to our staff estimates, this implies a modest reduction in the full employment surplus of about \$10.0 billion. Therefore, the FY 1978 budget is only mildly more expansionary than the restrictive budget of 1977. Fiscal policy continues to be unadventuresome.

#### Automatic Restrictive Monetary Effects Due to Inflation

As indicated above, a rapid rate of inflation makes for restrictive policy decisions. It is equally important to note that much of the restrictiveness of recent policy has come about quite automatically as a consequence of the high rate of inflation that has characterized the economy since 1973. Monetary policy automatically gets tighter when the inflation rate rises; the budget automatically moves towards surplus; and purchasing power is automatically diverted from the domestic economy toward foreign economies. The remainder of this chapter reviews these automatic mechanisms and show how they operate to produce automatic restriction. It is important to understand these mechanisms. Such understanding, for example, would help to explain why one method of financing social

security might retard recovery whereas another method might not.

Table III-2 shows the growth of both nominal and real M1 and M2. Particular attention should focus on the real magnitudes because it is their growth, and not the growth of nominal monetary magnitudes, that determines if monetary growth is sufficiently rapid to finance a particular target rate of real GNP growth. For example, if the target rate of real GNP growth is 6 percent, and the secular rise in the velocity of M1 is 3 percent, real M1 will have to grow at 3 percent to finance this expansion of production. If nominal M1 were growing at a rate of 5 percent, and if prices were rising at a rate of 2 percent, real M1 would be growing at a rate of 3 percent, and the target rate of growth of real output would be adequately financed. But if the inflation rate jumps to 4 percent, and if nominal M1 continues to rise at the same 5 percent, the growth of real M1 automatically drops to 1 percent and is then no longer sufficient to finance the target rate of real output growth.

TABLE III-2  
Monetary Growth at Annual Rates

Year	M <sub>1</sub>		M <sub>2</sub>		GNP Deflator <sup>2/</sup>
	Nominal	Real <sup>1/</sup>	Nominal	Real <sup>1/</sup>	
1972	9.2	4.7	11.4	6.8	4.4
1973	6.0	-1.4	8.8	1.2	7.5
1974	4.7	-5.7	7.2	-3.5	11.0
1975	4.1	-3.2	8.5	0.9	7.5
1976	6.0	1.2	11.4	6.4	4.7
1977 <sup>3/</sup>	6.2	0.0	9.0	2.6	6.2

Source: Board of Governors of the Federal Reserve System and Department of Commerce.

- <sup>1/</sup> Annual money supply figures are recorded as of December of each year. To obtain real money supply figures, these nominal values are deflated by the implicit price deflator for GNP for the fourth quarter of the respective years.
- <sup>2/</sup> Growth rates are computed by using fourth quarter over fourth quarter GNP deflators. For 1977 the growth rate is obtained by dividing the second quarter of 1977 deflator by the 1976 fourth quarter deflator and expressing this as an annual rate.
- <sup>3/</sup> For 1977 the money supply figures are June values. Real values are obtained by deflating the nominal values by the implicit price deflator for GNP for the second quarter of 1977. Growth rates are expressed as annual rates.

It is the rate of real monetary growth that is important for the financing of real economic activity. It is also the real rate of monetary growth that goes down (or up) automatically as the rate of inflation goes up (or down) if the Fed maintains a constant rate of nominal money growth. Table III-2 quickly discloses three important facts. First, it shows that although M1 increased 6.0 percent in 1973, real M1 actually declined because prices, as measured by the deflator for GNP, were rising faster than the growth of nominal M1. Monetary policy was therefore in the process of becoming very restrictive in 1973 although this fact is not disclosed by the growth of nominal M1.

Second, the Table shows that the growth rate of nominal M1 was reduced by 1.3 percent from the end of 1973 to the end of 1974. This modest reduction, however, obscured the fact that real M1 fell precipitously (minus 5.7 percent) because of the acceleration of the inflation rate to 11.0 percent. Finally, the table confirms the complaint of earlier parts of this chapter, that Federal Reserve policy first helped to push the economy into the worst recession since the great depression of the 1930s, and since that time has systematically obstructed recovery. The reduction in real M1 of 1974 was sufficiently damaging and inexcusable; but to continue a negative real growth rate in 1975, when the economy was flat on its back, constitutes a policy blunder of major proportions. Since that time, as the table discloses only too clearly, real M1 growth has been miniscule. Overall, the Fed has permitted real M1 to decline about 9 percent since the end of 1972.

There has been a great deal of controversy over whether M1 -- currency plus demand



deposits -- is the most significant money supply figure, or whether M2, which adds time deposits at commercial banks to M1, is the most significant. Without entering into this debate here, it may be noted from Table III-2 that the pattern of behavior between the growth rates of the two money supply series is quite similar. The main difference arises from the circumstances that the velocity of M1 has exhibited a trend rate of increase of about 3 percent a year, whereas the velocity of M2 has tended to remain constant. No matter how one looks at it, it is clear that monetary growth rates have been inadequate.

It is the movement of the real stock of money that determines whether short-term interest rates rise or fall. If prices rise, individuals and business firms will have to increase their holdings of cash balances to conduct day to day business, and firms will have to increase their borrowing in order to finance holdings of inventory and other business assets. To get these additional funds, individuals and firms will have to sell financial assets and/or increase their borrowings. In either case, financial markets will tend to become lenders' markets and interest rates will increase. This, in turn, will discourage some borrowers and will reduce the rate of expansion of economic activity.

The potential importance of automatic shrinkage in the real quantity of money as a restrictive force helps to explain the harm that many economists find in unrestrained wage behavior. If nominal wages rise throughout a large part of the economy, unit labor costs will rise. Businesses with considerable market power may raise prices immediately. But all firms, large or small, will tend to cut back production and

employment in response to the rise in unit labor costs. The reduction in production will be matched by an equivalent loss in real income. Those who lose income will spend less, but not by as much as their income loss. Because expenditure will drop by less than production, excess demand will appear in markets for goods and services and the price level will be pulled up. As this happens the real stock of money will decline, interest rates will rise, interest sensitive expenditures will be reduced, and the economy's rate of real output growth will fall and unemployment will increase.

To summarize: A rise in the price level, whether due to a rise in wages or some other cause, will lower the level of economic activity because the rise in the price level lowers the real quantity of money and therefore automatically causes monetary policy to become more restrictive. 2/

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2/ It useful to take note of another monetary effect that automatically restricts spending as prices rise. This idea, known as the "pigou" or "real balance" effect, suggests that a rise in the price level reduces the real value of government obligations -- i.e., currency and public debt. Those who hold these government obligations suffer a loss in the real value of their assets, and such a deterioration in the balance sheets of private wealth holders reduces their consumption spending.

Automatic Restrictive Fiscal Effects  
Due to Inflation

One of the several misfortunes that befell the economy in 1974 was the sharp swing of the Federal budget into restriction. As was shown in Table III-1, the full employment surplus rose from \$8.6 billion in the fourth quarter of 1973 to \$30.4 billion in the third quarter of 1974. A considerable part of this deflationary swing was caused by deliberate holding back of expenditures. However, much of it occurred on the tax side and this part happened automatically. As noted earlier, the Committee recommended a \$10 billion tax reduction to offset some of this restrictive movement of the budget.

The Federal personal income tax is the chief source of difficulty. It is a progressive tax, which means that high income taxpayers pay a larger fraction of their income in taxes than low income taxpayers. Because of this, the average rate of tax for both individuals and the economy as a whole rises as income rises. Normally, a 1 percent rise in Personal Income generates a rise in the Federal personal income tax of about 1.5 to 1.6 percent. This "elasticity" applies to all income increases regardless of whether the increase represents a real gain, a nominal gain that just keeps up with inflation, or even a nominal gain that loses ground to inflation. The result of this "money illusion" in our tax structure is that it is quite possible for the average rate of taxation to rise during a period of inflation, while the taxpayer's real income is constant or declining. A rise in nominal income raises the taxpayer's average tax rate because, in the progressive tax system, incremental money income is subject to a

higher rate of tax than the average rate applied to previous income.

The restrictive effect of inflation on the budget was dramatically illustrated by the events of 1974. A comparison of the fourth quarter of 1973 with that of 1974 discloses the following extraordinary facts. Real GNP fell by 3.5 percent during this period, and real Personal Income dropped by 1.8 percent. This fall in real Personal Income should have reduced the aggregate personal income tax rate as measured by the ratio of Federal personal tax and nontax payments to Personal Income.

Quite the opposite happened. Prices, as measured by the GNP deflator increased 11.0 percent during this period. Because the percentage rise in prices exceeded the percentage fall in real economic activity, both nominal GNP and nominal Personal Income increased. The rise in the latter came to 9.1 percent and caused revenues from the personal income tax to rise by \$16.8 billion (from \$120.3 billion to \$137.1 billion), a rise of 14.0 percent, or 1.54 times the percentage rise in Personal Income. Because of the faster rise in taxes, the aggregate income tax rate rose from 11.0 percent to 11.5 percent, and at a time when real income was falling. 3/

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3/ The events of 1974 were unique in that the proportionate drop in real output was less than the proportionate rise in prices. The consequence was that real and nominal GNP moved in opposite directions. It is this fact that caused the income tax to become an automatic destabilizer rather than the stabilizer it is normally expected to be. An

It is possible to estimate the restrictive effect of inflation by calculating what would have happened had real output not changed at all. In this event, the inflation rate of 11.0 percent would have carried Personal Income up to \$1,216 billion, and Federal personal tax and nontax receipts up to \$140.7 billion. The aggregate tax rate would have risen from 11.0 percent to 11.6 percent of Personal Income, even without any increase in real income. Clearly, inflation has a very restrictive effect on the revenue side of the budget.

The expenditure side of the budget is largely inflation indexed and therefore tends to rise in direct proportion to the growth of nominal GNP. However, when the inflation rate accelerates, an increasing lag in this adjustment is felt since such inflation adjustments as increased social security benefits occur only at distinct intervals.

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FOOTNOTE 3 (continued)

An issue of extreme importance that calls for careful study is whether 1974 was an aberration that is unlikely to be repeated, or whether it is likely to recur. The answer hinges to a large extent on the degree to which real aggregate demand responds to changes in the price level. In 1974, the elasticity of aggregate demand with respect to the price level was clearly less than unity. An investigation should be undertaken to ascertain if this is a permanent condition and/or if there has been a change in this elasticity from earlier values. If so, this would imply that shocks that originate from the supply side will again cause our progressive income tax to respond perversely as it did in 1974.

On the revenue side, tax yield rises faster than expenditure both because of the progressivity element of the personal income tax, but also because the revenue response to a change in the inflation rate is virtually instantaneous. Therefore, the net effect of inflation, and a rise in the inflation rate, is to move the budget sharply in the direction of restriction. For the private sector this means that the growth of real disposable income is much less than the rise in Personal Income. And this means, in turn, that consumer spending is slowed by the budget drag that comes about from income growth, whether real or due to inflation, both working through the progressivity factor.

Congress has provided tax relief to facilitate recovery. In March 1975 income taxes were reduced and a rebate on 1974 taxes was granted. Later that year the earned income credit was introduced, and early this year the standard deduction was changed in a way that granted relief to certain taxpayers. Despite these efforts, the recent inflation has prevented the burden on the average taxpayer from falling. The average personal tax rate was 11.5 percent in the fourth quarter of 1974. It fell sharply to 8.1 percent in the second quarter of 1975, but by the fourth quarter of 1976 it was back up to 11.0 percent, and it has averaged 11.4 percent in the first half of 1977.

In addition to the automatic restrictive effects noted above, certain forms of price level increase have an impact that is similar to the impact that would be felt if sales or excise taxes were raised. For example, when the price of imported oil rose from \$2.40 per barrel to \$10.50 per barrel between early 1973 and early 1975, the effect of this on

the economy was equivalent to the effect that would have been felt had a massive excise tax been placed on oil. The adverse effect of the price increase is particularly sharp when the commodity is a necessity that cannot be economized on short notice and that must be purchased at whatever price. The consequence of such price "inelasticity" is that when the price of the commodity rises, users of the commodity suffer a severe drain in their power to purchase other goods and services.

Economic policy should be alert to the need to provide offset to the purchasing power drains that occur as the consequence of sharp increases in food or oil prices. This was noted in the Joint Economic Committee's "1975 Joint Economic Report" and also in a Senate Budget Committee report of October, 1975, "Long Range Fiscal Strategy," which stated:

Fiscal offsets should be provided whenever an action has an equivalent restrictive effect as an excise tax even though the action yields no actual revenue to the Treasury. For example, when OPEC raises prices, the resulting purchasing power drain should be offset by fiscal policy. The "OPEC tax" produces a deficit in the current account of the balance of payments, and it is appropriate to offset this depressing force with a commensurate increase in the budget deficit of the Federal Government.

It is important to note, finally, that not all price level increases carry with them a purchasing power drain such as would result from an excise tax. If real income remains fixed and prices rise because aggregate demand is excessive, total real purchasing

power in the economy may be redistributed, but it is not reduced. Even if the price level increase results from OPEC action, this would not produce an excise tax type purchasing power drain if the OPEC countries used the proceeds of their oil sales to the United States to purchase goods and services here. It is because the "OPEC tax" caused a deficit in the current account of our balance of payments that a deflationary excise tax effect was felt.

### Inflation, Monetary Policy, and External Stimulus

As the domestic inflation rate rises relative to the inflation rates in other countries, the competitive position of domestic export industries deteriorates and foreign buyers are provided with an incentive to switch their purchases from U.S. goods to goods produced elsewhere. Similarly, these differential inflation rates will make home-produced goods relatively more expensive than foreign goods, so that there will be a tendency for imports to replace domestic production. Such a trend will be reflected as an increase in the deficit in the current account of our balance of payments; and it involves an expenditure shift from the domestic to foreign economies that reduces domestic employment.

The deficit in the current account of our balance of payments has recently been rising at an alarming rate. As measured by the National Income and Product Accounts, net exports of goods and services measured in current dollars have fallen from a surplus of \$10.2 billion in the second quarter of 1976 to a deficit of \$9.8 billion in the second quarter of 1977, a deflationary swing of



\$20.0 billion measured at an annual rate. Such a swing has a deflationary impact at least as great as an equivalent tax increase, and it is one of the principal reasons why many forecasters are growing pessimistic about the outlook for the economy.

The main problem is that recovery at home, combined with higher oil imports due to the cold winter, have caused our imports to rise \$37.4 billion between the second quarters of 1976 and 1977, while sluggish growth in other industrial countries has limited the growth of exports to \$17.4 billion. Domestic inflation can not be blamed for our recent bleak trade performance. However, this should not obscure the fact that inflation causes the competitive position of the economy to deteriorate and that this, in turn, has an automatically restrictive effect on domestic activity.

Imbalances between exports and imports tend to be eliminated by adjustments in the rates of international currency exchange under the flexible exchange rate system, provided that international movements of capital do not interfere with these adjustments, and provided that governments do not intervene to prevent exchange rates from reflecting market conditions.

Last spring, Treasury Secretary Blumenthal complained that the Japanese monetary authorities were purchasing U.S. dollars with the intention of holding the international value of the dollar at an artificially high level. The purpose of such policy was to maintain the competitiveness of Japanese goods in export markets. Subsequent to this complaint, Japanese authorities apparently curbed dollar purchases and the dollar then began to decline in international currency

markets. Although such a slide appeared appropriate and welcome in view of the magnitude of our current account deficit, the Federal Reserve exhibited concern over the "integrity" of the dollar and hinted that intervention in foreign currency markets might be necessary.

An open market sale of government securities by the Fed reduces the domestic money supply. Intervention in the foreign exchange market can bring about a similarly restrictive effect if the foreign exchange is sold in exchange for domestically held dollar balances. Restrictive monetary measures raise domestic interest rates and this attracts foreign capital. This inflow raises the international demand for the dollar relative to its supply, and its price rises relative to other currencies. The competitive position of our goods deteriorates, and a deflationary impact is imparted to the domestic economy.

In summary: Inflation causes the competitive position of the economy to deteriorate and this has an adverse effect on the current account of the balance of payments and on the level of domestic employment. These effects will tend to be offset if rates of international currency exchange are free to fluctuate. If, however, it is the policy of the Fed to prevent the dollar from falling in response to market forces, it will pursue foreign exchange intervention policies and/or restrictive domestic monetary policies. These policies will raise interest rates, attract foreign capital, prevent the exchange rate from falling, and thus perpetuate the purchasing power drain that comes from an excess of imports over exports.

Since 1973, this Committee has been on record as opposing official intervention in foreign exchange markets for the purpose of achieving domestic economic objectives. Because of the very close parallel between the economic effects of foreign exchange intervention and domestic monetary policies under the flexible exchange rate system, it is important to add that monetary policies should not be used to achieve exchange rate objectives.

### Coordination of Monetary and Fiscal Policies

As documented in an earlier portion of this chapter, both fiscal and monetary policies have been deterred from promoting recovery aggressively because of the fear that expansionary policies will raise the rate of inflation. This situation has also produced added potential for conflict between fiscal and monetary policy. There is little doubt that fiscal policy has been inhibited by the fear that any effort by Congress or the Administration to hasten recovery by an expansionary fiscal action will be negated by restrictive Federal Reserve monetary policy. Such policy conflicts are most unfortunate. If the Fed offsets the aggregate expenditure effect of the fiscal action, there will be no increase in employment to show for the effort, but there will be a larger deficit. Worse still, a movement towards fiscal ease combined with increasing monetary tightness raises interest rates, reduces the rate of capital formation, and impairs the economy's long-range growth potential.

The Fed is supposed to conduct monetary policy. To the extent that it is able to prod Congress and the Administration into the adoption of restrictive budget policies, it

controls fiscal policy as well. The Fed wishes to protect its independence. But as matters stand at the present time, that independence gives the impression of being a one-way street.

This Committee does not subscribe to the view that an independent monetary authority is a necessary last line of defense against the inflationary spending proclivities of the Executive and the Legislature. Indeed, the budgets that have been approved by Congress since the inception of the Budget Act bear witness to the fact that Congress is quite capable of conducting fiscal policy in a responsible manner. Congress cannot, and should not, remain forever tolerant of monetary policies that are clearly at variance with the economic goals toward which Congress is striving. Rational fiscal policy cannot be planned in a vacuum separate from monetary policy. Yet, that is the way economic policy is currently conducted.

This Committee is strongly of the opinion that it is time to coordinate and integrate monetary and fiscal policies. The macroeconomic strategy we propose is as follows:

1) Officials of the Administration and the Fed should begin the annual economic program by establishing a set of targets for the coming fiscal year. These targets would include, as a minimum, the rate of unemployment, the rate of growth of real output, the rate of inflation, and the distribution of the national product between consumption, capital formation, government purchases, and the net export of goods and services. The Administration and the Fed should be obliged to agree to a common set of

target values prior to the undertaking of the next step. Otherwise, further steps are apt to be futile and policy will work at cross-purposes.

2) The second step is for the Administration and the Fed to develop a consensus forecast of economic activity for the coming fiscal year. This forecast should be a baseline projection which incorporates the current services budget and also a clearly defined rate of monetary growth. It must be emphasized that this must be a consensus projection, and it should be made public.

3) The baseline projection should then be compared with the targets previously established. Policy decisions may then be made that, when implemented, will eliminate the discrepancies between the projected and the target values. In the absence of such a cooperative program, it will continue to be difficult for Congress to evaluate the adequacy of monetary-fiscal policies.

This planning step will also involve consideration of the important issue of policy mix. The expenditure requirements of new programs must be considered here. If more stimulus is needed, a joint decision must be made whether this should be provided by monetary policy in order to stimulate capital formation and growth, or by tax reduction in the hope that this might ease wage pressures and create fewer balance-of-payments problems. Economic conditions might be such that balanced monetary-fiscal expansion is advisable.

4) The national economic strategy having been agreed to, the next step is to see to its implementation. The results should be monitored as often as possible, but no less frequently than each calendar quarter as GNP data become available. Provision must also be made for altering the plan in a way that will provide offsets for unexpected deviations between the original forecast and the actual outcome. 4/

It will require a cooperative sequence of this sort to introduce rational macroeconomic policymaking. As we have indicated earlier, it is obsolete and much too costly to preserve the antiquated fiction that politicians are irresponsible spenders, in consequence of which an authoritarian central bank is required as a last line of defense against inflation. A last line of defense against unemployment needs to be given similar priority.

4/ Senator Bentsen states: "It has always been my view that cooperation between any Administration and the Federal Reserve is essential if a rational macroeconomic policy is to be designed. However, I oppose any policy which undermines the traditional independence of the Fed in the name of promoting greater coordination between monetary and fiscal policy."

#### IV. GOVERNMENT POLICY AND INFLATION

##### Government Policies that Cause Inflation

As indicated in numerous previous Joint Economic Committee reports, the Committee is strongly of the opinion that the Federal Government can and should use the policy instruments at its disposal to achieve and maintain full employment and to contain inflation. The modest anti-inflation program of the Administration should be strengthened, as proposed in "The 1977 Joint Economic Report." Moreover, there is need for closer scrutiny of many decisions and proposals in the field of labor, energy, foreign trade, and the environment where recent or impending action has inflationary potential. While such measures may be quite meritorious for various reasons, their inflationary potential should be recognized and, perhaps, offset in order to minimize damage to price stability and employment.

The Administration's energy program is receiving the greatest amount of attention at the moment. Very soon attention will shift to the nagging problem of financing social insurance -- both social security and unemployment compensation. Other items also bear notice.

Last January the Council on Wage and Price Stability (COWPS) challenged the proposal of the International Trade Commission to restrict the importation of color television sets. COWPS estimated that an annual quota of 1.3 million units would increase the cost of an average set by about \$43 and would cost consumers \$317 million per year. Nevertheless, an agreement was reached with Japan which will limit the importation of

color television sets to 1.75 million units in 1978.

Import quotas have recently been placed on shoes, and the Trade Commission may recommend new restrictions on the importation of CB radios, meat, and industrial fasteners (nuts and bolts). One of the best ways to slow domestic inflation is to avail ourselves of inexpensive supplies of foreign goods. However, recent trends have been in the opposite direction.

In March of this year, COWPS opposed an increase in milk price supports. Nevertheless it was decided to increase the support level to 84.3 percent of parity, raising the retail price of milk by 6 to 8 cents a gallon. In combination, the higher retail prices and the additional payments taxpayers will have to make to milk producers will come to a total cost of about \$1.3 billion in the coming year. 1/

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1/ Senator Humphrey states: "Several factors influence the price that consumers pay for milk, with parity being only one. A number of factors could alleviate economic problems that dairy producers face without economic hardship for consumers. For example, dairy products from the European Community that enjoy large subsidy could become the subject of import management programs. Our dairy producers, who are the most efficient in the world, need minimal income protection. Current government support levels at 83.6 percent of parity is designed to encourage moderate milk production (without price depressing overproduction) at a price that is fair to consumers. Americans, I might note, spend less per capita on food than any other nation in the developed world."



In March, COWPS noted that the imposition of standards designed to control lead exposure in places of work might be costly and add to inflation. The Occupational Safety and Health Administration had proposed standards that COWPS had estimated would cost consumers \$300 million per year. Additional environmental standards are apt to be costly and cause adverse price level effects in the next several years. Such regulations are of obvious merit, and in many cases are essential, but their effects on the inflation rate are substantial and impose a social cost that should not be ignored. More careful scrutiny to balance the costs and benefits of these programs is certainly appropriate.

Minimum wage legislation is once again in the limelight. The House bill, which was passed on September 15, 1977, raises the legal minimum wage from \$2.30 to \$2.65 per hour effective January 1, 1978. The bill also provides for increases in the minimum wage to \$2.85 an hour in 1979, and to \$3.05 an hour in 1980. Eliminated from the bill was a novel provision that would have indexed the minimum wage to a fraction of the average straight time wage of workers in manufacturing industries.

The need for an energy program seems clear. However, as noted by witnesses at the Committee's hearings on the program, the Administration's proposals will raise the price level. Unfortunately there is no agreement about the magnitude of these effects and how they will be spread over succeeding years. Much will depend on how the final legislation emerges from Congress. Also, the future course of OPEC pricing is an important and uncertain variable. Further, it is difficult to know to what extent crude oil equalization and industrial user taxes can be passed through into higher prices. And, the effects on prices and employment will also depend upon the uses that are made of the proceeds of the energy taxes. If they are rebated, as called for by the House bill (for 1978), prices and employment will both be higher than if they are effectively sterilized as would happen if they were used to reduce the Federal deficit. Finally, in the longer run it will be very difficult to predict effects on prices and employment that will stem from productivity losses that are likely to accompany a diversion of a portion of capital spending to coal conversion processes.

The proposed standby tax on gasoline has been removed in the House version of the energy bill, and this will reduce some of the upward price pressure of the program. In addition, the proposed rebate on fuel efficient autos has been discarded. Otherwise, the House bill leaves the Administration's program largely intact. The gas guzzler tax will be imposed but will have no effect until 1979. The price of gasoline at the pump will be decontrolled unless Congress extends these controls against the Administration's wishes. A tax is to be imposed on industrial users of oil and

natural gas in 1979. Finally, the interstate price of new natural gas will be permitted to rise in 1978, but the price of intrastate natural gas will become subject to control.

The enormous complexity of the energy program makes it extremely difficult to predict its inflationary effects. Various estimates place the increase in the annual inflation rate between 0.3 and 0.7 percent a year. Also, it must be noted that not all of this would be avoided if no comprehensive energy program were enacted. For example, something must be done to raise the output of natural gas and it seems clear that some increases in natural gas prices are inevitable. Finally, the full inflationary effects of the crude oil equalization and industrial user taxes are not expected until 1980 and 1983 respectively. This will mitigate the program's adverse short-term effects on inflation and recovery.

Labor costs are the most important element in the production costs of industry. As can readily be seen from the fact that in 1976 Compensation of Employees made up 76 percent of National Income. Unit labor costs are a primary determinant of commodity prices, and changes in such costs are overpoweringly important in determining the rate of price inflation. It is unfortunate, as pointed out in "The 1977 Joint Economic Report" (pp 17-18), that governments -- both at the Federal and the State level -- have chosen to permit their social insurance programs to be financed by payroll taxes that either act as a direct addition to labor costs, or that act as regressive forms of income tax.

Because of the system of trust fund financing of unemployment compensation, nearly all payroll tax receipts and benefit

payments flow through the Federal budget. These taxes, the so-called Contributions for Social Insurance, have been the fastest growing source of Federal revenue, rising from 20 percent of total Federal receipts in 1965 to 32 percent in 1976.

Although it is advisable to reduce taxes during recession, this precept of fiscal policy has almost never been followed in the case of the payroll taxes that finance social security and unemployment insurance (UI), and such financing has generally been planned without reference to the fiscal policy needs of the economy. Now that the social insurance taxes are so large and such a major fraction of Federal receipts, continuation of such an approach is exceedingly dangerous.

The present recession has thus far followed the traditional pattern. The inflationary recession has caused UI benefit payments to rise very rapidly and it has depressed the revenues that flow into the various social insurance Trust Fund Accounts. As a result, the recession has accelerated the trend towards higher and higher rates of payroll taxation. The maximum taxable base for social security rises automatically in response to inflation and therefore went from \$15,300 to \$16,500 on January 1, 1977. Under current law, the present 11.7 percent social security tax rate will rise to 12.1 percent next January, and President Ford had recommended a further increase to 12.3 percent. Recent Federal legislation (H.R. 10210, the Unemployment Compensation Amendments of 1976) provided for an increase in the Federal UI tax rate from 0.5 percent of covered wages to 0.7 percent effective January 1, 1977, and for an increase in the taxable base from \$4,200 to \$6,000 effective January 1, 1978. Once both financing

provisions are fully in effect, this change will amount to a doubling of the Federal tax per employee. Since States must adopt a tax base that is no lower than the Federal base, this legislation will force many States to raise their UI taxes. Finally, many State governments have increased their UI taxes in order to improve the financial condition of their Trust Fund accounts. The ratio of State UI tax receipts to taxable wages rose by an enormous 32 percent between 1974 and 1976.

Social security taxes are split evenly between employers and employees, whereas unemployment insurance (UI) taxes are borne entirely by employers in all but three States. In 1970, the total employer contribution for social insurance came to \$426 per employee for a wage earner whose income equaled or exceeded the taxable social security base. By 1976, this had more than doubled to \$1,021 and it has been estimated in a recent Senate Budget Committee Study, "Economic Recovery and the Financing of Social Insurance," (May 1977), that by 1980 total employer contributions will rise to \$1,500. This implies a more than threefold increase in employer payroll taxes in a single decade.

An increase in payroll taxes charged to employers may lower profits; it may be shifted backward and reflected in lower wages; or it may be shifted forward and reflected in higher prices. Evidence on what happens is inconclusive. However, there is a growing belief that considerable forward shifting does, in fact, take place. In concentrated product markets, where business firms price by fixed percentage markups over cost, a rise in payroll taxes will raise the prices of goods and services in the short run

because employers will view such tax increases as increases in their labor costs. Increases in payroll taxes may therefore contribute to inflation. In addition, since the rise in prices reduces consumer real income, an excise tax effect is felt, reducing consumer demand in real terms. Finally, the rise in the price level brings the automatic restrictive effects, discussed in the last chapter, into operation. In combination, all these effects will reduce the level of production and employment. The same Senate Budget Committee staff report as cited above reported simulations which showed that a forward shifted payroll tax reduces employment by twice as much as an equivalent yield increase in the personal income tax. In addition to the normal purchasing power effect of a tax, the higher payroll tax raises prices, and this brings to bear the various automatic restrictive effects. The income tax, on the other hand, tends to have a restraining effect on the price level and its impact is therefore limited to its direct effect on purchasing power.

Most of the factors discussed in this section cause a one-time upward price level push to occur. Unfortunately, this is generally not the end of the story. Increases in the cost of living, whatever their source, become incorporated in labor contracts and therefore in unit labor costs. Once that happens, the feedback system of wages on prices and prices on wages may produce inflationary effects that far exceed the magnitude of the initial inflationary shock.

The case against policy-induced inflation is well summarized by Professor Robert J. Gordon who testified on July 25, 1977, as follows:

Government regulations make prices higher than necessary. Every opportunity to deregulate airlines, trucking, telecommunications, and other industries should be welcome. Tariffs, quotas, and "voluntary agreements" in international trade should be ended, with mobility and retraining subsidies to help displaced employees of noncompetitive firms and industries. . .

. . . let me offer a recommendation relevant to the immediate deliberations of Congress in the area of tax reform. Indirect taxes (especially sales taxes and social security payroll taxes) are not only regressive, but they raise prices. Direct income taxes have a much smaller inflationary effect. A major shift in the U.S. tax system away from indirect taxes toward the personal income tax, and in particular a shift toward the personal income tax for the financing of social security, would eliminate the continuing upward pressure on business costs caused by payroll tax hikes. And a much needed shift in the legal retirement age from 65 to 70 would go far to eliminate the social security financing problems which have made those tax increases necessary.

### Government Policy to Reduce Inflation

At present, the bulk of the burden of inflation control falls on production and employment. It does this either through restrictive discretionary policies or through the automatic budgetary and monetary tightening that come about as the result of inflation. To make willing, but marginal,

workers the principal victims of what amounts to a national disease is cruel and primitive. As a matter of economic policy, it is also exceedingly costly and inefficient. The "side effects" of inflation control by means of fiscal-monetary restriction are too enormous to be tolerated.

Over the period 1970-1976, inclusive, the total of annual unemployment shows that the economy lost about 38 million man years of potential employment. That figure does not count the additional millions of discouraged workers who dropped out of the labor force because of the absence of job opportunities. The production loss is equally staggering, coming to a cumulative total of about \$600 billion in 1972 prices. Simple arithmetic shows that the typical family of four has lost about \$12,000 to underutilization of resources in the seven years prior to 1977. This waste continues in 1977 as the economy stumbles along below its potential.

What is to be done about this deplorable situation? If we refuse to accept continued sluggish growth and excessive unemployment, we will either have to learn to control inflation by means that do not cause unemployment, or we will have to learn to be more tolerant of inflation and find ways to render it less socially harmful and less disruptive of economic activity. All of the harmful effects of inflation and of attempts to control inflation can probably not be eliminated. But certainly attention must be paid to methods of redistributing this burden away from the disadvantaged groups in our society.

The scope for slowing inflation without resort to restrictive fiscal-monetary policies is enormous and requires careful



study. Possible areas where progress could be made are in the areas of public investment, tax policy, government spending priorities, environmental and other forms of regulation, credit and banking practices, international trade and commercial policies, public employment programs, Federal-State fiscal relations, and Federal management of publicly owned resources.

Of course, we cannot deal with all of these areas in this report. However, it is important to provide examples of how demand restriction can be replaced by constructive policies that slow inflation without increasing unemployment. Inasmuch as tax policy has recently been the most widely discussed method of combatting stagflation, we devote the remainder of this chapter to some illustrations of how tax policies can be used in this manner.

On July 14 and 19, 1977, several economists told the Subcommittee on Economic Growth that an important way to reduce the unfairness and disruption caused by inflation would be to introduce inflation correction, or "indexing," into certain portions of the tax structure. In addition, the Subcommittee on Fiscal Policy has published a study, "Indexing the Individual Income Tax for Inflation: Will this Help to Stabilize the Economy?" (December 1976), which proposes similar reforms.

Among the several reforms that many economists are now in substantial agreement on are the following:

- (1) Follow Canadian practice by changing the exemption level and bracket limits of the individual income tax at a rate equal to the rate of inflation. In

this way the real values of the exemptions and brackets will remain constant, and this will prevent the average tax rate from rising unless the real income of the taxpayer increases. Such "indexing" of the individual income tax would eliminate one of the major sources of automatic restriction discussed in an earlier section.

(2) Discontinue the taxing of nominal capital gains. When a capital asset rises in value at a rate no greater than the rate of inflation there is no real gain. The current practice of taxing nominal capital gains is, therefore, a senseless capital levy that varies arbitrarily in response to the rate of inflation. Whether or not real capital gains should be taxed is an entirely separate issue.

(3) Discontinue the taxation of nominal interest and replace this by a taxable real interest rate equal to the nominal rate of interest minus the rate of inflation. This would eliminate such outlandish inequities as those that occurred in 1974 when small savers earned nominal (and taxable) interest of 6 percent, but lost ground in real terms as their savings were eroded by an inflation rate that greatly exceeded the nominal rate of interest.

(4) Provide savers with an opportunity to inflation-proof their savings by issuing Federal Government purchasing power bonds in small denominations. This would be particularly helpful to the small savers who do not have the resources to overcome the fixed brokerage costs that full access to

capital and real estate markets entail. This change would create difficulties for saving and loan institutions and, therefore, would have to be accompanied by the abolition of Regulation Q. The latter is a reform that many believe to be overdue, but should be accompanied by measures that ensure an adequate supply of mortgage credit.

A proposal that is considerably more controversial than those listed above is the proposal to permit business firms to write the value of their physical assets up to a reproduction cost basis. If this were done, the tax laws during an inflationary period would no longer discriminate against firms with long-lived capital assets, relative to firms whose physical assets average a shorter life. The chief objection to this proposal is a technical one. If an overall price index such as the implicit price deflator for GNP were used, the proposal might be quite meritorious. But if, instead, a deflator for capital goods were used, the relative price signals that should indicate to business whether to switch from labor to capital intensive technologies would be lost, and this would create a very serious problem for the allocation of resources.

The full Committee has not held formal hearings on the subject of indexing and is not ready, at this time, to make specific recommendations. However, there is little doubt that tax indexing holds considerable promise for easing the inflation problem and will very likely become a subject for careful study by the Committee in the near future.

An obvious and promising way of combating stagflation is to reduce the payroll taxes that contribute both to inflation and

unemployment. Legislation has been introduced by Senators Javits and Williams (S. 1853) and by Representative Brodhead (H.R. 8291) that would establish a permanent program of emergency Federal assistance to State Unemployment Insurance Trust Funds during periods of excessive unemployment. Annual grants, based upon the excess cost of benefits in a State, would be provided to reinsure the State system against the high benefit costs that occur when insured unemployment rises above 6 percent. Such "cost equalization" grants would be made retroactive to include 1974 (in the Brodhead bill) or 1975 (in the Javits-Williams bill) in consideration of the extraordinary burdens that have been placed on the State Trust Funds by the present very deep and protracted recession.

These grants would permit States to maintain benefit levels which would help the recovery of the economy. The grants would also assist the States to avoid raising the payroll taxes that they charge employers. This is especially important during a recovery period when benefit costs are unusually high and tax increases are economically undesirable. Increases in these payroll taxes raise labor costs, and they therefore add both to inflation and to unemployment. It would be far better if a substitute could be found for such tax increases during these critical periods.

The Javits-Williams bill goes considerably beyond cost equalization assistance to the State Trust Funds. For example, it would limit the Federal penalty tax, which is imposed on employers in States that are in debt to the Federal Unemployment Trust Fund (FUTF), to 0.3 percent of taxable wages in any year. Under current law, this penalty

tax is 0.3 percent the first year and rises by an additional 0.3 percent in each succeeding year until the debt is eliminated. The bill also provides that no penalty tax applies in any year in which a State remained in a jobs recession with insured unemployment in excess of 4.5 percent.

As incentives for the States to strengthen their trust funds the bill would impose an interest charge on outstanding loan balances and provide for loan repayments to be made on a five-year schedule rather than making the entire loan balance come due all at once. These provisions would allow the States to catch their breath after the shock of a deep recession that they were not responsible for creating.

Finally, in the interest of reducing the Federal payroll taxes charged to employers the Javits-Williams bill would eliminate the \$5.3 billion FUTF debt to the general Treasury for Federal Supplemental Benefits incurred during 1975 and 1976. It would base Federal financing of Extended Benefits on the General Fund rather than the Federal unemployment tax. And it would eliminate State contributions to the Extended Benefits Program during national recessions when the national insured unemployment rate exceeds a trigger rate.

Adoption of the Javits-Williams bill would be a giant step toward cleaning up the financial shambles in which many State and the Federal unemployment insurance systems now find themselves. The bill would help to keep payroll taxes down and this would contribute greatly to the slowing of inflation and to the restoration of full employment. It makes little sense to have an unemployment compensation system that creates

additional unemployment because of the way the program is financed.

Similar considerations apply to the financing of social security. Since social security is much bigger, the stakes and the impact are far higher. The employer half of the tax is a payroll tax that adds to inflation and to unemployment. The employee half acts as a regressive income tax because no employee, regardless of how high his income, pays any taxes on income above the current wage base of \$16,500 or on nonwage income.

President Carter has made several challenging proposals in the social security area. Perhaps the most ingenious was his initial proposal to provide business firms with a tax credit that would permit the employer to compute 5 percent of the taxes that he pays for his employee's social security, and to deduct this amount from his business income tax. Adoption of this innovative proposal would have helped to neutralize the adverse economic effects of the payroll tax, without causing the Social Security Trust Fund to lose any revenue. The proposal, moreover, would have provided small, labor-intensive businesses with the kind of tax advantage that large capital-intensive businesses have been able to derive from the investment tax credit.

President Carter's current proposal for social security would raise revenues by abolishing the maximum taxable base for employers, and supplementing Trust Fund financing with grants from the General Fund that compensate for the revenue losses that come about as a consequence of excessive sluggishness in the economy, meaning revenue

that is lost because the GNP is too low to achieve a 6 percent unemployment rate.

President Carter's attempt to keep the employee share of the tax down by seeking General Fund emergency assistance is certainly a reasonable plan. Another idea that merits serious consideration is to utilize the proceeds of one or more of the energy taxes proposed by the President to help finance social security.

Such proposals often encounter opposition because they give the impression of "backdoor" financing. However, as Arthur Okun told the Committee on May 20, 1977, one of the main purposes of such a plan is to offset the inflationary effects of the energy taxes by combining these tax increases with tax reductions elsewhere in a way that will prevent the overall price level from rising. Dr. Okun was willing to accept reduction in payroll taxes in exchange for the higher energy taxes, although he greatly preferred to use the proceeds from the energy taxes to lower the sales and excise taxes of State and local governments. He therefore testified as follows:

I believe that Federal financing of cuts in State and local sales taxes would be the best inflation-neutralizing method. Reduction in sales taxes would hold down the cost of living (offsetting the rise caused by higher energy taxes) and thus restore the purchasing power of the American people by maintaining the value of their dollars, rather than by giving them more dollars of reduced value.

The potential of tax credits for use in slowing inflation without retarding recovery has attracted considerable attention. In

addition to the use proposed by President Carter, such credits could be applied to the employee portion of the social security tax as a means of granting individual income tax relief. This would be a very simple program to administer and it would grant tax relief in a progressive manner since the social security tax is regressive. It would not reduce the funds that accrue to the Social Security Trust Fund accounts.

The fundamental problem of employment expansion is that lower real wages are needed to induce employers to increase the quantity of labor they are willing to hire, whereas higher real wages are desired by workers. One way to drive a wedge between what the employer pays and what the worker receives is through various employment tax and subsidy schemes. The simplest plan of all, as the Committee recognized in "The 1976 Joint Economic Report," is to grant individual income tax relief in the hope that the added take-home pay will be viewed as a substitute for a wage increase and in this way alleviate upward wage pressure. Thinking of this sort has influenced economic policy in several European countries in recent years.

Many tax incentive schemes abound. In a Washington Post article of August 21, 1977, Governor Henry Wallich of the Federal Reserve attempted to resurrect his idea of imposing a penalty tax on the business income of firms that have granted wage increases in excess of an established guidepost. Others, such as Professor Lawrence Seidman of the University of Pennsylvania, would supplement the Wallich plan by varying the employee portion of the social security payroll tax in accordance with a formula that reflects the degree of wage restraint shown by the workers in that firm or industry.



The objective of these carrot-stick proposals is to reduce the incentive that inflation creates to pursue aggressive wage-price behavior, and in this way to cut into the wage-price spiral. One of the most promising proposals is the Okun-Perry plan which links wage increases to a predetermined target rate of price increase. If, at the end of the year, consumer prices have exceeded the price target upon which the original wage bargain was struck, a special tax rebate would be provided that would make up for the shortfall in real after-tax incomes caused by the greater than expected price level increase.

Many of the proposals that are currently being suggested have common themes. First, they reject awkward and unpalatable controls in favor of incentive schemes that, as Governor Wallich notes, "rely on forces of the market instead of on prohibition and controls." Second, they attempt, through the potential wedge provided by taxes, to make the low labor costs needed to stimulate employment compatible with the high real wages desired by workers. Third, they attempt to make it possible for the individuals and firms in our society to hold their own without the need to be embattled in a perpetual contest to see whether wages can be made to rise faster than prices and vice versa.

As indicated earlier, these various tax proposals were suggested here as illustrations of the enormous scope that exists for constructive approaches to the problem of inflation. Careful study of these proposals and proposals in the other areas mentioned earlier is needed in order to prevent inflation from continuing to be an impediment to economic growth.

## V. SUMMARY AND CONCLUSIONS

The economic outlook for the remainder of 1977 and for 1978 is for a slowing down in the rate of real economic growth. Further substantial reductions in unemployment seem unlikely to occur in the near future, and the inflation rate will continue to be high and dominated by the rapid growth of unit labor costs. Even with rather optimistic assumptions about consumer and government spending, the continuing weakness of fixed investment and the sharp deterioration in our international trade position seem likely to ensure fairly sluggish performance in our economy.

One of the most serious question marks concerns the future course of monetary policy. The obsession with inflation has caused the Fed to reduce real M1 by about 9 percent since the end of 1972. This disastrous policy was a principal cause of the magnitude and length of the recession; it has been a perennial source of obstruction to recovery; and it now threatens to abort the recovery entirely if the policy is continued. It is difficult to predict how monetary policy will behave in the next few months. On the one hand, M1 growth has accelerated in the last six months. But on the other hand, short-term interest rates have been rising and the Fed recently raised its rediscount rate to discourage member bank borrowing. Moreover, the view expressed by the Fed that monetary growth rates are excessive, and that the declining international value of the dollar may require Fed intervention, are strong signals that tightening is in the offing. Such tightening, at this time, would be inappropriate. It would abort the very healthy recovery of homebuilding, it would

keep the stock market depressed and further delay the long-awaited revival of capital spending, and because it would artificially lift the international value of the dollar, would cause a further deterioration in our international trade position.

Because inflation has been such an enormous deterrent to the recovery of the economy, we have devoted a sizeable portion of this report to this problem. While we may agree that inflation retards recovery and causes unemployment, we most definitely reject the conclusion that some draw from this fact, namely, that stabilization policy should devote itself exclusively to the elimination of inflation.

Our conclusion is quite the opposite. At present the entire burden of inflation control falls on production and employment. This burden should be shifted, and this report has indicated some ways in which this can be done. The disruptions and inequities caused by inflation can be eased by judicious changes in the income tax laws. Inflation can be reduced and unemployment simultaneously increased by replacing payroll taxes with alternative means of financing social insurance. And tax incentives can be designed that provide business and labor with economic incentives to moderate their wage-price demands.

To support orderly economic growth and to eliminate potential policy conflict, the Committee recommends the establishment of a procedure that would require the Administration and the Federal Reserve to come forward each year with a coherent monetary-fiscal program. This program should include a consensus forecast, a set of mutually agreed upon targets for policy, and

a plan for reconciling the forecast with the target values.

ADDITIONAL VIEWS OF  
VICE CHAIRMAN HUBERT H. HUMPHREY

The achievement of full employment with relative price stability must remain the principal objective of national economic policy. At the present time, I am deeply concerned with the slackening of the pace of economic growth and the bleak outlook presented in this report. The outlook for employment, inflation, and economic growth in 1978 presented in this report must not be allowed to occur. I believe that urgent attention to the growing danger of an economic relapse by the Administration, the Federal Reserve Board and Congress can improve the performance of our economy considerably.

As this Committee has emphasized on many occasions, the nation has failed consistently to meet the objectives of the Employment Act of 1946. After 30 years, it is evident that we must dramatically improve our capacity to manage the economy if we are to achieve full employment. To attempt less would be an inexcusable failure to use our ingenuity to build a more humane society.

This objective will require nothing less than fundamental reform of the institutions and policies we employ for making national economic policy. As the Committee stated in "The 1977 Joint Economic Report," and also in "The 1976 Joint Economic Report," new initiatives needed to achieve full employment include the following:

A national commitment to all adult Americans, able, willing, and seeking to work, to provide opportunities for useful

paid employment at fair rates of compensation;

The establishment of annual economic goals jointly by the President and the Congress to achieve full employment, production, and real income;

The use of fiscal and monetary policy to meet the annual economic goals with provisions to encourage the Federal Reserve to pursue monetary policies that support these goals and that achieve full employment as promptly as possible;

The establishment of a new long-term economic policy process to analyze developing trends and economic conditions; to recommend long-term goals for full employment, production, and real income; and to propose policies and programs to achieve such goals;

The establishment of supplementary employment policies to close the gap, if one should exist, between employment levels achieved through aggregate monetary and fiscal policy and the goals adopted, in order to achieve full employment as promptly as possible. Supplementary employment programs should be designed to reduce unemployment due to recessions and to structural barriers within regions and among particular labor force groups; and

The establishment of comprehensive anti-inflation policies that directly moderate price increases in non-competitive industries which threaten to undermine national progress toward price stability."

I believe that the most effective step to achieving these objectives would be to enact

the "Full Employment and Balanced Growth Act  
of 1977."

*Herbert H. Humphrey*

ADDITIONAL VIEWS OF  
REPRESENTATIVE HENRY S. REUSS

A word on monetary policy is appropriate.

Economic performance was mixed during the first half of 1977. Real growth averaged 6.9 percent per annum, substantially faster than nearly all analysts predicted last December.

Bad weather and 5 to 10 percent increases in OPEC oil prices combined to cause inflation to accelerate last winter. But more recently it has decelerated and is expected to continue to taper off in the second half of the year. Crops are excellent and even OPEC oil prices show signs of weakening.

On the other hand, the employment picture has shown little improvement overall, and has worsened in inner cities. Overall, employment has increased, and the unemployment rate has dropped from 8 percent last November to 7.1 percent currently. But employment for black teenagers is now at the all-time high, over 40 percent.

What is now called for is a steady hand on general economic policies -- monetary and fiscal -- together with specific rifle shot programs aimed at inner cities and improving employment opportunities for minority youth. Huge overall stimuli -- ever-larger deficits and hyped-up new money creation -- are not what is needed. Instead, what is needed is a moderately stimulative monetary policy and a fiscal policy in which the major stimulus is direct programs to create -- and quickly -- both private and public jobs.



In regard to monetary policy, we need to ask three questions. First, has money creation lagged, so that our present supplies of M1, M2, and so on are no longer adequate? Second, what money growth track do we follow for the 12 months October 1977 to October 1978? Third, how closely do we stay on that track?

### Has Money Creation Lagged?

Many say that it has, and that we need a catch-up. There are three aspects to the question. The first two are long-term: one involves velocity -- the relation of dollar GNP to dollar M1; the other centers on real M1 -- nominal M1 adjusted for inflation by dividing it by the current Consumer Price Index. The third aspect relates to money creation and the short-run needs of the economy.

### Velocity

Increases in velocity have helped to sustain the present economic recovery. The question to ask, therefore, is whether the rise in velocity can reasonably be expected to continue.

A look at the record is instructive. M1 velocity has been rising on average at 3.2 percent per year since the Korean War. In 1954, it was 2.81. In 1976, twenty-two years later, it was 5.61 percent, or almost exactly double what it was in 1954. Not coincidentally, with a 3.2 percent rate of rise per year, doubling takes twenty-two years.

Moreover, as the following Table shows, year after year M1 velocity has stayed close to what could have been predicted back in 1954 simply by compounding 1954's velocity at a 3.2 percent rate.

The table shows that velocity was slightly above trend in the 1960s and fell slightly below it in the early 1970s. It passed through trend in 1969 and returned to trend in 1976, the latest year for which data are available. Specifically, in 1976 M1 velocity was approximately where it was relative to trend in 1969. In 1976 it was 0.2 percent below trend. In 1969 it was 0.2 percent above. Nothing unusual appears to have happened in recent years.

Reasons for the relatively steady growth of M1 velocity since 1954 are still being debated by scholars. A very plausible explanation, however, is that as interest rates in general rose, as they have since the Treasury-Federal Reserve 1951 Accord, the public has increasingly economized on its non-interest bearing cash balances held as checking deposits in commercial banks. Reenforcing this explanation is that in the mid-1950s people moved out of both demand and time deposits at commercial banks, and shifted into thrift deposits. The velocity of M2 as well as that of M1 increased. Since 1960, however, M2 velocity has been roughly constant, while that of M1 has continued to rise. The reason for the different behavior in M1 and M2 velocities since 1960 is that while the prohibition against paying interest on demand deposits has been kept in force, ceiling rates payable on time deposits were raised first in 1957, then in 1962, and periodically thereafter.

TABLE ---Velocity and Interest Rates

Year	M <sub>1</sub> Velocity		Bill Rate	Long Rate	M <sub>2</sub> Velocity
	Actual	Trend			
1954	2.81	--	0.95	2.55	2.07
1955	2.97	2.90	1.75	2.84	2.17
1956	3.09	2.99	2.66	3.08	2.25
1957	3.24	3.09	3.26	3.47	2.31
1958	3.24	3.19	1.84	3.43	2.23
1959	3.39	3.29	3.41	4.07	2.31
1960	3.53	3.39	2.95	4.01	2.38
1961	3.57	3.50	2.38	3.90	2.34
1962	3.77	3.62	2.78	3.95	2.38
1963	3.86	3.73	3.16	4.00	2.36
1964	3.97	3.85	3.55	4.15	2.37
1965	4.12	3.97	3.95	4.21	2.38
1966	4.31	4.10	4.88	4.65	2.41
1967	4.38	4.23	4.33	4.85	2.37
1968	4.46	4.37	5.35	5.26	2.37
1969	4.53	4.51	6.69	6.12	2.40
1970	4.58	4.65	6.44	6.57	2.42
1971	4.65	4.80	4.34	5.74	2.35
1972	4.78	4.95	4.07	5.63	2.34
1973	4.96	5.11	7.02	6.30	2.38
1974	5.09	5.28	7.87	6.98	2.37
1975	5.28	5.44	5.82	6.98	2.39
1976	5.61	5.62	4.63	6.78	2.42

Actual velocity equals GNP divided by M<sub>1</sub>.

Trend velocity equals velocity in 1954 compounded annually at 3.2 percent.

These increases in time deposit rates reduced the pressure to economize on the time deposit component of M2 and allowed the public to economize on demand deposits by switching to time deposits.

Recent impulses for shifting out of demand deposits have been provided by technological innovations in cash management such as the development of zero balance accounts; lock-box collection systems; telephone transfers; and commercial savings accounts and checkable thrift accounts, neither of which are included in official estimates of M1.

### Purchasing Power of M1

The purchasing power of M1 has fallen in recent years, reflecting that prices have risen faster than M1 has grown. Some say the failure of M1 growth to keep pace with inflation exacerbated the recent recession and slowed recovery from it. They would use real M1 as a guide for monetary policy, urging acceleration of M1 growth if it has failed to keep pace with inflation.

It is instructive, once again, to look at the record before deciding whether real M1 growth is a good guide for monetary policy.

Real M1 as well as real GNP (dollar GNP adjusted for inflation) fell in 1974 and 1975, tending to affirm the argument that they rise and fall together. Real M1 fell 5.0 percent and real GNP 1.4 percent in 1974. In 1975, real M1 fell 4.5 percent and real GNP 1.3 percent. However, in 1976, real M1 fell again (0.6 percent) while real GNP increased strongly, tending to negate the argument. The rise in real GNP in 1976 was 6.04 percent, the largest annual rise since

1955. Clearly, in a year-to-year basis there is no simple relationship between real M1 and real GNP.

Second, in the early 1930's, the economy collapsed although real M1 remained roughly constant. That experience strongly warns against using real M1 as a guide to monetary policy.

Third, more recent evidence shows that real M1 is as likely to rise with moderate as with rapid growth of nominal M1. From 1960 to 1966, real M1 increased at an annual rate of 1.3 percent. In the next seven years, 1967 to 1973, real M1 increased 1.4 percent per year, or at about the same rate. The rate of rise in real M1 remained the same in the 1960-1966 and the 1967-1973 periods, despite the fact that nominal M1 growth averaged 6 percent per year in the 1967-1973 period, or more than twice as much as in the 1960-1966 period when nominal M1 growth averaged only 2.9 percent. Further, after hyping-up nominal M1 growth in the early 1970's (nominal M1 growth averaged 7.1 percent in the 1971-1973 period), inflation accelerated and real M1 fell. Rapid nominal M1 growth from 1971 to 1973 was the prelude to the fall in real M1 after 1973.

When the public saw the value of its money being eroded more and more rapidly by accelerating inflation, it justifiably reduced real M1.

### The Advisability of a Catch-Up

These observations on velocity and on the purchasing power of M1 make it difficult to justify ultra-rapid money growth as long-run policy. However, in the short run, the

dominant question is whether extra new money can finance production and employment without adding to inflation. Sometimes it can. That's what makes "adjusting" M1 for inflation such a tricky exercise.

When we entered 1977 the economy was hesitating. The recovery had stalled, mostly because M1 growth had been slowed in the summer and early fall of 1976. From June to November, 1976, M1 growth averaged 4.5 percent per year compared to 5.6 percent for the year ending in May, 1976. In terms of the Fed's M1 target for January 1976-January 1977 of 4-1/2 to 7 percent, M1 growth was crawling along the lower limit.

In the last six months, March-August 1977, M1 grew at a 9 percent annual rate, and helped account for the current good real GNP growth. For the Federal Reserve now to attempt to validate its current annual target by squeezing new M1 growth down to the 0 to 3 percent level for the next six months would abort the recovery. Such a strategy would be a tragic mistake. Now we should adopt the strategem of former Senator Aiken from Vermont, who in relation to the Vietnam War said that we should declare victory and get out. The 9 percent per year M1 growth of the last six months has provided the needed catch-up. The Fed, at hearings in early October 1977, before the Senate Banking Committee, should declare this recent overgrowth of M1 a one-time catch-up (of about \$5 billion of the current \$330 billion M1 supply) and then get back upon a more long-run track.

### What Track do We follow from Now On?

I am not persuaded at this time that the Federal Reserve should significantly raise its present target range for the post-October, 1977, growth of the monetary aggregates, but actual future growth should be aimed at the upper part of the range for the present.

### How Closely Should the Fed Stick to the Track?

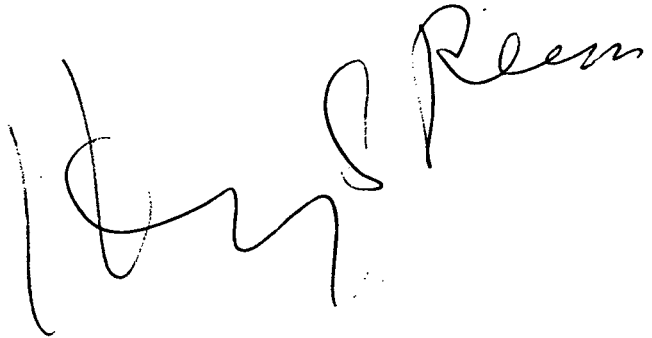
To instill public confidence, especially in the financial community, it is essential that the Federal Reserve show that it has firm control of the nation's money supply. The Fed must improve its short-run monetary management. During 1977 (February to August), wildly erratic movements in the money supply have been superimposed on an average growth rate 40 percent above the top of the target range for M1 growth. I cannot accept that these gyrations in the money supply are necessary. The Fed can do a much better job of controlling money growth in the short run. It has an adequate arsenal of monetary tools to do the job.

A major problem is that the Fed needlessly complicates the task of short-run money management. Specifically, its method of calculating required reserves on the basis of deposits held at the commercial banks two weeks earlier leads to unnecessary short-run gyrations in both money supply and interest rates. Scholars inside and outside the Federal Reserve have amassed persuasive evidence that this method of lagging reserve requirements makes short-run monetary management far more difficult than necessary. The Federal Reserve should return to the

system used before 1968 of coincident reserve requirements.

Second, the Federal Reserve's method of seasonally adjusting the money supply figures has been shown to be defective. This point was brought out in the House Banking Committee's recent hearings pursuant to House Concurrent Resolution 133 on the conduct of monetary policy on July 29, 1977.

Third, the Federal Reserve should coordinate its policy more closely with the Treasury's cash flows. There is no reason why the Federal Reserve must stand by in apparent ignorance and let such government expenditures as the monthly mailing of social security checks cause bubbles in money growth.

A handwritten signature in black ink, appearing to read "Henry Reson". The signature is written in a cursive style with a large, sweeping initial "H" and a long, horizontal tail.



ADDITIONAL VIEWS OF  
REPRESENTATIVE WILLIAM S. MOORHEAD

This report is excellent in many respects. I particularly commend the chapter entitled, "Inflation as a Deterrent to Recovery," which describes an important new phenomenon of our times.

I welcome the discussion of the various "micro" causes of inflation, and in the area of payroll taxes, I fear that Congress may be on the road to some serious errors. If we handle social security and unemployment compensation in the wrong way, we can -- almost inadvertently -- worsen the inflation problem and thus cause more unemployment down the road. The Joint Economic Committee is profoundly right in raising this issue along with others.

As a more general matter, I agree with the conclusion of the report that severe restriction of demand is not the right cure for our present inflation problem.

However, I am not persuaded at this time that the Federal Reserve should significantly raise its targets for growth of the monetary aggregates, as the report implies.

It is far from clear that monetary policy during the two years of recovery has been "too restrictive," as the report says. For example, long-term interest rates are lower now than they were when the recovery began.

More important, we must be mindful of the danger of accelerating inflation. The report makes abundantly clear that inflation is now a major enemy of growth and expanding employment. While there is no agreement on

the role of monetary expansion in causing inflation, this very uncertainty calls for caution. The worst thing that could happen to us now would be a return to double-digit inflation, and a switch to a much more expansionary monetary policy could raise that risk.

A handwritten signature in cursive script, reading "William E. Brock". The signature is written in black ink on a white background. The letters are fluid and connected, with a prominent initial "W" and a long, sweeping tail on the "k".

ADDITIONAL VIEWS OF  
SENATOR WILLIAM PROXMIRE

This report is a well written and very interesting discussion of our present economic problems, the background and causes of them, and the outlook for the future. While I have a number of differences with the analysis of each area, it is nonetheless an intelligent and useful review.

I believe the report is right to caution us about the difficulties of reaching the 1981 goals. For the goals on growth, unemployment, and inflation to be met will require the most fortuitous events.

While I appreciate the analysis of how we got where we are and the proper emphasis on causes other than excessive demand for the devastating period of inflation we have encountered since 1973, the monetary officials may receive somewhat more blame than they deserve. In the past year, for example, the money supply has increased at a rate in excess of 7 percent, which is more than the top of the 4 to 7 percent range set by the Federal Reserve Board itself. I doubt that the monetary policies would have been more than marginally different whoever had been in charge or if the somewhat elaborate plan of cooperation proposed by the report had been in effect.

Personally, I would be somewhat more humble than the report is in its relative certitude that there is an answer to the present problem of both excessively high unemployment and excessively high inflation.

Economists may not know the answer to stagflation. Perhaps there is no answer. On

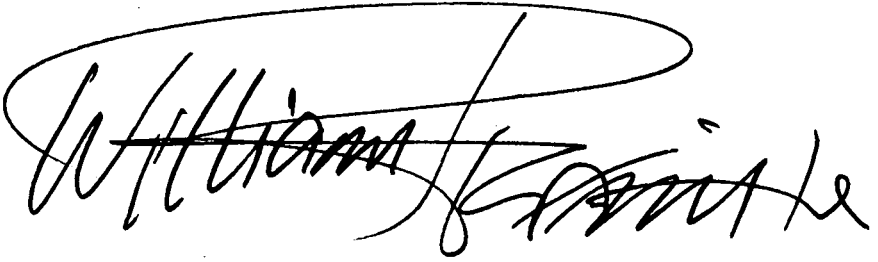
the job front we have run huge deficits, spent billions on job creating programs, and billions more on the education and training of our youth with disappointing results. On the inflation front we have gone from jawboning to a detailed incomes policy and back to virtually no policy at all. Each has produced the same disappointing results.

For my own part, I would put much greater stress on a combination of tax cuts to stimulate demand and consumption in the private sector, plus a reduction in public spending for a wide spectrum of programs. These should include military, and military aid, space, highway, and big project foreign aid programs, as well as funds for those education, health, and welfare programs which seem to have had no influence on increasing education excellence, or health or decreasing welfare. Such cuts should help restore business confidence and investment. Such actions in turn should make it possible for the Federal Reserve to pursue policies which would reduce interest rates and not only keep the housing stimulus going but make it possible for a much wider spectrum of Americans to purchase their own homes.

Such policies are preferable to more spending, the indexing of inflation (which essentially accepts it instead of fighting it), and the detailed coordination between the Executive Branch and the Federal Reserve Board, the agent of Congress, which the report proposes.

As the failures of the past give us very little confidence that there is any set of policies which can work in the immediate future to bring both relatively full employment and a victory over inflation, I propose these as preferable to those in the

report but without the certainty that they will work, which might have accompanied their advocacy in past periods.

A handwritten signature in cursive script, which appears to read "William F. Smith". The signature is written in black ink on a white background. A large, horizontal oval is drawn over the top portion of the signature, encompassing the first few letters of the first name and the first letter of the last name.

MINORITY VIEWS  
ON THE  
1977  
MIDYEAR REVIEW OF THE ECONOMY  
(99)

## I. INTRODUCTION

Because of our differences over monetary policy and the international sector and the recommendations emanating therefrom, the Minority cannot issue a joint report with the Majority. However, we do have substantial areas of agreement, which are outlined below. In the Minority Chapter III, "Demand or Supply Problems?" we discuss differences in emphasis or theory behind our basic agreements. These differences lead to our desire to discuss saving and social security in more detail than is done in the Majority views. Our chief point of disagreement, the Majority chapter on monetary policy, is discussed in a separate section.

## II. AREAS OF AGREEMENT

(1) Recovery is still a problem that extends well beyond the next fiscal year.

(2) We expect the economy to slow down in the last half of 1977, and in 1978.

(3) One of the principal reasons for the anemia displayed by the recovery is the continuation of a rapid rate of inflation.

(4) Many Government policies, including the energy program, higher social security taxes, import quotas and tariffs, increased price supports, certain OSHA regulations, the proposed minimum wage legislation, and other regulations and red tape, whatever their other merits or demerits, do affect the rate of inflation. Congress should take every opportunity to rationalize regulation of business and to liberalize trade. 1/ 2/

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1/ Representative Clarence J. Brown states: "I feel that freer trade can be of substantial benefit to the Nation. However, the steel industry has an important role to play in national security and must be supported."

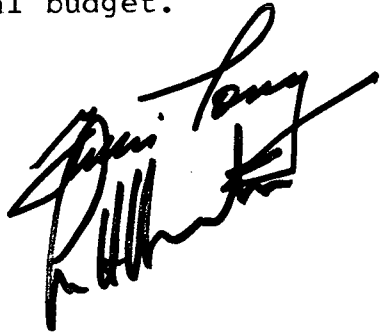
2/ Representative Heckler states: "I am concerned that a reduction in tariffs will have an adverse impact on the textile industry in Massachusetts. Increased textile imports are causing major problems with the domestic industry, bringing loss of jobs in Massachusetts and other States which depend



ADDITIONAL VIEWS OF  
REPRESENTATIVE GILLIS LONG  
AND  
REPRESENTATIVE LEE HAMILTON

We find ourselves in substantial agreement with most of the major conclusions contained in this report, and are not greatly encouraged about the economic outlook for the coming months. Unquestionably, both inflation (together with the fear of inflation) and unemployment continue to plague our efforts to achieve full economic recovery.

In particular, we are concerned about the importance of achieving high employment, reduced inflation and a balanced budget by 1981. As the report indicates, there are weaknesses in the present policy mix so far as achieving the goals are concerned. But, we believe that the Congress should be prepared to take action to reduce taxes in order to stimulate employment and investment. Experience has shown that the best route to a balanced budget is a prosperous economy and it is obvious that we can best achieve it by invigorating the private sector. For this reason we would also emphasize the importance of spending restraint. Obviously, this is no time for expanding the Federal budget.

Handwritten signatures of Gillis Long and Lee Hamilton. The signature of Gillis Long is written in a cursive style, with the name 'Gillis Long' clearly legible. Below it, the signature of Lee Hamilton is written in a more stylized, blocky cursive script.

(5) The exemptions and bracket structure of the tax system must be adjusted annually to prevent the now-automatic increase in tax rates due to inflation from destabilizing the economy.

(6) Taxation of nominal (unadjusted for inflation) capital gains should be ended. Only real gains should be taxed. The current practice of taxing that part of capital gains due only to inflation is a senseless capital levy.

(7) Congress should discontinue the taxation of nominal (unadjusted for inflation) interest rates. Tax only real interest earned in excess of the inflation rate to allow people a true return on their savings.

(8) Congress should examine seriously the problem of underdepreciation due to inflation and develop a workable formula for replacement cost depreciation.

(9) Capacity utilization measures overstate the amount of unused plant and equipment currently available. This is partly due to restricted energy supplies. In addition, certain environmental legislation is accelerating the rate at which our capital stock is becoming obsolete.

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FOOTNOTE 2 (continued)

heavily on this industry for their economic base. Although I generally favor free trade, I believe that we must protect American jobs when those jobs are threatened by foreign imports."

Finally, the conversion of oil and gas fired facilities to use coal will require billions of dollars of investment.

(10) The Congress should act promptly to end the uncertainties surrounding proposed tax changes, uncertainties which could easily cause investment decisions to be delayed.

While we join with the Majority report with the exception of the monetary and international economic policy recommendations, the Minority Members wish to sharpen a few points contained in the Majority report.

While the Majority fails to point out the importance of excessive deficit spending as a cause of inflation, they are to be commended for facing up to the inflationary consequences of Federal regulation, restraint of trade, and the taxes contained in the Carter energy plan.

We also commend the Majority report for its analysis of the tax consequences of inflation. The Minority has repeatedly warned, in reports and in proposed legislation, that inflation has boosted taxpayers into higher brackets, raising taxes even in recessions and destabilizing the economy.

The report's warning against taxation of illusory inflation-induced capital gains is most timely. If, as is rumored, the Administration will seek to tax capital gains as if they were ordinary income (a practice no other major nation follows), then at most only real gains should be taxed. Otherwise,

saving, investment, and the growth of jobs and income could be severely crippled.

The Majority recommendation that only real interest be taxed is also welcome. Today, a typical saver in the 20 percent tax bracket may get 5 percent interest on his savings. This is completely wiped out by the erosion of his savings by 5 percent inflation. To add insult to injury, the saver must turn one-fifth of that interest over to the government. He gets 5 percent interest, and loses 6 percent to inflation and taxes, for a net loss of 1 percent. Considering that savings (whether personal or corporate) is our only source of investment money, and our main source of job creation and productivity growth, this negative return is a disgrace.

The Majority discusses the underdepreciation of plant and equipment caused by inflation. This could be costing business as much as \$20-\$30 billion per year, roughly one-quarter of corporate profits. It is, in effect, a tax on capital equipment, retarding growth and reducing real wages by limiting the supply of capital with which labor can work. Some form of replacement cost depreciation is essential. Otherwise, corporate saving will be inadequate to sustain the growth we need to bring down unemployment.

### III. DEMAND OR SUPPLY PROBLEMS?

While the Majority's concern over higher taxes and inflation is most welcome, we do not feel our depth of concern over low rates of savings or higher tax rates is reflected adequately.

When the adverse impact of tax increases on the economy is discussed, the Majority stresses the idea that tax increases reduce aggregate demand, or total spending. However, they believe that if the tax dollars are returned through rebates or government spending, the aggregate demand problem is solved.

Unfortunately, this approach fails to take account of the impact of higher tax rates on aggregate supply. In every year without a tax rate reduction, inflation pushes people into higher tax brackets, even when they have no increase in real income. Their average tax rate rises, which means that their tax burden rises faster than inflation, and they have less to spend. However, there is an additional effect which the Majority ignores.

Inflation raises the average tax rate by raising the marginal tax rate. It is marginal income, the last few hundred dollars of the taxpayer's earnings, which falls into higher brackets and is taxed at a higher rate. The government takes a larger slice out of the last few hundred dollars of each person's wages, profits, interest, and dividends. These higher rates also apply to any increase in wages, profits, interest and dividends which could be earned by working longer, saving more, or investing more.

This change in marginal tax rates affects behavior. The reduced reward to productive activity discourages additional effort and encourages cutbacks. At the margin, leisure is substituted for labor, because the reward to labor has fallen. Consumption replaces saving and investment, because the reward to saving and investment falls. These shifts in behavior cause real GNP, investment, and job creation to drop, even if the government spends the money to keep nominal demand constant. Nominal demand cannot offset the shift away from productive activity as taxes reduce the rate of return to labor, saving, and investment. The Majority ignores these disincentive effects of their tax-and-spend policies.

This problem of higher tax rates resulting from inflation is not a minor matter. Inflation is producing real tax increases of more than \$5 billion per year on individuals. The average auto or steel worker, with a wife and two children, was in the 19 percent tax bracket after the tax cut of 1969. He is now in the 22 percent tax bracket, and will soon be paying 25 percent. The increased incentives for leisure and consumption, as opposed to work and thrift, are obvious.

This adverse effect on GNP occurs whenever a tax is imposed. For example, a payroll tax reduces the after-tax wage of labor, and raises the after-tax cost of labor to the firm. The supply and demand for labor fall. So do employment and GNP.

Similarly, a tax on the use of oil and gas reduces the after-tax receipts of the producers, and raises the after-tax prices of goods and services to consumers, which reduces the value of their wages. Output of

gas and oil falls. The supply of labor falls. Employment and GNP fall.

This inability to take account of the supply of productive effort is the biggest failure of demand management economics. It can lead to extremely strange policy prescriptions if demand is boosted at all costs, as the Majority report seems to advocate.

For example, the Majority lists a continued low saving rate as grounds for optimism. They view it to mean that consumption will be high, and so aggregate demand will be high.

Let us carry this line of thinking to its logical conclusion. If less saving is better than more saving, why not get saving down to zero? Then we could consume 100 percent of our income, demand would soar, and all's right with the world!

Well, not quite. Personal and corporate savings is the source of all investment funds, all replacement of worn out equipment, all growth of the capital stock, and much of our job formation, productivity growth, and wage increases. The Majority's attack on saving means stealing from the future. And for what? There would not even be any short-term gain. An end to investment would cost as many jobs in capital goods industries and in construction as would be gained elsewhere from inflated demand. And the capacity for future output would be destroyed.

#### IV. SAVINGS SHORTAGE AND ECONOMIC GROWTH

We want to make clear at this point why we are so concerned with savings. 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 investment and the government deficit.

Once the government chooses a deficit, the only way to get more investment is to raise savings. Since the ratio of investment to GNP basically determines the country's growth rate, only by increasing savings can the real growth rate be raised. This is especially true in the face of a massive diversion of investment to non-growth uses, such as pollution control and the coal conversion portion of the Energy Program.

The government could help growth by reducing government spending to lower the deficit. However, a tax increase to reduce the deficit would also reduce saving by reducing the after-tax return to saving, and would be counterproductive. Here again, the energy program, with its enormous tax increases, will be a major problem.

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 economic experts on growth and capital formation testifying before the Joint Economic Committee on July 14 and 19, 1977. 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.

The change from the current system would be quite simple. An additional tax deduction for savings would be created. For savings accounts, the deduction would be interest plus deposits minus withdrawals, or the amount in the account at the end of the year minus the amount at the end of the previous year. For stocks and bonds, the deduction would be purchases and reinvested dividends minus sales. (Net withdrawals or sales would be negative deductions and would be added to taxable income.)

The change would be simple, but its effects would be dramatic. No longer would foreign countries be out-saving and out-growing us by wide margins. No longer would our real incomes stagnate and our unemployment rate stick at an unacceptable level.

Table IV-1 shows the results of a low saving rate, which the Energy Plan, and higher social security and income taxes threaten to make worse.

TABLE IV-1. 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' '76 Est.
		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.

N.A. (Not available). Source: Bureau of Labor Statistics, OECD.

## V. SOCIAL SECURITY AND ECONOMIC GROWTH

The Minority agrees with the Majority on the negative effects of payroll taxes on inflation and employment. Indeed, the negative effects of high taxes were a major emphasis in The 1977 Joint Economic Report of the Minority. However, the Majority fails to point out the harmful effect of the social security tax on national savings.

The social security tax collected by the government is not saved or invested to increase the Nation's production of goods and services, but is transferred from present day workers to present day retirees for immediate consumption. This transfer payment slows economic growth because social security taxes tend to displace some of the taxpayers' otherwise normal savings. These savings are a portion of the investment funds that business needs to expand and improve its capital stock, an act which must be performed to continue any expansion. By contrast, the funds of the private pension system are saved and invested to aid economic growth. The retirees of a private plan have their retirement secured by this increased economic growth because the pension fund investment base is strengthened.

Why is economic growth so important in meeting the goals and problems of social security?

Economic growth is a key to solving our social security financing problems. As the economy expands the social security tax base expands. Indeed, it is generally accepted that the reason for a part of social security's financing problems is the present situation of high unemployment with high

inflation. Economic growth works to reduce unemployment and inflation and therefore increases social security tax revenues.

The belief that increases in the social security tax rate (instead of economic growth) can be used to solve long-run financing problems is shortsighted. Large increases in the social security tax rates, while raising revenue in the short run, eventually will reduce the demand and supply of labor which in turn will reduce the social security tax base.

The minor adjustments of social security tax rates that are needed to solve the system's short-run problems will not plunge the country into a slow growth period. However, the long-run problems are much greater, and an attempt to solve them solely by tax rate increases will be self-defeating.

These long-run problems arise from two sources.

First, an error in the formula for adjusting social security benefits for inflation, which was enacted in 1972, is increasing the promised benefits for future retirees at roughly twice the rate of inflation. The Senate Finance and House Ways and Means Committees are working to correct this error. This will eliminate about half of the Social Security System's \$4 trillion deficit.

Second, the country's low birth rate means that the number of retirees being supported by each worker will jump dramatically after the turn of the century, from 30 beneficiaries per 100 workers to 50 beneficiaries per 100 workers in 2030. Unless output per worker and real wages are

increased drastically over the next 50 years by a deliberate national program to encourage saving and investment, a larger percent of each worker's wage will have to go for social security payments.

As we stated in the 1977 annual report of the Joint Economic Committee:

"The current working population has some serious thinking to do about its provisions for retirement. Its saving rate is low. Its investment in physical capital is low. Nor is it investing in a large generation to succeed it. At the same time, it is promising itself major increases in retirement benefits, to be paid for by the next generation.

One of three things must occur:

(1) The current working population will choose to rely on the willingness of the next generation to pay taxes at a rate not yet experienced in the Nation's history.

(2) Drastic steps will be taken to increase the growth rate of the U.S. economy by increasing the profitability of work, saving, and investment compared to the rewards of idleness and consumption.

(3) The benefit formula will be revised."

The Congress must choose one of these approaches. There are no others. Congress cannot cause the birth rate to rise, and it is unlikely to increase immigration quotas substantially. Neither can it find an average of \$35 billion per year in general

revenues over the next 75 years to divert to social security without gutting other programs.

If we are to avoid a large tax increase, we have only two choices: a crash saving and investment program led by lower marginal tax rates, or a reduction in benefits.

Discussing the latter alternative, Secretary of Commerce Juanita Kreps has warned that young workers who have recently entered the labor force may not be able to collect social security benefits until age 68. Such a shift in the retirement age would ease the social security financing problems.

As is shown in Table V-1, social security taxes are projected to have to rise from the currently scheduled 11.90 percent of payroll to 17.85 percent of payroll in 2050, even assuming that the error in the inflation adjustment formula is corrected. It is to avoid this 50 percent jump in the tax rate that later retirement years have been mentioned. But, this assumes that nothing can be done to get income to rise more rapidly than the Social Security Administration anticipates. In fact, increased growth could solve this financing problem.

The Minority urges that the necessary steps be taken to increase the rate of growth of real GNP and real wages so that the Government's social security promises may be kept without enormous increases in the tax rate. It is far better to increase real wages by 50 percent more than the Social Security Administration predicts, than to impose 50 percent more tax on a lower real income.

TABLE V-1. Comparison of OASDI Cost Projection Under  
The Administration Wage-indexing Proposal 1/ and the  
OASDI Tax Rates Scheduled in Present Law

<u>Calendar year</u>	<u>OASDI Cost</u>	<u>OASDI Tax Rate</u>
1977	10.91	9.90
2050	17.85	11.90
75-year average: 1977-2051.....	15.11	10.99

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Source: "Staff Data and Materials Relating to Social Security Financing," prepared by the Staff of the Committee on Finance, United States Senate.

1/ The system considered here excludes any of the Administration's proposals that would increase income as well as the new proposed dependency test for living or surviving spouses.

Note: The above estimates are based on alternative II assumptions used in the 1977 OASDI Trustees report.

How do we produce real GNP and real wages 50 percent higher than predicted over the next 70 years? It will require an increase in our projected annual real growth rate by between one-half and three-quarters of 1 percent. This will not be as easy as it sounds. It will require that we devote an additional 3 percent or 4 percent of GNP to saving and investment. It will require a tax code which encourages work effort and saving.

Unless we take these steps to spur economic growth, Mrs. Kreps' proposal may become inevitable. 1/ 2/

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1/ Representative Heckler states: "I strongly favor a growth solution to the social security problem in order to make huge increases in social security taxes unnecessary. It is imperative that the social security program be strengthened, and that its inequitable treatment of women be brought to an end. I will be active in seeking a legislative remedy for this situation."

2/ Representative Rousselot states: "One way to dramatically increase the U.S. growth rate is to make social security a voluntary part of a pension plan for all new people entering the labor force. When each individual first goes to work, he or she could decide where to invest his or her social security taxes in a government or privately run pension fund. The gradual effect of such a plan would not seriously disrupt the Social Security System (that is, if the reforms being discussed by the House Ways and Means Committee are implemented), and the resulting increase in investment would enormously expand our productive capacity."



## VI. MONETARY POLICY

Because of the Majority's inability to recognize a falling after-tax rate of return to labor, saving, and investment as the cause of our lack of economic growth, they seek to place the blame elsewhere. The Majority states that the Federal Reserve has failed to provide enough "real balances" (money, after it is eroded by inflation) to finance necessary real growth plus anticipated inflation, which together account for the growth of nominal GNP. The Majority claims that nominal short-term interest rates will rise and choke off the recovery. Ignoring supply, the Majority suggests rapid money creation to stimulate demand.

There are at least four major errors in this line of reasoning:

- 1) Why does the Majority focus on nominal, short-term, interest rates as the driving force of the recovery?

The cost of borrowing money for business projects is the real (adjusted for inflation) interest rate, not the nominal (unadjusted) interest rate. If inventory is increasing in price at 5 percent per year due to inflation, then an additional 2 percent mark-up will cover a nominal interest rate of 7 percent. If there is no inflation, a nominal interest rate of 3 percent would require a 3 percent mark-up, and would be more of a burden than a 7 percent nominal rate at 5 percent inflation. What matters to the borrowers is the real interest rate, which is the spread between the nominal interest rate and the expected rate of price increase of

the asset to be purchased, which is generally the inflation rate.

2) Long-term real interest rates are an important influence on the rate of job creation and economic recovery. These long-term rates affect purchases of long-lasting plant and equipment, housing, and commercial buildings, creating thousands of jobs in the capital goods and construction industries. In fact, it is precisely this type of spending which has been lagging in this recovery. Even more important, it is this type of spending which provides for the increased productive capacity needed to create permanent jobs and higher wages for a growing labor force. These long-term interest rates cannot be lowered by boosting the money supply.

As we pointed out in The 1977 Joint Economic Report:

"There are those who call for further increases in the rate of growth of the monetary aggregates, 'to lower interest rates and get the economy moving.' The aim is admirable, but the method is madness.

"Long-term interest rates, the ones which determine the cost of major investments in houses, factories, and equipment, cannot be forced down by easing money. Risk factors aside, these rates (i) are the sums of the real returns demanded by investors (r), and inflation premiums (p) equal to the rate of expected price increases over the period of the loan. In other words,  $(i) = (r) + (p)$ ." Rapid money creation will

only rekindle inflationary expectations and drive interest rates higher.

(3) If the Federal Reserve is supposed to fund real growth and existing inflation, when do we start to reduce the inflation? If we have 5 percent real growth and 6 percent inflation, must the Fed supply 11 percent more money as the Majority implies? This monetary growth works to keep inflation at present levels. And this is directly opposed to the Majority's supposed desire to reduce inflation. If that 6 percent inflation is to be rationally reduced, the Fed must move gradually toward 10 percent, 9 percent, 8 percent, 7 percent, 6 percent and finally 5 percent growth rates of the money supply. The growth in the broadly defined money supply, M2, has averaged 10 to 11 percent this year. This is certainly ample to finance the economic recovery while beginning the gradual reduction of inflation and inflationary expectations.

4) The Federal Reserve does not create real money balances (adjusted for inflation). It controls only the number of dollars in existence -- nominal dollars. The public chooses to keep a certain amount of purchasing power on hand in the form of cash and bank balances. If the Federal Reserve pumps out additional money in excess of the public's desire to add to these balances, the public will simply try to spend it. As the public chases goods with the extra money, prices will rise. This price rise will continue until the value of the nominal balances falls back to the original level the public held

before the Federal Reserve injected funds. The Majority says that  $MV=PQ$ , that money times velocity of circulation equals the prices of all goods times their quantities. This also means that  $M/P \times V = Q$ . Real balances ( $M/P$ ) times velocity equals real output ( $Q$ ). But the Federal Reserve only controls  $M$ , nominal balances, NOT  $M/P$ , real balances. The public sets  $P$ ,  $V$ , and  $Q$ .

We believe that the Federal Reserve is providing money at a sufficient pace to maintain recovery while keeping inflation on a declining trend. The Fed has correctly anticipated an increase in money velocity to make greater money creation unnecessary. As we said in The 1977 Joint Economic Report, "A liberal fiscal policy of low tax rates must be used to reduce unemployment, while a tight money policy (gradually arrived at) must be used to lower inflation and interest rates. It is to be hoped that the Federal Reserve can pursue its part of this course in peace."

## VII. ENERGY

As the Administration's Energy Plan makes its way through Congress, evidence is building that the Plan will have a substantial adverse impact on prices, employment, gross national product (GNP) and even the balance of payments. 1/

Under continued price controls, natural gas production is expected to drop by 25 percent between now and 1990. Since gas is 36 percent of domestic energy production, we will lose 9 percent of our total energy output by 1990. Domestic oil production, under price controls and wellhead taxes, will also continue its recent decline. These shortfalls will be made up chiefly by importing more oil and by conversion to coal.

### Short-Run Impact

The economic impact of the taxes in the National Energy Act, whether the Administration or the House passed version, is expected to be minor in the very short term. The two largest taxes in the program, the crude oil and natural gas equalization (wellhead) tax, and the tax on industrial users of natural gas and oil, are to be phased in between 1978 and 1980, and will have little impact in 1978. Under the House bill, that part of the equalization tax

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1/ Senator Javits states: "Speaking as an individual Senator, I wish to disassociate myself from the Energy Chapter. My views on energy are contained in my additional views."

effective in 1978 will be rebated to State governments, homeowners, hospitals, schools and taxpayers in general. An illustration of net and gross receipts expected under the Administration plan, and the net receipts, after credits, of the House bill, appear below (Tables VII-1 and VII-2).

By 1980, however, the Administration proposal would have noticeable adverse effects on GNP, unemployment, and inflation, according to most observers outside the Administration (Table VII-3). The removal of the standby gasoline tax by the House relieves some of these effects, since the predictions by Chase, Wharton, DRI and the CBO all assumed that some of this tax would be imposed. Recent runs by Chase show the differences through 1985 between the Administration and House passed bills (Table VII-4).

The Committee, on May 20 and 25, 1977, held hearings on the Energy Act before the Energy Subcommittee. Witnesses, including Otto Eckstein, whose testimony was the source of the DRI estimates in the tables, generally supported the view that somewhat higher rates of inflation and unemployment, and reduced real GNP, would result from the adoption of the National Energy Plan. This would be true even if the tax proceeds were rebated to the public, while failure to rebate the tax proceeds would have a severe deflationary impact on the economy.

Two witnesses, however, went further. Professor Lester Thurow expressed concern that the burden of the Energy Plan would be unequally distributed across various regions of the country, and that a disproportionate share of the taxes would be borne by the South and New England. These distributional

**TABLE VII-1-** — *Increase in gross budget receipts in Administration energy proposals, fiscal years 1978-85*

[In millions of dollars]

	Fiscal year—							
	1978	1979	1980	1981	1982	1983	1984	1985
Net receipts (from table 5).....	253	2,189	4,831	5,793	6,523	8,686	11,127	15,050
Credits under crude oil equalization tax.....	2,232	5,993	10,039	11,607	11,285	10,915	10,653	10,450
Credits under oil and natural gas consumption tax.....		1,342	4,111	6,330	7,549	9,352	10,834	9,603
Total, gross receipts.....	2,535	9,524	18,981	23,730	25,357	29,453	32,614	35,103

Source: Secretary Blumenthal's statement to Ways and Means Committee, May 16, 1977.

Energy Program, Vol. 6, "Economic and Budget Considerations" p.23 Prepared for the Committee on Ways and Means of the House of Representatives by the staff of the Joint Committee on Internal Revenue Taxation.

TABLE VII 2 --Summary of Estimated Budget Effects of Title II of H.R. 8444, as Passed by the House, by Part, Fiscal Years 1978-85

[In millions of dollars]

	1978	1979	1980	1981	1982	1983	1984	1985	Total, 1978- 1985
<b>Part:</b>									
I. . . . Residential energy tax credits . . .	-387	-520	-553	-589	-633	-687	-748	-710	-4,827
II. . . . Transportation tax provisions . . .	87	859	4,239	4,426	4,647	4,853	5,073	5,304	29,488
III. . . . Crude oil equalization and natural gas liquids taxes <sup>1</sup> . . . . .	-347	3,105	8,638	11,557	3,633				26,586
IV, V. Excise tax on business use of oil and natural gas after business income tax offset and rebate . . . . .		-25	398	88	164	592	813	878	2,908
VI. . . . Changes in business investment credit . . . . .	-316	-247	-211	-321	-455	-97	464	502	-681
VII. . . . Miscellaneous provisions . . . . .	-9	-46	-58	-68	-73	-81	-102	-133	-570
<b>Total, all parts . . . . .</b>	<b>-972</b>	<b>3,126</b>	<b>12,453</b>	<b>15,093</b>	<b>7,283</b>	<b>4,580</b>	<b>5,500</b>	<b>5,841</b>	<b>52,904</b>

<sup>1</sup> The amounts shown for fiscal years 1978 and 1979 are net of business income tax offset and refunds and after per taxpayer rebates and special payments to rebate the tax collected from 1978 calendar year liability to the general public.

Source: Energy Tax Provisions: Summary, and Section-by-Section Explanation of Title II of H.R. 8444, as passed by the House, Prepared for the Committee on Finance, United States Senate, by the staff of the Joint Committee on Taxation, August 8, 1977, p. 34



TABLE VII-3

Effects of Administration proposal on Selected  
Economic Variables, 1978-1980

	1978	1979	1980
Real GNP (percent difference in level):			
Data Resources, Inc. (DRI) <u>1/</u> .....	-0.1	-0.4	-0.7
Wharton Econometric Forecasting Assoc., Inc. (Wharton) <u>2/</u> .....	0.0	-0.3	-0.5
Chase Econometrics, Inc. (Chase) <u>3/</u> .....	0.0	-0.3	-0.5
Administration <u>4/</u> .....	0.0	0.0	0.0
Congressional Budget Office (CBO) <u>5/</u> .....	-0.2	-0.5	-0.7
Unemployment rate (difference in rate):			
DRI.....	0.0	+0.1	+0.2
Wharton.....	0.0	+0.1	+0.2
Chase.....	0.0	+0.1	+0.2
Administration.....	0.0	0.0	+0.0
CBO.....	0.0	+0.2	+0.2
Consumer Price Index (difference in rate of increase):			
DRI.....	+0.5	+1.1	+1.4
Wharton.....	+0.4	+0.8	+0.4
Chase.....	+0.3	+0.7	+0.8
Administration.....	+0.3	+0.6	+0.2
CBO.....	+0.5	+0.6	+0.5

1/ Testimony of Dr. Otto Eckstein before the Joint Economic Committee, May 20, 1977, and private communications to staff.

2/ Forecast of April 21, 1977.

3/ Forecast of April 27, 1977.

4/ Communication to staff.

5/ Congressional Budget Office, President Carter's Energy Proposals: A Perspective, May 31, 1977.

Source: Energy Program: Economic and Budget Considerations, Prepared for the Committee on Ways and Means, House of Representatives, by the staff of the Joint Committee on Taxation, p.12.

TABLE VII-4

## Chase Comparison

Administration Bill vs. Standard Forecast

House Passed Bill vs. Standard Forecast

	<u>Real GNP*</u>			<u>Unemployment Rate</u>			<u>CPI**</u>		
	<u>1978</u>	<u>1980</u>	<u>1985</u>	<u>1978</u>	<u>1980</u>	<u>1985</u>	<u>1978</u>	<u>1980</u>	<u>1985</u>
Administration	0.0	-0.8	-3.2	0.00	0.26	1.32	0.2	1.5	4.4
House	0.1	-0.4	-2.5	-0.01	0.12	.94	0.2	1.0	3.3

\* Percent change from Standard Forecast

\*\* Difference from Standard Forecast

effects are hidden in the aggregate numbers. Professor Arthur Laffer agreed, adding that the automobile and crude oil taxes would strike at automobile producing states in the Midwest as well.

Professor Laffer also expressed doubts that a simple rebate of the energy taxes would be sufficient to prevent a further contraction of the economy. The rebate would be adequate to sustain nominal demand. However, the added taxes and higher prices would reduce the after-tax value of wages, interest, and profits. With these lower rates of return to productive effort, real aggregate supply might falter. Since the rebates are not related to work effort, saving, or investment, they would be unable to stop this effect. Further tax reductions on wages, interest, and profits would be required to maintain output.

### Natural Gas

Representatives Clarence J. Brown and Dave Stockman have prepared a study entitled, "The Cost of Natural Gas Deregulation: a Restatement." They predict that 25 tcf (trillion cubic feet) more gas will be produced under deregulation than under the President's Plan between now and 1990 as prices in excess of the Administration's proposed ceilings call forth more drilling and more discoveries.

There is genuine controversy in industry and within the Department of Energy and especially within ERDA and the U.S. Geological Survey, over the supply response and the expected rate of reserve discoveries to be had from higher prices. However, in the 1976 National Energy Outlook, the FEA

estimates differences in gas production under price scenarios roughly similar to those chosen by Brown-Stockman and the Administration and shows added output nearly as high as that predicted by Brown and Stockman. This should hold true whether deregulation is immediate or phased-in, because of the long time lag between exploration and production.

To the extent that deregulation produces additional gas, deregulation will relieve consumers from having to buy alternate fuels. Depending on which fuels are assumed to be substitutes for gas, and on how much additional gas is produced, a cost of alternate fuels can be calculated.

Additional gas also helps to pay for the fixed costs of the pipeline distribution system. These costs are spread over whatever quantity of gas is transported. The more that is shipped, the lower is the charge per unit. These are the pipeline costs "saved" by deregulation. Another way to look at them is as a proxy for the transportation costs for the alternate fuels, costs which are hard to estimate. The more gas that deregulation produces, the lower are these alternate fuel transportation charges.

Brown and Stockman assume that the provision of the energy plan which seeks to encourage or to require low priority industrial users to switch to coal from natural gas will be successful. Therefore, the recipients of increased supplies of gas will be homeowners and high priority industry (industry which cannot convert to coal or oil). The alternate fuel for these consumers is only partly distillate oil. About half the quantity of alternate fuel would be electricity, currently costing \$11 per mcf

equivalent. This makes the cost of alternate fuel approximately \$6 under the Brown-Stockman assumptions, versus an expected cost of deregulated gas of roughly \$2.50.

If the increase in production of natural gas under deregulation, the cost of alternative fuels, and the saving in pipeline charges are taken into account, deregulation (whether it is immediate or phased-in) could save consumers of natural gas upwards of \$50 billion between now and 1990. Only by ignoring these factors can the Administration claim that its own proposals are cheaper for the consumer. 2/

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2/ Representative Heckler states: "Although I have opposed deregulation in the past, recent studies indicating that it would lower costs for New England customers will receive my close scrutiny. I will be studying the statistics and conclusions on the energy problem provided by the Federal Reserve Bank of Boston and others.

"However, at the present time, my feeling is that deregulation should wait. If it does become necessary, it should be phased in gradually to blunt an unbearable increase in consumer prices."

## Loss to U.S. Economy from Oil Imports

Unfortunately, the balance of payments implications of this natural gas shortfall threaten to make the cost of the Administration proposal even greater. The oil used to replace part of the lost natural gas will have to be imported. Brown and Stockman calculate that, under the Carter program, the United States will spend \$26-\$40 billion on unnecessary imports of OPEC oil, instead of on domestic fuel and other goods and services, between 1978 and 1990. This \$26-\$40 billion shortfall in gross domestic product will cost the United States jobs, income, and tax revenue. (Table VII-5)

## OPEC Windfall from President Carter's Energy Plan

Under the Carter proposal to continue regulation of natural gas, U.S. consumers will spend an extra \$26-\$40 billion on additional imported OPEC oil between now and 1990. However, that is not the end of our balance of payments worries.

Professor Edward Erickson has warned the House Budget Committee that our rising oil imports will absorb much of Saudi Arabia's excess productive capacity, making it far easier for OPEC to push for higher prices. Suppose this leads to price increases averaging even \$1 per barrel over the period 1978-1990 (an 8 percent increase, less than most OPEC nations are already calling for). Such a price increase would apply to all U.S. oil imports.

The United States will import an average of 7 million barrels per day from OPEC between 1978 and 1990. This added dollar per

TABLE VII-5

U.S. OUTPUT, WAGES, PROFITS, AND TAXES LOST  
BY REPLACING \$26-\$40 BILLION OF  
DOMESTIC ENERGY PRODUCTION WITH OPEC OIL IMPORTS.

(figures in billions of dollars)

Gross Domestic Product*.....	26	-	40	100% **
Depreciation.....	2.5	-	3.8	9.5%
Indirect Business Taxes.....	2.8	-	4.4	11.0%
Wages and Salaries.....	15.2	-	23.4	58.5%
Taxes on Wages, Salaries..	2.3	-	3.5	
Disposable Income.....	12.9	-	19.9	
Employer's Social Security, Unemployment, etc.				
Contributions.....	2.2	-	3.4	8.5%
Profit Before Taxes	3.5	-	5.4	13.5%
Corporate Income Taxes.....	1.6	-	2.4	
After-tax Profit.....	1.9	-	3.0	

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Summary (nearest \$ billion)

Lost U.S. Production	26	-	40
Lost U.S. Wages and Salaries	15	-	23
(after taxes)	(13	-	20)
Lost Taxes, Federal, State and Local	9	-	13
Lost U.S. Profits	4	-	5
(after taxes)	(2	-	3)

\* Gross Domestic Product of Corporate Business. Excludes negligible amounts of net interest.

\*\* Percentages calculated from National Income and Product Accounts (Department of Commerce/Bureau of Economic Analysis) for recent non-recession years.

barrel could cost the United States \$2.55 billion per year, on average, or \$33 billion between now and 1990, in addition to the \$26-\$40 billion we shall be paying on new imports even if the price does not rise!

This \$59-\$73 billion increase in U.S. payments to OPEC does not include the effect of the \$1 price increase on non-U.S. purchasers of OPEC oil. We buy roughly one-fourth of OPEC's output. Europe, Japan, and the Third World would pay more than three times our \$33 billion loss due to a \$1 price rise, or nearly \$100 billion to OPEC between now and 1990.

Thus, the total windfall to the OPEC nations from the Carter program could easily reach \$160-\$170 billion between now and 1990.

The damage this could do to the balance of payments of the Third World, to debtor nations, to the international financial system and to major banks here and abroad, is incalculable. It could easily precipitate a worldwide recession, or worse. Furthermore, it could alter the delicate political and military balance in the Middle East in ways we cannot begin to foresee.

#### Growth Implications of Coal Conversion

The coal conversion program will also reduce domestic growth rates. Consider the following questions:

What will be the capital investment costs of this coal conversion program? Where will the money come from? And, what funds does that leave for other types of investment?



The Administration originally estimated that the coal conversion program -- the shift of most industrial and utility steam, heat, and power generation from oil and gas-fired boilers to coal -- would cost \$40 billion. However, it became clear in House Commerce Committee hearings that the electric utility industry alone would require well in excess of \$50 billion. Estimates that it would cost General Motors \$1 billion to convert to coal, and Ford \$0.5 billion, show why the rest of U.S. industry will probably require at least as much as the utilities, and further spending will be needed to upgrade rail lines and rolling stock, to open new mines, and to provide coal handling equipment.

Chase Econometrics has estimated the capital investment cost of the coal conversion program at \$120 billion at 1976 prices. This spending will be done mainly between 1981 and 1985. Assuming 6 percent inflation, \$120 billion translates into \$180 billion in 1983 prices, and this will amount to 11 percent of all business fixed investment for the five year period.

Will this investment be productive investment, just like a new factory, a new machine, or a new home? Hardly. It will merely replace or refit existing facilities to produce by a different method the same steam, heat, and power that we produce now.

Assume for a moment that this investment replaces investment that would have expanded capacity, productivity, output, and real GNP. Chase Econometrics paints this picture:

"Wholesale and consumer prices are both 9 percent above baseline values in 1985, while real GNP is 6-1/2 percent lower. The unemployment rate is 1.3 percent higher in

1985 and 2.2 percent higher in 1986 as the lagged effects of lower productivity growth come to fruition. Under such a program, the unemployment rate would remain near 7 percent for the entire decade. While this may seem unduly pessimistic, it does indicate the important effect that a slowdown in productivity growth has on the entire economic outlook."

The reduced growth rate, and higher taxes, unemployment, and inflation will affect homebuilding and personal savings rates. Chase predicts a drop in residential housing investment of \$39 billion through 1985, and a loss of 1.73 million housing starts.

In the year 1985, spending on residential construction will be down \$13.5 billion, or 8.3 percent, and 400,000 housing starts will be lost, down 17.5 percent.

By 1985, the energy program will reduce the savings rate from a projected 6.3 percent of disposable income to 5.3 percent, a drop of a full point, or a 16.1 percent fall in annual personal saving!

But, what if the coal conversion spending does not replace other investment?

Chase says, "Even if we assume that the investment for conversion purposes occurs in addition to plant and equipment spending which would otherwise take place, the results are not very encouraging. For a while real GNP is higher and unemployment is lower, but the higher rate of inflation and the higher level of interest rates engendered by this additional ex ante investment create enough congestion in capital markets that ex post investment is only marginally higher in the early 1980s and no higher at all by 1985. In

other words, the economy will not have the resources necessary to produce an additional \$180 billion worth of capital goods in the first half of the 1980s under present assumptions about productivity growth and capacity in the basic materials industries."

In this case, as compared with no energy plan, Chase predicts a loss of \$15.8 billion in residential housing investment through 1985, and a loss of 1.21 million housing starts.

In 1985, spending on residential construction will be down \$11.2 billion, or 6.9 percent, and 280,000 housing starts will be lost, down 12.5 percent.

By 1985, even in this optimistic scenario, the energy program will reduce the savings rate from a projected 6.3 percent of disposable income to 5.7 percent, a drop of 0.6 point, or a 10.3 percent in annual personal saving! 3/

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3/ Representative Heckler states: "Another issue that concerns me in the energy field is the coal conversion program and its effect on wages in the New England area. I share the Minority view that coal conversion will monopolize such a large amount of limited investment resources, that investment will decline, thereby affecting wages of workers in the firms involved. This is another situation I will be studying carefully."

Productivity Shortfall and  
Investment Needs

This potential future investment shortage and labor productivity reduction follows hard on the heels of a similar productivity drop due to the OPEC oil curtailments and price increases since 1973. Three studies have pointed to energy curtailments to explain the severity of the last recession, the persistence of unemployment, and poor performance of productivity during the recovery, and the early reappearance of bottlenecks and inflationary pressures at low official measures of capacity utilization.

Robert Rasche and John Tatom, in two studies in the May and June 1977, issues of the monthly Review of the Federal Reserve Bank of St. Louis, report that reduced energy availability has brought about a 4 percent drop in potential GNP relative to trend since 1973, and that our capacity utilization figures are too low by a corresponding amount. Consequently, there is much less slack in the economy than commonly believed.

Peter Clark, Council of Economic Advisers, reports a similar 4 to 5 percent drop in productivity. However, he attributes some of this drop to unusual cyclical factors, and only about 2 percent to restricted energy use.

Whenever a factor complementary to labor is reduced in quantity, we find that productivity and real wages are reduced. The loss of foreign energy supplies (or their increased real cost) can be made up by substituting increased domestic energy production, or through increased physical capital, which is also a complementary factor to labor. Thus, domestic energy production

and increased investment in plant and equipment are doubly important, to permit the attainment of the President's energy goals in the future, and to make up for damage already done by the OPEC cartel.

The importance to the average worker of increased investment to offset the reduced productivity and real GNP forecast under the Energy Plan is indicated by Table VII-6. The Table uses the recent historical ratio of wages and salaries to GNP (roughly 60 percent) to translate Chase's projected GNP reductions into a figure for lost wages and salaries, which is then divided by the expected number of workers, 110 million in 1985 (Wharton Econometric Associates).

Increasing investment by an amount well in excess of \$180 billion in the next few years will not be easy. If the Administration does not recognize the problem, it will be impossible.

TABLE VII-6

Chase Comparison  
Ways and Means Bill vs. Standard Forecast, 1985

Energy Plan With Specified  
 Coal Conversion Assumptions

Changes in:	<u>Pessimistic</u>	<u>Optimistic</u>
Real GNP*	-6.5	-1.4
Unemployment Rate**	1.27	-0.08
CPI*	9.7	4.4
Savings Rate**	-1.0	-0.6
Loss in GNP, \$ per worker....	1020	220
Loss in wages and salaries, \$ per worker .....	610	130

\* Percent change in level

\*\* Change in index

Source: Wharton Employment Forecast, and Historical Ratio  
 of Wages and Salaries to GNP for Recent Non-recession years.

Orrin G. Hatch

Jacob Javits

Clarence Brown

Garry Brown

Margaret Heckler

John Roussetot

Bill Roth

Jim McClure

ADDITIONAL VIEWS OF  
SENATOR JACOB K. JAVITS

The Midyear Economic Report is used more as a philosophical assessment of areas of particular interest than is the more technical overview which the Joint Economic Committee publishes in its annual report. For this reason, while I concur largely with the Minority Members and their views - except notably for the energy section - I wish to discuss three areas of vital concern to me.

The first area involves the international economic sector. There, certain strains are present in the international economic system which may have grave consequences for the West if left unchecked.

The "free" world continues to be profoundly and adversely affected by the drastic OPEC oil price increases dating from 1973-1974, and I am not at all sanguine over the consequences of present trends. The deep imbalances in the resulting balance of payments positions of the oil importing countries, those in the Third World and the weaker of those in the industrialized world, have resulted in stifling any recovery from the 1974 recession, unacceptable unemployment and high rates of inflation. The non-oil producing developing countries have financed these balance of payments imbalances by borrowing heavily from public and especially from private sources. Net private flows to these LDC's have totaled more than \$50 billion since 1973, with \$21 billion being advanced in 1976 alone. The outstanding debt of these countries directly to - or guaranteed by - governmental institutions in

the industrialized world rose from \$83 billion in 1973 to \$145 billion in 1976.

To overcome the shortfall in their current accounts, therefore, these LDC's have heavily mortgaged their futures. I am extremely concerned because such a situation cannot continue indefinitely, as it has severe implications both for the economic and political fabric of the developing world. Yet it promises to continue at least to 1985, with cumulative deficits in these countries of at least \$150 billion more. If heavy borrowing to finance trade deficits continues without concomitant improvements in other aspects of their current accounts, these LDC's must sink deeper into debt-created economic trouble without any real hope of generating the surpluses needed to remove themselves from that back breaking burden.

The implications for the international financial system, including the role of commercial banks, are ominous. Banks are confronting all too quickly self-imposed limitations on their lending exposure in certain of these LDC's. These commercial financing sources cannot be permitted to dry up, but neither can the continuation of the unconditional capital flows be accepted. The successful pivotal role played by our commercial banks in helping to finance the world's oil import bill must not obscure the fragile structure of the financing arrangements. To meet the collective external debt of the non-oil countries, which reached the \$160 to \$180 billion level at the end of 1976, the commercial banks recycled massive amounts of petro-dollars from their OPEC depositors to their oil importing customers. The essential weakness of this recycling effort lies in the situation of short-term OPEC deposits but long-term bank



credits, with no compensating balances or assurances against a threat of sudden withdrawals. In the absence of more solid long term commitments by the OPEC countries, this is a highly dangerous situation.

Solutions to these problems must be pressed on several fronts. First, we must maintain and increase the level of official aid flows to these LDC's, in order to sustain their growth rates - essential to preserving the viability of the international monetary system. At the same time, incentives for private international lending and long term debt financing must be stimulated.

Second, we should increase the opportunities for trade expansion with and among these LDC's, accelerate technology transfers and encourage private sector investment on fair terms. In addition, we should expand our system of trade preferences (GSP), which will permit these LDC's to accumulate sorely needed foreign exchange. I believe that this expansion of GSP can be undertaken while ensuring that our own labor force is not affected adversely.

Third, the international financial institutions (IFI's), particularly the International Monetary Fund (IMF) and the International Bank of Reconstruction and Development (IBRD), must be strengthened by greater capital commitment if their critical role in the viability of the development process through the international monetary system is to be sustained. The so-called Witteveen facility of the IMF, as well as provisions for the seventh quota increase of the IMF, need to be promptly adopted and implemented.

Fourth, a restructuring of the financial relationships between surplus oil producing and the deficit oil consuming countries is also needed. Major diplomatic efforts should be undertaken to require effective redeployment of the excess resources drained from both the developed and non-oil developing world by the OPEC cartel. For example, we should insist that if OPEC countries want the financial security afforded by our strong economy, their deposits must be investments of a longer term so that the overall term structure of the banking system's external credits and debits more closely parallel each other. In addition, we must adopt an effective energy policy so that the payments imbalances caused by oil imports can be minimized, through developing alternative sources of energy and introducing drastic conservation policies. And we need to attract investments by the oil producing countries into alternative energy sources.

A second area which I wish to address is the enhancement of industrial and agriculture productivity, a subject in which I have had a long-standing interest, and have initiated some major legislative efforts. While both the Minority and Majority reports touch somewhat on this issue, I believe its importance must be heavily underlined. I believe that a new productivity drive is imperative at this juncture when the United States is suffering from low economic growth and unacceptable rates of inflation and unemployment. Incentives both to business and to labor must be considered, and existing successful incentives must be strengthened.

I stress that the attack must be made on two fronts-- business and labor. First, incentives must be maintained for business

because private enterprise (and its underwriting of freedom) remains the "golden goose" for our economic strength. In recent years, we have seen a gradual whittling away of business profits in an increasingly entangling web of regulations, pollution control requirements, taxes and other factors which, while serving desirable social objectives, also have swung the pendulum too far.

It is reported that President Carter is considering a \$5 billion cut in business taxes, including a cut in the corporate tax rate, a substantial liberalization of the present investment tax credit, and some initial steps toward elimination of the so-called "double-taxation" of dividends. This is the right track; however, these measures can only be considered a start. Furthermore, other legislation now being considered such as new social security taxes may offset indirectly the favorable direct tax incentives for business. We need a concerted and prompt effort to develop more creative methods to encourage business capital investment.

As my legislative record makes very clear, investment in human capital is essential to maintain labor productivity. Labor-Management Committees have had a proven success record, in war and in peace. Very dramatic results could follow from this innovative approach to the common problem of maintaining economic health (and therefore job security and higher pay) through greater attention to productivity and worker morale. Legislation which I have introduced in both the 94th and 95th Congresses would provide Federal funding for demonstration projects in order to give a more solid experience base upon which to expand this concept.

Productivity increases are simply bonuses paid to both worker and business. This bonus finances increased wages at the same time that solid growth in output is stimulated. Productivity increases and consequent output gains, in turn, would help to reduce the inflationary spiral we are now experiencing. Finally, a lessening of upward pressures on prices would enable the Federal Reserve to accommodate real growth gains through the money supply and interest rates.

The third area which I wish to address is energy. Here, I must dissent from the Minority report's conclusion reached in the chapter on Energy. I place primary reliance, in the near term, on conservation measures to dampen the increase in our oil import levels. Conservation, through measures to retrofit existing facilities which consume oil such as in homes and industry, and by incentives to replace some major uses of oil with other sources such as coal, are our greatest immediate weapon to combat increasing oil imports and their consequent drain on the economy. I doubt, however, that across the board federal taxation of energy, which drastically raises prices to the consumer, will encourage much effective conservation. Taxes, in order to be used efficiently to promote conservation goals, must be carefully targeted on items which have a reasonably high elasticity of demand, such as automobiles. In addition, public education programs and prospective mandatory standards for energy efficiency will begin to provide results in the 1980's.

On the supply side of the equation, I differ strongly from the conclusions reached in the Brown-Stockman study, relied on so heavily in the Minority report. Although it is claimed that deregulation of natural gas

prices would produce greater supplies, I believe the price paid in distortion of prices levied on homeowners and industrial users is far more than we can afford. I believe it better in the national interest to seek the certainty of a fair price for natural gas, not to raise false hopes of deregulation in the calculations of producers, and to provide direct incentives for increased production. Prices for newly discovered gas and oil must be high enough to spur investment and production, but continued federal control is necessary to prevent CPEC type domination of our entire energy price structure until more normal market forces prevail.

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A handwritten signature in black ink, appearing to be "Harris", written in a cursive style.

revenues over the next 75 years to divert to social security without gutting other programs.

If we are to avoid a large tax increase, we have only two choices: a crash saving and investment program led by lower marginal tax rates, or a reduction in benefits.

Discussing the latter alternative, Secretary of Commerce Juanita Kreps has warned that young workers who have recently entered the labor force may not be able to collect social security benefits until age 68. Such a shift in the retirement age would ease the social security financing problems.

As is shown in Table V-1, social security taxes are projected to have to rise from the currently scheduled 11.90 percent of payroll to 17.85 percent of payroll in 2050, even assuming that the error in the inflation adjustment formula is corrected. It is to avoid this 50 percent jump in the tax rate that later retirement years have been mentioned. But, this assumes that nothing can be done to get income to rise more rapidly than the Social Security Administration anticipates. In fact, increased growth could solve this financing problem.

The Minority urges that the necessary steps be taken to increase the rate of growth of real GNP and real wages so that the Government's social security promises may be kept without enormous increases in the tax rate. It is far better to increase real wages by 50 percent more than the Social Security Administration predicts, than to impose 50 percent more tax on a lower real income.

TABLE V-1. Comparison of OASDI Cost Projection Under  
The Administration Wage-indexing Proposal 1/ and the  
OASDI Tax Rates Scheduled in Present Law

<u>Calendar year</u>	<u>OASDI Cost</u>	<u>OASDI Tax Rate</u>
1977	10.91	9.90
2050	17.85	11.90
75-year average: 1977-2051.....	15.11	10.99

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Source: "Staff Data and Materials Relating to Social Security Financing," prepared by the Staff of the Committee on Finance, United States Senate.

1/ The system considered here excludes any of the Administration's proposals that would increase income as well as the new proposed dependency test for living or surviving spouses.

Note: The above estimates are based on alternative II assumptions used in the 1977 OASDI Trustees report.

How do we produce real GNP and real wages 50 percent higher than predicted over the next 70 years? It will require an increase in our projected annual real growth rate by between one-half and three-quarters of 1 percent. This will not be as easy as it sounds. It will require that we devote an additional 3 percent or 4 percent of GNP to saving and investment. It will require a tax code which encourages work effort and saving.

Unless we take these steps to spur economic growth, Mrs. Kreps' proposal may become inevitable. 1/ 2/

1/ Representative Heckler states: "I strongly favor a growth solution to the social security problem in order to make huge increases in social security taxes unnecessary. It is imperative that the social security program be strengthened, and that its inequitable treatment of women be brought to an end. I will be active in seeking a legislative remedy for this situation."

2/ Representative Rousselot states: "One way to dramatically increase the U.S. growth rate is to make social security a voluntary part of a pension plan for all new people entering the labor force. When each individual first goes to work, he or she could decide where to invest his or her social security taxes in a government or privately run pension fund. The gradual effect of such a plan would not seriously disrupt the Social Security System (that is, if the reforms being discussed by the House Ways and Means Committee are implemented), and the resulting increase in investment would enormously expand our productive capacity."



## VI. MONETARY POLICY

Because of the Majority's inability to recognize a falling after-tax rate of return to labor, saving, and investment as the cause of our lack of economic growth, they seek to place the blame elsewhere. The Majority states that the Federal Reserve has failed to provide enough "real balances" (money, after it is eroded by inflation) to finance necessary real growth plus anticipated inflation, which together account for the growth of nominal GNP. The Majority claims that nominal short-term interest rates will rise and choke off the recovery. Ignoring supply, the Majority suggests rapid money creation to stimulate demand.

There are at least four major errors in this line of reasoning:

- 1) Why does the Majority focus on nominal, short-term, interest rates as the driving force of the recovery?

The cost of borrowing money for business projects is the real (adjusted for inflation) interest rate, not the nominal (unadjusted) interest rate. If inventory is increasing in price at 5 percent per year due to inflation, then an additional 2 percent mark-up will cover a nominal interest rate of 7 percent. If there is no inflation, a nominal interest rate of 3 percent would require a 3 percent mark-up, and would be more of a burden than a 7 percent nominal rate at 5 percent inflation. What matters to the borrowers is the real interest rate, which is the spread between the nominal interest rate and the expected rate of price increase of

the asset to be purchased, which is generally the inflation rate.

2) Long-term real interest rates are an important influence on the rate of job creation and economic recovery. These long-term rates affect purchases of long-lasting plant and equipment, housing, and commercial buildings, creating thousands of jobs in the capital goods and construction industries. In fact, it is precisely this type of spending which has been lagging in this recovery. Even more important, it is this type of spending which provides for the increased productive capacity needed to create permanent jobs and higher wages for a growing labor force. These long-term interest rates cannot be lowered by boosting the money supply.

As we pointed out in The 1977 Joint Economic Report:

"There are those who call for further increases in the rate of growth of the monetary aggregates, 'to lower interest rates and get the economy moving.' The aim is admirable, but the method is madness.

"Long-term interest rates, the ones which determine the cost of major investments in houses, factories, and equipment, cannot be forced down by easing money. Risk factors aside, these rates (i) are the sums of the real returns demanded by investors (r), and inflation premiums (p) equal to the rate of expected price increases over the period of the loan. In other words,  $(i) = (r) + (p)$ ." Rapid money creation will

only rekindle inflationary expectations and drive interest rates higher.

(3) If the Federal Reserve is supposed to fund real growth and existing inflation, when do we start to reduce the inflation? If we have 5 percent real growth and 6 percent inflation, must the Fed supply 11 percent more money as the Majority implies? This monetary growth works to keep inflation at present levels. And this is directly opposed to the Majority's supposed desire to reduce inflation. If that 6 percent inflation is to be rationally reduced, the Fed must move gradually toward 10 percent, 9 percent, 8 percent, 7 percent, 6 percent and finally 5 percent growth rates of the money supply. The growth in the broadly defined money supply, M2, has averaged 10 to 11 percent this year. This is certainly ample to finance the economic recovery while beginning the gradual reduction of inflation and inflationary expectations.

4) The Federal Reserve does not create real money balances (adjusted for inflation). It controls only the number of dollars in existence -- nominal dollars. The public chooses to keep a certain amount of purchasing power on hand in the form of cash and bank balances. If the Federal Reserve pumps out additional money in excess of the public's desire to add to these balances, the public will simply try to spend it. As the public chases goods with the extra money, prices will rise. This price rise will continue until the value of the nominal balances falls back to the original level the public held

before the Federal Reserve injected funds. The Majority says that  $MV=PQ$ , that money times velocity of circulation equals the prices of all goods times their quantities. This also means that  $M/P \times V = Q$ . Real balances (M/P) times velocity equals real output (Q). But the Federal Reserve only controls M, nominal balances, NOT M/P, real balances. The public sets P, V, and Q.

We believe that the Federal Reserve is providing money at a sufficient pace to maintain recovery while keeping inflation on a declining trend. The Fed has correctly anticipated an increase in money velocity to make greater money creation unnecessary. As we said in The 1977 Joint Economic Report, "A liberal fiscal policy of low tax rates must be used to reduce unemployment, while a tight money policy (gradually arrived at) must be used to lower inflation and interest rates. It is to be hoped that the Federal Reserve can pursue its part of this course in peace."

## VII. ENERGY

As the Administration's Energy Plan makes its way through Congress, evidence is building that the Plan will have a substantial adverse impact on prices, employment, gross national product (GNP) and even the balance of payments. 1/

Under continued price controls, natural gas production is expected to drop by 25 percent between now and 1990. Since gas is 36 percent of domestic energy production, we will lose 9 percent of our total energy output by 1990. Domestic oil production, under price controls and wellhead taxes, will also continue its recent decline. These shortfalls will be made up chiefly by importing more oil and by conversion to coal.

### Short-Run Impact

The economic impact of the taxes in the National Energy Act, whether the Administration or the House passed version, is expected to be minor in the very short term. The two largest taxes in the program, the crude oil and natural gas equalization (wellhead) tax, and the tax on industrial users of natural gas and oil, are to be phased in between 1978 and 1980, and will have little impact in 1978. Under the House bill, that part of the equalization tax

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1/ Senator Javits states: "Speaking as an individual Senator, I wish to disassociate myself from the Energy Chapter. My views on energy are contained in my additional views."

effective in 1978 will be rebated to State governments, homeowners, hospitals, schools and taxpayers in general. An illustration of net and gross receipts expected under the Administration plan, and the net receipts, after credits, of the House bill, appear below (Tables VII-1 and VII-2).

By 1980, however, the Administration proposal would have noticeable adverse effects on GNP, unemployment, and inflation, according to most observers outside the Administration (Table VII-3). The removal of the standby gasoline tax by the House relieves some of these effects, since the predictions by Chase, Wharton, DRI and the CBO all assumed that some of this tax would be imposed. Recent runs by Chase show the differences through 1985 between the Administration and House passed bills (Table VII-4).

The Committee, on May 20 and 25, 1977, held hearings on the Energy Act before the Energy Subcommittee. Witnesses, including Otto Eckstein, whose testimony was the source of the DRI estimates in the tables, generally supported the view that somewhat higher rates of inflation and unemployment, and reduced real GNP, would result from the adoption of the National Energy Plan. This would be true even if the tax proceeds were rebated to the public, while failure to rebate the tax proceeds would have a severe deflationary impact on the economy.

Two witnesses, however, went further. Professor Lester Thurow expressed concern that the burden of the Energy Plan would be unequally distributed across various regions of the country, and that a disproportionate share of the taxes would be borne by the South and New England. These distributional

**TABLE VII-1-** — *Increase in gross budget receipts in Administration energy proposals, fiscal years 1978-85*

[In millions of dollars]

	Fiscal year—							
	1978	1979	1980	1981	1982	1983	1984	1985
Net receipts (from table 5).....	253	2,189	4,831	5,793	6,523	8,686	11,127	15,050
Credits under crude oil equalization tax.....	2,282	5,993	10,039	11,607	11,285	10,915	10,653	10,450
Credits under oil and natural gas consumption tax.....		1,342	4,111	6,330	7,549	9,852	10,834	9,603
Total, gross receipts.....	2,535	9,524	18,981	23,730	25,357	29,453	32,614	35,103

Source: Secretary Blumenthal's statement to Ways and Means Committee, May 16, 1977.

Energy Program, Vol. 6, "Economic and Budget Considerations" p.23 Prepared for the Committee on Ways and Means of the House of Representatives by the staff of the Joint Committee on Internal Revenue Taxation.

TABLE VII 2 -Summary of Estimated Budget Effects of Title II of H.R. 8444, as Passed by the House, by Part, Fiscal Years 1978-85

[In millions of dollars]

	1978	1979	1980	1981	1982	1983	1984	1985	Total, 1978- 1985
<b>Part:</b>									
I. . . . Residential energy tax credits . . .	-387	-520	-553	-589	-633	-687	-748	-710	-4,827
II. . . . Transportation tax provisions . . .	87	859	4,230	4,426	4,647	4,853	5,073	5,304	29,488
III. . . . Crude oil equalization and nat- ural gas liquids taxes <sup>1</sup> . . . . .	-347	3,105	8,638	11,557	3,633				26,586
IV, V. Excise tax on business use of oil and natural gas after business income tax offset and rebate . . . . .		-25	398	88	164	592	813	878	2,908
VI. . . . Changes in business investment credit . . . . .	-316	-247	-211	-321	-455	-97	464	502	-681
VII. . . . Miscellaneous provisions . . . . .	-9	-46	-58	-68	-73	-81	-102	-133	-570
<b>Total, all parts . . . . .</b>	<b>-972</b>	<b>3,126</b>	<b>12,453</b>	<b>15,093</b>	<b>7,283</b>	<b>4,580</b>	<b>5,500</b>	<b>5,841</b>	<b>52,904</b>

<sup>1</sup> The amounts shown for fiscal years 1978 and 1979 are net of business income tax offset and refunds and after per taxpayer rebates and special payments to rebate the tax collected from 1978 calendar year liability to the general public.

Source: Energy Tax Provisions: Summary and Section-by-Section Explanation of Title II of H.R. 8444, as passed by the House, Prepared for the Committee on Finance, United States Senate, by the staff of the Joint Committee on Taxation, August 8, 1977, p. 34



TABLE VII-3

Effects of Administration proposal on Selected  
Economic Variables, 1978-1980

	1978	1979	1980
Real GNP (percent difference in level):			
Data Resources, Inc. (DRI) 1/.....	-0.1	-0.4	-0.7
Wharton Econometric Forecasting Assoc., Inc. (Wharton) 2/.....	0.0	-0.3	-0.5
Chase Econometrics, Inc. (Chase) 3/.....	0.0	-0.3	-0.5
Administration 4/.....	0.0	0.0	0.0
Congressional Budget Office (CBO) 5/.....	-0.2	-0.5	-0.7
Unemployment rate (difference in rate):			
DRI.....	0.0	+0.1	+0.2
Wharton.....	0.0	+0.1	+0.2
Chase.....	0.0	+0.1	+0.2
Administration.....	0.0	0.0	+0.0
CBO.....	0.0	+0.2	+0.2
Consumer Price Index (difference in rate of increase):			
DRI.....	+0.5	+1.1	+1.4
Wharton.....	+0.4	+0.8	+0.4
Chase.....	+0.3	+0.7	+0.8
Administration.....	+0.3	+0.6	+0.2
CBO.....	+0.5	+0.6	+0.5

1/ Testimony of Dr. Otto Eckstein before the Joint Economic Committee, May 20, 1977, and private communications to staff.

2/ Forecast of April 21, 1977.

3/ Forecast of April 27, 1977.

4/ Communication to staff.

5/ Congressional Budget Office, President Carter's Energy Proposals: A Perspective, May 31, 1977.

Source: Energy Program: Economic and Budget Considerations, Prepared for the Committee on Ways and Means, House of Representatives, by the staff of the Joint Committee on Taxation, p.12.

TABLE VII-4  
 Chase Comparison  
 Administration Bill vs. Standard Forecast  
 House Passed Bill vs. Standard Forecast

	Real GNP*			Unemployment Rate			CPI**		
	1978	1980	1985	1978	1980	1985	1978	1980	1985
Administration	0.0	-0.8	-3.2	0.00	0.26	1.32	0.2	1.5	4.4
House	0.1	-0.4	-2.5	-0.01	0.12	.94	0.2	1.0	3.3

\* Percent change from Standard Forecast

\*\* Difference from Standard Forecast

effects are hidden in the aggregate numbers. Professor Arthur Laffer agreed, adding that the automobile and crude oil taxes would strike at automobile producing states in the Midwest as well.

Professor Laffer also expressed doubts that a simple rebate of the energy taxes would be sufficient to prevent a further contraction of the economy. The rebate would be adequate to sustain nominal demand. However, the added taxes and higher prices would reduce the after-tax value of wages, interest, and profits. With these lower rates of return to productive effort, real aggregate supply might falter. Since the rebates are not related to work effort, saving, or investment, they would be unable to stop this effect. Further tax reductions on wages, interest, and profits would be required to maintain output.

### Natural Gas

Representatives Clarence J. Brown and Dave Stockman have prepared a study entitled, "The Cost of Natural Gas Deregulation: a Restatement." They predict that 25 tcf (trillion cubic feet) more gas will be produced under deregulation than under the President's Plan between now and 1990 as prices in excess of the Administration's proposed ceilings call forth more drilling and more discoveries.

There is genuine controversy in industry and within the Department of Energy and especially within ERDA and the U.S. Geological Survey, over the supply response and the expected rate of reserve discoveries to be had from higher prices. However, in the 1976 National Energy Outlook, the FEA

estimates differences in gas production under price scenarios roughly similar to those chosen by Brown-Stockman and the Administration and shows added output nearly as high as that predicted by Brown and Stockman. This should hold true whether deregulation is immediate or phased-in, because of the long time lag between exploration and production.

To the extent that deregulation produces additional gas, deregulation will relieve consumers from having to buy alternate fuels. Depending on which fuels are assumed to be substitutes for gas, and on how much additional gas is produced, a cost of alternate fuels can be calculated.

Additional gas also helps to pay for the fixed costs of the pipeline distribution system. These costs are spread over whatever quantity of gas is transported. The more that is shipped, the lower is the charge per unit. These are the pipeline costs "saved" by deregulation. Another way to look at them is as a proxy for the transportation costs for the alternate fuels, costs which are hard to estimate. The more gas that deregulation produces, the lower are these alternate fuel transportation charges.

Brown and Stockman assume that the provision of the energy plan which seeks to encourage or to require low priority industrial users to switch to coal from natural gas will be successful. Therefore, the recipients of increased supplies of gas will be homeowners and high priority industry (industry which cannot convert to coal or oil). The alternate fuel for these consumers is only partly distillate oil. About half the quantity of alternate fuel would be electricity, currently costing \$11 per mcf

equivalent. This makes the cost of alternate fuel approximately \$6 under the Brown-Stockman assumptions, versus an expected cost of deregulated gas of roughly \$2.50.

If the increase in production of natural gas under deregulation, the cost of alternative fuels, and the saving in pipeline charges are taken into account, deregulation (whether it is immediate or phased-in) could save consumers of natural gas upwards of \$50 billion between now and 1990. Only by ignoring these factors can the Administration claim that its own proposals are cheaper for the consumer. 2/

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2/ Representative Heckler states: "Although I have opposed deregulation in the past, recent studies indicating that it would lower costs for New England customers will receive my close scrutiny. I will be studying the statistics and conclusions on the energy problem provided by the Federal Reserve Bank of Boston and others.

"However, at the present time, my feeling is that deregulation should wait. If it does become necessary, it should be phased in gradually to blunt an unbearable increase in consumer prices."

### Loss to U.S. Economy from Oil Imports

Unfortunately, the balance of payments implications of this natural gas shortfall threaten to make the cost of the Administration proposal even greater. The oil used to replace part of the lost natural gas will have to be imported. Brown and Stockman calculate that, under the Carter program, the United States will spend \$26-\$40 billion on unnecessary imports of OPEC oil, instead of on domestic fuel and other goods and services, between 1978 and 1990. This \$26-\$40 billion shortfall in gross domestic product will cost the United States jobs, income, and tax revenue. (Table VII-5)

### OPEC Windfall from President Carter's Energy Plan

Under the Carter proposal to continue regulation of natural gas, U.S. consumers will spend an extra \$26-\$40 billion on additional imported OPEC oil between now and 1990. However, that is not the end of our balance of payments worries.

Professor Edward Erickson has warned the House Budget Committee that our rising oil imports will absorb much of Saudi Arabia's excess productive capacity, making it far easier for OPEC to push for higher prices. Suppose this leads to price increases averaging even \$1 per barrel over the period 1978-1990 (an 8 percent increase, less than most OPEC nations are already calling for). Such a price increase would apply to all U.S. oil imports.

The United States will import an average of 7 million barrels per day from OPEC between 1978 and 1990. This added dollar per

TABLE VII-5

U.S. OUTPUT, WAGES, PROFITS, AND TAXES LOST  
BY REPLACING \$26-\$40 BILLION OF  
DOMESTIC ENERGY PRODUCTION WITH OPEC OIL IMPORTS  
(figures in billions of dollars)

Gross Domestic Product*	26 - 40	100% **
Depreciation	2.5 - 3.8	9.5%
Indirect Business Taxes	2.8 - 4.4	11.0%
Wages and Salaries	15.2 - 23.4	58.5%
Taxes on Wages, Salaries	2.3 - 3.5	
Disposable Income	12.9 - 19.9	
Employer's Social Security, Unemployment, etc.		
Contributions	2.2 - 3.4	8.5%
Profit Before Taxes	3.5 - 5.4	13.5%
Corporate Income Taxes	1.6 - 2.4	
After-tax Profit	1.9 - 3.0	

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Summary (nearest \$ billion)

Lost U.S. Production	26 - 40
Lost U.S. Wages and Salaries (after taxes)	15 - 23 (13 - 20)
Lost Taxes, Federal, State and Local	9 - 13
Lost U.S. Profits (after taxes)	4 - 5 (2 - 3)

\* Gross Domestic Product of Corporate Business. Excludes negligible amounts of net interest.

\*\* Percentages calculated from National Income and Product Accounts (Department of Commerce/Bureau of Economic Analysis) for recent non-recession years.

barrel could cost the United States \$2.55 billion per year, on average, or \$33 billion between now and 1990, in addition to the \$26-\$40 billion we shall be paying on new imports even if the price does not rise!

This \$59-\$73 billion increase in U.S. payments to OPEC does not include the effect of the \$1 price increase on non-U.S. purchasers of OPEC oil. We buy roughly one-fourth of OPEC's output. Europe, Japan, and the Third World would pay more than three times our \$33 billion loss due to a \$1 price rise, or nearly \$100 billion to OPEC between now and 1990.

Thus, the total windfall to the OPEC nations from the Carter program could easily reach \$160-\$170 billion between now and 1990.

The damage this could do to the balance of payments of the Third World, to debtor nations, to the international financial system and to major banks here and abroad, is incalculable. It could easily precipitate a worldwide recession, or worse. Furthermore, it could alter the delicate political and military balance in the Middle East in ways we cannot begin to foresee.

### Growth Implications of Coal Conversion

The coal conversion program will also reduce domestic growth rates. Consider the following questions:

What will be the capital investment costs of this coal conversion program? Where will the money come from? And, what funds does that leave for other types of investment?



The Administration originally estimated that the coal conversion program -- the shift of most industrial and utility steam, heat, and power generation from oil and gas-fired boilers to coal -- would cost \$40 billion. However, it became clear in House Commerce Committee hearings that the electric utility industry alone would require well in excess of \$50 billion. Estimates that it would cost General Motors \$1 billion to convert to coal, and Ford \$0.5 billion, show why the rest of U.S. industry will probably require at least as much as the utilities, and further spending will be needed to upgrade rail lines and rolling stock, to open new mines, and to provide coal handling equipment.

Chase Econometrics has estimated the capital investment cost of the coal conversion program at \$120 billion at 1976 prices. This spending will be done mainly between 1981 and 1985. Assuming 6 percent inflation, \$120 billion translates into \$180 billion in 1983 prices, and this will amount to 11 percent of all business fixed investment for the five year period.

Will this investment be productive investment, just like a new factory, a new machine, or a new home? Hardly. It will merely replace or refit existing facilities to produce by a different method the same steam, heat, and power that we produce now.

Assume for a moment that this investment replaces investment that would have expanded capacity, productivity, output, and real GNP. Chase Econometrics paints this picture:

"Wholesale and consumer prices are both 9 percent above baseline values in 1985, while real GNP is 6-1/2 percent lower. The unemployment rate is 1.3 percent higher in

1985 and 2.2 percent higher in 1986 as the lagged effects of lower productivity growth come to fruition. Under such a program, the unemployment rate would remain near 7 percent for the entire decade. While this may seem unduly pessimistic, it does indicate the important effect that a slowdown in productivity growth has on the entire economic outlook."

The reduced growth rate, and higher taxes, unemployment, and inflation will affect homebuilding and personal savings rates. Chase predicts a drop in residential housing investment of \$39 billion through 1985, and a loss of 1.73 million housing starts.

In the year 1985, spending on residential construction will be down \$13.5 billion, or 8.3 percent, and 400,000 housing starts will be lost, down 17.5 percent.

By 1985, the energy program will reduce the savings rate from a projected 6.3 percent of disposable income to 5.3 percent, a drop of a full point, or a 16.1 percent fall in annual personal saving!

But, what if the coal conversion spending does not replace other investment?

Chase says, "Even if we assume that the investment for conversion purposes occurs in addition to plant and equipment spending which would otherwise take place, the results are not very encouraging. For a while real GNP is higher and unemployment is lower, but the higher rate of inflation and the higher level of interest rates engendered by this additional ex ante investment create enough congestion in capital markets that ex post investment is only marginally higher in the early 1980s and no higher at all by 1985. In

other words, the economy will not have the resources necessary to produce an additional \$180 billion worth of capital goods in the first half of the 1980s under present assumptions about productivity growth and capacity in the basic materials industries."

In this case, as compared with no energy plan, Chase predicts a loss of \$15.8 billion in residential housing investment through 1985, and a loss of 1.21 million housing starts.

In 1985, spending on residential construction will be down \$11.2 billion, or 6.9 percent, and 280,000 housing starts will be lost, down 12.5 percent.

By 1985, even in this optimistic scenario, the energy program will reduce the savings rate from a projected 6.3 percent of disposable income to 5.7 percent, a drop of 0.6 point, or a 10.3 percent in annual personal saving! 3/

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3/ Representative Heckler states: "Another issue that concerns me in the energy field is the coal conversion program and its effect on wages in the New England area. I share the Minority view that coal conversion will monopolize such a large amount of limited investment resources, that investment will decline, thereby affecting wages of workers in the firms involved. This is another situation I will be studying carefully."

## Productivity Shortfall and Investment Needs

This potential future investment shortage and labor productivity reduction follows hard on the heels of a similar productivity drop due to the OPEC oil curtailments and price increases since 1973. Three studies have pointed to energy curtailments to explain the severity of the last recession, the persistence of unemployment, and poor performance of productivity during the recovery, and the early reappearance of bottlenecks and inflationary pressures at low official measures of capacity utilization.

Robert Rasche and John Tatom, in two studies in the May and June 1977, issues of the monthly Review of the Federal Reserve Bank of St. Louis, report that reduced energy availability has brought about a 4 percent drop in potential GNP relative to trend since 1973, and that our capacity utilization figures are too low by a corresponding amount. Consequently, there is much less slack in the economy than commonly believed.

Peter Clark, Council of Economic Advisers, reports a similar 4 to 5 percent drop in productivity. However, he attributes some of this drop to unusual cyclical factors, and only about 2 percent to restricted energy use.

Whenever a factor complementary to labor is reduced in quantity, we find that productivity and real wages are reduced. The loss of foreign energy supplies (or their increased real cost) can be made up by substituting increased domestic energy production, or through increased physical capital, which is also a complementary factor to labor. Thus, domestic energy production

and increased investment in plant and equipment are doubly important, to permit the attainment of the President's energy goals in the future, and to make up for damage already done by the OPEC cartel.

The importance to the average worker of increased investment to offset the reduced productivity and real GNP forecast under the Energy Plan is indicated by Table VII-6. The Table uses the recent historical ratio of wages and salaries to GNP (roughly 60 percent) to translate Chase's projected GNP reductions into a figure for lost wages and salaries, which is then divided by the expected number of workers, 110 million in 1985 (Wharton Econometric Associates).

Increasing investment by an amount well in excess of \$180 billion in the next few years will not be easy. If the Administration does not recognize the problem, it will be impossible.

ADDITIONAL VIEWS OF  
SENATOR JACOB K. JAVITS

The Midyear Economic Report is used more as a philosophical assessment of areas of particular interest than is the more technical overview which the Joint Economic Committee publishes in its annual report. For this reason, while I concur largely with the Minority Members and their views - except notably for the energy section - I wish to discuss three areas of vital concern to me.

The first area involves the international economic sector. There, certain strains are present in the international economic system which may have grave consequences for the West if left unchecked.

The "free" world continues to be profoundly and adversely affected by the drastic OPEC oil price increases dating from 1973-1974, and I am not at all sanguine over the consequences of present trends. The deep imbalances in the resulting balance of payments positions of the oil importing countries, those in the Third World and the weaker of those in the industrialized world, have resulted in stifling any recovery from the 1974 recession, unacceptable unemployment and high rates of inflation. The non-oil producing developing countries have financed these balance of payments imbalances by borrowing heavily from public and especially from private sources. Net private flows to these LDC's have totaled more than \$50 billion since 1973, with \$21 billion being advanced in 1976 alone. The outstanding debt of these countries directly to - or guaranteed by - governmental institutions in

TABLE VII-6

Chase Comparison  
Ways and Means Bill vs. Standard Forecast, 1985

Energy Plan With Specified  
 Coal Conversion Assumptions

Changes in:	<u>Pessimistic</u>	<u>Optimistic</u>
Real GNP*	-6.5	-1.4
Unemployment Rate**	1.27	-0.08
CPI*	9.7	4.4
Savings Rate**	-1.0	-0.6
Loss in GNP, \$ per worker....	1020	220
Loss in wages and salaries, \$ per worker .....	610	130

\* Percent change in level

\*\* Change in index

Source: Wharton Employment Forecast, and Historical Ratio of Wages and Salaries to GNP for Recent Non-recession years.

Orrin G. Hatch

Jacob Javits

Clarence Brown

Garry Brown

Margaret Heckler

John Roussetot

Bill Roth

Jim McClure

the industrialized world rose from \$83 billion in 1973 to \$145 billion in 1976.

To overcome the shortfall in their current accounts, therefore, these LDC's have heavily mortgaged their futures. I am extremely concerned because such a situation cannot continue indefinitely, as it has severe implications both for the economic and political fabric of the developing world. Yet it promises to continue at least to 1985, with cumulative deficits in these countries of at least \$150 billion more. If heavy borrowing to finance trade deficits continues without concomitant improvements in other aspects of their current accounts, these LDC's must sink deeper into debt-created economic trouble without any real hope of generating the surpluses needed to remove themselves from that back breaking burden.

The implications for the international financial system, including the role of commercial banks, are ominous. Banks are confronting all too quickly self-imposed limitations on their lending exposure in certain of these LDC's. These commercial financing sources cannot be permitted to dry up, but neither can the continuation of the unconditional capital flows be accepted. The successful pivotal role played by our commercial banks in helping to finance the world's oil import bill must not obscure the fragile structure of the financing arrangements. To meet the collective external debt of the non-oil countries, which reached the \$160 to \$180 billion level at the end of 1976, the commercial banks recycled massive amounts of petro-dollars from their OPEC depositors to their oil importing customers. The essential weakness of this recycling effort lies in the situation of short-term OPEC deposits but long-term bank



credits, with no compensating balances or assurances against a threat of sudden withdrawals. In the absence of more solid long term commitments by the OPEC countries, this is a highly dangerous situation.

Solutions to these problems must be pressed on several fronts. First, we must maintain and increase the level of official aid flows to these LDC's, in order to sustain their growth rates - essential to preserving the viability of the international monetary system. At the same time, incentives for private international lending and long term debt financing must be stimulated.

Second, we should increase the opportunities for trade expansion with and among these LDC's, accelerate technology transfers and encourage private sector investment on fair terms. In addition, we should expand our system of trade preferences (GSP), which will permit these LDC's to accumulate sorely needed foreign exchange. I believe that this expansion of GSP can be undertaken while ensuring that our own labor force is not affected adversely.

Third, the international financial institutions (IFI's), particularly the International Monetary Fund (IMF) and the International Bank of Reconstruction and Development (IBRD), must be strengthened by greater capital commitment if their critical role in the viability of the development process through the international monetary system is to be sustained. The so-called Witteveen facility of the IMF, as well as provisions for the seventh quota increase of the IMF, need to be promptly adopted and implemented.

Fourth, a restructuring of the financial relationships between surplus oil producing and the deficit oil consuming countries is also needed. Major diplomatic efforts should be undertaken to require effective redeployment of the excess resources drained from both the developed and non-oil developing world by the OPEC cartel. For example, we should insist that if OPEC countries want the financial security afforded by our strong economy, their deposits must be investments of a longer term so that the overall term structure of the banking system's external credits and debits more closely parallel each other. In addition, we must adopt an effective energy policy so that the payments imbalances caused by oil imports can be minimized, through developing alternative sources of energy and introducing drastic conservation policies. And we need to attract investments by the oil producing countries into alternative energy sources.

A second area which I wish to address is the enhancement of industrial and agriculture productivity, a subject in which I have had a long-standing interest, and have initiated some major legislative efforts. While both the Minority and Majority reports touch somewhat on this issue, I believe its importance must be heavily underlined. I believe that a new productivity drive is imperative at this juncture when the United States is suffering from low economic growth and unacceptable rates of inflation and unemployment. Incentives both to business and to labor must be considered, and existing successful incentives must be strengthened.

I stress that the attack must be made on two fronts-- business and labor. First, incentives must be maintained for business

because private enterprise (and its underwriting of freedom) remains the "golden goose" for our economic strength. In recent years, we have seen a gradual whittling away of business profits in an increasingly entangling web of regulations, pollution control requirements, taxes and other factors which, while serving desirable social objectives, also have swung the pendulum too far.

It is reported that President Carter is considering a \$5 billion cut in business taxes, including a cut in the corporate tax rate, a substantial liberalization of the present investment tax credit, and some initial steps toward elimination of the so-called "double-taxation" of dividends. This is the right track; however, these measures can only be considered a start. Furthermore, other legislation now being considered such as new social security taxes may offset indirectly the favorable direct tax incentives for business. We need a concerted and prompt effort to develop more creative methods to encourage business capital investment.

As my legislative record makes very clear, investment in human capital is essential to maintain labor productivity. Labor-Management Committees have had a proven success record, in war and in peace. Very dramatic results could follow from this innovative approach to the common problem of maintaining economic health (and therefore job security and higher pay) through greater attention to productivity and worker morale. Legislation which I have introduced in both the 94th and 95th Congresses would provide Federal funding for demonstration projects in order to give a more solid experience base upon which to expand this concept.


Productivity increases are simply bonuses paid to both worker and business. This bonus finances increased wages at the same time that solid growth in output is stimulated. Productivity increases and consequent output gains, in turn, would help to reduce the inflationary spiral we are now experiencing. Finally, a lessening of upward pressures on prices would enable the Federal Reserve to accommodate real growth gains through the money supply and interest rates.

The third area which I wish to address is energy. Here, I must dissent from the Minority report's conclusion reached in the chapter on Energy. I place primary reliance, in the near term, on conservation measures to dampen the increase in our oil import levels. Conservation, through measures to retrofit existing facilities which consume oil such as in homes and industry, and by incentives to replace some major uses of oil with other sources such as coal, are our greatest immediate weapon to combat increasing oil imports and their consequent drain on the economy. I doubt, however, that across the board federal taxation of energy, which drastically raises prices to the consumer, will encourage much effective conservation. Taxes, in order to be used efficiently to promote conservation goals, must be carefully targeted on items which have a reasonably high elasticity of demand, such as automobiles. In addition, public education programs and prospective mandatory standards for energy efficiency will begin to provide results in the 1980's.

On the supply side of the equation, I differ strongly from the conclusions reached in the Brown-Stockman study, relied on so heavily in the Minority report. Although it is claimed that deregulation of natural gas

prices would produce greater supplies, I believe the price paid in distortion of prices levied on homeowners and industrial users is far more than we can afford. I believe it better in the national interest to seek the certainty of a fair price for natural gas, not to raise false hopes of deregulation in the calculations of producers, and to provide direct incentives for increased production. Prices for newly discovered gas and oil must be high enough to spur investment and production, but continued federal control is necessary to prevent CPEC type domination of our entire energy price structure until more normal market forces prevail.

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A handwritten signature in black ink, appearing to read "Harris", written in a cursive style.