EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

March 31, 1981

Mr. Dewey J. Daane
Vanderbilt University
2505 West End Avenue
Nashville, Tennessee 37203

Dear Dewey:

Here are my expenses for the trip to Nashville:

Cab to National Airport	$6.50
Plane fare (receipt enclosed)	264.00
Cab from National Airport	$7.50
	278.00

Please make the check payable to me.

Thanks again for your kindness. I very much enjoyed my short stay at Vanderbilt and look forward to a repeat engagement next spring.

Best regards,

Steve

Stephen H. Brooks
Senior Staff Economist

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EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

March 27, 1981

MEMORANDUM FOR: Murray L. Weidenbaum

FROM: Steve Brooks

SUBJECT: The CBO Report on the President's Budget Revisions

The CBO report is, to my mind, a relatively balanced analysis of the March budget submission. "Phony" was, of course, way too strong. Indeed in many ways, the Administration' position is strengthened by certain aspects of the report. Nevertheless, it raises some very important questions.

The Budget Totals

The headline grabber is that the CBO estimates a weaker economy, more spending, and a larger deficit than the Administration. The table below shows the budget detail.

CBO Estimates of Budget Totals Based on Administration Tax and Spending Poposals

(By fiscal year, in billions of dollars)

	1981	1982	1983	1984
Revenues				
Administration	600	650	709	771
CBO	599	654	707	769
Outlays				
Administration	655	695	732	770
CBO	662	721	766	818
Surplus or Deficit (-)				
Administration	-55	-45	-23	1
CBO	-63	-67	-59	-49

The economic forecasts are compared below:

	1981		1982		1983	
Percent Change	Admin.	CBO	Admin.	CBO	Admin.	CBO
Nominal GNP	11.1	11.8	12.8	11.9	12.4	11.5
Real GNP	1.1	1.3	4.2	2.5	5.0	2.7
GNP deflator	9.9	10.3	8.3	9.2	7.0	8.6

*CBO Alternative with Administration budget proposals.

The report notes that the budget deficit calculations are different because of two factors. The first, economic assumptions (unemployment rates, inflation, and interest rates, etc.), account for "more than half of the differences in outlay estimates. . .". The second, technical estimates (e.g., DOD spending patterns, trend growth in entitlement programs, farm production, etc.) account for the remainder. These are the traditional differences among budget estimates. They will remain continuing source of controversy about the accuracy of projections. There are no major philosophical differences between the CBO and Administration estimates.

One question that the report leaves unanswered is the accuracy of the budget cut estimates: do the program changes specified by the President actually result in outlay cuts equal to those projected by the President? I called Jim Blum and Bill Beeman to find their answer. They were unable to give me a specific estimate, but Blum's impression was

that his estimates of budget cuts would be different by no more than $4 or $5 billion at most. This is certainly within the normal range of budget accuracy.

The upshot of all of this is that the differences between the President's and CBO's estimates should be thought of as mainly "judgement calls"; judgement about the state of the economy and judgement about technical differences in budget estimation.

The Economic Impact

The CBO report compares their baseline forecast (which includes unspecified tax cuts) with their alternative forecast using the President's budget proposals, I was not totally clear about what policy was in their baseline thus I am uncertain as to the exact relevance of the estimates, but they show almost no economic impact. However, one important fact remains. Under the CBO alternative which includes the President's proposals, inflation is steadily reduced from 10.3 percent (GNP deflator) in 1981 to 7.0 percent in 1986. The clear implication of this is that under CBOs analysis the President's proposals are not inflationary as many have claimed. Other minor points:

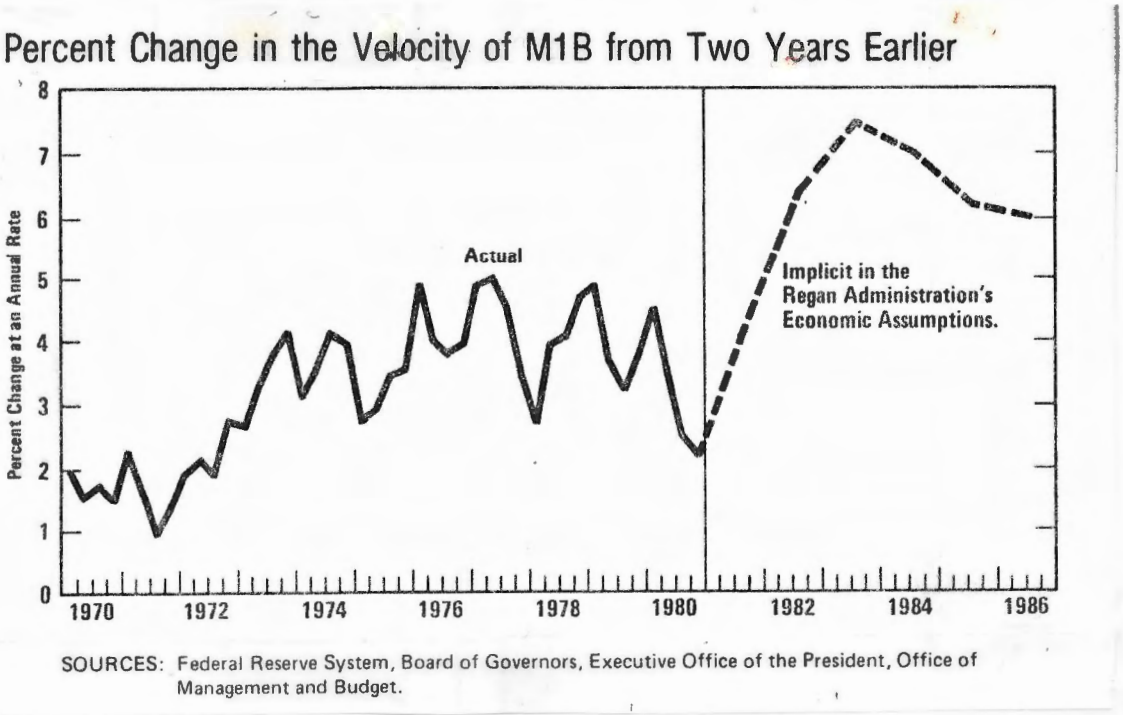
- The report spends a bit of time detailing the potential supply-side benefits from the program by inspecting labor supply elasticities etc. I think that it is a fairly balanced analysis of the econometric evidence.

- The report focuses a bit of attention on the potential deficit-increasing offsets to the budget cuts: cutting PSE payrolls will raise unemployment benefits and reduce payroll taxes, etc.

- The report recognizes that their evidence on macro impacts is drawn from large models "based on the history of the U.S. economy since World War II."

- The report notes that the impacts of many features of the program on expectations and the like are difficult to quantify. In addition it notes that the impact of unspecified regulatory reform on the overall economic outlook is also hard to estimate.

- The report specifically singles out monetary policy and velocity assumptions for questioning. The following chart captures the essence of the CBO criticism.



SOURCES: Federal Reserve System, Board of Governors, Executive Office of the President, Office of Management and Budget.

- The report specifically notes that the proposed personal tax cuts will merely offset the combined impact of the inflation-induced increases in individual taxes and scheduled Social Security tax increases. (see page xv).

What if CBO is correct?

The single most important question raised by the report is as follows: "The Administration's budget estimates are subject to error. The CBOs analysis suggests that under somewhat less optimistic economic assumptions the budget deficit would be considerably higher ($25 billion) than that estimated by the Adminstration. Does the Administration intend to achieve its deficit goals regardless of the state of the economy or will it allow a larger deficit if the economy is less boyant?" This question must be answered soon.

Are we going to chase the deficit wherever it may lead us or are we going to stick with these program changes and let the resulting deficit fall out of whatever the economy gives us?

cc: BN,JB, AW, DM, MM, DR

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

March 23, 1981

MEMORANDUM FOR: Murray L. Weidenbaum

FROM: Steve Brooks

SUBJECT: Growth Assumptions Given the "Flash"

The first-quarter flash estimate was very good news for meeting the 1981 growth targets. The details are these.

1. If we simply "string on" projected growth rates from the Budget for the second, third, and fourth quarters of this year we would get fourth-over-fourth growth of 2.5 percent and year-over-year growth of 2.0 percent.

2. We can sustain fairly sharp drops in output and still hit the projected growth rates (both year-over-year and fourth-over-fourth). Two alternatives are shown below.

Real GNP percent change
(SAAR)

	1980 Actual	Flash		Estimates	
	IV	I	II	III	IV
Alternative A	3.8	5.5	-4.6	0	5.0
Alternative B	3.8	5.5	-3.0	-3.2	5.7

3. If there were no growth in real GNP for the rest of the year, the fourth-over-fourth growth would be 1.4 percent and the year-over-year growth would be 1.7 percent.

cc: BN, JB, AW, DR, MM, DM

Chron

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

March 20, 1981

MEMORANDUM FOR: Murray L. Weidenbaum

FROM: Steve Brooks

SUBJECT: Talking Points on the Current Economic Environment

1. The recent "flash" estimate for the first quarter puts growth at a 5 percent annual rate. This is considerably above what had been the consensus. The first quarter strength comes from consumption -- in particular a surge in car sales, business fixed investment and housing.

2. Much of the strength in the first quarter was "banked" in January and February. March, it should be noted, is looking relatively weak. The details are these:

- o Personal income rose 0.6 percent in February with only a .5 percent gain in wages and salaries. The February personal income rise was smaller than January despite the 0.4 percent January loss to the social security tax increase.
- o Employment increased by 0.4 percent in January and 0.2 percent in February (based on household data). The February unemployment rate was 7.3 percent, down from 7.4 percent in January and 7.6 percent in last October.
- o Producer prices for finished goods increased at a seasonally adjusted annual rate of 10.7 percent in February -- the same as in January. Declines in food prices roughly offset energy price increases arising, in part, from decontrol.

- Consumer prices face bleak prospects in the immediate future. Gasoline at retail rose 8 to 9¢ in February, roughly twice the January increase.
  Housing and interest rates will still be rising about the same as January, due to reporting lag.
  Food price increases may slow, based on the PPI.
  The PPI increase for finished goods excluding food and fuel has been at a 10 percent annual rate in recent months.

- Retail sales rose 2.9 percent in January, 0.9 in February. Most of the increase, however, was in gasoline and cars. Real retail sales rose 1.4 percent in January and will probably be about unchanged in February. This would put February real retail sales 1.6 percent above the average for the preceding quarter.

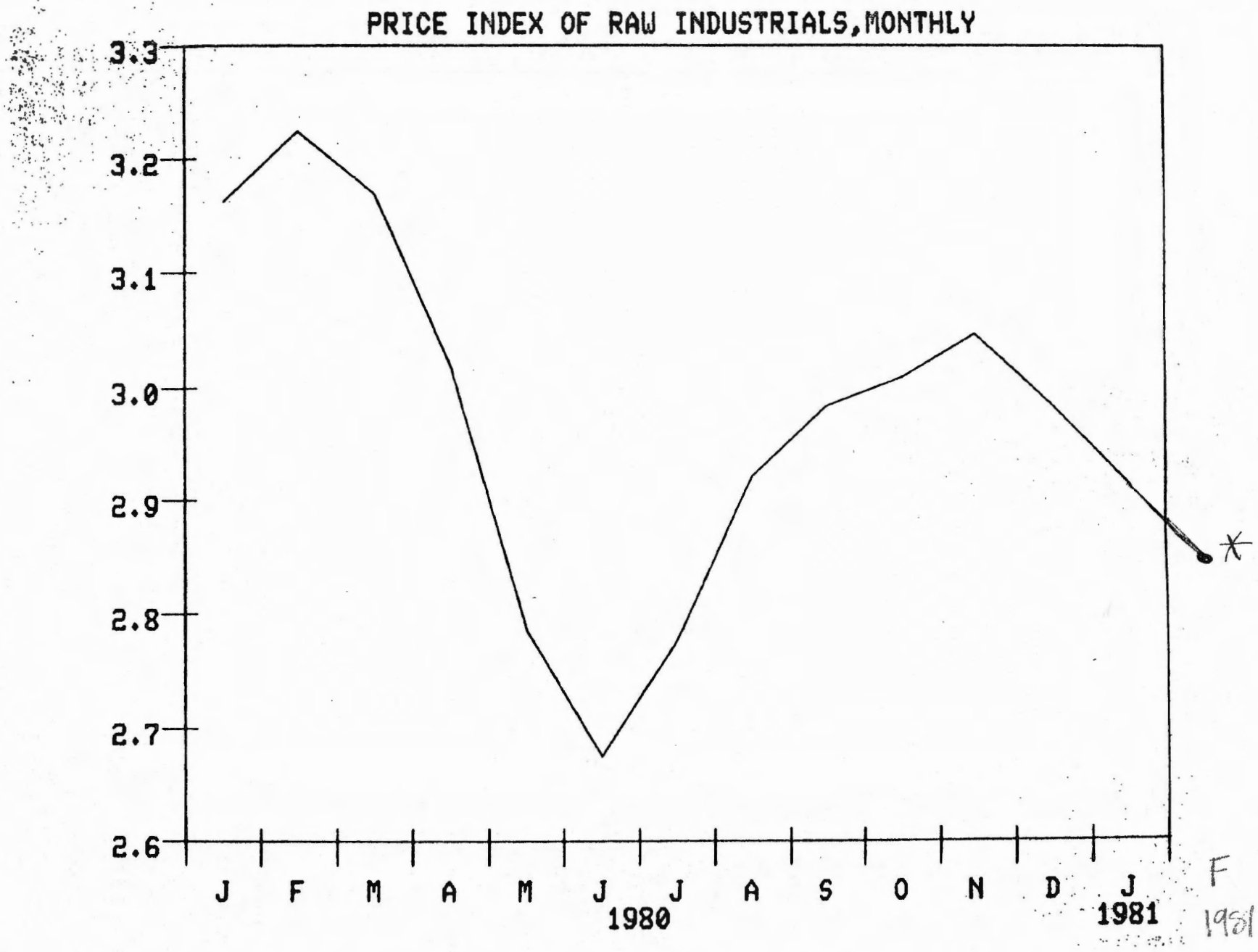
- Manufacturing inventories increased by $4.5 billion in January -- a strong increase, but at least partially reflecting abuildup of defense work in process.

- Industrial production fell 0.5 percent in February and capacity utilization dropped to 79.3 percent. Some of the decline may be caused by faulty seasonal adjustment. While the January and February industrial production results suggest a 5 percent annualized increase from last quarter to this quarter, the monthly pattern of increases has been tailing off since last fall.

- Housing starts in February fell 25 percent to a 1.22 million unit annual rate after remaining in the 1.55 area since last fall. Permits also fell to only 1.1 million, the lowest since last June.

- Capital spending indicators are up
  - New capital goods orders have been rising strongly since the trough last May.
  - The current BEA survey suggests flat year-to-year real investment in '81; which implies strong increases during 1981.

- Automobile sales increased in February to a 10.5 million annual rate from 9.6 million in January. The major strength in sales came in the last 10 days of the month, reflecting price rebates by producers. At the same time, production plans for March were revised down slightly.
  Domestic car sales for the first 10 days of March were at an annual rate of 8.2 million units, down from the 10.3 million of the prior 10-day period, but still reflecting strength from the industry price rebate.


PRICE INDEX OF RAW INDUSTRIALS, MONTHLY
3.3
3.2
3.1
3.0
2.9
2.8
2.7
2.6
J F M A M J J A S O N D J
1980
1981
F
1981
*estimate

- o Federal Reserve monetary policy appeared restrictive from late last year through February. Various measures of money exhibited less growth than implied by the Fed's announced monetary targets. For example, from November to February M1-B grew at a 2 percent annual rate -- well below the 6 percent lower limit (before adjusting for nationwide NOW accounts) for this aggregate. During this period the monetary base expanded at a 3-1/4 percent rate, compared to an 11-3/4 percent pace in the previous three months. However, in the early weeks of March both the monetary base and M-1B accelerated somewhat, while short-term interest rates declined 2 to 3 percentage points. At this time, the ease or tightness of monetary policy is difficult to call.

3. The forecast for a relatively flat second quarter looks pretty much on track although a decline in real activity is a distinct possibility. The early readings are as follows:

- o Neither we nor the Fed knows exactly what is happening with the aggregates. Nevertheless the recent decline in interest rates and in loan demand could very well be telling us something about weakness in the real economy.

- o Sensitive industrial prices have softened considerably since November of last year. The attached chart shows some of the detail. Although these prices increased somewhat near the end of February, the monthly average for February was below the January level. This could also signal a weakening in real demands (just as last year's industrial-price plunge foreshadowed the steep second-quarter drop.)

- o Initial claims for unemployment insurance have shown very little change since mid-February and the insured unemployed rate has held at about 3.3 percent since mid-January.

Also attached are two tables showing the monthly highlights for January and as much as we have for February.

MONTHLY ECONOMIC REPORT
JANUARY 1981

	LEVELS		LEVELS, OR % CH., A.R., FROM		
	CURRENT MONTH	PREVIOUS MONTH	PREVIOUS MONTH	3 MONTHS AGO	12 MONTHS AGO**
OR MARKETS					
UNEMPLOYMENT RATES (%)					
*Total	7.4		7.4	7.6	6.2
*Adult Male	6.0		6.2	6.4	4.8
*Insured	3.4		3.5	4.1	3.2
INITIAL CLAIMS (THOUSANDS, WEEKLY RATE)	415.0	394.0	86.5	-20.1	2.7
EMPLOYMENT AND LABOR FORCE (MILLIONS)					
Household Employment	97.7	97.3	5.2	2.0	0.0
Establishment Employment	91.5	91.1	5.0	3.5	0.5
Labor Force	105.5	105.1	5.6	1.4	1.3
HOURS OF PRIVATE EMPLOYEES (BILLIONS)	141.0	139.5	14.1	8.2	0.5
SONAL INCOME, CONSUMPTION, & SAVING ($BILL.)					
Personal Income	2,298.8	2,276.6	12.4	12.1	10.7
Wage & Salary Disbursements	1,431.9	1,411.2	19.1	15.3	9.6
Disposable Income	1,929.6	1,913.1	10.9	10.9	9.8
Nominal Consumption	1,795.0	1,771.0	17.5	15.9	10.2
Real Consumption	958.2	951.1	9.3	7.1	0.4
Retail sales--Nominal***	85.1	82.6	41.6	24.1	7.1
Retail Sales--Real***	44.0	43.4	17.6	9.8	-3.6
*Car Sales (Millions of Units)	9.7		8.9	9.2	11.9
*Saving Rate (%)	4.4		4.8	5.6	4.8
IANCIAL MARKETS					
MONEY STOCK ($BILLIONS)					
M-1B	416.1	411.9	12.9	4.0	7.2
M-2	1,681.3	1,673.4	5.8	6.1	9.6
INTEREST RATES					
*3-Month T-Bills	15.02		15.49	11.62	12.00
*Federal Funds	19.08		18.90	12.81	13.82
*Prime	20.16		20.35	13.79	15.25
*Moody's AAA Corporate Bonds	12.81		13.21	12.31	11.09
*Effective Mtg. (Existing Homes)	13.67		13.58	12.68	12.10
COM. & INDUS. LOANS AT COM. BANKS ($BILL.)	327.9	323.1	19.4	22.0	10.9
CONSUMER CREDIT					
Level ($Bill.)	307.3	306.5	3.5	4.4	0.3
Extensions ($Bill.)***	27.1	27.1	-3.9	4.4	-3.1
* -- % of Disposable Income	16.8		17.0	17.5	19.1
Liquidations ($Bill.)***	26.2	25.5	35.8	-6.9	3.9
* -- % of Disposable Income	16.3		16.0	17.0	17.2
NON STOCKS--COMPOSITE (12/65=50)	76.2	76.7	-6.8	5.8	19.6

	LEVELS		LEVELS, OR % CH., A.R., FROM		
	CURRENT MONTH	PREVIOUS MONTH	PREVIOUS MONTH	3 MONTHS AGO	12 MONTHS AGO**
PRICES AND WAGES					
CONSUMER PRICES (CPI-U, 1967=100)					
All Items	261.4	259.5	9.1	11.8	11.7
Food	269.8	270.2	-1.8	8.4	10.0
Energy	381.7	370.4	43.4	15.7	16.4
HPFIT	341.2	340.0	4.3	17.2	15.7
All Other	221.9	220.8	6.1	8.5	9.5
PRODUCER PRICES (PPI, 1967=100)					
Finished Goods	259.7	257.5	10.7	7.4	10.9
Food	250.6	250.5	0.5	1.0	8.0
Energy	652.9	635.8	37.5	26.0	26.1
All Other	229.0	227.1	10.5	6.5	9.3
PCE DEFLATOR (1972=100)	187.3	186.2	7.3	8.1	9.7
AVERAGE HOURLY EARNINGS INDEX (1967=100)	264.2	261.9	11.1	10.1	10.0
PRODUCTION AND BUSINESS ACTIVITY					
INDEX OF LEADING INDICATORS (1967=100)	135.8	136.4	-5.2	-0.9	0.8
INDUSTRIAL PRODUCTION INDEX (1967=100)	151.5	150.9	4.9	13.1	-0.8
*CAP. UTILIZATION IN MANUFACTURING (%)	80.0		79.8	78.2	83.9
HOUSING (THOUSANDS)					
Starts	1,585.0	1,532.0	50.4	18.5	14.1
Permits	1,213.0	1,235.0	-19.4	-31.4	-4.6
CONSTRUCTION PUT IN PLACE (1972 $BILL.)					
Total	110.5	105.3	78.3	50.2	-10.0
Private Non-Residential	25.5	24.1	96.9	63.2	-6.6
Public	27.1	25.4	150.9	61.5	-4.7
INVENTORIES AND SALES,					
Business Inventories ($Bill.)	461.8	456.8	14.1	4.7	7.0
*Business Inventory-Sale Ratio	1.36		1.37	1.40	1.38
*Retail Inventory-Sales Ratio	1.32		1.36	1.42	1.36
SHIPMENTS AND NET NEW ORDERS***					
Dur. Manu. Orders (72 $Bill.)	37.5	38.4	-24.0	-6.2	-7.8
Non-Def. Cap. Goods Orders ($B)	23.9	21.7	225.8	81.0	0.2
Non-Def. Cap. Goods Orders (72 $B)	12.4	11.7	115.3	68.4	-6.7
Non-Def. Cap. Gds Shpmnts (67 $B)****	8.8	8.7	20.5	0.9	-3.5
INTERNATIONAL					
MERCHANDISE TRADE ($BILL.)***					
Exports	18.8	19.3	-23.6	-7.9	8.1
Imports	23.2	21.4	157.5	68.8	9.7
*Merchandise Trade Balance	-4.4		-2.2	-1.1	-3.7
MULTILATERAL EXCHANGE RATE (3/73=100)	91.4	91.0	5.3	24.0	6.9

*DATA FOR PREVIOUS MONTHS ARE LEVELS.
**SOME 12 MONTH CHANGES CALCULATED FROM SEASONALLY ADJUSTED DATA, WHICH IS NOT QUITE CORRECT.
***LEVELS ARE AT MONTHLY RATES.
****NOMINAL SHIPMENTS DEFLATED BY THE PPI FOR CAPITAL EQUIPMENT.

MONTHLY ECONOMIC REPORT
FEBRUARY 1981

	LEVELS		LEVELS, OR % CH., A.R., FROM		
	CURRENT MONTH	PREVIOUS MONTH	PREVIOUS MONTH	3 MONTHS AGO	12 MONTHS AGO**
LABOR MARKETS					
UNEMPLOYMENT RATES (%)					
*Total	7.3		7.4	7.5	6.2
*Adult Male	6.0		6.0	6.4	4.7
*Insured	NA		3.4	3.8	3.2
INITIAL CLAIMS (THOUSANDS, WEEKLY RATE)	NA	415.0	NA	NA	NA
EMPLOYMENT AND LABOR FORCE (MILLIONS)					
Household Employment	97.9	97.7	2.9	2.4	0.1
Establishment Employment	91.5	91.5	0.7	2.6	0.4
Labor Force	105.7	105.5	1.6	1.5	1.4
HOURS OF PRIVATE EMPLOYEES (BILLIONS)	NA	141.0	NA	NA	NA
PERSONAL INCOME, CONSUMPTION, & SAVING ($BILL.)					
Personal Income	2,313.7	2,298.8	8.1	10.3	10.9
Wage & Salary Disbursements	1,438.9	1,431.9	6.0	11.5	9.4
Disposable Income	1,942.8	1,929.6	8.5	9.9	10.2
Nominal Consumption	1,818.2	1,795.0	16.7	16.0	12.0
Real Consumption	NA	958.2	NA	NA	NA
Retail sales--Nominal***	86.6	85.7	13.4	20.0	9.8
Retail Sales--Real***	NA	44.0	NA	NA	NA
*Car Sales (Millions of Units)	10.5		9.7	9.3	10.8
*Saving Rate (%)	NA		4.4	5.1	4.9
FINANCIAL MARKETS					
MONEY STOCK ($BILLIONS)					
M-1B	417.2	416.1	3.2	2.1	6.6
M-2	1,692.2	1,681.3	8.1	5.2	9.3
INTEREST RATES					
*3-Month T-Bills	14.79		15.02	13.73	12.86
*Federal Funds	15.93		19.08	15.85	14.13
*Prime	19.43		20.16	16.06	15.63
*Moody's AAA Corporate Bonds	13.35		12.81	12.97	12.38
*Effective Mtg. (Existing Homes)	14.13		13.67	13.26	12.62
COM. & INDUS. LOANS AT COM. BANKS ($BILL.)	NA	327.9	NA	NA	NA
CONSUMER CREDIT					
Level ($Bill.)	NA	307.3	NA	NA	NA
Extensions ($Bill.)***	NA	27.1	NA	NA	NA
* -- % of Disposable Income	NA		16.8	16.4	18.8
Liquidations ($Bill.)***	NA	26.2	NA	NA	NA
* -- % of Disposable Income	NA		16.3	15.9	17.1
NYSE COMMON STOCKS--COMPOSITE (12/65=50)	73.3	76.2	-35.3	-21.7	11.3

FEBRUARY 1981

	LEVELS		LEVELS, OR % CH., A.R., FROM		
	CURRENT MONTH	PREVIOUS MONTH	PREVIOUS MONTH	3 MONTHS AGO	12 MONTH AGO**
PRICES AND WAGES					
CONSUMER PRICES (CPI-U, 1967=100)					
All Items	NA	261.4	NA	NA	NA
Food	NA	269.8	NA	NA	NA
Energy	NA	381.7	NA	NA	NA
HPFIT	NA	341.2	NA	NA	NA
All Other	NA	221.9	NA	NA	NA
PRODUCER PRICES (PPI, 1967=100)					
Finished Goods	261.9	259.7	10.7	9.0	10.4
Food	249.2	250.6	-6.5	-1.7	8.0
Energy	676.2	652.9	52.3	35.0	22.3
All Other	230.9	229.0	10.4	8.8	9.0
PCE DEFLATOR (1972=100)	NA	187.3	NA	NA	NA
AVERAGE HOURLY EARNINGS INDEX (1967=100)	265.6	264.2	6.5	7.4	9.6
PRODUCTION AND BUSINESS ACTIVITY					
INDEX OF LEADING INDICATORS (1967=100)	NA	135.8	NA	NA	NA
INDUSTRIAL PRODUCTION INDEX (1967=100)	150.8	151.5	-5.4	3.8	-1.2
*CAP. UTILIZATION IN MANUFACTURING (%)	79.3		80.0	79.4	83.5
HOUSING (THOUSANDS)					
Starts	1,218.0	1,615.0	-96.6	-61.9	-4.3
Permits	1,143.0	1,228.0	-57.7	-49.4	-2.1
CONSTRUCTION PUT IN PLACE (1972 $BILL.)					
Total	NA	410.5	NA	NA	NA
Private Non-Residential	NA	25.5	NA	NA	NA
Public	NA	27.1	NA	NA	NA
INVENTORIES AND SALES,					
Business Inventories ($Bill.)	NA	461.8	NA	NA	NA
*Business Inventory-Sale Ratio	NA		1.36	1.39	1.40
*Retail Inventory-Sales Ratio	NA		1.31	1.36	1.38
SHIPMENTS AND NET NEW ORDERS***					
Dur. Manu. Orders (72 $Bill.)	NA	37.5	NA	NA	NA
Non-Def. Cap. Goods Orders ($B)	NA	23.9	NA	NA	NA
Non-Def. Cap. Goods Orders (72 $B)	NA	12.4	NA	NA	NA
Non-Def. Cap. Gds Shpmnts (67 $B)****	NA	8.8	NA	NA	NA
INTERNATIONAL					
MERCHANDISE TRADE ($BILL.)***					
Exports	NA	18.8	NA	NA	NA
Imports	NA	23.2	NA	NA	NA
*Merchandise Trade Balance	NA		-4.4	-1.1	-4.8
MULTILATERAL EXCHANGE RATE (3/73=100)	96.0	91.4	81.2	33.6	11.2

*DATA FOR PREVIOUS MONTHS ARE LEVELS.
**SOME 12 MONTH CHANGES CALCULATED FROM SEASONALLY ADJUSTED DATA, WHICH IS NOT QUITE CORRECT.
***LEVELS ARE AT MONTHLY RATES.
****NOMINAL SHIPMENTS DEFLATED BY THE PPI FOR CAPITAL EQUIPMENT.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

March 17, 1981

MEMORANDUM FOR: Jim Burnham

FROM: Steve Brooks

SUBJECT: The job-impact of the Economic Recovery Program

The most quoted single number describing the economic impact of the President's program is the 3-million-job-by-1986 estimate. This memo summarizes the short intellectual history of that number including its meaning and relevance.

Methodology

The estimate came straight out of a John Rutledge, Claremont model run. The technique used was traditional: First, a baseline forecast was generated reflecting the economy under the President's program. This baseline was the actual forecast presented in all the budget documents. Then, a second simulation or forecast was developed that was identical to the first except that the President's proposals were removed and government budget policies were assumed to follow those presented in the Carter budget. Comparing the employment results in the fourth quarter of 1986 from these two simulations yielded the 2.6 million jobs estimate. Rounding gives us 3 million jobs.

Note that this is not an estimate of the job gain between now and 1986 but rather a comparison in 1986 of two different states of the world: one with the program, one with the Carter budget. Note also that the Carter tax estimates were basically current law, that is allowing personal taxes to rise.

Was this a reasonable counter-factual simulation exercise? In general, the technique is unassailable provided the inputs are reasonable. This is certainly the way we do short-run multiplier exercises. The technique's validity over 5-years depends on believability of the model, about which we know very little.

The "no-policy-change" case assumed that for the next five years there would be no tax cuts and that the progressive personal tax structure together with inflation pushed personal tax rates higher and higher. Federal spending was assumed to grow relatively slowly following Carter assumptions. (Monetary policy was the same in both simulations.)

The 3 million job estimate for this exercise is probably pretty reasonable. However, I would argue that such a scenario was not realistic. First we would certainly have had <u>some</u> tax cuts between now and 1986. Assuming that personal tax rates would rise throughout this period ignores the ample historical evidence that Congress cuts taxes to

offset much -- but not all -- of the inflation-induced bracket creep. The comparison should have been the Reagan proposal versus some alternatively structured economic proposal.

Removing 2.6 million jobs from the economy in 1986 would result in an unemployment rate between 7.1-7.8 percent (depending on assumptions about labor force elasticity to employment growth). The Carter budget forecast for the fourth quarter of 1986 showed an unemployment rate of 5.9 percent. Thus we cannot claim that the 2.6 million is more than Carter had forecasted.

Short-Term Impacts

I am going to try to get the yearly employment changes from the CEI people today. There is some reason to believe that the gains in the early years would not be as large as the out years. First, the expenditure cuts will match tax cuts in the early year and thus have a roughly neutral macroeconomic impact. It is not until the out-year that the big tax differentials will be seen. Second, the investment stimulus will probably have a moderately long gestation period. Uncertainties about monetary policy, uncertainty about the need for capacity, and the complicated phase-in of the depreciation reform plan will all contribute to this result.

More on this later when estimates are available.

Some Miscellaneous Notes

Remember that the employment gains should be thought of as net of losses to CETA and Federal employment. The gross gains would thus be higher than the 2.3 million estimate. Note however, that the CEI model is not sufficiently detailed to pick up these subtlties.

The attached piece by Otto Eckstein suggests more modest employment impacts. (Unemployment rate lower by just 0.9 percentage points in 1986 due to the Reagan proposal).

SOUND FOUNDATIONS FOR THE PROGRAM FOR ECONOMIC RECOVERY?* by Otto Eckstein

President Reagan has proposed a set of economic policies designed to reverse the slide in the country's economic performance. The generation-long explosion of federal spending is to be brought to an end. Large increases in the personal tax burden are to be reversed. Depreciation reform is to provide new incentives for investment. And a more economic approach to regulatory policies, together with an endorsement of the monetarist reduction in money growth, are all designed to give our market economy another chance to renew the development process and to restore normal productivity growth.

The President's program is rather more ambitious than the more traditionally-minded thinkers like myself find comfortable. While intended as the long-awaited swing toward conservatism, the policy has tax initiatives of such magnitude that in some regards it creates the typical demand-stimulus which has, usually inadvertently, contributed so significantly to creating the present poor economic situation.

There are many issues before the Congress. Did the President offer the right kind and the right amount of expenditure cuts? Your Committee will be particularly deeply involved in those questions. My own feeling is that the President's list of proposed spending cuts is pretty well balanced, that most of the cuts he requests are in programs that never should have been allowed to reach the scale at which they are now operating, that the income-benefit programs have become too readily available to the non-poor, and that the government interventions to help business and other groups in many fields have become far too costly, having little logical foundation outside of the political reality of the powerful pressure groups and lobbyists who force the taxpayer to keep on paying the costly bills for these programs.

But the principal subject of today's hearing is not so much the expenditure side, but rather the macroeconomic effects of the program as a whole, and particularly the question of the size of the tax cuts. The panel of experts that you have invited specializes in the scientific question of expectations formation, one of the main theoretical issues of the program.

My testimony today will therefore focus on the probability of the economic analysis which would justify an anti-inflation program with tax cuts far in excess of spending cuts, an apparently anomalous condition.

The President's Program in a "Mainstream" Model

As a baseline for the discussion, I submit a set of econometric modeling exercises which follow closely the specifications requested by this Committee's staff. These exercises examine the short- and long-term economic effects of the spending cuts, the tax cuts, and the full program. The simulations are run on the 800-equation Data Resources Model of the U.S. Economy. All the solutions were performed under the assumption of unchanged monetary policy, with the Federal Reserve anticipating the effects of the program accurately enough to provide the right amount of bank reserves to continue to achieve the desired path for the monetary aggregate, M1-B.

Table 1 summarizes the macroeconomic effects of the spending cuts. As virtually all economic analysis suggests, a reduction in spending initially reduces final demand and leads to further demand reductions through various multiplier effects. But these impulses gradually diminish as the weaker economic activity allows easier financial conditions and permits a "crowding-in" of housing and other interest-sensitive spending.

Table 1 also shows not only the traditional multiplier effects, but also some of the newer measures which the revival of supply-side

*Presented to the Senate Budget Committee, February 27, 1981

Table 1
Results of Reagan Expenditure Cuts Only
(Billions of 1972 dollars unless otherwise indicated)
Test Period: Fiscal Years 1981-1988

	1981	1982	1983	1984	1985	1986	1987	1988
Real GNP	-1.2	-14.8	-31.2	-40.3	-42.6	-40.9	-34.8	-16.6
Business investment	-0.1	-1.3	-3.5	-5.1	-5.5	-4.6	-2.8	1.0
Consumption	-0.5	-6.7	-14.6	-20.4	-22.7	-22.7	-19.9	-10.0
Residential construction	0.0	0.3	1.2	3.1	5.0	6.2	7.6	12.7
Real Growth Rate (%)	-0.1	-0.9	-1.1	-0.6	-0.1	0.2	0.4	1.1
Inflation (%)	0.0	-0.1	-0.3	-0.3	-0.3	-0.3	-0.3	0.0
Unemployment (%)	0.0	0.2	0.6	0.9	0.9	0.8	0.7	0.4
Deficit - NIA Basis	2.0	26.2	45.1	59.3	67.4	71.7	75.0	97.3
Potential GNP	0.0	-0.2	-0.9	-2.5	-4.5	-6.5	-7.9	-8.3
Capital stock	0.0	-0.7	-3.1	-7.1	-11.4	-14.8	-16.5	-15.4
Labor supply (millions)	0.00	-0.01	-0.07	-0.11	-0.13	-0.12	-0.10	-0.07

economics brings into the picture. A reduction of government spending shrinks the labor force slightly by reducing job opportunities, and the weaker economy also has a modest negative impact on capital formation. Thus, there is a small loss of potential GNP. On the other hand, following both the conventions of national income accounting in the United States and the reality of the pattern of federal outlays, we treat all government spending as consumption, not recognizing the category of public investment. Thus, in the DRI model as in American thinking, there is no direct impact between the level of government spending and aggregate supply.

Charts 1 and 2 shows another important dimension of the impacts of fiscal policy on the economy. It shows the output-inflation transform (OIT), or the time profile of the distribution of the induced change in nominal GNP between real output and inflation. In the case of government spending, the initial reduction largely leads to reduced real activity, beginning with a coefficient of 0.93. After 8 years, the OIT coefficient drops to 0.16, showing that by that time most of the effect of the spending reduction has been converted into the benefit of reduced inflation.

Table 2 shows the simulation results for the depreciation reforms. This measure has much more powerful supply-side effects: for every dollar of direct revenue sacrifice, investment is boosted by $1.50, including the reinforcement achieved through the indirect pull of the stronger economy. Capital formation is strengthened, in turn boosting productivity. The impact is also summarized by the output-inflation transform shown in Table 2. To identify the supply-side effects achieved through the investment incentive, the OIT for government spending is also shown. The supply-side benefits, the boost to output which is retained to a much stronger degree due to a reduction in the cost to investment, are shown in the shaded area.

The third simulation adds the President's proposed personal tax reductions. The results in Table 3 show some supply-side effects, but these are relatively weak. The DRI model does contain a relationship between the personal tax burden and the supply of labor, and so extra people drawn into the labor force when personal taxes rise. The model also includes the personal tax burden in the model's productivity equations, showing heavy tax burden's damage to the efficiency of resource use. But these effects are much smaller than those for the depreciation reforms.

The final simulation includes the entire program, including the spending cuts and both kinds of tax cuts. The results are shown in Table 4. It can be seen that the program worsens inflation because the net impact on demand is very substantial, the expected result of a traditional Keynesian stimulus. The tax cuts exceed the spending cuts by $18 billion in 1982 and $41 billion in 1983, and it is quite unrealistic, at least according to the DRI

Output-Inflation Transform for Three Kinds of Fiscal Policy

Chart 1

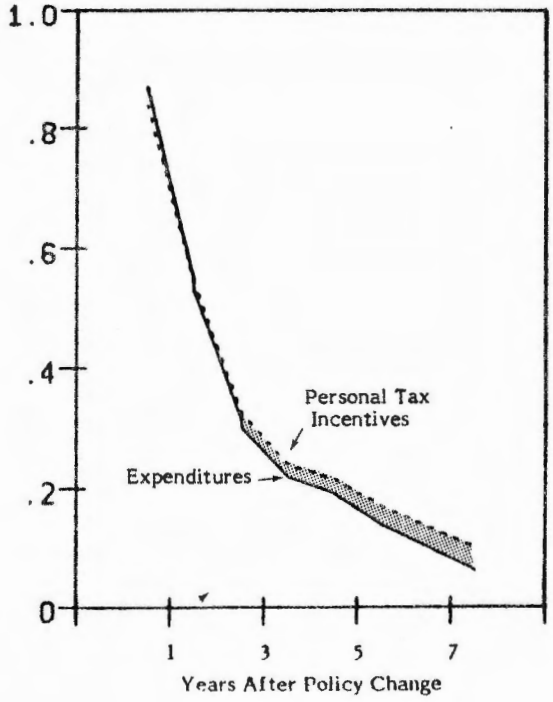


Chart 2

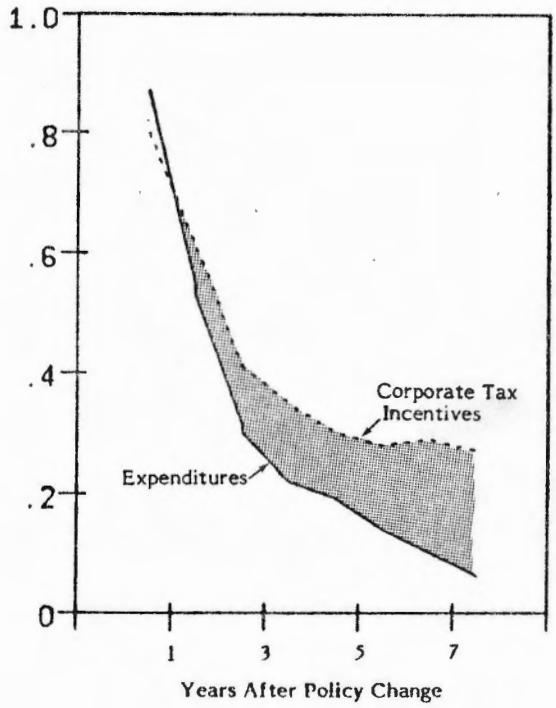


Table 2
Results of Reagan Corporate Tax Cuts Only
(Billions of 1972 dollars unless otherwise indicated)
Test Period: Fiscal Years 1981-1988

	1981	1982	1983	1984	1985	1986	1987	1988
Real GNP	0.2	3.1	8.2	14.5	22.5	31.4	38.3	42.6
Business investment	0.1	1.9	5.1	9.1	13.8	19.0	22.9	24.6
Consumption	0.1	1.0	2.9	5.3	8.1	11.7	14.5	16.7
Residential construction	0.0	0.3	0.7	1.5	2.8	4.1	4.8	4.9
Real Growth Rate (%)	0.0	0.2	0.3	0.4	0.5	0.5	0.4	0.2
Inflation (%)	0.0	0.0	0.2	0.3	0.5	0.6	0.6	0.5
Unemployment (%)	0.0	0.0	-0.1	-0.3	-0.4	-0.5	-0.5	-0.5
Deficit - NIA Basis	-3.0	-5.0	-7.6	-11.1	-14.2	-12.0	-10.2	-15.8
Potential GNP	0.0	0.1	0.6	2.1	4.8	8.9	14.4	21.0
Capital stock	0.0	1.1	4.6	11.1	20.9	34.3	50.3	66.6
Labor supply (millions)	0.00	0.00	0.01	0.03	0.04	0.05	0.06	0.05

Table 3
Results of Reagan Tax Cuts Only
(Billions of 1972 dollars unless otherwise indicated)
Test Period: Fiscal Years 1981-1988

	1981	1982	1983	1984	1985	1986	1987	1988
Real GNP	1.6	19.2	42.7	67.2	85.2	104.3	123.1	142.2
Business investment	0.3	3.9	10.5	18.2	25.6	32.1	37.0	39.8
Consumption	1.8	15.2	33.9	54.2	69.3	85.1	100.7	116.9
Residential construction	0.0	-0.2	-0.7	-1.9	-3.1	-3.5	-3.8	-3.9
Real Growth Rate (%)	0.1	1.2	1.5	1.5	1.0	1.0	0.9	0.9
Inflation (%)	0.0	0.1	0.6	1.0	1.6	2.1	2.4	2.6
Unemployment (%)	0.0	-0.3	-0.7	-1.2	-1.4	-1.6	-1.8	-1.9
Deficit - NIA Basis	-10.0	-37.7	-69.4	-100.4	-120.0	-134.1	-145.7	-158.0
Potential GNP	0.0	1.1	4.1	9.4	16.4	25.1	35.2	46.2
Capital stock	0.1	2.2	9.3	22.5	41.2	64.2	89.8	115.7
Labor supply (millions)	0.05	0.24	0.46	0.63	0.67	0.69	0.68	0.67

Table 4
Results of Reagan Whole Program
(Billions of 1972 dollars unless otherwise indicated)
Test Period: Fiscal Years 1981-1988

	1981	1982	1983	1984	1985	1986	1987	1988
Real GNP	0.4	4.5	11.5	26.7	42.6	63.4	85.1	106.9
Business investment	0.2	2.6	7.0	13.0	19.7	26.9	33.1	37.5
Consumption	1.3	8.5	18.9	32.9	45.1	60.0	76.2	93.5
Residential construction	0.0	0.2	0.6	1.0	1.6	1.9	1.5	0.5
Real Growth Rate (%)	0.0	0.3	0.5	1.0	0.9	1.2	1.2	1.1
Inflation (%)	0.0	0.0	0.2	0.5	0.8	1.2	1.4	1.6
Unemployment (%)	0.0	0.0	-0.2	-0.4	-0.6	-0.9	-1.2	-1.4
Deficit - NIA Basis	-8.0	-11.0	-22.9	-38.8	-51.0	-63.3	-79.9	-101.5
Potential GNP	0.0	1.0	3.2	6.9	11.9	18.6	27.2	37.3
Capital stock	0.0	1.4	6.2	15.4	29.6	48.7	71.9	97.0
Labor supply (millions)	0.05	0.23	0.40	0.51	0.54	0.57	0.59	0.60

model, to suppose that the supply-side or rational expectations effects will be sufficient to overcome the boost to demand. But there is an enhancement of aggregate supply: potential GNP and productivity improve significantly, with better trend and cyclical benefits.

Could the Results Be Much Better? Three Possible Miracles

To avoid the substantial enlargement of the budget deficit and to achieve the budget balance projected by the administration for 1984, the economy has to respond far more favorably to the President's program than the "mainstream" models would suggest. Models such as DRI's are based on equations derived from the historical record. That record inevitably leaves some ambiguity, and there always is the possibility that the future will represent a dramatic break with the past economic structure. Thus, we must examine the three possibilities of breakthroughs in economic performance, any one of which might

make the President's scenario come true. These three possible breakthroughs, or "miracles" are:

1) "Keynesian" economics, vintage 1945, really was right, and we can now replay the idealized version of the 1964 tax cut.

2) Supply-side responses really will be much larger than the historical data would suggest, and will fully offset the impact on aggregate demand.

3) The rational expectations theory is correct in its assertion that the President's program will lower the price expectations of the American people dramatically in a very short time.

Let me explore each of these potential "miracles" in turn.

1) The "Keynesian" Miracle: In their postwar heyday, some of Keynes's followers believed that demand-pull inflation would not set in until the economy reached a state of excess demand. So long as there is no inflationary gap, with aggregate demand not exceeding aggregate supply, there would be no inflationary pressure.

The output inflation transforms shown in the charts below were calculated under conditions of modest demand, and yet there is a strong downward slope to the curve. Chart 3 shows a textbook version of the OIT under the 1945 "Keynesian" view: the full benefit of stimulus appears in real activity and remains in that form so long as the economy is kept out of "excess demand."

One can, of course, hope that the economy has this characteristic. But even this happy circumstance would not assure success for the President's program. The growth of nominal GNP that this scenario implies would be so great, and so far beyond the targeted growth of the money supply, that the Federal Reserve clearly would not accommodate such expansion. Interest rates would be both very high in real terms and highly unstable, and so the fruits of the traditional fiscal stimulus would be dissipated in financial disturbances, including the crowding out which would damage investment. Thus, the Keynesian miracle can, I believe, be dismissed for the 1980s.

2) The Supply-Side Miracle: Work and productivity benefits many times larger than

Chart 3
"Keynes-1945" Output-Inflation Transform

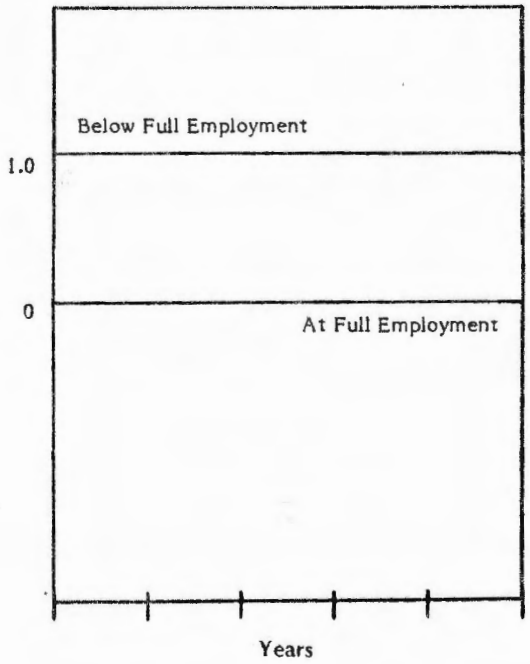
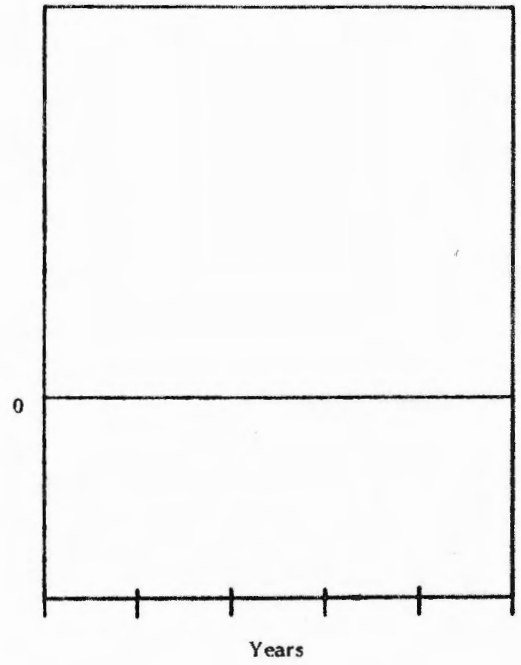


Chart 4
Output-Inflation Transform: Rational Expectations



supported by the consensus of the scientific literature would also reconcile the stimulating fiscal policy with inflation fighting. It would go beyond the scope of this testimony to rehearse the evidence, which is most usefully summarized in an important research paper.[1]

3) The Rational Expectations Miracle: Could the President's program so improve the people's belief about the future performance of the economy that price expectations are lowered dramatically? If this change could be accomplished, the rate of wage increase would diminish quickly because workers and union leaders would believe that nominal wage increases were no longer important to offset future inflation. Long-term interest rates would also show very sharp drops because investors would no longer need to discount such a high inflation rate.

The historical American record gives much evidence that the public forms its price expectations by gradually learning from actual experience. In a chapter in a soon-to-be published book, I report some empirical results on this learning process. My analysis of the past leads me to conclude that the public only learns from experience, that the learning process is gradual, and that the public finds it particularly difficult to learn from a highly volatile inflation experience like that experienced in the last seven years.

The important new work by Professor Sargent[2] reminds us that other societies have undergone dramatic improvements of inflation expectations in ways other than from slow learning from experience. The hyperinflation in Germany clearly came to an end without a depression in economic activity. Of course, once inflation proceeds at astronomical rates, the public understands that the government cannot let such a situation continue forever. The curative steps that governments undertake in such circumstance are far more drastic than any changes in economic policy experienced by the United States in modern times.

The narrow scientific question then becomes whether the Reagan program is an event of the same order of magnitude as the economic policies adopted by the countries studied by Sargent, or whether the moves are too limited. There is also the question of credibility, which Fellner has emphasized as the prerequisite of policy-induced dramatic shifts in expectations.

Only time will tell whether the public will interpret the Reagan program as being of such enormous historical moment. The initial reaction of the bond market seems to have been very moderate. Bond yields are now about the same as they were before the election of President Reagan. It does not appear that there has been any immediate shift of expectations in either direction. The record on wages is currently deteriorating rapidly: apparently workers are cranking worsening price expectations into their decisions.

Price expectations as represented by a DRI model forecast are actually improving at this time. Table 5 compares the Reagan Administration forecast with the current DRI forecast. Immediate oil decontrol has "front-loaded" this year's inflation record; the world oil market is likely to remain in a state of mild glut for some time, and the feared food price explosion clearly is not happening—indeed last month's consumer price index showed no increase of food prices whatsoever.

But whatever good news there may be from the price front in the very short run, it certainly would be grossly premature to believe that the President's program is changing price expectations. It would be a very high-risk statement to assert that expectations will improve dramatically beyond what the public will learn from the actual price record. Yet without such a spontaneous and dramatic improvement in price expectations, the administration's inflation forecast cannot materialize, and the probable nominal increase in GNP cannot accommodate the assumed high real growth rates within the Federal Reserve's monetary targets.

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[1] Don Fullerton, "On the Possibility of an Inverse Relationship Between Tax Rates and Government Revenues," NBER Technical Paper, No. 467, April 1980.

[2] Thomas J. Sargent, "The Ends of Four Big Inflations," NBER Working Paper, October 1980, for an analysis concerning the ends of hyperinflation.

Table 5
Comparison of Forecasts

	1981		1982		1983	
	Reagan	DRI Control	Reagan	DRI Control	Reagan	DRI Control
Real GNP	1497.0	1504.6	1560.0	1556.7	1638.0	1601.4
(% change)	1.1	1.6	4.2	3.5	5.0	2.9
Inflation (% change)	9.9	10.1	8.3	9.9	7.0	8.9
Unemployment (%)	7.8	7.4	7.2	6.9	6.6	7.0
Treasury Bill Rate (%)	11.1	13.0	8.9	13.6	7.8	12.0

	1984		1985		1986	
	Reagan	DRI Control	Reagan	DRI Control	Reagan	DRI Control
Real GNP	1711.0	1637.6	1783.0	1706.1	1858.0	1749.7
(% change)	4.5	2.3	4.2	4.2	4.2	2.6
Inflation (% change)	6.0	8.3	5.4	8.8	4.9	8.5
Unemployment (%)	6.4	7.0	6.0	6.5	5.6	6.2
Treasury Bill Rate (%)	7.0	10.8	6.0	10.3	5.6	10.5

Conclusion

It would certainly be rash to assert that not a single one of the three possible miracles will occur. But it would be even more rash to conclude that one of them will. The risks to the society are not symmetrical. If things go wrong, for whatever reason, inflation will stay very high or even get worse, and the historic opportunity will have been missed.

If the economy acts in the future as it has in the past, it will show healthy responses to the President's initiatives. There will be good supply-side effects, better capital formation and productivity performance, and some enhancement of labor supply and the incentive to work hard. But on the President's schedule, there will also be an increment of fiscal stimulus to boost nominal demand, and that factor will make the inflation worse. On a net basis, one cannot escape the conclusion, if one believes in the relationships that have governed our economy in the past, that the net effect of the President's program, on the President's schedule, is to make the inflation rate worse.

The answer to the problem is simple enough. The Congress must stretch out the tax cuts to a schedule which will take the stimulus out of the fiscal policy. If the personal tax reductions are stretched 18 months beyond the President's schedule, the difference in the directly induced budget deficit will be negligibly small for the economy as a whole. Budget deficits would decline substantially, whereas under the present schedule, they would remain over $50 billion as far as the trained eye can see. The most dramatic change in economic policy since 1933 would be given a much greater chance of success because the inflation risks would be reduced. A reasonable sense of caution demands that the Congress not bet on any of the three miracles, and save the administration from its enthusiasm by phasing in the tax cuts on a schedule which the country can afford.

Q: Background: The mainstay of the recovery from the last recession was consumer buying, which accounts for about two-thirds of the Nation's output.

What real evidence do you have that the average consumer will save the additional take home pay which could result from the proposed individual tax cut, especially when price increases in energy, housing and food will more than consume that additional income?

Follow-up: Are there any guarantees that corporate America will reinvest the additional funds derived from the business tax reductions? What would be the effect of 1 percent shortfall in your assumed economic growth?

A: We are forecasting that the personal saving rate which has been running at extraordinarily low levels recently will return, over the next several years, to somewhere in the range of 5.5-7.0 percent, [is this what we are saying now?] numbers closer to the historical norm. While this forecast depends in part on the nature of the personal tax cuts, it also depends on the economy's ability to achieve a stable growth path with moderating inflation and inflationary expectations. We do expect that a portion of the tax cut will be saved, this has certainly been the historical norm. Nevertheless our projections are consistent with the bulk of the tax cut being spent.

As to your question about business investment, the President's program is designed to provide not only the

funds but also the incentives for business investment. Accelerated cost recovery will make investment in plant and machinery more attractive than it has been recently.

If the economy were to grow one percent less than projected we would experience higher unemployment, increased outlays for unemployment insurance, reduced taxes and a larger deficit. Inflation would be essentially unchanged although some modest improvement would be possible.

Draft Replies to Questions from Mr. Gray of the House Appropriations Committee (from your February 26 Testimony)

Q: The President's economic plan assumes that inflation will decrease to an annual rate of 9.9 percent in 1981 and to 8.3 percent in 1982. Do your economic assumptions take into consideration jumps in energy, food and wages? Isn't this a very optimistic projection?

A: We believe that our inflation forecast for the next two years is reasonable and realistic. It should be noted that our inflation forecast for 1981, which the Congressman has correctly noted is 9.9 for the GNP deflator, is actually an increase in inflation from the levels in 1980. Page 13 of the President's March 10 Budget submission shows all the relevant detail. It can be seen there that the GNP deflator (the broadest-based index of price changes in the U.S.) rose 9.0 percent in 1980. It is forecasted to rise almost one percent faster in 1981 or 9.9 percent.

The slow down in inflation in 1982 to 8.3 percent is well within the range of historical experience given relatively high unemployment rates experienced during 1980 and expected to persist at least into early 1982. An historical example is revealing. In 1975, the inflation rate (as measured by the GNP deflator) was 9.3 percent. Just one year later the inflation rate was nearly cut in half, falling to 5.2 percent for 1976. While special circumstances of that earlier period make

it unlikely that such a reduction would be possible today, it is clear that the modest 1.6-percentage-point reduction in inflation forecasted for 1982 is not overly optimistic. Moreover, it is based fundamentally on the important considerations of food and energy price inflation as well as projected movements in compensation rates for the private economy.

Q: Background: A recent study conducted by the Massachusetts Institute of Technology indicated that small businesses (businesses with less than 20 employees) accounted for over two-thirds of all new jobs created nationally and accounted for over 90 percent of all new jobs created in the Northeast.

What specific measures are included in the Administration's proposal which will stimulate the growth and creation of small businesses? Will small businesses be the primary benefactors of increased depreciation allowances?

Follow-up: You've indicated in the past that over 2 million new jobs will be created if the Administration's proposal is enacted entirely. How and where will these jobs be created?

A: We believe that our economic program, which balances expenditure and tax reductions with regulatory reform and slowing in monetary growth, will aid all businesses large and small. In particular small businesses will receive benefits for expansion directly in the corporate and personal tax reductions. But beyond this, small businesses, more so than large businesses, find it hard to comply with burdensome and costly regulations. Our program of regulatory reform will significantly benefit smaller businesses. In addition the general improvement in economic activity, reduced inflation, reduced Federal pressure in credit markets will certainly aid our small businesses.

In addition, reduced personal tax rates will decrease the incentives for investors to find exotic and counter-productive tax shelters. More funds for venture capital -- especially to smaller firms -- will be available.

SB - 3/12/81

The Reagan Outlay Cuts

The most striking feature of the President's economic proposals is the dramatic slowing in the growth of budget outlays. Table 1 shows the important details from the March 10 budget submission.

Table 1

Budget Outlays, selected fiscal years

(billion of dollars)

	1982	1984	1986
Current policy base*	742.7	893.7	1055.7
Proposed reduction (net)	-47.4	-123.5	-143.7
Budget Outlays	695.3	770.2	912.0

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* Note: The current policy base consists of the most recent "Current Services" outlay estimates but with National Defense and Foreign Aid priced at January-budget inflation assumptions. An addition, funding for adequate defense was added to this modified current-service estimate to derive the "Current Policy Base."

The outlay cuts measured relative to the January budget are somewhat smaller than those shown in the table (e.g., $44 billion for FY 1982). This is because the Current policy base includes both higher defense outlays and upward reestimates of other spending.

Measuring the spending cuts relative to any arbitrarily chosen baseline is, at best, an uncertain exercise. What is more meaningful is the dramatic deceleration in outlays. From FY 1977 to FY 1981 total budget outlays grew at an average annual rate of 13.3 percent. The proposed growth in outlays for FY 1982 is less than half that rate, 6.1 percent. For the next five years through FY 1986, budget outlays are projected to grow at an average annual rate of only 6.8 percent. Outlays as a percent of GNP will fall from the record high of 23.0 percent in FY 1981 to just 19.0 percent in FY 1986.

The following table shows the real rates of growth in total outlays as well as the defense and nondefense components.

Table 2

Growth in Real Budget Outlays

(percent changes, fiscal year)

	Actual	Estimates					
	1980	1981	1982	1983	1984	1985	1986
Total budget outlays	4.4	-0.6	-2.8	-1.8	-0.6	4.9	3.5
Defense	3.6	7.2	6.7	11.6	6.3	12.6	7.3
Nondefense	4.7	-1.5	-6.2	-7.2	-4.0	0.7	1.2

National Income and Product Account Estimates

The largest cuts in outlays are in the transfer and grant-in-aid areas. The following table details the cuts, relative to the January budget, in FY 1982 NIPA outlays by category.

Table 3

NIPA Outlays, FY 1982
(billions of dollars)

	January Budget	Reagan Budget[1]	Change
Purchases	249	247	-2
Defense	168	177	+9
Nondefense	81	70	-11
Transfers	314	290	-24
Domestic	309	285	-24
Foreign	5	5	--
Grants-in-aid	95	85	-10
Net subsidies	14	11	-3
Net interest paid	75	70	-5
Total	746	703	-43

1/ estimates

Detail may not add to total due to rounding.

Of the $43 billion in NIPA-outlay reductions, $34 billion is accounted for by reductions in transfers to persons and in grants-in-aid.

High-Employment Budget Estimates

One conventional (Keynesian) measure of discretionary budget policy is the high employment surplus or deficit (HES). Preliminary HES estimates of the Reagan budget proposals indicate that -- far from being overly stimulative -- the Reagan budget proposals show a moderate but steady movement toward between 1980 and 1984. Thereafter the HES remains roughly constant.

High-Employment Surplus or Deficit (-)
(billion of dollars, fiscal year)

	1980	1981	1982	1983	1985	1985	1986
Surplus or deficit (-)	-16.7	17.3	19.0	24.9	29.6	28.0	25.7
Change*	NA	34.0	1.7	5.9	4.7	-1.6	-2.3

* an increase in the high employment surplus indicates a movement toward restraint in budget policy, and vice-versa.

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20506

March 10, 1981

MEMORANDUM FOR: Nick Filippello

FROM: Steve Brooks

SUBJECT: Jones Queries

Here follow some thoughts. These are very tough questions and I would endeavor to avoid answering them. But if you must, here are a few selected answers and tidbits of answers.

1. There is no single model that we rely on for our forecasts. Rather they have been developed using results from a variety of different models: some "supply-side", some "rational expectations", some traditional Keynesian. Each of these models requires different assumptions and inputs. But no economist would be so foolish as to rely on the results from a single model. We must use our judgment to weigh the important results from a variety of different models.

[Note: I think this kind of hedge is both accurate in fact as well as being appropriate in the current political environment. Discussions in the press and in testimony of how "our model" differs from other models makes us wide open for questions such as this and should be avoided at all costs. Indeed "the model" (i.e., Rutledge) does not have a set of internally consistent macroeconomic equations. David Munro's controtions to make S=I is ample demonstration of this fact. Further, by his own admission, Rutledge has no documentation and no plans to release equations until some as-yet-unspecified date when he can put together a "conference."]

2. The policy package includes four key elements: expenditure reduction, tax reduction, regulatory reform and stable monetary policy. But it is wrong to think of it as for separate elements. The package must work together as a whole if we accept one element without the other three it is doomed to failure.

[Note: "3 million jobs by 1986" is not the number they want. They want a relatively detailed look at the total program impact across a number of important economic indicators.]

3. Good luck! - there's nothing I can do here.

4. We expect a slow and gradual deceleration in the money supply. To accomplish this will, necessarily, require a slowing in the growth of the key elements of the monetary base. We in the Administration have goals for monetary policy which are consistent with those of the independent Federal Reserve. We do not intend to dictate policy to the Federal Reserve.

5. We are constantly in contact with the Chairman in informal and formal meetings. We expect that the stated goals of the Federal Reserve, which we strongly endorse, will be followed with consistency and with prudence over the coming years. Steady, reliable, believable and well-publicized long-run policy positions are an important element in our package.

6. [Perry's literature on this point is difficult to refute].

7. See 6 above.

8-16. [See the Munro detail. As to supporting evidence I think it best that the "scenario" be labelled as such. We should refer to it by a term, such as "goals" or "targets" for economic policy. We must get away from referring to the 1983-1986 projection as a forecast. It is instead a plausible [?] scenario provided there is a substantial boost to BFI and a dramatic improvement in inflation expectations. It is nothing more or less.]

cc: JB, AW, DM, DR, MJM, PQ

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20506

March 6, 1981

MEMORANDUM FOR: Murray L. Weidenbaum

FROM: Steve Brooks

SUBJECT: Review of the "Economic Recovery and Job Creation Act of 1981"

This bill (H.R. 3) introduced by Representative Albosta in the House and Senator Long in the Senate is essentially the bill reported out of the Senate Finance Committee at the end of the last Congress.

It is one of many competing depreciation bills which are of a type with the Administration's proposals for accelerating depreciation. It has many features that make it similar to the Administation's bill, but there are important differences.

The biggest single criticism of the bill is that it is less generous to business investment and thus less stimulative than the Administration's bill. There are two reasons for this. First although the bill would shorten the lives of most equipment (in many cases, more so than the Administration's plan), it would offset this stimulus to investment by sharply reducing the allowable investment tax credit. On balance, the benefits to many investments, particularly shorter-lived assets, would be far less than under the Administration's bill. (For shorter-lived assets the value of the ITC is relatively more important as a stimulus to investment than a shortening of asset lives).

Second, the bill offers less advantageous tax treatment for public utility investment. The bill would only widen the allowed ADR range to 30% from 20%. The Administration's proposals are more generous.

There are two other notable features of the bill. First, the bill proposes a targeted jobs credit. The Administration, I assume, would be opposed to these tax expenditures, on efficiency grounds. In addition it is believed that the tax rate reductions offer sufficent incentives to labor supply and productivity to obviate the need for job credits.

Finally, the bill would allow expensing of certain Federally-mandated "nonproductive" expenditures. This particular element of the bill requires additional Federal presence to certify that a given expenditure is "nonproductive." Even if problems of defining "nonproductive" were soluable, the Administration should also oppose this initiative. The Administration's proposed reforms to the regulatory process will tend to limit the range of nonproductive regulations.

The bill itself is more complicated than this summary would indicate. However, an exhaustive review of the bill at this time is not recommended since there are other stronger competitors to the Administration's proposals -- notably the proposal introduced by Senator Bentsen. The attached piece by Emil Sunley reviews some of the other major depreciation proposals.

EXECUTIVE OFFICE OF THE PRESIDENT
COUNCIL OF ECONOMIC ADVISERS
WASHINGTON, D.C. 20506

February 18, 1981

MEMORANDUM FOR STEVE BROOKS

FROM: Alice Williams/Jim Burnham

Subject: H.R. 3 - "Economic Recovery and Job Creation Act of 1981".

Please review the attached legislation to determine whether it requires CEA comment. If you do recommend review, please prepare a draft response for the Chairman's signature together with a background memorandum if appropriate, and return to me no later than March 10, 1981. Our comments are due at OMB by cob March 13, 1981.

The attached referral and legislative bill should always accompany your response and should be returned to this office even if is determined that CEA does not wish to submit comments.

(Please initial)

Review_____

Do Not Review SAB

Q: You have given us an optimistic forecast for economic growth, inflation, productivity and federal budget deficits. Indeed, many economists have labelled them as unrealistically optimistic. If the economy does not perform as well as you expect, if inflation does not improve, and if growth remains sluggish the federal deficit will, of course, be much worse than what you have projected in your budget documents. How would this Administration react to such an occurrence? Would expenditures be cut further? Would tax cuts be delayed?

A: Our forecasts may seem optimistic by the depressed standards of the last few years. However, sustained growth of the kind we are projecting has been achieved in the past by the U.S. economy. Our package of spending and tax cuts in conjunction with a slow, gradual, deceleration in the money supply will set the stage for renewed growth in a non-inflationary environment.

Of course the economy may not develop exactly as we have planned. Unforeseen external events may make achieving these particular goals very difficult. However, it is important to realize that the future path for economic policies has been set and will remain in place. The success or failure of the policies depends in large part on their consistent and steady application. We intend to follow that steady course. If we do, the economy will ultimately reap the benefits of renewed growth and reduced inflation.

Q: When will the Administration present its second tax bill including tuition credits, removal of the marriage penalty etc.?

A: The Congress has plenty to do with the spending and tax proposals that we have already submitted. If in the future, the budget and economic environment improves sufficiently, we will be able to review efforts to achieve some of these very desirable reforms that you have mentioned.

DRAFT SENATE BUDGET TESTIMONY INSERT

Today I would like to spend a little time dealing with some of the macroeconomic implications of the President's budget proposals. In your deliberations on budget policy it is important that you understand the overall balance of the package. Let me begin by focussing on what I think are the two most frequently mentioned criticisms of the President's budget submission.

- o The program will be inflationary.
- o The forecast is too optimistic.

I have found that in a general way all of the comments and criticisms that I have heard to date fall broadly into one or both of these categories.

Is the program inflationary?

The program is not inflationary by any standard. The conventional wisdom has it that by simply comparing the relative size of the outlay cuts and tax cuts one can judge the inflationary impact of the program. Using this rule-of-thumb, if the tax cuts exceed the budget cuts then the program will be inflationary and vice versa.

But this analysis is far too simple because it ignores what is happening to both the "tax baseline" from which the tax cuts are measured and the "spending baseline" from which the spending cuts are measured.

The baselines that were chosen for taxes and spending were, with some minor modification, current law estimates. It is a simple fact, that is well known to this Committee, that under current law, tax revenues will grow much faster than the economy. This is because individuals will be persistently pushed into ever higher tax brackets and will therefore find their tax liabilities rising. In addition under current law, scheduled increases in the so-called "windfall profits tax" on oil company revenues and in Social Security taxes will guarantee an even greater-than-normal rise in the current-law tax burden between now and 1986.

The current law baseline from which our tax cuts are measured is therefore one which includes very sizeable tax increases. Because of this, the net change in the overall tax burden (total taxes in relation to Gross National Product) is a far-more meaningful measure of the size of the proposed cuts. Similarly, we can measure the size of the net spending cuts by inspecting the proposed change in total spending in relation to the Gross National Product (GNP).

The table below, taken from the March budget submission, shows the details.

Budget Receipts and Outlays

(percent of GNP, fiscal year)

	Actual		Estimate				
	1980	1981	1982	1983	1984	1985	1986
Receipts	20.3	21.1	20.4	19.7	19.3	19.3	19.5
Target Outlay Ceiling	22.6	23.0	21.8	20.3	19.3	19.2	19.0

As can be seen, between 1981 and 1986 we are projecting that taxes will be cut by enough to lower the tax burden from 21.1 percent of GNP to 19.5 percent, a decline (a net cut) amounting to 1.6 percent of GNP. Over this same period we are projecting that outlays will be cut by enough to lower the spending burden from 23.0 percent of GNP to 19.0 percent of GNP, a net cut amounting to 4 percent of GNP. The spending cuts are thus far greater in terms of the overall share of GNP than the tax cuts.

It should also be noted that even under the very pessimistic CBO estimates presented last Wednesday, the proposed spending cuts easily exceed the proposed tax cuts as a share of GNP. Moreover, the CBO economic projections, which we think are far too pessimistic, nevertheless show declines in inflation under the Reagan tax proposals over the next five years.

Are our projections too rosy?

The Administration's assumptions for 1981 and 1982 are, in our judgment, reasonable estimates of the economic outlook, given the timely adoption of the President's entire program. These forecasts are well within the range of forecasts currently being made by a wide variety of private economists. For example, the March 10, 1981 issue of Blue Chip Economic Indicators, an authoritative composite report of the forecasts of leading economists, shows the following results, which are quite close to our own:

	1981		1982	
Percent Change	Blue Chip	Administration	Blue Chip	Administration
Nominal GNP	11.3	11.1	13.0	12.8
Real GNP	1.3	1.1	3.7	4.2
GNP Deflator	9.9	9.9	9.0	8.3

As in past Administrations, our forecasts are not the product of any single model or any single forecaster. The Administration has access to a number of commercial models, as well as several developed within the government over many years. All of these models have been used, at one stage or another, in the development of the forecasts.

It is important to realize the limitations inherent in any econometric model. At best, models can help to inform and to enforce consistency upon the prior judgment of seasoned economic forecasters. It is in this capacity that they are used in this Administration, as they have been in other Administrations. Economics is too important to be left to statisticians and mathematicians. It requires judgment.

Following the practices of prior Administrations, we have made an effort to forecast the current and next years as accurately as possible, given the current situation and assuming the adoption of the President's economic package.

With this in mind, we reluctantly accept the inevitable legacy of the stop-and-go-policies of the past -- a disappointing 1981, in the form of a combination of low economic growth

and double-digit inflation. Our forecast allows for the possibility of very sluggish economic activity -- or even a period of outright decline -- during the spring and summer quarters of the year, until the elements of the economic program are put into place.

At the same time, following several more months of disappointing price performance, the general rate of inflation is expected to begin to improve. Barring further oil disruptions or crop problems, that improving trend is expected to continue into 1982 and beyond.

You will note that our projection is for a 7.8 percent average unemployment rate for 1981 -- and that February's unemployment rate was 7.3 percent. That implies some increases during this year as a result of the sluggish economy. However, as economic growth begins to pick up toward the end of th year, the unemployment rate -- like inflation -- is expected to begin a downward trend.

Over the next two years our forecast is not very different from anyone else's. More optimistic, perhaps, but it is only a matter of a slight degree. Beyond 1982, the Administration's "scenario" becomes less forecast and more a projection of trends reflecting the proposed policies. This is in keeping with the practice of past Administrations. All too frequently, though, the Administration has been faulted

for our projections to 1986, as if 1986 were the day after tomorrow. I know of no traditional forecaster who was ready in 1976 to forecast double-digit inflation in 1981. Today, there are few who seem willing to give up this double-digit inflation readily. Our economy is a marvelously adaptable arrangement. We in the Administration think it can adapt as well to good policy as it did to bad.

Finally, the most important thing to remember for those who are critical of our forecast is that even those forecasters who disagree sharply with us about the outlook do agree that the President's program is a major step in the right direction. Although forecasters disagree on how far down inflation will come, they all agree it will come down. Although the professional prognosticators can't agree how much real growth will improve there is no doubt there will be more real growth. It is time to battle inflation, not to squabble over forecasts.