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THE 1980 MIDYEAR REVIEW OF THE ECONOMY: THE RECESSION AND THE RECOVERY

REPORT

OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

together with

ADDITIONAL VIEWS

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INTRODUCTION BY SENATOR LLOYD BENTSEN, CHAIRMAN

This 1980 Midyear Report is the fourth consecutive unified report issued by the Joint Economic Committee. The Committee's Democrats and Republicans have risen above partisan politics during the middle of a highly charged election year because we know that our country faces serious economic problems and we are determined to work together to help find solutions to those problems.

The consensus reports of the Joint Economic Committee are helping to forge a consensus within the Congress and the country for long-term policies to increase the capacity of the economy to produce as opposed to the temporary palliatives that result in short-term bursts of false prosperity, only to be followed by serious economic downturns.

Near the Nation's Capitol, a valuable saying is carved on one of the monuments of the National Archives. It says, "Study the past." Sage advice, although it is—for whatever reason—abbreviated. The full admonishment, attributed to the philosopher Confucius, is: "Study the past if you would divine the future."

In preparation for its 1980 Midyear Report, the Joint Economic Committee heeded that advice and studied the economic trends and recessions since World War II. After examining actions taken to combat those economic slumps over the last 35 years, the Committee is convinced that government responses too often have been too late and too ineffective to influence recessions. That conviction, detailed in this Midyear Report, follows by 6 months the 1980 Annual Report, which was aimed at ushering in a new era of economic thinking—an era in which there would be balance between demand and supply side economic policies. There was a special message in the Annual Report: America does not have to fight inflation during the 1980's by periodically pulling up the drawbridge with recessions that doom millions of Americans to unemployment.

There is a special message in this Midyear Report as well: that once the American economy has entered a recession, Congress' attention should focus on programs which enhance the quality of the recovery. Chief among these are supply initiatives which can help pave the road to an early recovery and put us on a steady, predictable growth path which will create jobs and hold down prices by putting more goods on the shelves of the Nation's businesses.

In our 1980 Annual Report, we expected that rising taxes or recession, or both, would lead to a tax cut designed to increase productivity through providing incentives for individuals and firms to save and invest and by offsetting the increasing burden of payroll taxes and inflation induced taxes on individuals. That is still our expectation.

Any tax cut that is enacted should be carefully designed to improve productivity, ease the pains of inflation and create long-term, permanent jobs. The Committee further believes that existing public and private training and education programs should be used to relieve the joblessness among the poor, among minorities and young people by utilizing the market knowledge of private employers who offer the best assurance that relevant job experience and training will be provided.

In the past 35 years, there have been six recessions, driving into the jobless ranks millions of Americans who were producing, who wanted to produce more, and who were contributing—with dignity—to this Nation. A stagnant economy chops off the ladder of success in the middle, affecting those who are attempting to start the climb and those who are only part way up.

Inflation and unemployment are interrelated problems requiring long-term solutions which can be characterized by one phrase—"greater and more efficient production." This Report calls upon the Congress to adopt long-term policies to insure moderate demand restraint and greater productivity, which is the best way to simultaneously attack the twin problems of inflation and unemployment during the decade of the 1980's.

INTRODUCTION BY REPRESENTATIVE CLARENCE J. BROWN, RANKING MINORITY MEMBER

The current recession will end, thank goodness. Any expensive Federal efforts to make it shorter or more shallow will come too late, as usual. Programs to offer social relief for those who are unemployed and need assistance have humanitarian benefits, but will not restore to these people the benefits of productive employment. Rather, we should concentrate on the long-run policies that will lay a foundation for productive private market economic prosperity in the 1980's. This is the message of the Joint Economic Committee 1980 Midyear Report, and I agree with it.

While recognizing the seriousness of the social impacts of current economic conditions, this Midyear Report recommends that Federal economic policy not focus on the recession, but concentrate on the recovery and the achievement of the objectives set forth in previous JEC reports—expanding the capacity of the economy to increase the standard of living for all Americans over the long run.

In June 1979, Chairman Bentsen and I called for supply-stimulating tax cuts for businesses and individuals to encourage savings, investment, productivity improvement, and economic growth. Had we enacted those cuts last year, we could have avoided the worse of our present economic crisis and we would have taken our first major step toward building a base for enhanced real economic growth in the 1980's.

Excessive taxes are the bane of the economy. Even without any further action by Congress, Federal taxes are now programed to increase by $1.9 trillion during the 1980's as a result of social security increases already enacted, from inflation-induced income tax increases and from increases moving toward world market pricing and windfall profits taxes on domestic crude oil production. Inflation-induced taxes alone will drain $1.2 trillion from our citizens in the 1980's, assuming inflation rates of 9 to 12 percent at the beginning of the decade and tapering to 5 or 6 percent at the end of the decade.

Some of these tax increases may be justified by the need to shore up social security and curb energy consumption and stimulate domestic oil production. However, increases in Federal taxes on labor, savings, and investment will dampen the recovery from the current recession and will sap vital sources of economic growth in the 1980's.

Prompt action to improve allowances for depreciation and to increase incentives to save and invest are the two most important supply side steps that Congress could take. It is certainly true that any tax cuts under consideration for the next few years should be supply side tax cuts. It is *not* true, however, that all supply side tax cuts are the same or only are special benefits for business. Personal tax rate reductions that increase the supply of savings or expand the amount of labor also are on the supply side. In seeking to balance tax reductions for business with those for individuals, the Congress should not assume that the part of the tax package benefiting individuals must reduce government revenues in an inflationary demand-side way. Specifically, tax cuts which induce increases in savings and increased depreciation allowances enlarge the savings pool to finance Federal deficits or pay for increased investment without creation of additional money, which is inflationary. Such tax cuts are not inflationary. To get such non-inflationary improvement of U.S. industrial productivity and competitiveness, we must press forward with a supply side tax reduction package now—savings incentives, enhanced depreciation allowances, and marginal rate reduction on individual income taxes. And the fact is, such reductions may not even catch up with already scheduled tax increases.

The American people and the American economy are ready to grow again. All we need is to get back some of the after-tax incentive that recently voted tax increases and inflation have taken away.

Chapter I. REVIEW AND OUTLOOK

Review

The perils of economic forecasting never have been more apparent than in the first half of 1980. At the beginning of the year, most economists were predicting a mild recession with some drop in inflation and some increase in the unemployment rate. Many forecasts were revised after the events of the first quarter: both the Consumer Price Index (CPI) and the Producer Price Index (PPI) increased at seasonally adjusted annual rates exceeding 18 percent, approximately 5 percentage points more than their rates of increase in the last quarter of 1979; the unemployment rate rose from 5.9 percent in December 1979 to 6.2 percent in March 1980; and the annual rate of change in real gross national product (GNP) was 1.2 percent—down from 2.0 percent in the last quarter of 1979, but still positive.

In light of these developments, most forecasters significantly modified their predictions—some removed their recession scenarios altogether. The comparison between the Administration's January and March forecasts is typical: the estimated drop in real GNP (fourth quarter 1979 to fourth quarter 1980) was changed from 1.0 percent to 0.4 percent; the projected increase in the CPI was raised from 10.7 percent to 12.8 percent; and the estimated fourth quarter unemployment rate was reduced from 7.5 percent to 7.2 percent.

But the early spring revisions were inaccurate; in most cases, they were in precisely the wrong direction. In the second quarter the economy was in what has been described as a "free-fall" situation. Preliminary figures indicate that real GNP decreased in the second quarter at a seasonally adjusted annual rate of 9.0 percent.

The economy has been gradually weakening for over a year as inflation, income transfers to the Organization of Petroleum Exporting Countries (OPEC), and rising taxes have stretched incomes thinner and thinner. Consumers were able to offset this for a while by reducing their savings rate to 3.5 percent in the fourth quarter of 1979, the lowest in 30 years, and raising the household debt-to-income ratio to a record high. But a retrenchment began in February, and the Federal Reserve Board's March 14 action to restrict the use of consumer credit accelerated the decline in consumer spending.

The housing market continued the slide begun last year. The combination of rising prices, extraordinarily high mortgage rates, and a scarcity of funds brought a drastic slowdown to the homebuilding industry. Housing starts fell to an annual rate of 0.9 million in May before rising to a 1.2 million rate in June and 1.3 million in July.

The unemployment rate rose sharply in the second quarter, from 6.2 percent in March to 7.0 percent in April and 7.8 percent in May (the largest 2-month increase on record), before leveling off at 7.7 percent in June and 7.8 percent in July. Since March, the number of unemployed persons has risen by more than 25 percent, to over 8 million. The unemployment rate for black teenagers is about 37 percent, little changed in the past year. Consistent with the pattern of reductions in consumer spending, unemployment is much more concentrated in the automobile, construction, and steel industries than has been the case in previous years.

A few other statistics confirm the speed of the second quarter's decline. In April, all of the leading indicators fell simultaneously, a rare occurrence. Industrial production has fallen for 6 months in a row, and retail sales dropped for 4 consecutive months, before rising moderately in June and July. Auto sales in the second quarter were at a 7.7 million annual rate, and imports accounted for 29 percent of the cars sold, up from 22 percent in 1979 and 18 percent in 1978. However, auto sales improved to an 8.9 million annual rate in July.

One encouraging sign is that the rate of inflation, as measured by the Consumer Price Index, has slowed in recent months, although much of the slowdown may be transitory. In the early months of 1980, the rate of increase in the CPI exceeded 18 percent. But that high level, as measured by the CPI, was due in part to the very rapid escalation of mortgage interest rates and rising energy costs. The GNP deflator, which treats housing and energy costs differently, increased at a 9.5 percent rate during the same period.

Now that the increases in energy costs have slackened (the energy CPI rose at an 8 percent annual rate in the second quarter, down from a 65 percent rate in the first), we are seeing the other side of the same phenomenon. The CPI rose in the second quarter at an 11.6 percent annual rate, and this could easily fall to within the 8 to 9 percent range before the end of the year, as the fall in interest rates begins to show up in the index. In addition, if gasoline prices are merely stable throughout the summer, the normal pattern of seasonal adjustment will cause the increase in the CPI to slow significantly. However, a new round of energy price increases later in the year, together with food price increases as a result of the adverse weather conditions in the farm areas this summer, could offset some of the recent progress in the fight against inflation.

Fiscal and Monetary Policy

Between the fourth quarter of 1978 and the fourth quarter of 1979, the high employment budget shifted from an annualized deficit of $10.0 billion to a surplus $10.4 billion, a swing of over $20 billion in the direction of fiscal contraction. Fiscal policy tightened somewhat further in the first half of 1980; at an annualized rate, the high employment budget surplus was $13.1 billion in the second quarter of 1980, an increase over the fourth quarter of 1979 of nearly $3 billion.

The contractionary posture of fiscal policy has been matched by tighter monetary policy during the first half of 1980. The degree of tightness is under dispute. The rate of growth of the narrowly defined aggregates slowed sharply over the period. The growth of the larger aggregates, which included more interest-bearing assets, slowed by much less. A large part of this apparent discrepancy can be explained by a shift of deposits out of the non-interest-bearing or low-interest accounts which form the bulk of the narrower aggregates into the higher yielding assets which are included in the broader aggregates.

During the early months of 1980, interest rates escalated sharply. One school of thought attributes this increase to the slower rate of money growth. Another viewpoint holds that interest rates merely rose to reflect the equally sharp surge in inflation in early 1980. Since March, interest rates have plummeted although in recent weeks they have risen slightly. Some attribute the decline partly to the credit control program instituted on March 14, and partly to the precipitous decline in the level of economic activity. Others attribute the drop to the expected sharp decline in the inflation rate in the last half of the year, after the unsustainable rates of the first quarter, and growing evidence that the Federal Reserve intended to remain in a disinflationary posture.

Outlook

In spite of the fall in real GNP in the second quarter, the six previous postwar recessions show that the size of the initial drop in GNP is not necessarily an accurate guide to the recession's length or severity. The consensus among forecasters is that the total peak-to-trough drop in real GNP will be about 4 to 5 percent with the low point occurring in the third or fourth quarter of this year. While the recent track record of forecasters suggests that their crystal balls are at best imperfect, they are still one of the few guides to a largely uncertain future.

The main differences among forecasters today concern the speed and extent of the recovery. The Administration's Midsession Budget Review predicts that, for 1980 as a whole, inflation will be 12.0 percent as measured by the Consumer Price Index, and 10.1 percent as measured by the GNP deflator. Because these two indexes rose at annual rates of 14.8 percent and 10.0 percent for the first half of the year, the forecast implies rates of 9.3 percent and 10.2 percent for the second half of 1980. The corresponding estimates for 1981 are 9.8 percent and 9.7 percent.

The Administration also predicts a drop in real GNP of 3.1 percent for 1980. For the first half of the year, real GNP fell at a 4.0 percent annual rate. Thus the forecast implies a further decrease at an annual rate of 2.1 percent in the second half. For 1981, the Administration foresees a turnaround to real growth of 2.6 percent.

For the fourth quarter of both this and next year, the unemployment rate is projected to average 8.5 percent, up from June's 7.7 percent. This means that the unemployment rate will still be rising at the end of 1980 and will reach a peak above 8.5 percent early in 1981.

It should be noted that all of the Administration's forecasts are based on an assumption of no tax cut in 1981.

The Administration's Review is somewhat comparable to the consensus among leading private forecasters, though they generally assume a tax cut. For example, Data Resources, Inc. (DRI), Chase Econometrics, and Wharton Econometric Forecasting Associates believe that the peak level of real GNP reached in the first quarter of 1980 will not be attained again until the last quarter of 1981 or the first quarter of 1982. All three forecasters predict that the unemployment rate will peak at a rate above 8.5 percent sometime between the end of this year and the middle of 1981, but that it will decline very slowly and average 7.5 percent or higher in 1982. According to the Congressional Budget Office, unemployment could go as high as 9.4 percent in the fourth quarter of 1980.

With regard to inflation, the short-run outlook depends on the choice of index. As discussed above, the Consumer Price Index has recently overstated the rate of inflation due to its treatment of housing costs. This may be reversed in the short run if the drop in interest rates persist, and the CPI could increase at annual rates as low as 7 to 8 percent before the end of this year. The GNP deflator will show a more steady pace in the 9 to 10 percent range for the remainder of the year.

In summary, economic growth and employment have deteriorated rapidly since early 1980 and may not improve until 1981. The rate of increase in the Consumer Price Index has fallen sharply, but some of this reflects the distortions in the CPI.

Although the current recession will be worse than average, it may not be as bad as the 1973–75 experience. The critical question at this time is the prospect for the recovery. One thing that could reduce the strength of the recovery is the burden of taxation weighing on the private sector resulting from both inflation-induced taxes and from legislated tax increases. Unless Congress undertakes important policy changes, the recovery is likely to be very weak, and the recovery and the entire decade of the 1980's could be characterized by simultaneously high rates of inflation and unemployment.

Chapter II. THE RECESSION

A review of the business cycles in the past 35 years shows that government attempts to shorten the duration or reduce the intensity of recessions through countercyclical programs initiated during specific downturns have been ineffective. In a number of instances, the effects of such efforts have been quite different from what was intended. Programs designed to reverse downward economic trends during recessions have frequently accelerated upward trends during the periods of recovery, sometimes with unfortunate results. The explanation for this phenomenon lies mostly in a series of delays that take place between economic performance, the perceptions of economists and policymakers, policy proposals, actions, and economic results.

The Record of Earlier Recessions

There were six recessions in the period 1945–79. These occurred during 1948–49, 1953–54, 1957–58, 1960–61, 1969–70, and 1973–75. An examination of the recessions reveals several uncertainties which increase the likelihood that the Government's responses have been too late to affect the recessions. In the first place, the onset of a recession is rarely, if ever, accurately anticipated, and the existence of a recession may not be known until several months or quarters after it has begun. For example, the 1954 Economic Report of the President submitted to Congress in January of that year asserted that the economic state of the Nation was "marvelously prosperous," although the downturn had begun in July of 1953. Similarly, not until Congress convened in 1958 was it fully realized that a recession was in progress, although it had started the previous August.

The first recession of the next decade began in April 1960, but economists and government officials were still debating whether a recession was underway during the latter part of that year. The relatively brief recession of 1969–70 ended before most people realized it had taken place. The President gave assurances in February of 1974 that there would be no recession that year, unaware that a downturn began in November of 1973, and as late as October 1974, the President stated that the Nation was not in a recession. In August, the President had proposed a tax increase. Only in November 1974, did the President acknowledge the existence of what was then the longest and deepest recession since World War II. Most recently, the National Bureau of Economic Research (NBER) determined in June of this year that the seventh recession since World War II began in January.

The present period typifies the uncertainty surrounding the starting time of a recession as well as the uncertainty about its intensity and duration. It is no more possible to predict confidently when a recession will begin than it is to predict how deep it will go or how long it will last. Most forecasters expected a recession to begin in 1979 and some predicted it for 1978. As mentioned in Chapter I, in January of this year, most forecasters were predicting a mild recession. Indeed, early in the year some forecasters began wondering whether there would be any recession at all in 1980.

These uncertainties present policymakers with several dilemmas. One is that the recession will always be partly over and may be mostly over before it is firmly established that the economy is in a downturn. This is accentuated by the fact that, in most cases, the NBER waits until it is clear that the gross national product has declined for two consecutive quarters before formally declaring a recession. Another dilemma is that during much of the recession it is not known whether it will be deep or mild, long or short. The ending of a recession is as hard to predict as the beginning, and economists and policymakers often do not realize the economy has turned upward until several or more months afterwards.

The lag that occurs in changes in the economy and the recognition of such changes is followed by a sometimes equally long lag in the taking of government action. Except for the automatic stabilizers, such as unemployment compensation and welfare payments which do not require discretionary actions, antirecessionary fiscal policy initiatives generally require two steps. One is a decision on the part of the President; the other is by Congress. Of course, the order of this procedure can be reversed, with Congress taking the initiative followed by Presidential approval or disapproval. Most often, the President will propose one or more major programs to counter a recession, and these will be debated and modified by Congress. It is possible for the President to veto a bill originally proposed by him because of the changes imposed by Congress.

The steps in this process do not always lead to unusual delays, but they frequently do. In view of the time that may have elapsed in the recognition of a recession, even a 1- or 2-month delay means an action may be too late to affect the course of the downturn.

Fiscal Actions

A few examples will illustrate the consequences of delays in the taking of government action.

In 1954, in the midst of a recession that was more than one-half over, the President proposed a number of stimulative programs, including expansion of public works and tax reductions. The most significant action taken, although not intended for antirecessionary purposes, was a tax cut of about $7 billion, enacted late in the year, several months after the upturn began. In 1958, congressional leaders urged a number of antirecessionary steps, and measures were adopted in April and May of that year to stimulate residential construction and increase unemployment compensation. But the downturn ended in April 1958.

Although the 1960–61 recession ended in February 1961, antirecessionary actions were not taken until 1961 and 1962. The 1961 actions consisted of acceleration of tax refunds, increased social security benefits, increases in Federal housing programs, and the Area Redevelopment Act (a program of grants and loans for business and public works). None of these actions had any effect in reversing the downturns and only one, the acceleration of tax refunds, added significant stimulus to the recovery. About $2.1 billion in tax refunds were paid in the first 3 months of the year. The other actions were not completed until May and June. In September 1962, Congress authorized $900 million for an accelerated public works program, also intended to counter the 1960–61 recession, but then in October appropriated only $400 million for it. The Revenue Act of 1962, containing a 7-percent investment tax credit, was held up in Congress for 18 months before enactment.

Major tax proposals, whether for antirecessionary or other purposes, are commonly delayed for many months. The Revenue Act of 1954 took 15 months to enact, the Revenue Act of 1964 took 13 months, and the Revenue and Expenditure Control Act of 1968 was delayed for 18 months. The Tax Reduction Act of 1975 is an example of relatively swift action. It was proposed by the President in February 1975, and passed by Congress the next month. By then, the recession was over, but Congress acted again the following December to extend the tax cuts for an additional 6 months.

The Public Works Impact Program was approved in 1972 to fight the recession that ended in 1970. Two public works programs were enacted in response to the 1973–75 recession—the Local Public Works Capital Development and Investment Act and the Local Public Works Employment Act. Both were approved after the recession ended, the former in 1976 and the latter in 1977.

There are other problems in the use of public works as antirecessionary measures: the delay that occurs in hiring once funds are available for construction, the lower labor intensity of public works projects, the fact that the unemployed typically do not have the skills required in construction activities, the short duration of public works employment for individual workers, and the high costs of public works employment.

The delays in recognition of a recession and implementation of Government actions to counter it are followed by lags in the time it takes for the Government actions to be transmitted to the economy. These lags further reduce the effectiveness of antirecessionary programs. The lags between implementation of public works programs and new construction activity and employment are especially long. Such lags also occur with respect to revenue sharing, public service employment, Government contracts, categorical grants, and tax initiatives.

In theory, it is possible to transmit quickly to the economy new initiatives such as income tax reductions and increased unemployment compensation and other transfer payments. However, such quick responses seem to be limited to consumption rather than to supply-side activities, and in none of the six recessions were such actions taken soon enough or with sufficient force to alter significantly the duration or intensity of the downturn.

The Emergency Home Purchase Assistance Act of 1974 is an example of excellent congressional foresight and quick action to assist a sector of the economy during a period of deteriorating conditions. Housing starts had declined from 2.4 million units in 1972 to 1.3 million in 1974. The act was passed that year to stabilize the housing market by increasing the availability of reasonably priced mortgage credit and thereby the demand for new homes. Although the action was not taken to counter the recession, it did achieve limited success. As a result of the program, according to a study conducted by the General Accounting Office, single-family starts were increased by 18,000 to 35,000 during the period beginning with the last quarter of 1974 through the end of 1975.

Monetary Actions

The discussion so far has concerned fiscal policy. As is true of fiscal policy, the problem of determining the effectiveness of monetary policy as an antirecessionary tool is largely a problem of determining the length of the time lags. In monetary policy, the crucial lags concern recognition of the recession and the time it takes to transmit monetary action to employment and production.

The uncertainties of forecasting make it as difficult for monetary authorities to understand the need for action as it is for those in charge of fiscal policy. In practice, there is evidence to suggest that the Federal Reserve has usually recognized changes in the direction of economic activity within one or two quarters of a major turning point, about the same as for fiscal policy. In any event, there is no reason to suppose that the economic intelligence apparatus of the fiscal authorities is either more or less efficient than that of the monetary authorities.

Because of the organizational independence and flexibility of the Federal Reserve, the administrative lag between the time the need for action is recognized and the time the action is actually taken is generally shorter than in the case of fiscal policy.

The lag between the time monetary action is taken and the time the action influences production and employment is a matter of considerable controversy. There is a substantial amount of evidence to indicate that short-term interest rates and credit in financial markets and institutions adjust rapidly to changes in monetary policy—a matter of weeks. Long-term interest rates appear to adjust considerably more slowly. But the principal controversy concerns the amount of time it takes consumers and businesses to react to changes in finanical conditions. Many experts believe this process is quite lengthy, that the noticeable effect on employment and production occur with a lag of something like 6 to 9 months. Some researchers claim to have found evidence suggesting a shorter time lag, while others have discovered evidence suggesting that it is longer. Another view is that the lag is both long and variable and that it is not possible to know in advance how much time will elapse before monetary actions will be transmitted to the economy. If this view is correct, it would be almost impossible to design an effective discretionary countercyclical monetary program, since it would never be known when to initiate a particular monetary policy action and have confidence that it would have the desired stabilizing influence. Actions with respect to credit can have a quick, dampening effect on the economy, especially during a downturn, as we have seen recently. Whether credit policy can be employed to reverse a downturn is debatable.

Policy Implications

Several important policy conclusions can be drawn from these facts. The delays in implementing a government action in the case of fiscal policy and the lags in transmitting actions to employment and production in the cases of fiscal and monetary policy suggest that most of the effects of actions taken during a recession will occur during the recovery rather than during the recession. Therefore, attempts to shorten the present recession through fiscal or monetary initiatives should take these lags into account. The delays in recognizing a downturn mean that the recession is partly over before a decision can be made to respond to it. Most government actions influence medium- and long-term economic trends rather than present trends.

The uncertainties surrounding the issue of how government actions influence the business cycle are, if anything, more pronounced with respect to monetary policy. There is no consensus among economists and other experts as to how monetary policy affects the economy. The monetarists believe substantial changes in the rate of monetary growth are the principal cause of economic instability. The Keynesians believe monetary growth is only one of several factors that influence the performance of the economy. The monetarists advocate constant growth in the money supply to alleviate inflationary pressures during periods of economic growth and to moderate declines in employment and production during economic contractions. Keynesians advocate changes in monetary growth rates depending upon the likely effects on investment spending, taking into account current economic conditions, fiscal policy, and other factors. Whatever approach is taken, it is generally acknowledged that there are substantial lags between actions by the Federal Reserve and changes in employment and production, and that monetary actions by themselves cannot end a recession.

Another factor discourages reliance upon monetary policy to counter a current recession. The relative independence of the Federal Reserve and the fact that decisions are made without public discussion or explanation reduces the control that the Administration and Congress can exercise over monetary policy. Neither branch could be confident in any specific situation that monetary decisions were being made for antirecessionary purposes.

The second policy conclusion from this analysis is that, while fiscal and monetary policies may not prove effective in fine-tuning the economy, they can and should be employed for other purposes, including reducing the burdens of a recession on particular groups and sectors and enhancing the quality of the recovery from a recession. Discretionary actions can and should be taken to supplement the effects of the automatic stabilizers that are built into the economic system.

The Government generally responds to economic slowdowns in ways that have the effect of alleviating the burdens imposed on portions of the population and of the business community. At different times and in varying degrees, steps have been taken to extend unemployment benefits, aid small business and the housing industry, and increase the flow of funds to State and local governments. On other occasions, tax initiatives have been used to sustain consumer demand or stimulate investment.

The problem is that the Government's responses tend to have scattered, hit-or-miss qualities about them. In the past, they have not been well thought out or coordinated and typically are put together hurriedly and without much foresight as to the longer term consequences. In effect, the Government has treated recessions inappropriately as short-term emergencies. Unfortunately, by the time a recession is recognized, it is too late to treat it. The prudent course of action during a recession is to design new policy initiatives to steer the recovery along the most desirable path so as to improve the structure and the performance of the economy over the long run, while at the same time addressing in a coordinated and comprehensive way the temporary needs of those persons who need help until the economy improves.

Chapter III. THE RECOVERY

The middle of a recession is not the time to reduce existing public service jobs programs or curtail unemployment benefits. But we should begin to tailor our employment policies to help foster a supply-side recovery so that the decade of the 1980's is not characterized by the boom and bust cycles of the 1970's. Training should come earlier in a variety of income support programs, and it should be focused on the private sector industries most likely to expand in the future. Wherever possible, the unemployed should have every opportunity to acquire the skills that will assure them good jobs with a future in the private sector of the economy.

The emphasis on adding to our stock of plant and equipment and improving the skills of our work force will help to solve a wide variety of problems currently plaguing the American economy. Investment in people and new capital will raise productivity, reduce inflation, improve our competitive position overseas, and help keep our markets open to the manufactured products of the developing world.

Fiscal and Monetary Policy

The major economic problem of the 1980's is the problem of long-run supply—expanding the capacity of the economy over the long term to increase the standard of living for all Americans.

Progressively weaker labor markets and rising prices and tax rates have combined to cause a 7-year slide in average weekly real spendable earnings of the typical worker. Earnings have not kept pace with prices in large part because the capital-labor ratio (the amount of tools and equipment the average worker has to work with) has grown much more slowly in the 1970's than in the 1960's. The effects of changes in the terms of trade, such as increases in the price of oil and other raw materials, have also been factors contributing to the 3-year decline of the capital-labor ratio, which is a key factor in the productivity slump.

Inflation is one of the major factors disrupting the supply side of the economy. Inflation and the Tax Code interact in unfortunate ways to depress national saving both by individuals and businesses and to depress the rewards of investment. Since saving is the source of funds for investment, inflation is acting to reduce both the ability and the desire to invest in modernizing and rebuilding America.

On the personal side, inflation has sharply lowered the reward to saving. This is one reason why the personal savings rate fell by nearly half, from about 7 percent in the early 1970's to under 4 percent in the first quarter of 1980.

On the business side, inflation depresses corporate savings and investment by interfering with depreciation and the replacement of inventory. Depreciation set-asides and retained earnings are the two principal sources of business savings.

The Tax Code permits only a tax deduction based on the historical cost of plant, equipment, and inventory. When inflation increases the cost of new plant, equipment, and inventory, the firm finds that the money it has set aside for replacement is inadequate. It must retain part of its apparent taxable earnings to supplement its depreciation allowances just to maintain its productive capacity—just to stand still. Thus, actual economic depreciation is understated. Inflation "disallows" the deduction of part of a real cost of doing business, increases the firm's tax liability, and reduces its ability to grow. In fact, the real earnings of many companies were inadequate to cover their tax and dividend payments, and for some companies reported profits were actually real losses. These companies were actually disinvesting—shrinking in real size.

Finally, the heavy burden of taxation on the private sector will increase substantially in the 1980's even without new congressional action due to inflation-induced income tax increases and legislated tax increases. Some of these tax increases may be justified by the need to shore up social security and curb energy consumption. However, taxes on labor and taxes on savings and investment may discourage vital sources of growth.

It is with these fundamental problems in mind that the Committee recommends changes in economic policy for 1981. Economic policy must focus on the supply side of the economy, on the long-term capacity to produce, and not just on the current recession.

In our 1980 Annual Report to the Congress, the Joint Economic Committee expected rising taxes or a recession (or both) to lead to a tax cut of about $25 billion. At that time, we felt strongly that at least half of any tax cut should be directed at improving productivity. We still do.

Individual tax relief should be provided as well, for several reasons. Taxpayers are in need of relief from rising tax burdens, particularly in this time of rising prices and lagging wages. However, tax reductions for individuals need not be aimed only at stimulating demand; they may contribute to the supply side of the economy as well. One-time tax rebates or minor adjustments in deductions are less likely to lower labor costs, encourage hiring and employment, or increase personal saving than, for example, adjustments in payroll taxes or further tax incentives for savings.

Employment Policies

Federal employment and training programs also can help to assure a strong recovery, contributing both to the growth of the economy and the improvement of workers' skills. There obviously are heavy and deplorable costs to the idleness caused by the recession, but the country can still cut its losses by enabling persons without regular work to acquire training and educational background needed for permanent employment.

The recession will sharply compound the Nation's structural unemployment problems. Minorities, younger workers, older reentrants, and workers displaced by industrial and technological changes will find their opportunities further reduced. The financial hardship, in many of these cases, will fall upon those least able to afford it.

The full costs of unemployment extend well beyond the economic consequences for individuals and the rising bills for income transfer programs. While not possible to quantify in dollar terms, the social costs of unemployment include higher crime, homicide and suicide rates, marital problems, and a variety of physical and mental illnesses.

The Committee believes that targeted employment policies and specific job programs may be required to relieve the burden of rapidly rising unemployment, particularly upon minorities and the economically disadvantaged.

The existing array of government programs under the Comprehensive Employment and Training Act (CETA) is heavily oriented to public sector job creation, partly as a result of the course followed after the last recession. From fiscal year 1975 to April of fiscal year 1978, the number of public service job slots increased from about 110,000 to a record high of 755,000. During this period, total spending on CETA more than tripled. Over the same period, the proportion of CETA funds devoted to training activities declined. Of the $9.4 billion spent by CETA programs in fiscal 1979, less than one-fifth went for either classroom or on-the-job training. In fiscal year 1980, expenditures are expected to total $8.6 billion, with no sizeable increase in the amount of funding devoted to training. By the end of fiscal year 1980, the number of federally funded public service jobs will decline to about 390,000, down more than 48 percent from the April 1978 record. According to estimates made by the Senate Budget Committee concerning the impact of the First Concurrent Budget Resolution for fiscal year 1981, the number of federally funded public service jobs will drop to about 250,000, down more than 66 percent from the record level of April 1978.

Income security programs, such as unemployment insurance, and trade adjustment assistance, provide an important safety net for temporarily unemployed workers. The Committee wishes to emphasize the value of employment and training programs as support for temporarily unemployed workers. But to cope with the problems of long-term joblessness and dislocation, the programs should be refocused during the recovery to assist workers in improving their skills and finding new private sector jobs.

Compared with CETA, the Government has had relatively limited experience with financial incentives to private industry for employment and training. Such measures, if given a prominent role in the recovery, can speed the reemployment of considerably greater numbers of people. Moreover, as discussed in previous reports of this Committee the direct involvement of private employers offers the firmest assurance that relevant job experience and training will be provided.

Special efforts must also be made during the recovery period to remedy the serious education deficiencies of certain labor force groups. Financial incentives to encourage the return to school may help in some cases, but high school dropouts and others lacking competence in basic skills may be better assisted by community-based organizations outside of the educational system.

Recommendation

Because it is difficult as a practical matter through government discretionary actions to shorten the duration or reduce the intensity of a recession once it has begun, Congress should design policy initiatives taken during a recession for the purpose of enhancing the quality of the recovery and promoting sustained growth. With respect to the recovery from the current recession: (1) Any tax cut that Congress enacts during the next year should be carefully targeted to improve productivity, reduce inflationary pressures, and create jobs for the long run. Accordingly, about one-half of the next tax cut should be directed to increasing productivity, with the remainder of the tax cut directed at reducing personal rates in order to stimulate work, saving, and investment at the individual level.[1] Any tax cut should be accompanied by systematic and vigorous efforts to reduce or eliminate unnecessary and wasteful government spending. (2) Existing public and private programs should be utilized to relieve the burden of rising unemployment on the poor, minorities, and youth, and these programs should be restructured to emphasize the training of unemployed workers in skills that are likely to be needed in the private sector during the 1980's. These programs should be considered for possible expansion should unemployment continue to worsen into 1981.

Income maintenance programs such as unemployment compensation and trade adjustment assistance initiated to alleviate the suffering which results from the recession should also be structured, where possible, to train and retrain workers in skills which are likely to be needed in the next decade.

[1] Representative Henry S. Reuss does not join in this sentence.

adversity, and because it drains badly needed consumer purchasing power. On the employer side, it is bad because it adds unnecessarily to costs, thereby driving up prices, and because it deters the employment of human beings. The social security rate increase should be repealed, and the resulting deficit treated exactly like any increase in the deficit from any other source.

The hard issues remain. We should first restore ill-advised cuts in social welfare programs, and bring immediate relief to the most distressed. We need an industries policy that will restore our fading industrial base and foster the growth of new competitive enterprise. We need an incomes policy that will coordinate wage and salary claims and help to bring the spiral of prices and wages under control. There are no quick fixes: not on the demand side as we have learned, and not on the supply side either.

ADDITIONAL VIEWS OF REPRESENTATIVE HENRY S. REUSS

The Joint Economic Committee has wisely realized that short-run macroeconomic stimulus is no solution to inflation and recession. And, as the Committee has been emphasizing for some time, indiscriminate reductions in corporate and personal income taxes are no solution either.

Blunderbuss income tax reductions do not bring relief to those who suffer the most from stagflation.

The elderly, single-parent families, racial minorities, and those trapped in declining industrial towns are hurting badly in today's recession/inflation: first because recession cuts into jobs and earnings, second because inflation reduces real purchasing power, and third because stagflation-induced budget cuts have severely hurt the programs that most help the needy. Many of these people have little taxable income; income tax reduction does little or nothing for them.

Blunderbuss corporate income tax reductions will not restore the profitability of America's industry or increase investment by new competitive firms.

Companies in basic industries, hard hit by the slump, desperately need to make new investment. Many such companies are not making profits now, and are not paying tax. Likewise new companies, to which the Nation must turn for future industrial greatness, but which usually pass years before turning a profit. Neither benefits by corporate income tax reductions. Indiscriminate corporate income tax reductions will increase the cash flow of those companies that are already making profits. Many of these, such as the oil companies, have plenty of money already, and unlimited access to credit. Their problem is insufficient scope for productive investment. Tax reductions do not put oil in the ground that was not there before.

The major effect of an indiscriminate tax reduction now would be a windfall to large corporations and to upper income individuals. These would be put into liquid and semi-liquid assets, particuarly corporate stocks, commodities, and real estate. There would be a new wave of corporate takeovers, and another speculative inflation of commodity, land and asset prices. There would be some stimulus to real output, productive investment, but renewed inflation would soon force the Federal Reserve to step in and end it.

What is to be done?

There is clearly a case for carefully targeted investment incentives in plant and equipment. But the Committee needs to spell out exactly what sort of targeting it has in mind.

The $17 billion social security tax rate increase scheduled for January is bad public policy on four counts. On the employee side, it is bad because it most hurts the working poor, already struggling against

ADDITIONAL VIEWS OF SENATOR WILLIAM PROXMIRE

While I strongly support this report and a timely tax cut, I believe that it should be earned by equal or larger reductions in unneeded, wasteful, or marginal spending. Further, any expansion of public programs should be paid for by reductions elsewhere.

ADDITIONAL VIEWS OF SENATOR EDWARD M. KENNEDY

I commend the Joint Economic Committee for issuing its fourth consecutive unified report and I am pleased to support it. The Joint Economic Committee under Senator Bentsen's leadership has been on the cutting edge in generating innovative and creative ideas to deal with our Nation's difficult economic problems.

I am particularly supportive of the theme of this year's report which indicates that policy initiatives undertaken during a recession should be structured to provide meaningful employment opportunities, job training, and improvement in our Nation's productivity over the long term.

Over the last several months, I have spelled out my economic views in great detail. Although I agree with the major conclusion of the report, I additionally believe that the only way to stop the present inflationary spiral is through a temporary program of across-the-board controls on prices, wages, profits, dividends, and rents. I have also urged the adoption of an equitable system of gasoline rationing. And finally, I have proposed an additional $12 billion Federal program for public service and other jobs, and for youth employment and training. I have described these views more fully in two policy papers.

I do believe, however, that this report makes an important contribution to developing a strategy to deal with our complex economic problems, and that is why I support it.

ADDITIONAL VIEWS OF REPRESENTATIVE PARREN J. MITCHELL

While I agree with the general recommendation of the Joint Economic Committee's midyear report, I must take issue with the Committee's reticence to support a countercyclical stimulus program which would be targeted to assist those who suffer most from cyclical variation.

I support the efforts of the Committee to promote long-term growth. Through a long-term economic plan which includes increases in capital and labor productivity, reduction in our foreign oil consumption and a revitalized primary and secondary metal industry, our competitive capabilities in the world market are enhanced. In the interim, however, we should not neglect those who disproportionately suffer from the short-term deficiencies in the economy. To emphasize the long run to the exclusion of the short run is to relegate black teenagers to inordinate rates of unemployment; acquiesce to massive layoffs in the East North-Central and Northeastern corridor, sites of the oldest, less efficient capital; and lose sight of the fiscal problems that our major municipalities face when confronted with high unemployment. I acknowledge that the recommendation of the Committee is designed to address those issues in the long run, however, I must withdraw my support for the report because of its failure to endorse a short-term, immediate fiscal stimulus which is designed to provide the much needed assistance to the 8 million American workers who are currently actively seeking employment.

If we accept the prediction of the three major economic forecasters, unemployment will peak at nearly 9 percent sometime between the end of 1980 and the middle of 1981. The economic recovery is predicted to be slow with an average rate of approximately 7.8 percent unemployment in 1982. From a historical context, black unemployment should peak at nearly 20 percent and average 15 percent in 1982. I cannot, in good conscience, support a report that fails to adequately address the basic need for employment as expressed by more than 2.5 million unemployed black workers.

I am in accordance with the assessment which depicts the budget process as untimely. The lag associated with congressional action and Executive initiative quite often renders ineffective program startup during general economic upswing. It should be pointed out, however, unemployment in the innercity and depressed areas of the country is the leading indicator to recession and the lagging indicator for economic recovery. Consequently, using unemployment rates, as a trigger mechanism, for a targeted countercyclical program will provide the much needed regional assistance while avoiding the inflationary pressures caused by untimely startup during general upswing. This temporary regional relief is a mode to "addressing in a coordinated and comprehensive way the temporary needs of those persons who need help until the economy improves."

Again, I applaud the Committee's efforts to address the long-term economic issues which include expanding the capacity of the economy and enhancing labor productivity through comprehensive training programs. However, I cannot endorse the report because of its failure to prescribe an immediate stimulus designed to address the rampant rate of unemployment in our black, Hispanic, and rural poverty stricken areas in America.

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