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IS THE ECONOMIC EXPANSION OVER?

A 1985 MIDYEAR REVIEW OF THE U.S. ECONOMY

PREPARED FOR THE USE OF THE

JOINT ECONOMIC COMMITTEE CONGRESS OF THE UNITED STATES

BY THE

REPUBLICAN MEMBERS

OF THE

JOINT ECONOMIC COMMITTEE

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LETTER OF TRANSMITTAL

AUGUST 2, 1985.

Hon. DAVID R. OBEY,
Chairman, Joint Economic Committee, Congress of the United States, Washington, DC.

DEAR MR. CHAIRMAN: I am pleased to transmit a 1985 midyear review of the U.S. economy entitled "Is the Economic Expansion Over?" This review was prepared by the Republican members of the Joint Economic Committee for the use of the committee and the Congress.

Mixed signals in the economy at the present time have given rise to differences of opinion as to where the economy is heading. Is the economic slowdown in the first half of 1985 a last gasp before a recession, or is it just a healthy pause before a new spurt of economic growth? The Republican members of the Joint Economic Committee are of the latter view. The current economic expansion is far from over. There are many good months ahead.

In this review we analyze the economic outlook and then devote specific attention to several major economic policy issues facing Congress: the Federal budget, tax reform, monetary policy, international trade, U.S. competitiveness and the continuing hardship in the agricultural and rural economies.

The views expressed in this review are those of the Republican members of the Joint Economic Committee.

Sincerely,

JAMES ABDNOR,
Vice Chairman,
Joint Economic Committee.

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INTRODUCTION

Is the expansion over?

Real growth of 2.0 percent in the second quarter of 1985 is better than the 0.3 percent in the first quarter. It is not nearly as high as the 4.3 percent growth experienced in the fourth quarter of 1984, but very comparable to the 1.6 percent change recorded in the third quarter of 1984. All of this demonstrates that expansion is a relative term—especially in the art of economics. About the only definitive statement one can make at this time about the eventual change in real gross national product in 1985 is that it will be substantially lower than the change in 1984 and substantially higher than that in 1982.

The change in real gross national product, while an important economic indicator, does not measure what may be termed the strength of the public confidence factor. That is, while a 0.3 quarterly growth in previous Administrations may have been confidence shattering, contributing to a slide toward recession, the recording of this same number under the Reagan Administration was perceived entirely differently, as a result of today's strong foundation of public confidence. Is the economic expansion over? To quote Yogi Berra, "It ain't over till it's over."

I. ECONOMIC OUTLOOK

The U.S. economy had a dramatic 18-month growth from the fourth quarter 1982 recession trough through the second quarter of 1984. In fact, it was the fastest growth of any 18-month period since the Korean war. Real GNP rose at a 7.1 percent annual rate. Inflation was moderate—less than 4 percent. The unemployment rate dropped sharply—3½ percentage points. Only in net exports, agriculture, and some manufacturing areas was there any negative economic news.

Since mid-1984, the economy has expanded more slowly, with real GNP growing at a slow pace of 2.0 percent and doing so in fits and starts—1.6 percent in the third quarter of 1984, 4.3 percent in the fourth quarter of 1984, 0.3 percent in the first quarter of 1985, and 2.0 percent in the second quarter of 1985. We expect the engine to smooth out and give us a fairly good surge in the last half of 1985 and on into 1986, not at the powerful pace of 7.1 percent annual rate during the first 18 months of recovery, but at a pretty good clip.

Table I.1 shows the trends in major economic measures during the recession year 1982 and during the first 2 years of recovery, 1983 and 1984. The table also shows staff forecasts for 1985 and 1986.

TABLE I.1.—THE U.S. ECONOMY—SELECTED ECONOMIC MEASURES

[Annual percentage rates of change, unless otherwise noted, 1982–86]

	Actual			Forecast	
	1982	1983	1984	1985	1986
Real gross national product	−2.1	3.7	6.8	2.9	3.9
Consumption	1.4	4.8	5.3	3.8	3.7
Residential investment	−15.0	41.7	12.2	3.0	7.5
Business fixed investment	−4.7	2.5	19.8	6.8	7.1
Exports[1]	−7.8	−5.6	4.7	1.0	8.1
Imports[1]	1.3	7.6	27.0	9.0	6.5
Unemployment rate (civilian percent)	9.7	9.6	7.5	7.2	6.9
Consumer prices	3.9	3.8	4.0	3.4	4.0
GNP deflator	6.0	3.8	3.8	3.8	3.9
3-month Treasury bill rate	10.6	8.6	9.5	7.4	7.5
Housing starts (million units)	1.1	1.7	1.7	1.8	2.0
Productivity[2]	.2	2.7	3.2	2.0	2.8

[1] Goods and services.
[2] Output per worker per hour, business sector (includes farming).

Sources: Joint Economic Committee, U.S. Department of Commerce, U.S. Department of Labor, Congressional Budget Office, and Data Resources, Inc.

To answer the question posed by the title of this review, this economic expansion is *not* over, despite the cries and warnings of a large number of doomsayers. The character of the expansion has changed, and will change some more, but the expansion itself will

go on for some time. It is now 31 months old. The average age of post-World War II expansions is 45 months (including the Korean war and Vietnam war expansions). So this one is well into middle age, but it is certainly not old. It has a lot of life yet. It could live to 50 or 60 months.

There are no signs of a recession on the horizon. The economy slowed considerably during the first half of 1985, but none of the typical causes of recession are present. There is no excessive inventory buildup; production is not bumping up against factory capacity; there are few pockets of labor shortages; inflation is quiescent; interest rates are relatively stable; while consumers have large debts, they are manageable.

A cyclical downturn typically occurs because of stresses that build up during an expansion. There are no such stresses in the economy right now. Demand is strong but not so strong as to create shortages, nor to bid up wages, prices, and interest rates. There are some depressed sectors in the economy—namely, export-oriented agriculture and manufacturing sectors. We are deeply concerned about the problems in these sectors. They are painful for those involved, but weaknesses in these areas have been more than offset by gains in other sectors, and the overall economy is healthy.

The slow growth rates in the third quarter of 1984 and the first half of 1985 are not all that serious. Prolonged economic expansions generally include a few quarters of below-trend growth. In fact, such breathcatching can be healthy. By slowing itself down, the economy helps to avoid a recession. The average growth of 6.8 percent in 1984, and certainly the 8.6 percent pace of the first half of 1984, was an unsustainable pace. Something in the neighborhood of 4 or 5 percent is sustainable, and we believe attainable, in the second half of 1985 and in 1986.

With 4 percent real GNP growth, inflation would remain subdued, living standards would rise, unemployment would decline, and the United States would maintain its lead among world industrial competitors.

Is a 4 percent growth path attainable? We believe the answer is yes—if inflation and interest rates do not get out of hand. There is nothing in the current economic statistics to indicate that they will get out of hand.

The decrease in money supply growth probably can account for the slowdown in economic growth in the third quarter of 1984 and the first half of 1985. The Federal Reserve reduced M1 growth to practically zero (0.5 percent) from June through October of 1984. This took its toll in the third quarter of 1984, but especially in the first quarter of 1985, when real GNP growth screeched to a halt (0.3 percent), followed by a modest 2.0 percent rise in the second quarter of 1985.

During the past 6 months, the Federal Reserve has permitted a much more rapid expansion of the money supply. M1 has been growing at an annual rate of 11.6 percent, and this should provide a base for strong economic growth in the latter part of 1985 and into 1986. Such a rapid expansion could also set loose some inflationary pressures, but we believe there is enough slack in the economy to avoid an acceleration of inflation. The declining dollar could also eventually put some upward pressure on prices.

However, there are offsetting economic factors that should continue to keep the lid on inflation. Wage increases are projected to remain moderate. OPEC will likely continue to exceed production quotas, and the resulting oil gluts will bring even lower oil prices. Farm surpluses will persist and food costs will remain moderate. Productivity, though volatile, will continue to rise at a fairly good clip, thus moderating real unit labor costs.

Summary Forecast and Risks

For the year 1985 as a whole, we believe real GNP will rise by 2.9 percent. This is considerably below the 4 percent forecast earlier, but it would be a satisfactory performance, enough to keep unemployment from rising. To accomplish this, in view of the relatively flat first half, we will have to grow at a 4.8 percent clip during the second half of the year, and we believe we will. For 1986, we believe real GNP will grow by 3.9 percent.

Facilitating the continuation of the economic expansion, consumer inflation should moderate even further to 3.4 percent in 1985 and rise slightly to 4 percent in 1986, as the dollar continues its slide.

While the unemployment rate has remained stuck at about 7¼ percent for a year now, growth in labor demand remains strong. In the first half of 1985, the number of workers on nonfarm payrolls increased 1.4 million. The bulk of the job growth was in the service and trade sectors, where employment has expanded at rates similar to last year's rapid pace. Strong growth in the labor force is what is keeping the unemployment rate at its 7¼ percent level. While there might be an uptick over the next few months, as the economy expands more rapidly in the last half of this year and in 1986, the unemployment rate should resume its downward trend, although at a more gentle pace than in the early part of the recovery.

The risks to this optimistic shortrun forecast relate to inventories, energy prices, international finance, and interest rates. Fortunately, the odds favor optimism on all of these risk fronts.

In the past, inventory accumulation helped to fuel recoveries, and the ensuing recessions have been made much worse by inventory selloffs. But right now we do not have excess inventories. The total business inventories/sales ratio at the end of May 1985 was 1.35, well below its average of 1.49 of the past two decades and not far from its two-decade low point of 1.30 in January 1984.

Regarding energy prices, it appears that OPEC is powerless to stem the tide of falling oil prices. The recent behavior of spot and forward crude prices indicates continued oil price declines. The political problem for OPEC is that it can't keep its members in tow. The economic problem for OPEC is worldwide weakness in oil demand resulting from conservation and relatively slow economic growth. For the United States, declining oil prices will hurt some oil producers and the banks that finance them, but it will be good for the U.S. economy as a whole. Each $1 decline in the price of oil can reduce our consumer prices by about 0.3 percent, and can increase economic growth.

The trend in the international value of the dollar and foreign investment in the United States are two of the most difficult of all economic measures to predict. Yet, they have become two of the most important factors affecting the U.S. economy, something we have not experienced before. The strong dollar has impeded a large part of our industrial and agricultural growth by pulling imports into this country, and by curbing our exports.

With regard to foreign investment, a total of more than $275 billion in both direct and portfolio investment has flowed into the United States the past 3 years. This has helped finance our annual $200 billion budget deficits, particularly in the face of comparatively low U.S. savings rates. A risk is that foreign investors may lose faith in the U.S. economy and sharply reduce their investments here. A modest reduction is fine, but a sharp reduction would be bad. This could bring a plunge in the dollar, which has already declined in recent months, and U.S. interest rates could shoot up. The odds are against this loss of confidence, particularly with an expected speedup in the U.S. economy later this year, but it is a risk. The best of all solutions for the strong dollar is for our foreign industrial friends to adopt measures to increase their own economic growth.

After a sharp runup the first 2 months of 1985, the dollar has declined and will probably continue to do so in an irregular fashion for some time. Much of the dollar's strength over the past 4 years has resulted from high U.S. interest rates, but rates are now relatively stable after a period of easing.

A continuing decline in the value of the dollar is a mixed blessing. It will put upward pressure on prices, but it will, after the usual 12- to 18-month lag, improve our very weak net export situation. The latter benefit probably exceeds the former cost, and we should welcome it.

Factors pointing to slightly higher interest rates over the near term are an expanding economy, a continuing slide in the dollar, and a somewhat smaller deficit reduction package than initially promised. On the other hand, factors pointing to slightly lower interest rates are low inflation, a continuing accommodative policy by the Federal Reserve, at least some progress on deficit reduction, and a virtual end to the high-inflation, high-interest rate psychology of the late 1970's. Thus, anticipated interest rate trends are a standoff. Rates will fall a little more from current levels, and then as the expansion speeds up later this year and into next year, they may rise somewhat. Over the next year and a half, however, interest rates will probably not move more than a point or so down or up from where they are right now.

In making this generally optimistic forecast, we are not ignoring some major problems—our fiscal and trade deficits, an agriculture sector that is on the ropes and some manufacturing sectors that are severely underutilized. We discuss these problems in later sections of this review. But, with regard to the economy as a whole, there is a green light. There are many good days ahead.

II. FISCAL POLICY: THE FEDERAL BUDGET

Recent budget trends indicate that Federal spending is still out of control. Despite the pressing need to reduce Federal budget deficits, Federal outlays continue to grow faster than the economy as a whole.

Between 1960 and 1985, total Federal outlays surged from $92 billion to $954 billion, a ninefold increase, and a rise in real terms of 178 percent. In this same period, total Federal outlays as a percentage of national output climbed from 18.5 percent to about 25 percent. Current budget developments offer little ground for optimism that these rising trends can be reversed. Between fiscal 1984 and 1985, Federal spending is projected to increase by $102 billion, the largest such increase in U.S. history.

This growth of Federal spending accounts for the size of budget deficits in recent years. The argument that the deficit problem was wholly or in part created by the Economic Recovery Tax Act of 1981 is not supported by the facts. Federal revenues as a share of GNP have been at or above their postwar average of 18.5 percent since 1981. Clearly the case of those who argue that ERTA has "starved" the Federal Government of revenues rests on the assumption that taxation ought to be set at historically high levels. By choosing 1981 as a base year, it is possible to show a decline in the GNP share of Federal revenues, as several analysts have done. What they never point out is that this GNP share in 1981 stood at about 21 percent, the highest level since the war year of 1945. Selecting this as the reference year obviously biases the results.

Not only is the trend in total Federal outlays significant, but their changing composition is equally important. Over the last 25 years there has been a pronounced shift in Federal spending priorities from providing goods and services (including defense), to funding transfer payments.

In 1960, transfer outlays comprised 26 percent of the Federal budget; by 1985 these programs amounted to 45 percent of total Federal spending. Meanwhile, defense outlays declined from 52 percent of the budget in 1960 to 23 percent in 1981, rising to 26.5 percent in 1985. Between 1960 and 1985, transfer spending exploded from $24 billion to $427 billion, a real increase of about 460 percent. Transfer spending amounted to 4.9 percent of GNP in 1960; by 1985 its share had grown to 11 percent.

While much of the increase in transfer payments during this period is due to demographic and other factors which increased the number of Social Security recipients, it also reflects the initiation of the Great Society programs. An aggressive and well intentioned effort was initiated to wage a war on poverty in an effort to eliminate this problem. The poverty rate declined in the 1960's, but then reversed direction in the 1970's and 1980's. After the early 1970's, the poverty rate trended upward, until by 1983 it stood at 15.2 per-

cent, higher than in the mid-1960's when the war on poverty was declared. Though data are not yet available, the strength of the economic expansion should have been sufficient to lower the rate in 1984. Recently the members of the Joint Economic Committee received testimony on this subject which suggested that the war on poverty programs may have actually created perverse incentives which tended to be counterproductive. Moreover, a strong correlation was reported between the level of AFDC payments by State and the increase of child poverty. These disturbing findings suggest that a revision of Federal poverty programs is urgently needed.

Recently the GNP share of Federal debt and debt servicing costs has been on the rise. Though not yet at a critical stage, this trend must be contained. Rising debt servicing costs are important because they imply a higher future tax burden and higher interest payments to foreign holders of U.S. Government securities. One way to address this problem is for the Treasury Department to issue inflation-indexed bonds, along the lines of H.R. 1773.

Budget Outlook

Obviously the current budget situation is not good. Unless Congress takes strong action to reduce Federal spending growth and budget deficits the budget outlook will continue to deteriorate in the next several years. Despite the fact that Federal revenues are projected to increase by at least $70 billion in each of the next 3 fiscal years, Federal outlays are estimated to rise by an even larger amount. As a result, by 1988 baseline outlays would grow to $1.2 trillion, while the baseline deficit would expand to $248 billion. The table below tells the story:

TABLE II.1.—BUDGET OUTLOOK FOR FISCAL YEARS 1985 TO 1988 [1]

Budget component	1984 actual	1985 enacted	Baseline		
			1986	1987	1988
Budget totals:					
Revenues	$667	$741	$794	$864	$952
Outlays	852	954	1,024	1,109	1,200
Deficit	−185	−213	−230	−246	−248
Shares of GNP:					
Revenues (percent)	18.6	19.1	18.9	19.0	19.3
Outlays (percent)	23.8	24.7	24.4	24.4	24.4
Deficit (percent)	5.2	5.5	5.5	5.4	5.0
Spending and revenue growth over prior year:					
Revenues (percent)	11.0	11.3	7.7	8.8	10.2
Outlays (percent)	5.4	12.0	6.7	8.3	8.2

[1] Budget totals include off-budget outlays.

Note.—Totals may not add due to rounding.

Source: Office of Management and Budget.

The Budget Dilemma

Excessive Federal spending and deficits are a drag on the economy. Federal finance through taxation, borrowing, or inflation imposes costs by withdrawing resources that would otherwise be de-

voted to private saving, investment, and consumption. While provision of public goods and certain other functions are better suited to government than the marketplace, the marginal cost and benefit of additional Federal expenditures must be considered. Federal spending is inefficient if spending levels impose higher costs than the benefits generated.

Current levels of taxation and borrowing suggest that the cost of maintaining the current level of Federal spending as a share of the economy is excessive. Therefore, the highest priority must be placed on reducing the GNP shares of Federal outlays, deficits, and net interest outlays. We can neither tax nor borrow our way into prosperity. The Constitution gives Congress the primary responsibility for setting Federal spending and tax policies; Congress must exercise this responsibility to restrain the growth of Federal spending in future years. If the growth rate of spending were held to less than that of the economy, the GNP share of Federal spending would, of course, decline. Meanwhile a growing economy will boost tax revenues, resulting in shrinking deficits both in absolute amount and as a share of national output. However, there are institutional defects in the current political system that will continually operate to undermine any such strategy.

The Need for Institutional Reform

The fragility of the congressional budget process is highlighted by recent events. Under the Budget Act, the first concurrent resolution is supposed to be passed no later than May 15. To date, Congress has yet to approve a final first budget resolution for fiscal 1986. Moreover, the start of the new fiscal year is only about 2 months away.

Special interests often pressure Members of Congress to support pet constituent programs. From the perspective of Members of Congress, objective evaluation of each item of Federal spending is almost impossible. An asymmetry in congressional budgetmaking results from the separate consideration of program benefits and costs. Moreover, while program benefits tend to be highly concentrated, the costs are diffused among all citizens. This creates an institutional situation wherein the benefits of any program are magnified, while the costs are obscured and therefore not fully considered. Thus, institutional reform is needed to link more effectively consideration of program benefits and costs. The Balanced Budget/Tax Limitation Constitutional Amendment would be an effective way to address our institutional defects and reduce future budget deficits. Until such a reform is ratified, Congress must reduce baseline Federal spending and deficits by $50 to $60 billion annually for the next several years.

III. TAX REFORM

The Tax Code is economically inefficient, inequitable, and excessively complex. There is broad agreement among economists and the general public that any of a broad range of tax reform plans would be an improvement over the current system.

In 1981, the Congress passed the Economic Recovery Tax Act (ERTA) designed to lower tax barriers to work, saving, and investment. Personal tax rates were cut 23 percent, and business depreciation schedules were accelerated. The result of this act was a strong, investment-led expansion that generated about 8 million jobs. The contribution to GNP growth made by investment was about three times the average of all post-World War II recoveries. Recent research by Michael Boskin of Stanford University shows that net investment in the 1981–84 period under ERTA was about 25 percent greater than would have been the case under the previous law.

The Joint Economic Committee's 1985 Annual Report contains a chapter on tax reform which discusses the merits of income and consumption-based tax systems. Without restating the whole discussion, both systems have advantages and disadvantages. The chief advantage of a consumption tax base, as opposed to an income tax base, is that it does not impose double taxation of saving and investment. A cash flow type of consumption tax would feature special savings accounts through which tax deductible saving and investment of many kinds could be channeled, and also would provide expensing of business investment. Although this approach has gained support among economists in recent years, many misconceptions about consumption taxation have resulted in a lack of public support for such a reform.

The President's Tax Reform

The President's tax plan is an altered version of Secretary Regan's plan of last December. As such it is a modification of the comprehensive income tax model, which has garnered support by many economists for decades. Its guiding precept is that consumption plus additions to net wealth should be fully taxed. In practice, this means that all income, regardless of source, would be subject to the income tax. In its pure form, even unrealized capital gains would be taxed as ordinary income. Many such applications of the model present difficult tax administration problems. For this and other reasons, Treasury I represented a less than pure comprehensive income tax reform. The President's proposal further compromises the purity of this tax reform concept. Thus the appeal of the abstract model, still visible to many tax specialists in the form of Treasury I, was lost in Treasury II.

Treasury II would compress the current personal tax schedule into three brackets with progressive rates of 15, 25, and 35 percent. The personal exemption would be increased to $2,000, and the zero bracket amount to $4,000. Deductions for State and local taxes and two-earner families would be repealed; these two changes have proven to be controversial. A 50 percent exclusive of long-term capital gains would be permitted.

The top corporate tax rate would be reduced from 46 to 33 percent. The investment tax credit would be repealed, and capital cost recovery periods stretched out. Many businesses, especially those in heavy industry, argue that the current Administration plan would be especially detrimental to them at a time when they are desperately trying to compete and survive in the international marketplace.

KEMP-KASTEN

The personal tax provisions of Kemp-Kasten represents another variant of the comprehensive income tax. While setting a 24 percent tax rate by statute, the application of a phased-wage exclusion formula produces three effective marginal tax rates: 19.2 percent, 24 percent, and 28.8 percent. Though many individual tax breaks are modified or repealed, the real property deduction is retained. Relative to the Administration plan, the lower 28.8 percent top rate of Kemp-Kasten provides improved incentives to work, save, and invest. This is important for investors and small unincorporated businesses.

In addition, the 28.8 percent tax rate would make investment in many tax shelters unattractive. Extensive research presented in hearings before the Joint Economic Committee indicates that a reduction in the top rate from 50 to 30 percent would not lead to a loss of revenue, but might actually gain revenues. Although this decline in the importance of tax shelters may be doubted, it will be recalled that such tax avoidance activities do entail substantial legal, accounting, and business costs. These must be covered by accrued tax benefits derived through tax shelter investments. The lower tax rates would sharply reduce the value of all deductions, including those used to shelter income.

It is in the business provisions that Kemp-Kasten departs most from the comprehensive income tax model, and most other tax reform bills. Although it would repeal most special tax provisions, including the investment tax credit, it abandons the economic depreciation concept for a range of writeoff periods adjusted so as to be equivalent in present value terms to immediate expensing. This feature is a giant step toward consumption tax treatment of business saving and investment. In business taxation it would remove the inherent bias against saving in any income tax. Thus, economic neutrality would be preserved, not only between different kinds of assets, but also between saving and consumption.

By sharply cutting tax rates and providing adequate capital recovery, Kemp-Kasten would improve the prospects for economic growth. To date, much valuable time and energy has been used up in the struggle over the specific provisions of the Administration

plan, which tends to be closer to the Bradley-Gephardt proposal than Kemp-Kasten in many respects.

Bradley-Gephardt

In many respects, the Bradley-Gephardt bill, like the Administration bill, is based on the comprehensive income tax. It contains a base broadening feature that would dilute most personal deductions, including home mortgage interest, State and local taxes, and charitable contributions, to a level of 14 cents on the dollar. It does recognize the economic desirability of lower marginal tax rates, and in so doing establishes a three-tier tax rate schedule with a top rate of 30 percent. It sets a 30 percent rate on corporations.

Reforming Tax Reform

We are concerned that the Administration's aggressive effort in pushing its current reform plan has been detrimental to the Kemp-Kasten bill.

Instead of expending further efforts on behalf of its plan, perhaps the Administration should revise it in consultation with the sponsors of the Kemp-Kasten bill, and have new legislation introduced this fall. The Administration and congressional proponents of this measure could then unite for a vigorous push for enactment early in 1986. Although the eventual tax reform plan may be less than perfect, at least we would be moving in the right direction.

A number of analyses of the impact of the tax reform plans on individual taxpayers have shown potential tax increases under some circumstances. This situation has caused political difficulties for tax reform, particularly in the case of the Administration plan. If this situation is addressed in any particular tax reform, it is more desirable to do so by further lowering tax rates than tinkering with various deductions. It is true that this approach would not only limit tax increases for certain taxpayers, but lead to greater tax breaks for others as well. This could entail a greater loss of revenue at some income levels. Fortunately, there is a relatively direct way to plug this or any other revenue shortfall experienced in reducing tax rates.

The Business Transfer Tax (BTT), introduced as S. 1102 by Senator Roth, would raise as much as $20 billion annually to help finance reductions in personal and corporate marginal tax rates, and provides other saving and investment incentives. The tax base would consist of each firm's gross receipts minus its total outlay for materials and other physical inputs. A 5 percent tax rate could be imposed. Domestic companies would receive a credit for its BTT payments to offset their FICA liabilities. These payments would be remitted to the Social Security Trust Fund.

Receipts earned overseas would not be included in domestic receipts subject to the BTT. However, receipts earned through import sales would be taxable. Because foreign nations depend on indirect taxation to a far greater extent than does the United States, U.S. exports are put at a disadvantage relative to imports. The BTT would raise about $3 billion from domestic sources, and $17 billion from imports.

Tax policy can affect the economy by changing the relative prices of alternative activities such as work/leisure, or saving/consumption. By raising the prices of factors of production, taxation can restrict their quantity supplied for use in production processes. Excessive taxation can thus reduce national output below what it would otherwise be. For instance, heavy taxation of capital may undermine productivity gains and economic growth both by depressing the rate of capital formation and restricting the introduction of new technology embodied in new capital. A growth-oriented tax policy is one in which the tax impediments to the devotion of land, labor, and capital to production are minimized. Economic efficiency and tax neutrality require that the imposition of a particular tax does not materially affect resource allocation, relative to what it would otherwise be in the absence of the tax. It is imperative that tax reform preserve and extend incentives for investment in new capital and technology. This would raise the capital/labor ratio, resulting in productivity gains and a higher American standard of living.

The Administration and Congress should jointly develop a growth-oriented tax reform package with the lowest possible top personal rate and with adequate capital cost recovery provisions.

IV. MONETARY POLICY

Monetary policy has assumed a degree of visibility that would have astonished economists 20 years ago. The extended period of rapid consumer price increases in the 1970's has so sensitized Congress and the public to the need for monetary stability, and the role of the Federal Reserve in conducting monetary policy, that any official statement or news release by the Federal Reserve is given maximum exposure.

Although there is a wide range of disagreement among economists about the best way to conduct monetary policy, there is agreement on two fundamental propositions: (1) There is a correlation between increases in the money supply and economic growth and (2) rapid increases in the money supply can lead to inflation.

BACKGROUND

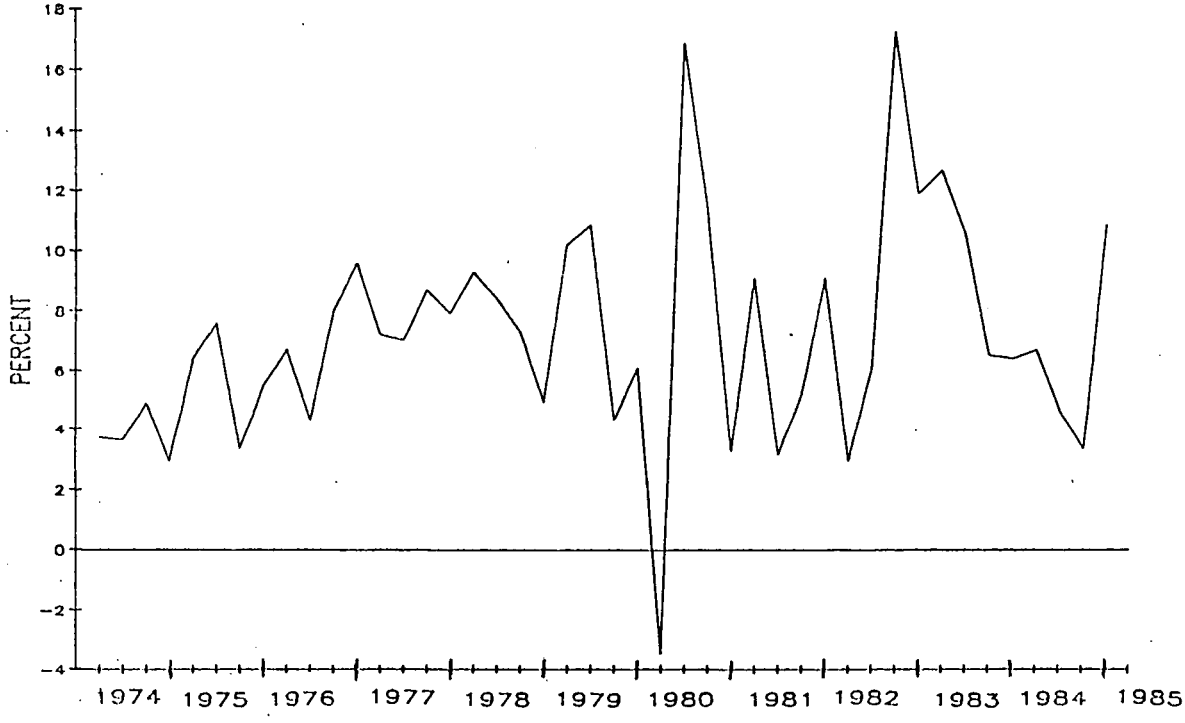
The problem in monetary policy, and the focus of public concern, is always whether money supply is growing fast enough to stimulate the economy, but not so fast as to cause inflation. In the past 6 years, monetary policy has shifted dramatically between these extremes.

Chart IV.1 shows quarterly changes in the money supply beginning in 1974. Since 1979, quarterly money supply changes have ranged from a high of 17.4 percent growth in the fourth quarter of 1982 to a decrease of −3.5 percent in the second quarter of 1980. Since the fourth quarter of 1984, the M1 money supply has surged at an 11.6 percent annual rate.

CHART IV.1

MONEY SUPPLY (M1)

QUARTERLY ANNUALIZED RATE OF CHANGE



In the first year or so of this decade, the Federal Reserve's policy was described as "monetarist," to the irritation of many economists who advocated tight and steady control over the money supply. In more recent years, the conduct of monetary policy has been explicitly antimonetarist. Federal Reserve Chairman Paul Volcker recently testified to Congress:

> We simply do not have enough experience with the new institutional framework surrounding M1 (which will be further changed next year under existing law) to specify with any precision what new trend in velocity may be emerging or the precise nature of the relationship between fluctuations in interest rates and the money supply. . . . For those reasons, the [Federal Open Market] Committee has continued to take the view that, in the implementation of policy, developments with respect to M1 be judged against the background of the other aggregates and evidence about the behavior of the economy, prices, and financial markets, domestic and international.

Recent Developments

The Federal Open Market Committee has just announced a revision in its upper and lower ranges for money supply expansion for the balance of 1985, just as it did in 1983. From the third quarter of 1982 to the third quarter of 1983, the money supply grew 12.1 percent. Chairman Volcker described this policy in his testimony: "The earlier 1982-83 period of rapid growth in M1 was correctly judged not to presage a resurgence of inflationary pressures, contrary to some expectations." Real economic growth in the first quarter of 1984 peaked at 10.1 percent, with annual rates of 3.7 percent and 6.8 percent, respectively, in 1983 and 1984.

The very rapid increase in M1 during the first half of this year may represent a repeat of the 1982-84 episode, or it may turn out to be inflationary in 1986. In the most recently published Record of Federal Open Market Committee policy actions, the members clearly indicate that their tolerance of the present rapid money supply expansion is derived from a concern about the sluggish economic performance in the first quarter, as well as the impact of a strong U.S. dollar on agriculture and manufacturing, two sectors of the economy significantly affected by relative prices in international markets.

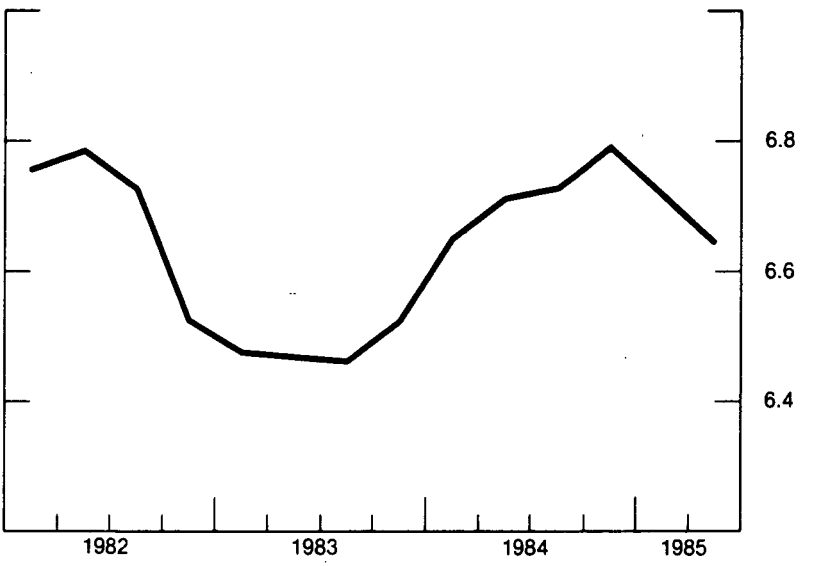
Unfortunately, the method of conducting open market policy that is employed today is substantially the same as that used in the late 1950's, which has been shown to be procyclical. The operating procedures adopted by the Federal Open Market Committee tend to focus on the quantity of reserves in the banking system. In the Record of Policy Actions for May 21, 1985, for example, the Committee voted "to maintain about the same degree of pressure on bank reserve positions." The Committee has consistently voted "to maintain pressure" throughout the period of rapid M1 growth.

THE SHORT-TERM OUTLOOK

Whether the recent rapid expansion of the money supply will bring us more inflation than growth, or more growth than inflation, will depend critically upon the behavior of a statistic known as the velocity of money. The recent trend in velocity is shown in Chart IV.2.

CHART IV.2

VELOCITY OF M1



Source: Federal Reserve Board

The velocity of money is a simple mathematical ratio between gross national product or national income and the money supply; it declines when people don't spend as fast as the Federal Reserve creates money. It typically decreases when the Federal Reserve steps up the rate of growth in bank reserves, but the critical issue is to determine whether and when it will begin to increase again. There is about a 6-month delay before an accurate calculation of money velocity can be made, and revisions may still be needed a

year later. The recent decline in the M1 velocity measure is not an adequate rationalization for recent monetary policy actions.

For example, the relatively strong fourth quarter of 1984 and the weak first quarter of 1985 might properly be viewed together, since there was an incentive in December 1984 to accelerate spending that otherwise might have been scheduled for the first quarter of 1985. The announcement of Treasury's tax revision program, which would have significantly increased taxes on capital investments after January 1, would have both artificially expanded December and depressed January economic activity, and subsequent months of the first quarter would have also been depressed due to uncertainty about the fate of the tax increases on business.

We can anticipate a very strong economy for the balance of 1985 and for 1986. The Federal Reserve's own estimate is for 2.75 to 3.0 percent real economic growth this year and 2.5 to 3.25 percent real growth in 1986. These estimates seem low, but they are based on the sluggish performance in the economy during the first half of the year. Since the Federal Open Market Committee is committed to a policy of watching every possible indicator in the world economy, and relying upon intuition, there is a serious risk that a one- or two-quarter abberation in reported economic indicators could trigger a misjudgment.

While economists disagree about the best way to conduct monetary policy, and disagree about even the correct rates of increase (or decrease) in the "best" indicators, there is widespread agreement that monetary policy should be stable. The Federal Reserve's current method of conducting monetary policy does not contribute to monetary stability. (See Chart IV.1.) A policy that is subject to wide swings and reversals is—in truth—not a policy at all.

There is need for the Federal Open Market Committee to adopt some internally consistent set of economic indicators, select one indicator to be its control variable, and announce the procedure to the public. One possibility is to focus on the monetary base or the price level as the control variable.

V. INTERNATIONAL TRADE

In mid-1985, global expansion continues to depend on America's willingness to finance it. And nowhere is this reality more apparent than in the international trade arena. For example, in 1984, of the total growth in world imports measured by volume, the United States accounted for a whopping 51 percent.

The United States, to be sure, derives substantial benefits from international trade—notably the profitmaking opportunities provided U.S. firms by a $2 trillion marketplace. Last year, a number of American businesses took advantage of these opportunities by registering $218 billion worth of merchandise sales, an 8.7 percent increase over 1983. The American economy likewise benefits from imports. A recent Commerce Department study of U.S. trade finds that "In the short run, record U.S. imports have boosted U.S. economic recovery by holding down inflation and have contributed to economic recovery abroad."

But America's growing trade deficit—which increased from $42.6 billion in 1982 to an estimated $150 to $160 billion in 1985—has reached a point where this Nation must demand a greater willingness on the part of its allies to carry their fair share of the burden. For instance, there has been a huge disparity between United States and European Community and Japanese imports of Third World manufactured goods between 1979 and 1983. Where the United States was absorbing nearly 58 percent of those goods in 1983 (a jump of 13 percent over 1979), the Japanese import share dropped from 11 percent to 8 percent, and the European import share declined from 37 percent to 27 percent. The result is that the United States has become "an import sponge."

Two key questions surround present discussions of U.S. trade policy—both of which involve America's growing trade imbalance: (1) Why are we running those deficits and (2) what can be done to reduce them?

CAUSES OF THE U.S. TRADE DEFICIT

In a broad sense, America's trade deficit stems from one central fact: the Nation's ability to generate 10 consecutive quarters of solid, noninflationary growth which has attracted huge volumes of imports and foreign capital. The long-term answer to America's import dilemma, then, can best be found in greatly expanded sales of U.S. exports to the Third World, Western Europe, and Japan—the major sources of the U.S. trade deficit. But, this can only be accomplished through more imaginative, progrowth policies in those countries. So for the medium term, a continuing depreciation of the dollar can be expected to reduce the large trade deficit, a trend which can be encouraged through reduction in our Federal deficits. Failure to initiate budgetary reductions will invariably

result in further erosion of America's agriculture and industrial competitiveness.

An equally significant cause of America's trade deficit is to be found in restrictive import practices of our trading partners. By this we mean (1) the myriad nontariff barriers (NTB's) which both our Japanese and European partners place around their protected marketplace and (2) the many structural rigidities which, even in the absence of NTB's, would seriously inhibit demand for U.S. imports.

In the case of the European Community, restrictive trade practices are partly responsible for the 13 percent reduction in U.S. exports between 1980 and 1984, while U.S. imports of EC goods have expanded by more than 50 percent over the same period. The result? A major reversal in the U.S.-EC trade account—moving from +$24 billion in 1980, to a deficit of $11 billion in 1984, and the prospect of a $20 billion U.S. deficit with the Community this year. But American-European trade tensions also extend to Third Country markets, where subsidized EC agricultural exports have severely reduced U.S. market shares.

Regarding Japan, that dynamic economy could play a key role in revitalizing the global economy and reducing the huge U.S. trade deficit. But will Japan grasp this opportunity? This is a haunting question in light of a projected $50 billion U.S. trade imbalance with a partner that persists in the outmoded view that its survival requires a trade surplus, even at the expense of the United States. Japan had a stunning manufactured goods trade surplus of more than $125 billion in 1984, while the United States had a comparable deficit of $80.7 billion.

Finally, Third World debt servicing requirements compel these countries to adopt severe adjustment programs, designed to conserve hard currency, through drastic cutbacks in imports and equally significant increases in exports. The United States supports these adjustment programs; but the United States has paid a major price for doing so in the form of growing trade deficits with a number of less developed countries. A case in point is the vital Latin American market where the U.S. merchandise trade deficit was $16 billion in 1984.

The United States welcomes international competition. But the Japanese, and to a lesser degree, European and Third World adherence to anticompetitive trade practices, threatens the very foundation of the Western free market system. The Congress has, accordingly, called upon the Administration to negotiate a meaningful liberalization package with our trade partners. But, in the absence of visible and immediate progress in opening up foreign markets and ameliorating the worst export abuses, the United States may, regretfully, have to consider retaliatory measures.

The United States remains the largest trading nation in the world. Last year, U.S. merchandise exports of $218 billion were 34 percent greater than those of Japan, and 22 percent greater than those of West Germany.

While the ratios of U.S. exports and imports to gross national product are relatively small—5.8 percent and 9.3 percent in 1984, respectively—America cannot be expected to carry the burdens of maintaining the international trading system in the absence of

greater assistance from its partners, beginning with a major, long-term reduction in the U.S. trade deficit.

SOLUTIONS

How can this reduction be achieved? One means is through adoption of protectionist practices which could undermine American competitiveness. A preferable option would be to consider more constructive approaches to trade deficit reduction. The following deserve special consideration:

- A new round of multilateral trade negotiations for the purpose of seriously combating the kinds of unfair practices which diminish sales prospects for U.S. goods.
- Complementary rigorous enforcement of U.S. trade laws on the bilateral level in order to provide American producers with a more level playing field.
- Most important, adoption by the Third World, Europe, and Japan, of the kinds of free market, progrowth policies which, over the long term, provide the best guarantee for future trade-generated growth from which everyone benefits, including the United States.

VI. U.S. COMPETITIVENESS

Our fundamental, long-term competitive position depends mainly on the strength of our domestic economy and the efficiency with which we use our economic resources. While current U.S. trade policy focuses on such specific problems as access to Japanese markets, it must be recognized that our competitiveness is ultimately determined by the same economic forces that determine domestic economic growth.

Long-term per capita economic growth depends upon technological progress and upon increasing output per worker. During the current expansion, some very favorable trends are emerging, with the implication that technology and productivity developments will contribute significantly to the continuation of the expansion.

Background

During the 1970's, productivity slumped alarmingly. Between the late 1940's and the early 1970's, output per hour in the private business sector grew at an average annual rate of nearly 3 percent. But by 1982, the level of productivity was scarcely higher than it had been in 1973. In the 1970's, business sector productivity grew only 1.5 percent per year, and actually declined in 1979 and 1980.

Another worrisome sign during the 1970's was the slowdown in spending on research and development. Not only did Federal funding of R&D tail off after NASA's Apollo project ended, private R&D spending also slowed, from an average growth rate of around 6 percent (in constant dollars) during the late 1950's and 1960's to only 2.8 percent between 1968 and 1977. In 3 of those years, real R&D spending actually fell. Since technical progress almost always begins with research, this drop in R&D growth was ominous. It spelled trouble not just for productivity growth, but for foreign trade as well, since a significant share of U.S. exports are goods that incorporate new technology.

Recent Developments

Productivity has improved since 1982 at a pace close to that of typical recoveries. In 1984, however, productivity surged, quite possibly reflecting a movement back to the high secular growth rates of pre-1973 vintage. Productivity in the business sector increased by 3.2 percent, the best since 1976. Manufacturing productivity grew 3.5 percent in 1984, the largest gain since during the Eisenhower Administration. Unit labor costs in manufacturing have declined in the current recovery, thanks to the combination of healthy productivity gains and moderate wage increases.

Company spending on research and development has been growing at a rapid pace since 1979, apparently banishing the earlier slump for the foreseeable future. Surprisingly, R&D spending by

companies did not decline during the 1982 recession but instead continued to expand (owing in part to the tax credit for R&D that took effect in mid-1981). In 1984, R&D spending surged by 14 percent in current dollars (according to the McGraw-Hill survey) to nearly $50 billion.

Short-Term Outlook

Productivity growth in 1985 will probably moderate from the unusually strong performance of 1984, but an 11 percent increase in R&D spending (or about 7 percent in real terms) appears likely. This is good news for U.S. competitiveness, thanks to the cost reductions that result from productivity growth. The new products that the past several years of R&D will have generated will also help exports. In addition, if the dollar continues its downward drift, U.S. exports will develop a relative price advantage from the shift in exchange rates. Actual increases in exports, however, typically lag a year or more behind decreases in their relative prices.

Policy Considerations

As stated earlier, our basic, long-term competitive position depends upon the strength of our domestic economy and the efficiency with which it operates. For this section, this broad topic is narrowed to cover only the economic policy issues related to technological change.

The near-term policy decision most relevant to research and development is whether to extend the R&D tax credit, which expires at the end of 1985. The President's tax-reform proposal calls for a 3-year extension, but many technology advocates recommend making the credit permanent. Only a permanent credit can be fully incorporated into business planning. Consequently, the credit should be made permanent.

The tax reform debate touches on several points of importance to technological change. Taxing capital gains at lower rates than ordinary income (as is now the case) is favorable to the formation of venture capital and hence to startup high-technology companies. Both the President's proposal and the Kemp-Kasten bill would retain the capital-gains differential, but Bradley-Gephardt would not. Capital formation issues are doubly applicable to technology. High-tech industries typically have high rates of capital formation, so they are relatively sensitive to changes in tax provisions which affect the cost of capital (e.g., depreciation rates and the retention of the investment tax credit). More generally, U.S. high-tech companies are essentially capital goods producers, meaning that they flourish when capital formation in the industrial sector is rapid. The capital-formation aspects of the various tax plans have been hotly debated for their effects on all industry, but suffice it to say that "as capital formation goes, so goes high-tech industry." Capital formation issues should be given priority in overall tax reform.

Our high-technology industries are, by and large, our leading exporters in manufacturing—aerospace, computers, instruments, and certain chemical products. But other nations' efforts to develop their high-tech sector have too frequently engendered barriers to imports from the United States. Efforts to reduce these barriers

are important not only to short-term employment and trade performance, but also to the long-term competitiveness of our technology base. Markets for high-tech goods expand rapidly, and lost markets are difficult to recover. The Congress needs to continue to press the Administration to negotiate reductions in trade barriers that affect our technology-based exports.

VII. THE AGRICULTURAL ECONOMY AND FARM POLICY

If most farmers, ranchers, and rural business owners were asked the question "Is the expansion over?" the likely response would be "When did it begin?" According to Department of Agriculture forecasts, real 1985 net farm income will be 40 percent lower than last year, almost 60 percent less than in 1981 and one-half the level realized in 1975. In contrast, real gross national product during the last 10 years has increased by better than 30 percent.

The real gross national product for agricultural, forestry, and fisheries industries has been on the decline since 1981, oblivious to the "aggregate" or general economic recovery which began in December 1982. Compounding the financial problems in agriculture, in addition to the substantial decline in real income, the farming sector suffered real capital losses on farm real estate amounting to $149 billion in the first 4 years of the 1980's.

The U.S. Department of Agriculture projects that total net farm income in 1985 could be as low as $29 billion, down from $31 billion the previous year. Cash receipts for crop and livestock sales and total farm cash expenses are virtually unchanged from 1984, resulting in little change between 1984 and 1985 in farm net cash income. Off-farm income in 1985 is expected to be up $2 billion from 1984 levels, attaining a historic record $45 billion.

The volume of U.S. agricultural exports in 1985 will record its fourth consecutive yearly decline—a drop of 12 percent or almost 20 million tons of product since the 1980–81 peak of 162.3 million tons. The value of U.S. agricultural exports in 1985 is expected to total $34.5 billion, down 21 percent or $9.3 billion from its historic high of $43.8 billion achieved in 1980–81.

Little if any improvement in farm net income is seen over the next couple of years because global demand is expected to remain weak while global supplies continue to grow. In spite of low prices, supply controls, farm bankruptcies, and export promotion programs, the 1986–87 marketing year will be burdened with additional surpluses of 47 million bushels of soybeans, 95 million bushels of wheat, and 855 million bushels of corn. Price and income prospects over the short term are better (relatively) for the livestock industry as the U.S. cattle herd is projected to reach 106 million head by January 1, 1987, 4 million below January 1985 levels and 10 million fewer head than the most recent peak of 1982. All of this demonstrates that at least in agriculture the forces of supply and demand will have their way.

Farm Policy

Every 4 years since 1973, Congress has enacted new legislation governing the production and marketing of farm products. The 99th Congress, however, is confronted with a particularly difficult

task in devising the 1985 farm bill: designing farm legislation which must do better with less. Increased Federal spending on traditional farm programs—doing more of the same—is not an acceptable option given the questionable effectiveness of these programs and record Federal deficits. Doing less of the same would be wholly inadequate in effectively dealing with the serious and deepening financial stress of the agricultural community.

Eleven comprehensive bills have been introduced to replace the 1981 Farm Act since the opening of the 99th Congress. Each bill has its proponents and opponents, all of whom profess to have the solution. One thing for sure, whatever the Congress does regarding the nature of food and agricultural programs, the consequence will be widespread impacts throughout the U.S. economy. The challenge is the identification and measurement of these impacts.

In January 1985, Senator Jim Abdnor, Vice Chairman of the Joint Economic Committee, requested the Council for Agricultural Science and Technology (CAST) to assemble a taskforce of university agricultural economists for the purpose of devising a methodology which could be employed to measure the impacts of alternative farm bill proposals. The taskforce was successful in devising such a methodology—or common measurement tool—and subsequently applied the methodology to gauge the effects of four farm options: (1) An extension of the Agricultural and Food Act of 1981, with target prices and loan rates frozen at 1984–85 levels, (2) the Administration's proposed Agricultural Adjustment Act of 1985, (3) a modification of the current farm program, and (4) a mandatory supply-reduction program.

The following is a brief description of these policy options:

Option 1: "Extension of 1981 Act" with target prices and loan rates frozen at 1984–85 levels.

Option 2: "The Agricultural Adjustment Act of 1980," the most "market-oriented" option. Substantially lower target prices and loan rates and reduce payment limitations to farmers from $50,000 per farmer to $20,000 in 1986, $15,000 in 1987, and $10,000 thereafter.

Option 3: "Modified current program," instituting lower loan rates but higher target prices. Farmers choosing to voluntarily participate in the program by reducing production would be eligible for target price protection on only one-half of their production.

Option 4: "Mandatory supply-reduction program." Target prices would be eliminated. Marketing quotas would be approved for a 4-year period by 60 percent of farmers voting in a referendum. When approved by producers, marketing quotas would be established at levels necessary to reduce supplies sufficiently to generate prices at 70 percent of parity in 1986, the legislated loan rate. Loan rates subsequently would be raised by two parity-index points per year until a 90-percent price parity level is achieved.

Direct point-by-point comparisons between the expected impacts of the four options on agricultural prices and incomes, agribusiness, trade, food prices and consumer expenditures for food, and government costs are facilitated by the following summary tables.

Estimates of impacts are made for the short term (1 to 2 years) and intermediate term (3 to 5 years).

The findings of the analysis clearly demonstrate the dilemmas confronted by farm policymakers. The higher and more stable incomes for grain farmers claimed by the mandatory supply control policy advocates would yield negative impacts for livestock producers, agribusiness firms, farm labor, grain storage and transportation companies, consumers and export sales. Yet the more "market oriented" farm policy options appear to offer little relief to the financially distressed grain farmers. In fact, of the four policy options analyzed, a simple extension of current policy with a freeze in loan rates and target prices at 1984–85 levels apparently would yield the best balance between conflicting interests.

TABLE VII.1.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON CASH RECEIPTS AND NET FARM INCOME FROM 1987–90

[In billions of dollars]

Item	Option 1 "Extension"			Option 2 "AAA"		Option 3 "Modified"		Option 4 "Mandatory"	
	1985	1987	1990	1987	1990	1987	1990	1987	1990
Total cash receipts	147	159	175	152	164	152	167	169	191
Direct Government payments	5	5	4	5	0	7	4	0	0
Realized gross farm income	169	178	196	175	186	177	192	184	221
Net farm income	25	25	26	20	16	21	23	38	40
Net farm income in 1972 dollars	11	10	9	8	5	8	8	15	13

TABLE VII.2.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON SELECTED ASPECTS OF FARMER WELFARE

Nature of policy impact	Option 1 "Extension" [1]		Option 2 "AAA" [1]		Option 3 "Modified" [1]		Option 4 "Mandatory" [1]	
	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr
Farm production prices	NC	H	L	L	L	L	H	MH
Variability of farm product prices.	NC	NC	H	H	H	H	L	ML
Variability of net farm income	NC	NC	H	H	NC	NC	L	L
Relative concentration of farm income in large farms.	NC	NC	H	H	H	H	H	H
Net farm income of livestock producers.	NC	NC	H	NC	H	NC	ML	NC
Land values	L	L	L	L	L	L	H	MH
Cost of credit in agriculture relative to other sectors.	NC	H	H	H	NC	H	L	L
Number of commerical farms	L	L	L	L	L	L	L	L
Amount of grain stocks in storage:								
Privately held	NC	NC	NC	H	L	L	L	ML
Publicly held	NC	NC	L	ML	L	L	L	L

[1] NC=No Change; L=Lower; ML=Much Lower; H=Higher; MH=Much Higher.

TABLE VII.3.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON U.S. AGRICULTURAL EXPORTS

Units of measure and commodities	Option 1 "Extension"		Option 2 "AAA"		Option 3 "Modified"		Option 4 "Mandatory"	
	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr
Volume:								
Wheat	NC	H	H	MH	NC	MH	ML	ML
Corn	NC	H	NC	H	NC	H	L	ML
Soybeans	NC	MH	H	MH	H	MH	L	ML
Cotton	L	H	NC	H	NC	H	ML	ML
Value:								
Wheat	NC	MH	H	MH	NC	MH	MH	L
Corn	NC	H	ML	NC	ML	MH	MH	MH
Soybeans	NC	MH	L	H	NC	MH	MH	MH
Cotton	L	MH	ML	MH	ML	MH	L	ML

NC=No Change; L=Lower; ML=Much Lower; H=Higher; MH=Much Higher.

TABLE VII.4.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON THE DEMAND FOR THE PRODUCTS AND SERVICES OF AGRIBUSINESS

	Option 1 "Extension"		Option 2 "AAA"		Option 3 "Modified"		Option 4 "Mandatory"	
	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr
Input suppliers:								
Fertilizer and other agricultural chemicals.	NC	H	NC	H	NC	H	L	ML
Machinery	NC	NC	L	L	NC	NC	H	NC
Demand for credit	NC	H	NC	NC	NC	H	NC	NC
Management and technical personnel.	H	H	H	H	H	H	H	H
Farm labor	NC	NC	NC	NC	NC	NC	L	L
Marketing system:								
Demand for commercial storage facilities.	L	L	L	ML	NC	L	L	ML
Other services, including transportation and initial processing.	NC	H	NC	H	NC	H	L	ML

NC=No Change; L=Lower; ML=Much Lower; H=Higher; MH=Much Higher.

TABLE VII.5.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON FOOD AVAILABILITY, PRICES, AND EXPENDITURES BY THE TYPICAL CONSUMER

Nature of impact	Option 1 "Extension"		Option 2 "AAA"		Option 3 "Modified"		Option 4 "Mandatory"	
	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr	1 to 2 yr	3 to 5 yr
Food availability	NC	NC	NC	NC	NC	NC	NC	NC
Food prices	NC	NC	NC	NC	NC	NC	NC	H
Food expenditures	NC	NC	NC	NC	NC	NC	NC	H

NC=No Change; H=Higher.

TABLE VII.6.—PROJECTED IMPACTS OF AGRICULTURAL POLICY OPTIONS ON GOVERNMENT COSTS

[In billions of dollars]

Program costs for food grain, feed grain, and other programs	Option 1 "Extension"			Option 2 "AAA"		Option 3 "Modified"		Option 4 "Mandatory"	
	1984–85	1986–87	1989–90	1986–87	1989–90	1986–87	1989–90	1986–87	1989–90
Direct payments to producers	4.8	5.7	3.3	4.6	0	7.0	4.0	0	0
Other nonrecoverable costs	1.3	1.6	1.4	3.5	.8	1.5	1.2	1.0	1.0
Total Government costs	6.1	7.3	4.7	8.1	.8	8.5	5.2	1.0	1.0

VIII. THE RURAL ECONOMY: HARDSHIP CONTINUES

It is no secret that nonmetropolitan and rural areas are not keeping pace with the economic growth of metropolitan America. And because the rural economic base is smaller than the urban on a per capita basis, a reduced growth rate has resulted in a widening gap in economic performance between metro and nonmetro localities.

The acclaimed "rural renaissance" of the 1970's came to an end about 1978. Since then, nonmetro population and personal income growth has lagged behind metro growth. Nominal nonmetro income growth in the 4 years 1979–83 was about 35 percent, compared to about 40 percent for metro. Since nonmetro per capita personal income is 40 percent less than metro, the income differential between metro and nonmetro increased significantly during this 4 year period. Population growth in nonmetro areas outpaced metro areas by nearly 25 percent in the 1970's, but that trend reversed to its historical pattern by the end of the decade. From 1979 to 1983, nonmetro population growth slacked off to just four-fifths of the pace of metro population growth. These trends of slower income and population growth relative to metro continued in 1984 and 1985 to date.

Nonmetro economic growth varies by region as well. New England, Southwest, and Rocky Mountain nonmetro areas actually exceeded the U.S. average metro growth rate between 1979 and 1983. The Plains States' nonmetro areas fared the worst, with annual personal income growth rates around the 2 percent range, compared to about 9 percent nationwide.

While data are not readily available, the population and income picture for the rural subset predictably is worse than is indicated by the nonmetro figures. Three-quarters of the Nation's 3,200 counties are rural by definition. Of this number, some 700 depend on farm income for at least 20 percent of total earned income. Given the condition of the agricultural economy during the past 5 years, these farm-dependent counties have experienced little if any growth in the 1980's. Limited off-farm job opportunities exist there, further compounding the economic problems of those areas.

The slow down in nonmetro performance can be explained largely by the condition of the agricultural and manufacturing sectors of the nonmetro economy. Excluding agriculture and manufacturing, nonmetro growth in earnings is 46 percent higher than the overall nonmetro rate, while metro earnings growth is just 15 percent higher than the overall metro rate. That dramatic difference demonstrates the rural dependency on agriculture and manufacturing as sources of income and their present lackluster condition.

When the primary industries of a local economy contract, supportive economic activity such as Main Street stores and services and government experience a decline as well. This is evident in

smaller towns across the Nation. Adjustments of this nature can be expected for the remainder of this year because little change is expected in agriculture, forestry, mining, and rural manufacturing.

At a time when increased governmental assistance could be justified, rural and nonmetro programs have been reduced due to deficit reduction actions. For example, budget authority for nonfarm development programs of the Farmers Home Administration have fallen from $2.3 billion in fiscal year 1980 to $0.4 billion in fiscal year 1985. Making matters worse, nonmetro areas will receive less than 21 percent of total farm and development program funding even though 27 percent of the population resides in these areas.

Other agency programs show that nonmetro America may not be receiving an equitable share of funding. Only 1 percent of Community Development Block Grant funds and 12 percent of Urban Development Action Grant funds are slated for nonmetro areas in fiscal year 1985. Even Rural Electrification Administration programs are not devoted exclusively to rural America. Only about 80 percent of REA funding goes to nonmetro areas. Any further budgetary cuts in rural programs would be devastating to the rural population.

Decreased funding levels for rural programs do not indicate an outright abandonment on the part of the Administration, but probably suggest frustration. The ineffectiveness of some programs may have been a compelling reason to reduce support. The Reagan Administration has placed considerable emphasis on promoting the merits of free enterprise, fostering private and public sector partnerships, expanding rural export programs, creating Certified Development Companies and Small Business Development Centers, and proposing rural enterprise zones to encourage investment in economically distressed areas.

Rural data reported by the Federal Government are subject to inaccuracy due to sampling and collection errors and cutbacks in funding. As a result, Federal funding allocation formulas are flawed, to the disadvantage of rural residents. This is particularly true regarding labor data. A striking example of this unfair bias against rural areas is the funding formula used for the Job Training Partnership Act of 1982. Two-thirds of the funding was allocated by unemployment figures that were of little relevance to rural labor conditions.

Underemployment and lower income are two nagging problems facing rural laborers. A recent study constructed a "subemployment" rate for the metro and nonmetro labor force. The rate for nonmetro males was some six times greater and for females three times greater than that for their metro counterparts. Nonmetro household income presently lags about 28 percent below the metro average. While income is not specifically an employment statistic, it certainly reflects the general welfare of the labor force and is a valid consideration for use in allocation formulas, as is "subemployment." Yet, current funding practices do not adequately account for these hardship considerations. Federal allocation formulas should employ rural unemployment and income factors which reflect rural hardship.

If public policy toward rural America is to be effective in the future, a wholesale reassessment of the rural economy is impera-

tive. The stereotyped description of rural America no longer is an adequate representation. Technology and other market forces are changing the face of small communities and the way rural areas interact with the rest of the economy. No longer is rural America insulated from macroeconomic factors such as inflation, interest rates, the value of the dollar in foreign exchange, U.S. competitiveness and foreign trade.

The human and natural resources of rural America offer both opportunities and challenges, requiring policymakers to redefine economic development goals for the future. This is not a nostalgic desire to maintain the status quo. Clearly, agriculture and other natural resource and raw materials industries alone cannot support a growing rural population. The industrial bases of rural communities must expand and diversify to accommodate the changing demands of an increasingly technology- and information-based society. Rural America must adapt to the new U.S. and world economies or face an economic identity crisis for years to come. Congress must renew its commitment and support to the rural economy.

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