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THE MACROECONOMIC GOALS OF
THE ADMINISTRATION FOR 1981:
TARGETS AND REALIZATIONS

A STUDY

PREPARED FOR THE USE OF THE
JOINT ECONOMIC COMMITTEE
CONGRESS OF THE UNITED STATES



AUGUST 5, 1977

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LETTERS OF TRANSMITTAL

July 27, 1977

To the Members of the Joint Economic
Committee:

Transmitted herewith is a staff study entitled, "The Macroeconomic Goals of the Administration for 1981: Targets and Realizations." This study was prepared by Thomas F. Dernburg and L. Douglas Lee of the Committee staff. It was prepared at my request as a supplement to the Committee's midyear hearings on the state of the economy. Hopefully it will assist the Members as they review President Carter's budget policies.

This study examines the Carter Administration's budget goals to determine if they are consistent and attainable. It concludes that reaching all of the goals simultaneously in 1981 is not possible. Further, the study confirms the views expressed by several of our witnesses that the key to continuing recovery lies in more expansive monetary policies.

The views expressed in this study are those of the authors and should not be interpreted as representing the views or recommendations of the Joint Economic Committee or any of its Members.

Sincerely,

Richard Bolling,
Chairman, Joint Economic Committee

July 27, 1977

Honorable Richard Bolling
Chairman, Joint Economic Committee
United States Congress
Washington, D. C. 20510

Dear Chairman Bolling:

Transmitted herewith is a staff study entitled, "The Macroeconomic Goals of the Administration for 1981: Targets and Realizations." This report, which was prepared at your request as a supplement to our midyear hearings reaches the following conclusions:

(1) In order to reach the inflation target of 4.3 percent using only fiscal and monetary policies, the unemployment rate would have to rise well above its current 7 percent level. The Administration's current anti-inflation program is not powerful enough to change this overall picture significantly.

(2) Even if the inflation target were to be achieved, to reach the full employment and balanced budget targets, non-residential fixed investment will need to grow 10 percent per year in real terms for five consecutive years. This necessitates rapid rates of expansion of the money stock which would have adverse consequences for the inflation target.

(3) The balanced budget and full employment targets are unlikely to be compatible because of structural changes in the economy which have weakened aggregate demand.

The study was prepared by Thomas F. Dernburg and L. Douglas Lee of the Committee staff. Research assistance was provided by Beverly Park.

(v)

The views expressed in this paper are those of the authors and do not necessarily represent the views of the Committee, its individual members, or other members of the Committee staff.

Sincerely,

John R. Stark
Executive Director
Joint Economic Committee

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THE MACROECONOMIC GOALS OF
THE ADMINISTRATION FOR 1981:
TARGETS & REALIZATIONS

I. INTRODUCTION

President Carter's macroeconomic goals for 1981, as revised in the Mid-Session Review of the 1978 Budget, are

- reduction of the unemployment rate to 4-3/4 percent,
- reduction in the rate of inflation to 4-3/10 percent,
- balance in the Federal budget at expenditure and revenue levels equal to 21 percent of GNP.

Although President Carter originally proposed a 4 percent inflation goal; and at one point hoped to achieve that goal as early as the fourth quarter of 1979, this target is clearly unattainable as is acknowledged in the Mid-Session Review. Table I, taken from that Review, shows that the Administration's targets now appear as shown in Table I, where it can be seen that the inflation target for 1981 is now set at an average of 4-3/10 percent.

It appears that current services outlays in 1981 are now projected as 20.4 percent of GNP while revenues are projected at 21.9 percent. These projections imply that there may be room for the introduction of some additional expenditure programs, as well as for tax reduction without violating the 21 percent of GNP target. Unfortunately, however, the revenue estimates appear to be considerably exaggerated. The yield from the

Table I

Economic Projections From The Mid-Session Review of The 1978 Budget

	<u>Calendar Years</u>					
	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
GNP in constant (1972) dollars..	1,265	1,330	1,399	1,468	1,545	1,621
Annual Rate.....	6.1	5.1	5.3	5.0	5.2	4.9
GNP deflator--annual rate.....	5.1	5.9	6.3	6.1	5.1	4.3
Unemployment rate.....	7.7	7.0	6.3	5.7	5.2	4.8
	<u>Fiscal Years</u>					
	<u>1976</u>	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Federal receipts.....	299.2	358.3	401.4	466.8	536.6	606.9
Federal outlays.....	365.7	406.4	462.9	498.6	532.7	564.8
Deficit (-).....	-66.5	-48.1	-61.5	-31.8	3.9	42.1
As percent of GNP:						
Receipts.....	18.1	19.5	19.6	20.4	21.2	21.9
Outlays.....	22.2	22.1	22.6	21.8	21.1	20.4

personal income tax between 1978-1981 is projected with an elasticity of 1.73 percent by the Administration, whereas a more normal assumption about this responsiveness is 1.60 percent.

In this report, an attempt is made to evaluate the consistency of the Administration's targets. Can we, in fact, get there from here? Doubters would point out that winding down inflation will require fairly conservative budgetary and monetary policies. It is, therefore, questionable whether the growth and employment targets are compatible with the inflation target. Similarly, balancing the budget in 1981 will necessitate a relatively restrictive budgetary policy after fiscal year 1978, so that the employment target may be incompatible with a balanced budget. Finally, if monetary policy is sufficiently expansionary to reconcile the employment and balanced budget targets, this may very well raise the inflation rate above the target level.

This report begins with the presentation of some simulations designed to estimate the consistency and feasibility of the Administration's targets. It then supplements these simulations with discussion of why full employment and budgetary balance are likely to be inconsistent goals throughout the foreseeable future. It concludes with the policy implications that are indicated by the analysis.

II. ARE THE TARGETS ATTAINABLE?

To check if the Administration's targets are consistent and attainable, we have conducted a number of computer simulations using the Wharton econometric model. The Wharton model generates forecasts whose outputs, in common with all forecasting models, are products of consistent simultaneous solutions.

However, the present purpose is not to generate a forecast; it is rather to assume certain outcomes and to check these for consistency with each other. The tool needed to conduct such an analysis is a so-called "fiscal gap" model. Because such a model has not been available to us, we have adapted the Wharton model to our purpose.

We began with the Administration's unemployment target, and by a procedure independent of the Wharton model, translated the required unemployment rate changes into a required path of real GNP growth. The method of doing this is to utilize the well-known "Okun's law" relationship according to which a reduction in the unemployment rate of 1 percent in a given year requires real GNP to grow by about 3 percent more than the growth of potential output. The rate of growth of potential output, in turn, is the rate of growth that is needed to absorb increases in productivity and growth of the labor force. Therefore, if the economy grows at the rate of growth of potential output, the unemployment rate will tend to remain unchanged.

Until recently, it was believed that real growth of about 4 percent was needed to absorb productivity and labor force growth. More recently productivity projections have

lowered this figure; in some cases to as little as 3.5 percent. From OMB's Mid-Session Review we have inferred that their assumed figure for these longer-run growth factors is 3.7 percent. We have adopted this figure here as our midpoint estimate because it seems reasonable, and also because it provides a basis for consistency between OMB's estimates and our own.

These considerations suggest the formula,

$$\Delta'Q = 3.7 + 3(\Delta u),$$

as the relationships that translates an annual change in the Unemployment rate (Δu), into a growth requirement for real GNP ($\Delta'Q$).

Our computations use the second quarter of 1977 as a benchmark. Unemployment in that quarter averaged exactly 7 percent. To achieve a 4-3/4 percent unemployment rate by 1981 implies a reduction in the unemployment rate of about one-half of 1 percent per year (0.53 percent to be exact). Using the above formula, this implies that real GNP must grow at an annual average rate of 5.3 percent between now and the end of 1981. The implied values for the unemployment rate and for real GNP (in 1972 constant prices) are shown in Table II.

Table II shows that the key target for 1981 is a real GNP of about \$1,630 billion in 1972 prices. If the more pessimistic productivity assumptions prove correct, so that potential output grows at a rate of only 3.5 percent, real GNP in 1981 would have to be \$1,615 billion to meet the 4-3/4 percent unemployment target. On the other hand the more optimistic productivity assumption which retains the traditional 4 percent growth of

Table II

Growth Requirements Associated With Target Unemployment Path

	<u>1977</u>	<u>1978</u>	<u>1979</u>	<u>1980</u>	<u>1981</u>
Unemployment Rate (%)	6.86	6.33	5.80	5.27	4.75
Real GNP* if Potential Output Grows at:					
3.5 percent	1324.1	1391.5	1462.3	1536.7	1615.0
3.7 percent	1324.4	1394.6	1468.5	1546.4	1628.3
4.0 percent	1324.8	1398.0	1475.4	1556.9	1643.0

* In constant 1972 prices.

potential output, would imply a real GNP of \$1,643 billion. Thus, the range is \$1,615 billion to \$1,643 billion, with the value consistent with OMB assumptions in the middle of this range. By examining whether the values of various forecasts fall inside this range, we can determine whether the Administration's other targets are compatible with its employment and growth targets.

Tables III, IV, and V permit comparison of 1976 actual values with the results of four separate simulations for 1981. Table III shows selected economic indicators, Table IV shows Gross National Product and its components in constant 1972 prices, and Table V shows the Federal budget in current prices on a National Income and Product Accounts (NIA) basis. All data are shown as calendar year magnitudes. With the fiscal year now beginning October 1, there is only a one quarter separation between the fiscal and the calendar year so that, for present purposes, it only creates confusion to jump back and forth between discussion of fiscal and calendar year magnitudes.

The first column of each Table shows the actual data for 1976. The second column shows the Wharton model's control solution for 1981. This is Wharton's best guess as to the likely outcome. It yields a real GNP of \$1,520 billion, which is more than \$100 billion below the midpoint of the range needed to achieve the 1981 target unemployment rate. Since the annual rate of real growth in the control forecast is about the same as the growth of potential output, there is hardly any change in the unemployment rate, which falls from the mid-1977 value of 7.0 percent to 6.9 percent. The control forecast also implies a

Table III
Selected Economic Indicators

	1976 Actual	Wharton Control	1981 Projections			
			Simulation Results			
			I	II	III	IV
Gross National Product.....	1691.6	2745.8	2720.1	2698.0	2726.6	2715.3
Annual Rate of Growth.....	11.6	9.97	9.97	9.79	10.02	9.93
Real Gross National Product (\$72)....	1264.7	1520.4	1604.1	1591.4	1516.0	1542.6
Annual Rate of Growth	6.13	3.75	4.87	4.70	3.69	4.05
Implicit Price Deflator for GNP.....	133.7	180.6	169.6	169.5	179.8	176.0
Annual Rate of Growth.....	5.14	6.20	4.87	4.86	6.10	5.65
Unemployment Rate (%).....	7.71	6.92	5.05	5.33	7.02	6.42
Real Disposable Personal Income (\$72)	890.6	1063.3	1160.4	1119.0	1051.1	1070.3
Personal saving rate.....	6.50	6.64	8.41	8.62	5.95	6.32
Nominal money supply, M ₁	304.2	431.1	432.5	413.2	433.0	434.6
Annual Rate of Growth.....	5.11	7.22	7.29	6.32	7.32	7.40
Real value of money supply (M ₁ /GNP deflator).....	227.5	238.7	255.1	243.8	240.8	246.9
Annual rate of growth.....	--	0.97	2.32	1.39	1.14	1.65
3-month Treasury bill rate.....	4.97	7.36	7.35	8.36	6.99	6.92
Moody's total corporate bond rate ...	9.01	10.11	9.87	10.43	10.05	9.43

∞

Table IV
Real Gross National Product
(In 1972 Prices)

	1976 <u>Actual</u>	Wharton <u>Control</u>	1981			
			<u>Simulation Results</u>			
			<u>I</u>	<u>II</u>	<u>III</u>	<u>IV</u>
Gross National Product	1264.7	1520.4	1604.5	1591.4	1516.1	1542.6
Personal consumption expenditures ..	813.7	970.7	1004.5	999.1	966.4	979.6
Non residential fixed investment ...	115.7	156.2	176.8	173.2	156.4	162.7
Residential structures	47.1	54.3	63.3	60.3	58.9	59.1
Change in business inventories	8.1	14.3	18.3	17.6	14.2	14.4
Exports	96.1	119.0	128.8	128.0	122.9	125.5
Imports	80.1	100.1	103.3	102.7	100.0	102.3
Federal purchases of goods and services	96.7	114.3	111.3	111.3	104.5	106.9
State and local purchasers of goods and services.....	167.4	191.7	204.7	204.7	192.8	196.7

Table V

Federal Government Receipts and Expenditures
(Calendar Years, NIA Basis)

	1981					
	1976 Actual	Wharton Control	Simulation Results			
			I	II	III	IV
Receipts	330.3	585.1	580.7	573.8	578.9	573.5
Personal tax and nontax receipts .	145.3	290.0	290.9	289.5	287.6	286.3
Corporate profits tax accruals....	55.6	63.8	53.8	49.5	59.0	54.4
Indirect business taxes*	23.5	41.2	42.6	42.5	42.5	42.5
Contributions for social insurance	105.8	190.2	193.5	192.4	189.7	190.3
Expenditures	388.9	602.9	566.8	569.6	569.2	563.5
Purchases of goods and services...	133.4	222.2	195.3	195.3	195.3	195.3
Transfer payments.....	162.1	231.1	227.0	227.4	231.2	230.0
Grants in aid to State and local governments.....	60.2	102.9	102.9	102.9	102.9	102.9
Net interest.....	27.5	33.3	28.1	30.5	26.3	21.8
Subsidies less current surplus of government enterprises.....	5.6	13.5	13.5	13.5	13.5	13.5
Surplus (+) or deficit (-)	-58.6	-17.7	13.9	4.2	9.6	10.0
Addenda: As percent of GNP						
Receipts.....	19.5	21.3	21.3	21.2	21.2	21.1
Expenditures.....	24.0	22.0	20.8	21.1	20.9	20.8

* Includes estimated effects of Administration energy proposal.

disappointing average annual inflation rate of 6.2 percent.

The policy assumptions in the control solution are a 7.2 percent rate of growth in the nominal quantity of money, M1. It also assumes that expenditures will be 22 percent of GNP in 1981, while revenues are 21.3 percent. Thus, a deficit of \$17.7 billion is forecast. It should be noted that despite the poor performance of the economy in this control forecast, the budget is actually more stimulative than the Administration's target for 1981 calls for it to be.

In our first simulation (column 3) we constrained the budget to yield approximate balance at the 21 percent of GNP target. We also introduced the Administration's most ambitious inflation target -- namely, a reduction in the inflation rate to 4.0 percent by the end of 1979, and maintenance of that rate thereafter. Although we regard this inflation assumption as completely unrealistic, the imposition of this constraint on the simulation produces results that are most instructive and useful.

Because the rate of growth of the nominal stock of money remains practically unchanged, the drastic arbitrary reduction in the inflation rate raises the rate of growth of the real value of M1 to an average annual rate of 2.32 percent as compared with 0.97 percent in the control solution. The result is a much stronger economy, although the real value of Federal purchases has been reduced by the balanced budget constraint, the lower inflation rate improves the competitive position of the economy, causing a substantial rise in the real value of exports. Similarly, the rise in the rate of real monetary growth, combined with a lower

inflation rate, causes the long-term interest rate to fall, and this adds substantially to all three components of investment. For 1981, non-residential fixed investment is 13.8 percent above the control forecast; residential construction is 16.6 percent higher, and inventory investment is nearly 30 percent higher. These sources of strength raise real disposable income and therefore increase real consumption expenditure despite a sharp rise in the personal saving rate from 6.64 percent in the control forecast to 8.41 percent in the simulation. (It may be noted that the saving rate is quite sensitive to the inflation rate in the Wharton model. Whenever the inflation rate is low, anticipatory buying is also low, and the saving rate is therefore high.)

The first simulation yields a real GNP of \$1,604 billion for 1981, and an unemployment rate of 5.1 percent. It, therefore, comes close to generating sufficient strength to achieve the unemployment rate target set by the Administration. It may be concluded that, if miraculously the inflation rate were to follow the path arbitrarily imposed here, all the Administration's targets could be achieved provided that monetary policy does not reduce the nominal rate of monetary growth. Because the budget is balanced, most of the strength has to come from private investment and from a strong foreign sector. In particular, non-residential fixed investment grows at a rate of almost 9 percent in real terms, and it is able to do this because of the easier monetary conditions assumed in the present simulation.

To get real GNP up by the additional \$15 billion needed to achieve 4-3/4 percent unemployment, non-residential fixed

investment would have to grow even faster than 9 percent per year. Indeed, the Administration has conceded that a 10 percent annual rate of growth of non-residential fixed investment would be required.

A question that needs to be addressed is how monetary policy would actually behave if the inflation news is unexpectedly favorable. Some might argue that this will permit the Fed to relax its battle against inflation and prompt it to step up the rate of monetary growth in the interest of faster recovery. Others would argue that the Fed will not relent until the inflation rate falls to well below 4 percent. It is our view that this latter reaction is the more probable one; and this implies that the rate of nominal monetary growth will be reduced whenever the inflation rate falls. Our second simulation reflects this assumption. We now assume that the Federal Reserve will finance our target rate of real growth (5.3 percent) with additional allowance for a 4.0 percent rate of inflation. From the sum of these two rates, we deduct allowance for a secular rise in velocity of M1 of 3.1 percent. The result is a rate of nominal M1 growth of 6.2 percent in 1981, and an annual average rate of growth of 6.3 percent for the period 1976 to 1981. In this manner, the average rate of growth of real M1 is cut back from the 2.3 percent of the first simulation to 1.4 percent.

This change in monetary policy assumptions considerably weakens the economy. Because the inflation assumptions remain the same, the export sector remains strong. However, the tighter monetary conditions imply higher short and long term interest rates and this takes its toll on all components of investment spending. This weakening also reduces real disposable income

and therefore reduces real consumer spending. Real GNP falls to \$1,591, or about \$15 billion below the level of the first simulation. Unemployment, at 5.33 percent, remains well above the 1981 target. Note, finally, that the weaker economy raises Federal expenditures, primarily interest payments, and lowers Federal revenues and, therefore, causes the \$14 billion budget surplus of the first simulation to shrink to \$4 billion.

In our third simulation, we abandon the unrealistic inflation assumption of the first two simulations and assume instead that the deflator for GNP rises at an annual rate of 6 percent after 1977. Monetary policy once again attempts to accommodate real growth of 5.3 percent, plus allowance for inflation less the secular rise in velocity. In this case, the path of M1 -- indeed, the path of the entire economy -- is very similar to the control forecast. The real quantity of money and long-term interest rates are virtually the same as in the control. However, because of the balanced budget constraint, there is a deflationary swing of about \$27 billion in the budget. This makes for a weaker economy through lower real Federal purchases and consumption, but since the more restrictive fiscal policy reduces short-term interest rates, this weakening is partially offset by slightly stronger investment than in the control solution.

The final simulation incorporates the inflation assumptions presented by the Administration in the Mid-Session Review. Because of the more optimistic inflation assumption relative to the preceding simulation, the real quantity of money again grows somewhat more rapidly, so that the economy is again somewhat stronger. However,

neither in this case nor in the preceding simulation, does the growth of GNP proceed at a rate fast enough to come anywhere near the target range for real GNP.

In conclusion, these simulations illustrate the awkward position the Administration has gotten itself into by promising a combination of economic targets that are plainly inconsistent. According to the control solution, the economy will be too weak to reach full employment, and inflation will exceed the target rate. To reduce inflation to the target rate using restrictive fiscal and monetary policies would require a set of policies that would raise the unemployment rate in 1981 well above the current rate of 7 percent. Indeed, the adverse implications of the old-time religion policies would lower inflation to 4.3 percent by 1981, are so horrendous that we did not even consider it worthwhile to undertake the simulation. Further, the non-macroeconomic portions of the Administration's anti-inflation program are not powerful enough to change the overall picture significantly.

Only pure good luck -- a reversal of the shocks of 1974 -- including bumper world food harvests and massive and unexpected increases in energy supplies, would reduce both the inflation and the unemployment rates. That is the only way inflation can be slowed without also slowing real growth through restrictive monetary-fiscal policies, or without introducing a yet to be invented anti-inflation program that does not need to rely on demand restriction.

The foregoing is the message of the first simulation. But as the second simulation showed, it is not enough to have

good luck, since attainment of the targets must also be combined with a willingness on the part of the monetary authority to permit the real rate of monetary growth to rise as the inflation rate declines under conditions in which the inflation rate continues to remain high by historical standards.

III. BASIC QUESTIONS RAISED BY THE ADMINISTRATION'S TARGETS

Under prodding by Chairman Bolling at the JEC hearing of June 9, Chairman Schultze of the Council of Economic Advisers clarified a number of aspects of the Administration's 1981 targets. Chairman Schultze indicated that:

- the employment target is more important than the balanced budget target;
- the purpose of the balanced budget target is to serve as a basis for fiscal planning. Its importance is that it ensures the prevention of inflation should the private economy be strong enough to carry the economy back to full employment;
- balancing the Federal budget in 1981 will be possible only if the performance of the private sector of the economy is extremely strong.

Each of these points raises important questions: (1) Is an unemployment rate of 4-3/4 percent deserving of being regarded as full employment? (2) What is the rationale for the balanced budget target as a basis for fiscal planning? (3) In view of the importance of generating strength in the private sector, what is being planned or done to assure such strength without added budget cost?

The first of these questions is bypassed here because it has been extensively analyzed and discussed by the JEC in its Report of

1977. 1/ There is no need to repeat that discussion here. For present practical purposes, the Administration's 1981 target of 4-3/4 percent is accepted as the definition of full employment, even though, and as we have said before, such a target is woefully unambitious.

The second question is why the balanced budget target for 1981 plays such an important role in the Administration's plans. Chairman Schultze would certainly not approve of attempts to balance the budget when the economy is at less than full employment. Such policy has long been recognized as harmful because it would reduce, rather than increase, the Federal Government's contribution to aggregate spending during recession.

As a substitute for annual balance, many fiscal economists have advocated annual balance of the full employment budget. This prescription is a great improvement over the simple balanced budget rule because it rejects restrictive fiscal measures as a response to the lower tax yield and higher transfer expenditures that accompany a sluggish economy. On the other hand, observing this rule would not always provide sufficient aggregate expenditure to make up for deficiencies of private sector demand. In FY 1976, for example, the full employment budget was roughly balanced; but the economy remained a long way from full employment because private spending continued to be depressed.

1/ See, The 1977 Joint Economic Report, March 15, 1977, Chapter 4.

The economy would have been far better off in FY 1976 if the full employment budget had been in substantial deficit. However, Chairman Schultze has often said that he is reluctant to accept such a deficit because of the fear that added expenditure programs or tax reductions will affect the permanent fiscal base of expenditure and revenue. If that happens, and if private demand recovers, the economy could overshoot the full employment mark, and inflation would then be the consequence. In the past, Congress has sometimes added public works programs in an effort to combat recession, only to find that the bulk of the outlays do not materialize until after the recession is over. The result of such mistiming has been inflation.

2/

The above is an important consideration. However, fears that such mistiming will happen again may be exaggerated. As pointed out in a Senate Budget Committee staff study, 3/ a deficit in the full employment budget need not lead to an actual deficit at full employment because it will take time to get to full employment. The Administration does not think we will get unemployment below 5 percent until 1981. During the intervening

2/ See Nancy H. Teeters, "The 1972 Budget: Where It Stands and Where it Might Go," Brookings Papers on Economic Activity, 1971, No. 1, for a discussion of the timing pattern of the accelerated public works program of 1962.

3/ "Long Range Fiscal Strategy: Revenue Options," Committee on the Budget, United States Senate, October 9, 1975. See especially Chapters 5 and 6.

four years we will have growth of potential GNP, and with this we will have automatic growth of potential Federal revenue. Because of the progressivity of the personal income tax, this growth will be faster than the growth of nominal potential GNP. This will provide a revenue margin that will be large enough to ensure that most reasonable permanent increases in spending above the current services level, if undertaken soon, would not cause a deficit when (and if) full employment is reached.

As pointed out in the report cited above, the more sophisticated budget rule implied by these considerations is that it is pointless to attempt to balance the full employment budget until the time when full employment actually has some chance of being attained. Because of the extreme depth of the present recession, that time is at least four years away. Within reasonable limits, therefore, it is entirely appropriate to raise the full employment (and actual) deficit in FY 1978 and perhaps also in FY 1979, because the risk that this will cause a deficit when the economy reaches full employment is minimal.

Chairman Schultze's concept that the budget should not be in deficit at full employment is quite consistent with the notion that deficits in the full employment budget are permissible when full employment is still a long way off. The difficulty is that these principles generally assume that the economy is free from the kind of structural problems that might require budget deficits to offset weaknesses in private demand that are more than cyclical, and instead likely to persist to 1981 and beyond.

For full employment and budgetary balance to be compatible, the combined income receipts generated by the non-Federal sectors when the economy is at full employment must equal the combined expenditures of these sectors. However, if a particular component of non-Federal expenditure remains weak for an extended period of time, total outlays in the economy will not be sufficient to purchase the goods and services that the economy is capable of producing at full employment. When this happens, either GNP will decline and the economy will fall below full employment, or the Federal Government must be prepared to run a deficit. This deficit will prevent GNP shrinkage either by providing additional demand directly through Government purchases of goods and services, or indirectly through tax reductions that raise consumption and investment spending.

A substantial number of economists now believe that there are long-range structural problems afflicting our economy that may cause several components of non-Federal demand to remain below their normal historic shares of GNP. Because of this, total spending in the foreseeable future is not likely to be sufficient to purchase the economy's full employment output without a budget deficit. The "stagnationist" theorists point to factors such as the following:

(a) The Administration has acknowledged, and our simulations confirm, that attainment of full employment and budgetary balance in 1981 will require non-residential fixed investment to grow at a rate of 10 percent in real terms over a sustained five-year period. Such an investment rate would raise the share of fixed investment of GNP to

well above the past "normal" ratio of about 10.3 percent.

To complicate matters, there are economists who believe that even the 10.3 percent ratio of fixed investment to GNP is not likely to be restored. For example, Professor Dale W. Jorgensen of Harvard University argues that the rising cost of energy has produced an incentive for business to switch from capital to labor intensive methods of production. If this argument is correct, the economy's ratio of capital to output will tend to fall over the next several years. This will also mean that the annual share of new output devoted to capital formation will remain below 10.3 percent.

(b) Population trends and the energy shortage are very likely to reduce the resources needed for public school and highway construction. Spending by State and local governments could, therefore, become a relatively weaker source of demand growth than has been the case in recent decades.

(c) There is reason to be pessimistic about the prospects for our foreign sector. A flood of oil imports combined with partial recovery has produced very large current account deficits in recent months. Continuing recovery at home will widen the deficit by raising the demand for imports, whereas recovery abroad will narrow the deficit because of the favorable effect of such recovery on export demand. It is unreasonable to expect the economy to receive any net stimulus from abroad in the next few years, and, indeed, the likelihood is that the purchasing power drain will continue as long as the OPEC surpluses continue and as long as growth in other industrial countries remains sluggish. The sharp increases in

exports of 1973 and 1974, which largely reflected agricultural exports in response to poor world food harvests, are not apt to be repeated.

Much will depend upon the movement of international capital in the next few years. Recently, the dollar has fallen somewhat in value relative to other currencies. Such a drop in the international value of the dollar has a beneficial effect for the economy inasmuch as it makes our goods more competitive abroad, and it makes imports more expensive to our own citizens. Consequently, a fall in the value of the dollar tends to improve the current account and reduces the purchasing power drain that is caused by a deficit in the current account of the balance of payments.

Recently, there has been speculation that investors in Europe are becoming nervous. Unstable coalition governments are pervasive throughout Europe; there is fear of war in the Middle East; and even Switzerland may no longer be viewed as a haven for financial capital in the wake of financial scandal. Some writers predict -- perhaps prematurely and perhaps erroneously -- that the next few years will witness a capital flight to the United States similar to the one that preceded World War II. If that happens, it will help to finance the deficit in the current account of our balance of payments. But unfortunately, it will also tend to enlarge the current account deficit because the capital inflow will raise the price of the dollar, and this, in turn, will depress exports and encourage imports. The net effect for the economy would be a deflationary switch of spending away from the domestic economy towards foreign economies. This switch would have to be offset by an

equivalent increase in the Federal budget deficit, if its deflationary impact is to be neutralized.

The third point made by Chairman Schultze -- and confirmed by our simulations -- is that attainment of full employment and budgetary balance in 1981 will require extraordinary strength in the private sector of the economy. Non-residential fixed investment has been especially singled out as a component of demand that must show very rapid and sustained growth. Growth of non-residential fixed investment at an annual rate of 10 percent, in real terms, and for a sustained period of five years, is not unprecedented, having occurred during the period 1961-1966. However, that particular performance was nurtured by expansionary Federal budgets, and it followed almost a decade of sub-par capital formation. It was, moreover, accompanied by willingness on the part of the Federal Reserve to provide a reasonably accommodative monetary policy.

If investment is to grow rapidly without benefit of a stimulative budget, this will necessitate a much more expansionary monetary policy. Unfortunately, there seems to be very little inclination on the part of the Administration to insist on termination of the conservative monetary policies that the Federal Reserve has pursued for the last four years.

As long as excessively slow rates of monetary growth persist, homebuilding, consumer installment buying, and State and local borrowing will all be held back. The combination of high interest rates and low stock prices will keep the market value of business assets low relative to their replacement cost and this will prevent the

rapid rise of fixed investment that is essential if we are to get at all close to the targets.

Expansionary monetary policy could help to rectify this situation by raising the market value of financial assets and reducing borrowing costs for new physical capital. Thus far, there is no indication of any such change in policy. Since the Administration is counting on fixed investment to lead expansion, it will have to take radical steps to redirect monetary policy if the announced targets are to be achieved.

Monetary policy can also play an important role in improving one of the other trouble spots cited earlier -- the current account of the balance of payments. A more rapid rate of monetary growth would lower interest rates and promote an outflow of short-term capital. This would raise the international demand for foreign currencies and cause the international exchange value of the dollar to fall. Our exports would then become less expensive to foreign buyers, and at the same time foreign goods would become more costly here. There would, therefore, tend to be an improvement in the current account of our balance of payments as a result of an expansionary monetary policy, and this would have a stimulative effect on our economy. Such action, moreover, might prod other industrial countries into expanding their economies.

In Summary: The 1981 balanced budget constraint removes a great deal of potential flexibility from stabilization policy. If this budget target is to be taken seriously, full employment can be achieved only by aggressive resort to monetary policy. The all important question that now cries for an

answer is whether the Administration will attempt to put pressure on the monetary authorities in the interest of achieving its economic goals, or whether it will continue to permit the Fed to operate as a sovereign power, free to pursue its own aims, regardless of whether these are consistent with those of the Administration and the Congress.

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