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

May 22, 1981

Dear Leon:

Thanks very much for lunch. I enjoyed our conversation.

I remain skeptical of the raw rental-price measures used in most investment equations. Moreover, I think DRI's (and MPS's) investment equations respond far too strongly to rental-price changes. Nevertheless, the interaction of the rental price and output is perfectly justifiable -- indeed theoretically correct -- under a Cobb-Douglas world.

Under a Cobb-Douglas world, $Y = AK^aL^{1-a}$ and the marginal revenue product of capital,

$$MRP_k = \frac{aPY}{K},$$

where P is the price of output (Y). Now the desired capital stock (call it K*) will be that level of K which equates the MRP with the rental price, c. Thus

$$K^* = \frac{aPY}{C}.$$

So if we want the desired capital stock as AN element on the right-hand side, we should use this term which has output and the rental price interacting.

I'll drop you a line when I'm settled back in Massachusetts. Again, many thanks for lunch.

Sincerely,

Steve

Stephen H. Brooks
Senior Staff Economist

Mr. Leon Taub
Chase Econometric Associates
900 17th Street, NW

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

May 19, 1981

MEMORANDUM FOR: Jerry Jordan

FROM: Steve Brooks

SUBJECT: Goldman Sachs Essay on Money Demand

The basic point of the essay, written I am sure by John Paulus, is that even with very slow growth in output during the remainder of the year the Fed's money targets will be sufficiently binding to yield an increase in interest rates.

A subsidiary point, on which he spends a great deal of time, is that patterns of money growth can be affected by "fundamental alteration of payment practices..." Thus a slowing in the growth of money (which he identifies as having occurred between last November and this February) may not signal a slowing in output growth if it has been due to a shift in money demand. He notes that such a shift usually is "in response to extraordinarily high interest rates..." such as those that prevailed in November and December.

Nevertheless he points out that even if output were to slow, the prospects for interest rates remain pessimistic. He uses a simple Fed-type money demand equation to illustrate the degree of restraint embodied in the targets.

<u>Was There a Shift in the First Quarter of 1981?</u>

I have looked at some very simple equations to see if there was a shift in money demand in the first quarter. My equations were two variants of the traditional type (i.e. they do not use the stock market's decline to explain post-1974) money-demand behavior). The equations were estimated through 1974 and then simulated dynamically from 1975 to the first quarter of 1981. The equations drift off by large amounts as is well known. However, there is typically a fair amount of quarter-to-quarter stability in the residuals except when there is a shift in money demand. The results from one of the equations is shown below.

Year	Quarter	Absolute Error (actual-predicated, $ billions)	Quarter-to-Quarter Change* ($ billions)
1979	1	-44.7	-3.4
	2	-43.0	1.7
	3	-42.0	1.0
	4	-43.5	1.6
1980	1	-43.5	0.1
	2	-53.9	-10.5
	3	-48.9	5.0
	4	-44.3	4.6
1981**	1	-51.7	-7.4

* Error in indicated period less error in prior period.

** Adjusted for $7 billion (estimated) NOW-induced increase in M-1B.

The year 1980 was clearly a confusing one for this equation. There was a sharp drop in money demand (worth roughly $10 billion) in the second quarter followed by two quarters in which the equation basically moved back "on track" very quickly. (Here "on track" means the residuals returned to their 1979 levels of around $44 billion!) By the way, this is the only time since 1975 that a sharp drop in money demand was reversed. The introduction, then removal, of credit controls were clearly contributing factors.

Nevertheless the equation moved far off track in the first quarter of 1981. (I have used the most recent GNP release for the first quarter data.) The error is roughly 1.7 percent, a relatively big shift by historical standards.

My guess is that this shift, unlike its 1980 cousin, is more likely to be permanent than temporary. The interest rate outlook is bleak enough without worrying about a snap back in money demand.

cc: MW. WN, JB, AW, DM, MM, DR

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20506

May 13, 1981

MEMORANDUM FOR: William Niskanen

FROM: Steve Brooks

SUBJECT: Delay of the Personal Tax Cut

Time is quickly runnining out on a July 1 effective date for the personal tax cut. This, plus Congressional resistance to its size, suggest a possible January 1, 1982 starting date. Following your request I have looked at the macro and budget impacts of such a six-month delay in the personal tax cut.

Direct Budget Impacts

The reduced revenue loss for fiscal 1981 and 1982 from such a move comes not only from the delay but also from the fact that the cut would be only ten percent as of January 1, 1982; under the current proposal the effective cut totals 15 percent as of January 1, 1982. The table below shows the details for 1981 and 1982.

	Calendar Quarters 1981		1982				Fiscal Years	
	III	IV	I	II	III	IV	1981	1982
Proposed								
Rate Cut (%)	10	10	15	15	15	15		
Revenue Loss* ($ billions)	28.9	29.6	48.2	49.2	50.5	51.8	6.4	44.2
Delayed								
Rate Cut (%)	0	0	10	10	10	10		
Revenue Loss* ($ billions)	0	0	32.1	32.8	33.7	34.5	0	24.7
Difference in Revenue Loss ($ billions)	28.9	29.6	16.1	16.4	16.8	17.3	6.4	19.5

*Brooks estimates taken from BEA budget material.

As can be seen, the direct deficit reduction would amount to around $6-7 billion in fiscal 1981 and $19-20 billion in fiscal 1982.

Macro Impact: Two Approaches

There are really two ways of looking at the macro impact, both flawed. The first is the traditional multiplier analysis. We assume a time path for the impact on nominal GNP of a certain sized tax change (the multipliers). Then, depending on assumptions about price response, we calculate the real-price mix of this nominal GNP change. This approach assumes that velocity is relatively "spongy". Under this world, the reduced tax cuts will lower GNP and velocity without altering the money supply path, and with little effect on interest rates.

A second approach assumes that nominal GNP (both real and prices) is given by fixed velocity and many supply growth. In this case interest rates would be much lower (reflecting the reduced demands) and the composition of GNP would be altered, but total GNP, money and therefore velocity would be unchanged.

(The IS-LM interpretation of these two worlds is straightforward, and depends on the demand for money and the Feds stubbornness in hitting its targets.)

Under the first approach, I have used the following multipliers:

Multipliers

	Quarters After Tax Change					
	1	2	3	4	5	6
Change in GNP as a fraction of sustained changes in personal taxes	.5	.6	.7	.8	.9	1.0

In addition I have assumed that virtually all of the (percentage) nominal GNP reduction will be reflected in real GNP and almost none of it as lower prices. The following table shows the resulting real GNP reduction.

Change in Real GNP
(percent difference from March Budget Assumptions)

1981		1982				4th Quarter Growth	
III	IV	I	II	III	IV	1981	1982
-0.4	-0.5	-0.4	-0.4	-0.4	-0.4	-0.5	+0.1

The reduced cuts would lower GNP by about one-half of one percent through the end of 1982. The fourth-over-fourth growth rate of real GNP would be lowered by about one-half a percent in 1981 and raised slightly in 1982.

The reduced incomes would lower revenues and reduce the direct impact of the tax change on the budget. Using simple rules of thumb, I would estimate the total budget effect including feedback to be about $4 billion in fiscal 1981 and $15 billion in fiscal 1982.

Under the fixed velocity assumption there would be no change in GNP. The direct budget effect would be equal to the net effect including feedback.

One would have to argue that under this assumption interest rates would be much lower. If one assumes that the income elasticity of money demand is roughly 20 times the interest elasticity then I calculate a reduction of interest rates of about 100-150 basis points from this policy change. This last calculation is <u>very</u> approximate.

cc: MW, JB, AW, MM, DM, DR, SN

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20506

May 5, 1981

MEMORANDUM FOR: Jim Burnham

FROM: Steve Brooks

SUBJECT: Commodity-Monetary Reserves

Attached is the draft response to Mr. Page's bizarre suggestions. By the way, I found his graphical exposition most helpful. In particular, if you are confused about his proposal I strongly recommend a look at pages 50 and 51.

EXECUTIVE OFFICE OF THE PRESIDENT

COUNCIL OF ECONOMIC ADVISERS

WASHINGTON, D.C. 20506

May 5, 1981

Dear Mr. Page:

Thank you very much for sending us your material on Commodity-Monetary Reserves.

The use of inventories and stockpiles to maintain stability of production and prices has, of course, been a long-standing policy in certain sectors of the economy, notably agriculture. Moreover, open-market operations by the Federal Reserve control the money supply through daily purchase and sale of government securities.

What you propose is essentially a merger of these two techniques into a kind of open-market operation in which the government buys or sells commodities to influence the supply of money.

I found your suggestions very intriguing and worthwhile.

Sincerely,

James B. Burnham
Special Assistant
to the Chairman

Mr. Robert F. Page
6057 Jones Avenue
Riverside, California 92505

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

May 4, 1981

MEMORANDUM FOR: Murray Weidenbaum

FROM: Steve Brooks, Bob Turner

SUBJECT: High-Employment Budget Surplus

Revised estimates of the high-employment surplus continues to show that the discretionary policy embodied in the Reagan budget remains modestly contractionary though fiscal 1982. The attached table shows the details. Between fiscal 1979 and 1980 the high-employment surplus (HES) fell by $14 billion. Under the March budget assumptions the HES would increase by $30 billion in FY81 and another $11 billion in fiscal 1982. The quarterly pattern is also shown. As can be seen, after the second quarter of this year, the biggest increases in the HES will be behind us. This is due to the combined influence of the 1981 Social Security rate and base change as well as the step-up in windfall profits tax receipts.

Out-year estimates will be available soon.

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

High-Employment Budget Surplus or Deficit (-)
(billions of dollars)

	Quarters					
	I	II	III	IV	Fiscal Years	Calendar Years
1978				-9.6		
1979	-4.6	5.1	-2.3	-7.0	-2.9	-2.2
1980	-17.1	-21.6	-21.2	-13.2	-16.7	-18.3
1981	12.5	36.1	17.0	25.7	13.1	22.8
1982	19.9	27.8	24.2		24.4	

Sources: 1978:4 to 1980:4, actual HES from BEA
1981:1 to 1982:3, estimated HES from CEA
Based on March 1981 budget.

Today we are experiencing the most dramatic and exciting change in economic policy of the last fifty years. I welcome this opportunity to discuss the Reagan Administration's economic proposals with you. In my remarks today I hope to discuss with you not only the proposed changes in tax, budget, regulatory, and monetary policy, but also the intellectual foundation of these changes.

The economic policy of the Reagan Administration is, despite criticism to the contrary, firmly based in the conservative mainstream. But we are not doctornaire about our economic principles. We are nothing more or less than eclectic, neo-conservative, monetarist, supply-siders.

Whereas our umbrella is wide enough to cover a great number of views about how the economy operates and how policy should be set, we remain opposed to the economic policy mind set which, for the last twenty years stressed the importance of activist fiscal and monetary policy. The most eloquent statement of this position can be found in the writings of Walter W. Heller, the distinguished former Chairman of the Council of Economic Advisers:

> "Economics has come of age. . . . The paralyzing grip of economic myth and false fears on policy have been loosened, perhaps even broken. . . . We at last accept. . . that the Federal government

has an overarching responsibility for the nation's stability and growth. And we have at last unleashed fiscal and monetary policy for the aggressive pursuit of those objectives."1/

1/ Walter W. Heller, <u>New Dimensions in Political Economy</u>, Harvard University Press, Cambridge, Mass., 1967, pp. 1-2.

Since the early 1960s we have followed policies based on this hope that we could "fine tune" our way out of inflation and unemployment. The result has been 20 years of stop-and-go policies of fighting inflation one year and unemployment the next. Whenever inflation became too high, Washington would increase unemployment by raising taxes, cutting spending and reducing the money supply. Whenever the unemployment rate became too high, Washington would reopen the budget and money-supply floodgates and stimulate aggregate demand. The problem with these policies is that each time we applied the appropriate cure, the patient seemed to need even larger doses of medicine. Reducing inflation now requires prolonged periods of very high unemployment. By the same token, reducing unemployment by stimulating the economy now translates quickly into higher inflation rates with little lasting reductions in unemployment.

The Reagan Administration, of course, shares the goals of economic growth of its predecessors. It nevertheless wholeheartedly rejects the notion that this growth is the "overarching responsibility" of the Federal government. Our economic manifesto, is best summarized by several lines from the President's first statement on our economic program:

> "We must remember a simple truth. The creativity and ambition of the American people are the vital forces of economic growth. The motivation and incentive of our people -- to supply new goods and

services and earn additional income for their families -- are the most precious resources of our Nation's economy. The goal of this Administration is to nurture the strength and vitality of the American people by reducing the burdensome, intrusive role of the Federal Government; by lowering tax rates and cutting spending; and by providing incentives for individuals to work, to save, and to invest. It is our basic belief that only by reducing the growth of government can we increase the growth of the economy."2/

This -- in a nutshell -- contrasts the ambitious, interventionist style of economic policy making since the early 1960s with the proposals of the Reagan Administration.

Nevertheless, supply is just one blade of Marshalls _, the other being demand. One cannot lose sight of the important role that monetary and fiscal policy have in influencing aggregate demand. To borrow a line made famous by Paul Samuelson: The Lord gave my two eyes so that I could watch both supply and demand. But our policy differs from that part in realizing the very funding constraint imposed by aggregate supply. A policy designed to stimulate demand will be quickly dissipated in higher inflation if we do not -- in step -- enhance the supply conditions of the economy.

2/ Program for Economic Recovery, February 18, 1981

Failure to appreciate the importance of supply is the fundamental factor in the the economic conditions that we have inherited. There can be no question, but that, viewed over the past two decades, the basic trends in the American economy have been highly unsatisfactory. They have led us to what can be fairly described as a "mess." The average yearly rise in the consumer price index in the 1960s was 2.3 percent; in the 1970s it more than tripled to 7.1 percent. The average unemployment rate in the 1960s was 4.8 percent; in the 1970s it rose to 6.2 percent. Productivity in the American economy in the 1960s grew at an annual rate of 3.1 percent; in the 1970s it slowed to 1.5 percent.

Real GNP per capita grew at an annual rate of 2.8 percent in the 1960s compared to 2.3 percent in the 1970s. And, of course, the tail end of the 1970s -- and the first year of the new decade -- offered little hope of any turnaround from these long-term trends. Inflation reached double-digit levels and productivity actually decline.

While it is convenient to blame these economic failings on factors beyond our control -- oil price increases, poor harvests, declines in the dollar -- we cannot escape the fact that much of the blame belongs right here in Washington.

The Reagan Administration has proposed a far-reaching overall in the way Washington does its economic business. We plan to make economic policy in a consistent, steady and easily predictable manner. We do not propose quick fixes, we must adopt the long-view. Our program consists of four broad elements:

(1) an immediate, substantial, and sustained reduction in the growth of Federal expenditures;

(2) a significant across-the-board reduction in marginal personal income tax rates over the next 3 years, and an acceleration and standardization of business depreciation schedules;

(3) elimination of unnecessary Federal regulations; and

(4) steady and predictable reduction in the growth of money and credit.

These four complementary policies form an integrated and comprehensive program.

The budget reductions will lessen the government's call on resources thus allowing for a healthier private economy. Between 1960 and 1980 Federal government expenditures have grown explosively rising from _ percent of GNP to _ percent of GNP. Moreover, during all but one of those years the budget was in deficit draining real as well as financial resources from the private sector.

Recently the growth in the capital stock has slowed alarmingly. This has unquestionably contributed to the slowdown in productivity growth. The proposed tax incentives to business investment, by raising the expected after-tax return on investment, (the Accelerated Cost Recovery System) will result in expansions of plant and equipment, and thus improved worker productivity. The investment tax incentives of 1962 and 1971 were followed by strong expansions in real business plant and equipment expenditures and productivity growth. From the end of 1961 to late 1965 real business fixed investment increased by more than 50 percent, while productivity growth averaged 3.4 percent per year. Likewise, from the end of 1970 to late 1973 real business fixed investment increased by 28 percent while productivity growth averaged 2.9 percent per year. Some of the performance in each case was due to cyclical recovery, but the stimulus to investment was unmistakable.

The across-the-board reductions in marginal personal income tax rates will release substantial funds for saving. Moreover, these tax rate cuts will improve incentives and increase the quality and quantity of labor supply.

The reductions in unnecessary regulations will increase efficiency and lower costs to consumers. Reduced regulation in the transportation and financial industries in recent years has resulted in increased competition and a relative reduction in costs to their customers.

A moderate rate of monetary growth is an absolute prerequisite for stabilizing prices. The explosive growth in the money supply of the recent past has gone in hand with significant price acceleration. We must reverse these trends.

What makes this program different is that all of these policies are to be implemented together. Rather than competing, each is designed to complement the others. We recognize, of course, that there is no exact historical precedent for an integrated economic program of this type. But neither is there an historical precedent for the sustained high level of inflation simultaneous with the sustained high level of unemployment which has been experienced by the American economy in recent years.

Now, of course, things are not all sweetness and light in Washington. What are the critics saying about the program? The most frequently heard complaint is that the program is inflationary and thus, in John Kenneth Galbraith's words, is "unwise and alarming." It is said that the tax cuts far outweigh the outlay cuts and will therefore contribute to stimulating inflation.

Even abstracting from balanced-budget multiplier issues, this is a hopelessly narrow line of reasoning, since it ignores what is happening to baseline "current law" projections of outlays and receipts from which these cuts are measured.

A more meaningful measure of the stimulus (or restraint) embodied in our proposals comes from comparing the net change in the overall tax burden (total tax receipts or a percent of GNP) from now until 1986 with the net change in the total spending share of GNP. The table below 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 <u>far greater</u> in terms of the overall share of GNP than the tax cuts.

A second line of reasoning has it that a profligate Congress will pass the tax cuts while ignoring the recommended outlay cuts. This will widen the deficit beyond Administration's projections and result in more inflation. Nothing could be less likely. I have been working these past months with the Budget and Appropriations Committees of the 97th Congress. I can tell you that this argument is totally without merit and does a great disservice to the very responsible Budget actions already taken by the Congress. Indeed, the Congressional budget cuts are likely to exceed our own recommendations. The Congressional tax package, on the other hand, may well fall short of the ambitious three-year program prepared by the Administration.

Another complaint about the program concerns the fairness of the Budget cuts.

Having participated as a member of the Administration's Budget Review Group, I can assure you that not all the expenditure reductions were easy ones. Unfortunately we cannot escape the fact that there will be hardship to some degree. Many currently receiving benefits will no longer get them and this may face some temporary problems. But the cuts were made easier by following some rather elementary, basic principles: protecting the truly needy, providing for an adequate national defense, and following carefully drawn guidelines.

Based on the telephone calls, cards, and letters that I have received, I believe we did a good job -- and I'm referring to the complaints, not the praise. We appear to have followed the traditional budgeteers maxim: "Good budgeting is the uniform distribution of dissatisfaction." And if you think that my own profession, economics, escaped the cuts, you haven't been reading my mail.

A final frequently heard complaint concerns the optimism embodied in our economic forecasts.

The Adminsitration'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. Indeed, our near term forecast for 1981 now looks, if anything, too pessimistic.

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.

The projections for 1983 through 1986 reflect the trends of declining inflation and sustained robust economic growth which we believe are attainable if the President program is adopted in full.

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.

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.

* * * * *

Earlier I noted that the importance of enhancing the supply side of the economy. Let us be more specific about this supply-led rejuvenation in the U.S. economy. What exactly are we talking about?

It is useful to focus on six broad and fundamental supply forces that the Administration's proposals will clearly support.

The first and most significant element is the supply of labor services by our work force. The cuts in tax rates, and the reform of perverse entitlement programs which encourage unemployment, will all result in an increased quality and quantity of labor supply.

Second is the supply of capital through investment in new plant and equipment as well as innovation supplied by more research and development. The growth in the capital stock is slowing and its quality is deteriorating. The result has been trends in worker productivity and ultimately standards of living. The Administration's proposal for Accelerated Cost Recovery will improve the attractiveness of new plant and equipment and support the cash flow of firms willing to invest in their future.

Third is the supply of financial capital and services. Our financial institutions require a steady, predictable and supply of money to perform their essential intermediary role between savers and investors. Today financial markets are at sea, in confusion and uncertainty about monetary policy. The Administration supports the goals and operating procedures of the Federal Reserve in its efforts to steadily slow the growth of money and credit. Moreover, the Administration with its budget cutting initiatives will reduce the Federal government's need for external finance, further improving conditions of financial supply.

Fourth is the supply of raw materials and commodities. One desirable by-product of our regulatory reformr efforts will be a more rationalized policies toward raw material and commodity supply. In addition, increased trade flows, a stronger dollar and improved financial markets will all improve the availability and distribution of our scarce primary commodities.

Fifth is the supply of entrepreneurial drive and talent. This has too long been stifled by the inadequate reward to risking-taking that has been the inevitable result of high and rising taxes on capital and capital income.

The final source of supply is the most important,, and although it is the easiest to describe it is the hardest to quantify. It is, as George Guilder has taught us, the life blood of the capitalist system: hope and faith in the future. Without it there would be no entrepreneurs, no one willing to risk today's immediate consumption for the uncertain future benefit, there would be no financial capital, no need to invest in plant and machinery, no reason to explore for scarce raw materials, and no need for or gain from improve one's skills and talents in the work place.

It is the nurturing of these six elemental forces of economic growth that represents the "supply-side" policies of the Reagan Administration.

Draft Response to Question 1(d)

Uncertainties in the Projections

The principal uncertainty to the forecast concerns the likely response of Congress to the President's policy initiatives. Whereas both Chambers of Congress have ratified the overall dimensions of the President's proposals, much uncertainty surrounds the outcome of the on-going appropriations process in the various Congressional Committees. A program of tax and budget cuts that differed dramatically from that proposed by the Administration would clearly alter the forecast. Delay in passage of the President's program would also necessitate a revision to the forecasts.

A second key policy uncertainty revolves around the Federal Reserve's ability to achieve its monetary targets for this year and the next. The pace of financial-structure change within the U.S. is clearly accelerating. What this means for the conduct of monetary policy is not clear. But it is of critical importance to the success of the program, that the growth in money gradually and steadily be slowed. Moreover, it is especially desirable that this be done while avoiding the erratic month-to-month and even quarter-to-quarter volatility that has characterized the last several years. Interest rates in particular and financial conditions in generally are greatly affected by expectations about the future course of monetary policy. If the Federal Reserve falters and is unable to achieve its targets, then financial conditions could deteriorate with further cycles of high and erratic interest rates. This would jeopardize the success of the President's program and would necessarily alter the path of the economy.

Finally, a backward glance at economic activity of the last year and one-half dictates a humility on the part of the economic forecasters, government or private. Quarter-to quarter movements in aggregate demand have been very volatile and difficult to predict. The economy's largely-unexpected growth in the first quarter of 1981 is only the most recent example of this.

It is possible, of course, that the economy could enjoy several more quarters of rapid growth before slowing as anticipated in the Administration's projections. Strong business investment or consumption outlays could lead this pattern. Investment and consumer confidence surveys continue to show a modestly healty and robust outlook.

On the other hand, significant weaknesses in demands is also possible. Velocity growth has been unusually rapid recently and a sharp slowing in the growth of nominal demands would not be out of the question particularly given the level of interest rates.

SB 5/18/81

IMF CONSULTATION

Draft Response to Question 1a: Review of Policy Assumptions

The economic projections contained in the March budget submission assumed passage of the Administration's Economic Recovery Plan. This program consists of four fundamental and interdependent parts: Federal budget outlay cuts, a three-year, phased reduction in Federal personal income tax rates combined with an acceleration and standardization of business depreciation schedules, a gradual and steady reduction in the rate of growth of the monetary aggregates, and finally, substantial review, analysis, and reform of the burden imposed by Federal government regulations and rules.

Budget Outlay Cuts

The most striking feature of the President's economic proposals is the dramatic slowing in the growth of budget outlays. The cuts will total $6.4 billion in fiscal 1981 and $48.6 billion in fiscal 1982. Reductions in "off-budget" outlays and increases in certain user fees will save $0.3 billion in fiscal 1981 and $2.6 billion in fiscal 1982. In addition, the President's proposals call for sharp cuts in Federal credit programs of $ _ billion in fiscal 1981 and $ _ in fiscal 1982. As a result, the total claim on credit by the Federal government will be significantly reduced.

The effect of these budget actions can be seen in the dramatic slowing of outlays in the year ahead. From fiscal 1977 to fiscal 1981 total budget outlays grew at an average annual rate of 12.9 percent. The proposed growth in outlays for fiscal 1982 is less than half that rate, 6.1 percent.

The budget proposals will not only reduce the growth but also change the composition of budget outlays. As a share of total outlays nondefense spending will show a sharp drop. Defense spending, on the other hand, is projected to increase rapidly over the next several years, and increase its share of total outlays.

Tax Reductions

Under the President's proposals individual tax rates would be reduced by 10 percent a year for three years. For businesses, the President proposes to accelerate the write-off of depreciation for machinery, equipment and structures. Under the plan, (the Accelerated Cost Recovery System), autos, light trucks, and machinery and equipment used in research and development would be written-off in three years according to an accelerated schedule and would be eligible for an investment tax credit of 6 percent, 2-2/3 percentage points more than for property with 3-year lives under current law. Other machinery and equipment, including certain public utility property would be depreciated over 5 years and eligible for the full 10 percent investment tax credit. Factory buildings, retail stores, and warehouses used by their owners, and other longer-lived public utility property would be written off over 10 years. No change in the investment tax credit is proposed for this class. Other nonresidential structures and low-income rental property would be assigned 15-year lives, and other rental residential property would be written off in 18 years. In addition, the Accelerated Cost Recovery System will substantially simplify depreciation accounting by substituting a few, clearly defined categories of capital assets for the 140 classes under current law.

In addition to these changes in tax law, the economic projections assume the continuation of current policy with respect to Social Security tax increases and the so-called "windfall profits" tax on oil company revenues.

The total discretionary stance of the Federal budget is expected to be modestly restraining over the next two years. The table below shows the high-employment budget surplus under the Reagan economic assumptions.

High-Employment Budget Surplus or Deficit (-)

(billions of dollars)

	I	II	III	IV	Fiscal years
1980	-17.1	-21.6	-21.2	-13.2	-16.7
1981	12.5	36.1	17.0	25.7	13.1
1982	19.9	27.7	24.2	NA	24.4