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SUBCOMMITTEE ON ECONOMIC STABILIZATION

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BANKING, FINANCE AND URBAN AFFAIRS
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LETTER OF TRANSMITTAL

APRIL 4, 1977.

Hon. HENRY S. REUSS,
Chairman, Committee on Banking, Finance and Urban Affairs, U.S. House of Representatives, Washington, D.C.

DEAR MR. CHAIRMAN: Enclosed for your consideration are papers presented at a briefing on the 1978 Federal Budget. The topics of the speakers dealt principally with the issues of unemployment and inflation now before us. The briefing was arranged by the Public Interest Economics Foundation and was held on February 7, 1977.

The papers range in coverage from discussion of econometric models and forecasting, through discussion of tax cuts versus jobs creation, and tradeoffs implied between unemployment and inflation. The views and conclusions of the papers presented here do not necessarily represent those of the Subcommittee on Economic Stabilization or of any individual members. It is suggested they be made available for reading for both Congress and the administration since the overall problems of inflation and unemployment persist. The thoughts of the authors raise almost as many questions as are answered, but these are issues to be dealt with by the Congress. The availability of the views expressed herein can be of assistance in that quest for solutions.

Sincerely,

WILLIAM S. MOORHEAD,
Chairman, Subcommittee on Economic Stabilization.

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ECONOMETRIC MODELS AND ECONOMIC FORECASTING

By Dr. Robert A. Levine

My concern here today is with forecasts of general economic activity—gross national product, growth rates, unemployment, and inflation—as compared to more specialized forecasts. What I want to suggest is that the forecasts we have now for 1 or 2 years ahead are not very good, and forecasts for longer than that are virtually useless. I don't think it's impossible to live with that, but I want to talk a bit about how we do so.

It seems to me that for each of these two time periods—1- to 2-years and 3- to 5-years—the major problem lies in the same area, the inability of economists to forecast private investment, particularly the business plant and equipment expenditures portion of private investment. Now, I was brought up in a primitive era of macro-economics. We were taught that consumer demand was a dependent variable, investment demand and government spending were independent variables. (Export demand for U.S. goods was also an independent variable, but to keep the discussion simple, I will ignore exports.) What one learns from one's instructors is very difficult to forget, so I will assert that by and large this division of dependent and independent variables still holds, although perhaps not for the very short run. For a very short period, a few months ahead, we can examine consumer confidence and consumer intentions, independently of longer-run determinants such as consumer disposable income. The consumption rate and, conversely, the savings rate out of disposable income, will vary in a short period. However, for any longer period, even the 1-to-2-year period and the 3-to-5-year period, I go back to my basic primitive precepts. They state that consumer demand is a relatively stable function of consumer disposable income which is largely a function of everything else. Over longer periods of time, the consumption/income ratio grows, but gradually.

Government and investment spending I take as being more independent. Government spending is primarily a policy variable. Government can set out to spend a certain amount and within certain ranges spend that amount—the ranges being determined in part by changing external economic conditions. The ranges are fairly narrow, although the shortfalls recently discovered in government spending—the differences between what spending actually was in fiscal year 1976 and in the transition quarter and what it was supposed to be—indicate that the level of Government spending is less controlled than we had thought. Nonetheless, it is a policy variable, relatively controllable compared to the other variables.

So, if as I contend, consumer spending is largely dependent and government spending is largely determined by policy, that leaves investment as being both difficult to control and difficult to predict. It is this difficulty in prediction that causes our forecasts for these 1-to-2 and 3-to-5-year time periods to begin breaking down. Whether we talk about the commercial forecasting models or the judgmental forecasts based in part on data from the models (CBO makes its forecasts by examining the entrails and then going into our own trance), producing such forecasts just turns out to be very, very difficult. In the short run, many forecasts miss the turning points when aggregate economic activity changes from rising to falling or vice versa; in the long run the forecasts provide very little. In other words, we come in for a lot of surprises, particularly over the 3-to-5-year time period.

One way to allow for our inability to predict private investment very well with a behavioral model is to use surveys. The Department of Commerce takes such a survey of business intentions to invest, and most forecasters use this. Unfortunately, however, the survey is very short run, predicting only a year ahead. In addition, the intentions reported by businesses are not always firm, but change within the year, with changing economic conditions. Although it is possible to improve the use of the surveys as forecasting tools by doing some correction for changing conditions—I know that because my Ph. D. thesis 20 years ago was on that topic—it has not been done systematically.

Why is it that we cannot predict investment very well for either the shorter or longer time period? One reason is that another group of policy variables—money supply and interest rates—is outside the control of the Congress. It is very difficult to incorporate into the forecast a behavioral model of those who control these policies—Arthur Burns and the Federal Reserve Board.

More fundamental, however, is that private investment behavior is a function of some other variables very difficult to predict or quantify. Going back again to my primitive economic training, I was once a student of one of the greatest of the 20th century economists, Joseph Schumpeter, who emphasized private innovation and entrepreneurship as determining investment. Although not excluding the role of policy in establishing an atmosphere for entrepreneurship, Schumpeter stressed the role of the business entrepreneur in recognizing and promoting technological change, and recognizing and developing new markets. This role can be examined systematically by economists, but to pin it down for forecasting purposes has proved virtually impossible.

In any case, I think we can do a little better in forecasting investment through the use and adjustment of business surveys, but what we will still end up doing is to pray and make 1-to-2-year forecasts and frequently miss the turning points. With even more prayer and maybe incantations, we may occasionally make 3-to-5-year forecasts.

Getting down to the policy issue, however: For most policy purposes our 1-to-2-year forecasts are probably acceptable. We need to make 1-to-2-year forecasts because when the Congress and the President make fiscal policy, they're making it essentially for a period of 1-to-2-years ahead. What I have suggested about the 1-to-2-year forecasts is that what we miss here is primarily the turning points, but given a little bit of flexibility we're not going to miss levels or rates by too much, and policy can adjust to these changes. The fact that the Congress has been able to respond to the economic and political changes of last fall by taking up in good order a third concurrent resolution on the budget for fiscal year 1977 indicates sufficient flexibility, at least for the case of a need for added stimulus. If new constraints were needed, the question might be more open. At any rate, it seems likely that the state of the art is up to supporting the state of policy for the 1-to-2-year forecasts.

For the 3-to-5-year forecasts, the policy result may be similar, but in a different context—that is, the 3-to-5-year forecasts are not very good but there's not very much the Congress is called upon to do in fiscal policy for the 3-to-5-year period. That is, if the Congress passes a program like President Carter's stimulus program consisting of spending and tax packages, it is a 1-to-2-year program and can be adjusted as the economy changes. The difficulty here, however, is that a lot of what Congress does—not considered in the sense of impact on the overall economy, but in terms of its impact on future federal spending—really does involve commitments of at least 3-to-5-years ahead. For example, shipbuilding programs, the institution of health insurance schemes, changes in social security, all constrain budgets either legally, morally, or politically for many years ahead.

In many ways, therefore, Congress has got to take account of the 5-year impacts—not impacts on the economy as a whole, but impacts on particular program commitments—of what it does and it's got to do so in the light of very, very imperfect long-run economic forecasts. The key question thus is: If Congressional decisions now commit major portions of the Federal budget 5 years (and more) from now, but the total size of the budget 5 years from now depends on economic conditions we cannot now forecast, how can the Congress live with the resultant uncertainty?

How do we reconcile this? I'll wind up by saying that's what we've been trying to do at CBO. We have not been trying to do the impossible task of making very accurate forecasts for 3 to 5 years ahead, but what we have been trying is to reconcile the need for certain kinds of information in 3 to 5 years with the possibilities of getting such information.

What we find then is that we can arrive at a very wide range of forecast results 5 years from now, but that we can make use of even this wide range. For example, depending on national goals for economic growth and on assumptions about the contribution of the non-Federal (primarily private) sector to this growth, the room available for new Federal spending by fiscal year 1982 can vary from $30 billion to $132 billion at current tax rates. Or, if spending is held at current policy, the room available for tax cuts in fiscal year 1982 can vary from $39 billion to $168 billion. (Dollar for dollar, spending is somewhat more stimulative than tax reduction.)

The higher end of the ranges of spending increases or tax cuts comes from the adoption by Congress of a vigorous growth path goal for GNP (resulting in 4.2 percent unemployment in 1982), with this ambitious national goal getting support from only moderate non-Federal economic activity, at a level well below the maximum that might seem plausible. In that case, a good deal of stimulus from the Federal budget will be required to achieve the ambitious goal and the "stimulus required" is the equivalent of the "room available" for new spending or for tax cuts. The other end of the range comes from the combination of a less vigorous GNP goal (resulting in 5.5 percent unemployment in 1982) with the same level of private activity.

This $130 billion range in "room available" is about the best that economic forecasting can do, and it tells the Congress less than we would like to. Nonetheless, it does say some things. It says that even in the most constraining case we consider plausible—a goal as modest

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as 5.5 percent unemployment in 1982—$30 billion or more of additional Federal stimulus will be necessary. Were that stimulus not injected into the economy, unemployment would be higher than 6 percent. Furthermore, it says that if the growth goal is higher or the performance of the non-Federal economy weaker relative to that goal, a good deal more room will be available or stimulus needed from new spending or tax cuts.

Indeed, except in the most constraining case, room will be available for many new Federal spending programs now proposed, with flexibility left over for tax cuts. A quite elaborate welfare reform, for example, could cost $15 billion by 1982; a substantial Federal catastrophic health insurance program, $20 billion; proposed defense increases, $10 billion to $20 billion additional, depending upon what defense spending base line is used. These numbers compare to the expenditure range suggested above of $30 billion to $132 billion, and under a wide variety of circumstances, that range would allow some combination of the new programs together with tax cuts by 1982. About the only program now proposed that would be difficult to fit into these numbers is a fully tax financed national health insurance plan, which might cost between $108 billion and $138 billion by fiscal year 1982.

Thus, even in spite of the uncertainty of our forecasts and the consequent width of our range, we can predict substantial flexibility for the Federal Government to make decisions now, committing resources into the future. Let me conclude, however, by mentioning briefly the other side of this same picture. Flexibility is, of course, a good thing, but it also follows that only by private economic growth going substantially beyond that of recent history, can we avoid the need for continued Federal stimulus (and deficits) if we want to reach a goal like the 4 percent or so rate of unemployment that is thought of as full employment. Going back to my Schumpeter, this suggests that some sort of strong wave of private innovation, engendering susbtantial investment, would be needed, and so far as I know, such a wave is not now foreseen by business forecasters. Without it, it might be possible that the economy is entering a period of what was called in the 1930s "secular stagnation," meaning a private economy stagnant enough to require continuing heavy Federal stimulus to reach full employment.

If this were the case—and I am only asserting that such "secular stagnation" is within the realm of possibility—the implications for the short run as well as the long would be interesting. For example, the debate on the short-run economic stimulus package provided by President Carter is focused in part on the issue of whether such devices as public works can be effective in providing stimulus "in time" to work their effects before the economy is out of trouble anyhow. But if the economy were expected to stay in trouble for quite a while without continuing stimulus, then the timing issue would become less crucial.

On the other hand, although public works and similar slower-acting stimulus measures might become competitive with fast-acting tax rebates if we are in this for the long haul, even longer run measures might also enter the competition. Welfare reform, health insurance, stronger defense might become candidates for a stimulus package under these assumptions.

As I said, I do not make the assumptions, but as is the wont of the Congressional Budget Office, merely point out their implications.

COMBATTING UNEMPLOYMENT—TAX CUTS VERSUS JOBS CREATION

By Dr. Walter Heller

To begin with, let me disagree a bit with my assigned title for today of "Combatting Unemployment—Tax Cuts versus Job Creation." I prefer to call it "Tax Cuts versus Other Ways of Creating jobs" since tax cuts are the most readily available instrument, even though the job content per billion dollars of cost in Government revenue is lower than most alternatives.

Let me get that straight at the beginning. You get more bang for the buck out of public service employment programs—and the CBO has these figures all at their fingertips. Whether it's public service employment or other CETA programs or countercyclical revenue sharing, it's clear you can get more job content per billion dollars of expenditure. The trouble is you can't get it fast. If you're going to take the approach that you want to do something rapidly, the tax rebate has to come front and center. I will defer to Bob Levine on the exact job-creating content of the different approaches although I have some numbers if you press me.

As that indicates, I'm going to focus particularly on the tax rebates—that is, the $50 refundable credit proposal—as a means of creating jobs. I did that Friday before the Ways and Means Committee and did it again this morning before the Joint Economic Committee. Sometimes when I hear the Senators and Congressmen, I wonder whether if I'm on a kamikaze mission, but I hope that the opponents are more vocal than the proponents and that the tax rebate still has an optimistic future in Congress.

Let me go back to basics for just a moment. If one argues strongly for a quick booster shot, a fast tonic for the economy, one has to argue it on the basis that there is no time to lose in terms of what's ailing the economy. I would cite not the month-to-month or week-to-week numbers to support that case. Rather, I would cite first of all, the lagging recovery that we've had from this deepest of the recessions since the thirties. Most of the comparisons you get are with the trough of recession—and people say we've been doing pretty well since the trough. They forget that the trough was twice as deep as any other postwar trough. If, instead, we compare the economy's position today with the previous peak—as we ought to, in an economy in which we pride ourselves on its tremendous potential and its ability to absorb new human and material resources—if we compare it with previous peaks, this recovery is miserably deficient.

Compared with the prerecession peaks in 1973, at the end of 1976, consumer income—and these are all in real terms, boiling out inflation—consumer income and GNP were up only half as far as they are normally, that is, on the average in the previous five postwar recoveries. Consumer income is up over 4½ percent as against an average rise of 8 percent; GNP is up only 3 percent as against an average rise of 8 percent. Industrial production at this stage of the game is usually 8 percent above its preceding peak. This time it has just barely managed to struggle above the peak that it reached in 1973—and that's in an economy whose potential has been growing between 3½–4 percent a year. Or take business investment—usually by now its up 5 percent from the preceding peak in real terms. This time it's down 12 percent from the preceding peak.

Second, as a result of this sluggish recovery the number of jobless workers rose during 1976. With the drop to a 7.3 percent rate in January, we find that a number of jobless is about even with a year ago. But during 1976 it rose. Factory operating rates have been stuck—virtually stuck for a year at about 80 percent of capacity. Now remember this is supposed to be a year of recovery. Unemployment went up, factory operating rates stayed about where they were, and the gap between actual and potential GNP—figured not at 3 or 4 percent unemployment—is about $150 billion. If unemployment were brought down to 50 percent, we would be producing about $150 billion more goods and services than we are. The recent Ford Economic Report seems to dispute that by referring to a $99 billion gap but that's in 1972 prices. When you price that out to 1976, it comes out to $138 billion. What it amounts to is that after 20 months of recovery, unemployment and economic slack are still about at the average levels that characterized the troughs of our previous postwar recession.

Why do I take so much time to go into that—simply because I think there's a misperception when an Arthur Burns steps up and says, "You know it looks to me as if the economy is doing pretty well on its own and maybe you don't need this stimulus program after all." I think that's a pretty good summary of the papal bull that was issued from the monetary Vatican. We've been conditioned for eight years to believe that passivism and inaction are virtues. Slow is beautiful. It's not. We ought to focus on the economic shortfall that really motivates the stimulus program and will, I believe, motivate the Congress to act.

There's a third point that's worth making—and that is that the prospects for 1977 without stimulus, were for economic expansion at an unsatisfactory 4 to 5 percent rate. It's worth underscoring that the Carter proposals were predicated on this kind of an advance—not on a fizzling out of the recovery, not on the threat of recession, but on the threat of too slow a rate of expansion, just like 1976, to make real inroads on this persistently large excess of unemployment and unused resources. I get so annoyed with these analyses that say "See, the economy didn't fall into a recession after all, so why act?" Bob, did anybody forecast that the economy was going to spiral down into a recession this year? Not that I know of. To discover that it is going up at a modest rate is simply to find that it is rising at the pace which was assumed when the stimulative program was put forward.

We have to also look at the international dimension. If the U.S. economy doesn't expand it may not mean bankruptcy for other countries, but it's going to be very very tough on the less developed countries in particular. I wonder how many of you are aware that last year Germany ran a trade surplus of $17 billion. Japan ran a surplus of

$9 billion. The OPEC countries, $30 billion. In other words, they piled up $56 billion of surplusses. That means that somebody has to have $55 billion in deficits to p:.:' :or it. And needless to say, these are concentrated in the nonoil ..:.JC's and in weak countries like Italy and Britain. We have an enormous responsibility, side by side with Germany and Japan, to lead the world in economic recovery.

One should remember that total imports and exports come to about 10 percent of the economy. Imports of goods and services will be running around $180 billion a year. Our projected 1977 GNP is $1,875 billion. That $180 billion of imports is of obvious importance to the rest of the world. Unless we expand briskly, we're going to put them under great economic pressure, especially the weaker countries.

That brings me to the size of the program—$15 billion this year roughly and $15 billion next year. The kind of design and structure and composition that Carter came forward with makes good sense: The early punch of the tax rebate and then a measured follow through of jobs programs and public works and training programs and countercyclical revenue sharing, recognizing you can't get it going overnight, phasing those in as the impact of the tax cuts phases out.

As to size of the program, I can't stress too much how the magnitudes in this economy have overtaken us. We simply haven't caught up with the fact that by a year from now, give or take a few minutes, the economy will be producing $2 trillion of goods and services per year. We suffer from "fiscal acrophobia" as I call it, a fear of great heights in our fiscal actions—not orienting them to the huge numbers that characterize the U.S. economy.

To bring home how the numbers are getting away from us: In mid-1960, to draw a little attention to the way the economy was growing—GNP was running at about $500 billion in 1960—I said to one audience, "Are you aware that we will cross the trillion dollar GNP mark on January 10, 1978 at 10:10 a.m.?" The New York Times, obviously tongue-in-cheek, reported this "forecast". The next day, I got the following wire from Joe Pechman: "Having trouble checking your estimate of trillion dollar GNP on January 10, 1978 at 10:10 a.m. Are you using central or eastern and is it daylight or standard time?" But note what my forecast was—$1 trillion—instead it's going to be $2 trillion. My forecast was right on the nose, give or take a trillion dollar.

What I've said implicitly, perhaps I should make explicit; namely, I think $15 billion is a very modest program. Appearing before the Senate Budget Committee a month ago, I was outbid by Paul McCracken. I had $20 billion as my target and he suggested $24 billion; David Grove of IBM and the AFL-CIO have agreed on $30 billion—all in the first year, not the second. This morning, Franco Modigliani also told the JEC he would go beyond $15 billion. I believe we could safely go $20 billion in 1977 without testing any of the inflationary parameters of the economy.

What about the Carter product mix? It reflects an economic conviction in the Carter administration something like the following: In the longer run, you can't achieve your employment objectives without at the same time subduing inflation. You have to be as strongly anti-inflationary as you are pro-jobs. President Carter learned early in the game that the United States can probably push unemployment down to about 5½ percent—there would be some quarrel as to exactly where this level is between 5 and 6—through traditional aggregate demand, Keynesian measures of the type Bob Levine was talking about before—fiscal and monetary stimulus. But to go the last mile—to 4½ or 4 percent, you simply have to rely on structural measures.

There's just no other way, given the fact that a good part of our unemployment is structural in the sense of being concentrated among the young, the black, women and in urban and rural ghettos and so on. There you need to pinpoint it with direct measures of job corps training, public service jobs and the rest. You have to launch the program simultaneously so as to deal both with the cyclical and the structural unemployment. The shortest distance between two points still is a straight line. To the extent that you can get the jobs programs—a direct creation of jobs—underway efficiently, that is the cheapest way to produce a job. Sure there are detours and potholes and so forth, but the idea is not to abandon the road but to correct those deficiencies.

What about public works? We're suffering from the "Nancy Teeters syndrome." Nancy will understand what I mean by that. Nancy Teeters did a study for Brookings of the $900 million or so accelerated public works program back in 1962 and found that the final impact wasn't felt until about 1969. Everybody who has been dubious about public works has grabbed Nancy's study and said, "That proves that it's not a good antirecession device." I am sure Nancy herself feels that her study has been overinterpreted, that circumstances change, that the shelf of public works is more up to date now. Most important, we are so far away from our economic objectives—given a target date of 1980 to get there—there's plenty of time to have a very productive public works program that would also help us on the jobs front.

There ought to be amber light about public works in the sense that you can't get them going fast, but it ought not to be a red light. In this connection, Paul McCracken had an interesting statistic and conclusion in his last Wall Street Journal article in arguing for stepped-up public works:

> The volume of public construction is now in real terms 25 percent lower than a decade ago in an economy that in real terms is 30 percent larger. Public construction is now so low that the real value of public capital is probably not being maintained.

We have had so much alarm and propaganda dinned into our ears about the public sector expanding like some protoplasmic blob that I think the public has lost perspective. Take Charlie Schultze's recent Brookings study: Federal baseline expenditures in current dollars rose from 18.2 percent of GNP in 1955–60 to 20.1 percent in 1975–77. But in constant dollars, corrected for inflation rates as they affect different sectors of the economy, there actually was a drop from 18.2 percent to 15.8 percent of GNP. In other words, in terms of the prices of the things that the Federal Government buys relative to what others buy, the money it spent in 1975–77 bought only 16 percent of GNP as against a little over 18 percent in 1955–60.

Let me come back for a moment to public works. One can't get them going overnight. But if Congress makes money available to the States and localities that have $25 billion to $30 billion of public works in process, the budget authorities are going to have to keep very close tabs on them to see that they don't simply put the money in on projects that are already in full swing and let that displace other money. This could make it look as though they spent the money overnight. They can't—there's just no way you can do it in public works.

Let me finally say a few words about the tax rebate per se. It is a clear-cut case of putting first things first.

One might quote Vince Lombardi, "Winning isn't everything, it's the only thing." The tax rebate isn't everything, it's the only thing that can give you an early and sizeable booster shot. It keeps options open, it doesn't preempt tax revenues for the future, it doesn't rule out any other kind of program (unless there's some deficit constraint that would rule out some larger programs in 1977). I don't believe that the tax rebate will prevent you from doing everything that is possible physically so to speak in fiscal 1977 on the jobs front, the jobs program and public works and so forth. Then, as one moves into fiscal 1978, one will be gearing up to a much greater rate of speed in these programs.

There is, of course, a great controversy over whether the tax rebate will be spent or saved by consumers. Although you can find more opinions than there are economists on this subject, I think the circumstances in 1977 are such that they will predispose people to spend that tax rebate. In 1975, they were still afraid of inflation and contrary to what we used to think, inflation causes people to squirrel away funds to build up the real buying power of their cash balances rather than rushing to beat price increases. Inflation has receded from double digits to single digits, down to about 5 to 6 percent, so the inflation jitters are less of a factor. Second, just think of the impact, the economic frostbite of the cold wave. A lot of people are having to dip into savings just to pay their heat bills. Third, the cold wave aside, I think the state of consumer confidence is such that, as Burns Roper tells us, if there is a tax cut it will be spent rather promptly. Fourth and finally, looking at the savings behavior of consumers after the 1975 cut—with savings first bounding upwards but then falling below their average in the 1970's—I'm satisfied that it will work.

Also, it is remarkable that we just by chance have a vehicle that is in motion on which we can load a little additional offset to the cold wave. I've seen the estimates of the cold wave's impact on consumer buying of about $8 billion by the Library of Congress. And one far-out econometric model says $10 billion to $15 billion (it's a model that seems to enjoy coming up with startling numbers). I come up with perhaps $5 billion of reduced spending on nonfuel items. Not being all that sure of the numbers, one ought to add maybe $3 billion to the tax rebate. Not because it will precisely compensate the individual people who are hurt by it but rather that it will compensate for the loss of aggregate demand. It's a lesson we should have learned when we were hit by the $30 billion explosion of oil prices back in 1974. I want to emphasize in closing once more that even though the jobs programs are more jobs intensive and one ought to be putting them into place right now, the only really strong instrument at our command for quick stimulus of the economy is the tax rebate.

ASPECTS OF THE INFLATION—UNEMPLOYMENT TRADEOFF

By Dr. Norman H. Jones, Jr.

I would like to note at the onset, that Dr. Heller's forecasting capability is not something he should be modest about. In terms of 1960–61 prices, and he's got the numbers there, his trillion dollar figure for 1978 is pretty close. In his anecdote, Dr. Heller does bring home what has happened to prices and inflation over the past decade and a half or so. I think this is something that we must concern ourselves with despite Dr. Brannon's admonition that we could swallow a little inflation while getting rid of some unemployment.

One of the things that stands out in the recent flurry of data and material regarding the Carter Administration's economic stimulus package is that practically everybody seems to lay the blame for the current slow recovery on a lag in business investment.

Dr. Heller indicated that the fourth quarter of 1976 business investment in real terms was about 12 percent below the previous peak fourth quarter of 1973. If one looks around, one finds that corporate profits are at unprecedented levels—up 25 to 30 percent from the previous peaks—with company after company reporting record earnings for 1976. There's only one problem—when we put these figures in real terms we find that corporate profits are running about 5 percent below the 1973 peak. I would argue that this explains in part, at least, the lag in the recovery of business investment and the poor performance of our economy through this recovery period.

I think inflation has a particularly significant impact in some of the key sectors that we have been relying on to drive some of the major portions of our economy.

Past recoveries were marked in their early phases by deflation rather than inflation. In contrast, this recovery has been marked by an average annual price rise of 5.3 percent (measured by the GNP deflator). Even more, we find forecasters all talking in terms of 5½ percent or 6½ percent inflation—not just for this year—but implying that it's going to go on and on and on, forever. For these reasons, I think that we really do have this inflation in the face of the kinds of unemployment that we've experienced.

Dr. Schultze in his various testimonies on Capitol Hill has referred to our current situation as being one of "momentum inflation" that somehow or other will stop rolling. I take a somewhat different view, and I would attribute our current circumstances to four major factors. First of all, a really significant change in business and labor expectations has taken place over the last few years. Second, some interesting shifts in the structure of our labor force have occurred. Third, there has been a continual and continuing institutionalization of mechanisms that promote rising prices or at least facilitate them.

Finally, a set of real changes has taken place with respect to energy costs and our international position.

One of the nice things about being where I am is that I don't fail to read the Wall Street Journal and the New York Times every day.

It sensitizes you to some things and one of the things that I have become sensitive to is notices of price increases. Industry after industry, firm after firm report price rises of 5 percent, 4 percent, 10 percent, 7 percent or what have you. Occasionally, so very occasionally, that they stand out, you see a firm saying, "We're having a little trouble, we're going to drop our prices 5 percent, but we hope that by June we'll be able to bring them up again."

We see a steady, almost continual stream of price increases. Why? Because business and labor assume, and I think rightly so, that any administration is going to bail them out. In effect, any administration is going to take those fiscal and monetary steps that will validate their price and wage increases. I think, for example, this is the message that is embodied in the Federal Reserve money supply targets that are no different than the targets of the past year or so. It is also the message coming out of the administration's stimulus package.

The argument for a tax rebate is that it will stimulate the economy. What kind of a jolt can we expect. Let's assume that it all gets spent. The consequence would be to reduce the inventory sales ratio from 3.1 to 3.0, which is great—except that historically the inventory ratio runs around 2.5 to 2.7 so that we're really making essentially very little progress with the package.

Another way of looking at it is that a 6-percent annual rate of increase in prices absorbs the entire tax rebate in less than three months so that it is very hard to find a rationale for the tax rebate except that it conveys signals to the decisionmakers in our system that we can expect inflation in the future comparable to the rates we have experienced in the past. This in turn shapes business and labor decisions. The evidence of that I would argue shows up in terms of the investment statistics for the past 1½ or 2 years.

We find increasing adoption of cost-of-living arrangements in wage negotiations. In other words, in addition to the adjustment which is necessary to bring a particular union into balance with other unions, we find each taking on, pretty obviously, a hedge against more inflation. More and more the unions are, thus, showing concern about the real wages of their members, as opposed to the money wages, though they appear to have no concern to the unemployment consequence of this emphasis.

Similarly, we find a whole series of rigidities in the business environment. These all serve, whether we like it or not, to slow price declines in economic decline; these rigidities do have the virtue of slowing price rises also. It remains that given a basic inflationary impetus arising out of our fiscal and monetary policy the system will keep generating new price increases.

A whole set of regulatory activities has been attacked in Congress by those concerned that the regulations lead to a misallocation of resources. I think in the current instance, we might want to look at the regulatory activity as it contributes to inflation. For example, the Interstate Commerce Commission recently approved general freight rate increases for railroads. The Commission argued that the action was not inflationary—all it was doing was responding to the rise in the costs that the railroads had shown and the railroads had made a very persuasive case. There was no question that rail costs had gone up substantially and that, given this trend, the rails would soon run out of money, and we would be left without a financially sound rail system. Nobody on the Commission asked the nasty question as to whether or not the railroads had expected to get the rate increase when they entered wage negotiations and their contracts with their suppliers. Obviously they had. They looked at the past history of the Commission's behavior and realized that whenever they come in with the appropriate cost figures, the Commission gave them the appropriate rate increase.

One really should not pick on the ICC, but they are such an obvious target that it is hard not to take advantage of them whenever you're looking for a good example. But the other commissions behave in much the same way. The problem, of course, is that the concept of cost-plus-pricing institutionalized a process that assures the transmission of inflation throughout our economy.

A third factor is the changing structure of the American labor force. We are only now beginning to probe what this really means for unemployment statistics and what it means for economic policy. In 1965, about 19 percent of the labor force fell into the 24 and under age bracket; while in 1975, 24 percent fell into that age group. The reason I am interested is that this is the age bracket of our society which is most mobile, which bears the smallest share of family responsibility, who are really moving around, job-hopping, looking, trying to enjoy all of the nice things of life. Put another way, is there any reason why a 20-year-old who happens to be working instead of going to college shouldn't follow essentially the same kind of nonworking behavior pattern as his college peers? And, therefore, should this voluntary youth unemployment be of great concern to policymakers?

The statistics show, at least for the white youth, that their teenage unemployment doesn't influence later labor force participation and unemployment rates.

There does seem to be a frustrating and disturbing relationship between black teenage unemployment and later labor force participation and unemployment that should be of special concern. This is new in the Seventies, and may in some way be related to the hopes raised by the civil rights movement of the Sixties which have not been fulfilled. This problem requires a more innovative public response than to merely recommend the same old job training programs.

In addition to the fact that our young people are much less job centered, we have established an unemployment compensation system that may be causing us problems too. The penalty for taking a job can be significant if you're not really too anxious to work, and if the job doesn't offer much promise. Why give up unemployment compensation for a salary which is going to get taxed? Our peculiar system of incentives and penalties would, I suggest, not only be exacerbated by the change in the age structure of our labor force, but in effect would reduce job search cost.

In addition, the way we have it set up imposes essentially no costs on the firm so that a company has very little interest in these younger people. They do with respect to the more mature, skilled workers and we find that the employment rates of older workers reflect this interest.

The last item is that we really have two things going on in our system that call for substantial economic adjustment that we are trying very hard to avoid. The first of these is the rising real costs that are beyond our control. They are represented by the energy problem and I would say in the short-run by the drought and the severe cold spell. These are causing real changes—real incomes are in fact going to be smaller this year than they would otherwise have been—whether we like it or not. We may hide from that by passing a program designed to increase money income, but it doesn't change the simple fact that we have less than we otherwise would have had.

The economic and personal costs associated with the cold winter, the similar costs that we are going to be confronted with when the drought and the freeze begin to make their impact felt on food prices are real. We are going to have a smaller bundle of goods and we ought to face it. This is a point we have to keep in mind especially when we talk about the Carter stimulus program. How we want to take the pill is up to us but we are going to have to swallow it.

The second thing is that we have made fairly significant changes in our national product mix. I would argue that EPA and all of the environmental legislation. OSHA with its health and safety regulations and so on, all represent a significant change in the composition of what our society produces, with consequent real impact. We have continued, if not consciously, at least unconsciously, to observe the consequences of these changes through an essentially inflationary policy.

Inflation is important; it has real impacts. I am nevertheless still willing to pursue programs to lower unemployment but I am concerned that we pursue efficient programs. I am beginning to think that the argument for a jobs program is considerably more persuasive than the argument for a tax rebate as a consequence of my position. In the absence of an incomes policy, if I'm going to be forced to swallow some inflation, I think I would prefer to have it with more jobs rather than less.

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