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Excerpt From Report of Economic Council

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WASHINGTON, Jan. 26—Following is an excerpt from the Annual Report of the Council of Economic Advisers, which, together with the President's Annual Economic Report, was submitted to Congress today:

Economic Policy and Outlook

The U.S. economy is now recovering from the most severe recession in postwar history. Spurred by a lower inflation rate, tax cuts, and increasing employment, significant gains have already been made in the purchasing power of consumers. Production has been rising rapidly since the spring of last year. But because this recovery started from very low levels of resource utilization, unemployment will almost surely remain distressingly high this year even though large gains in employment are expected during 1976.

The social hardships and economic waste associated with the current level of unemployment should not be underestimated. Accordingly, we must seek to lower unemployment as rapidly as is consistent with the need to ensure that the reductions will be lasting. Policies that might speed the decline in unemployment in the short run should not be so expansionary as to lead to increased instability and greater social hardships in the long run.

Thus, policies for 1976 must attempt to sustain the recovery now in progress but at a pace sufficiently moderate to prevent renewed imbalances and a rise in inflation. They must also continue to mitigate the hardships associated with high unemployment. At the same time, our present policies must lay the foundations for a long period of steady growth.

The Need for a Durable Recovery

Because we began the present recovery with more slack than in any of the previous postwar cycles, a much longer period of above-average growth will be required for a return to full resource utilization. Even under the best of circumstances the return to full employment cannot realistically be accomplished this year or next. To ensure that we return to high levels of resource utilization—as is our objective—the recovery must therefore be a durable one.

Our best estimate is that real gross national product (GNP) will be 6 to 6½ percent higher in 1976 than in 1975. This growth rate is not a goal. Rather, it is a projected outcome of the forces of recovery that were set in motion in 1975, by stimulative fiscal measures, by a return of consumer and business confidence, and by external economic factors discussed elsewhere in this report. The availability of much unemployed labor and unused plant capacity requires that economic policy should continue to support an economic expansion at growth rates significantly above the long-term growth of capacity output. But our knowledge of the interdependence between real growth and inflation is not sufficiently precise to permit a direct translation from general goals to specific targets.

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President Ford discussing his economic message. Behind him is Alan Greenspan, head of his economic advisers.

As a consequence, policies cannot be designed to reach any particular targets with a high degree of confidence. We believe, however, that policies consistent with a moderate but sustained recovery offer a far safer and surer route to full employment than policies which attempt to engineer a very rapid return to full capacity. What we need is a durable recovery—not a boom that carries the seeds of renewed instability in prices, incomes, and employment. Our view is based on several considerations.

The difficult inflationary period through which we have come makes it likely that overly expansionary policies, which risk increasing inflationary pressures, will quickly influence consumers' and producers' expectations. It is a harsh fact of economic life that expectations of inflation are built into labor and other contracts in such a way as to be partly self-fulfilling. Moreover, increased inflationary expectations could restrain both consumption and investment expenditures and thus jeopardize long-term economic goals.

High and variable rates of inflation not only create imbalances and sectoral distortions by capriciously changing the real value of existing contracts, but they also raise risk premiums in investment decisions and in wage bargains. As such, inflation could pose a major threat to the viability of the present recovery. Policies that are perceived to entail higher inflation risks may not, therefore, affect economic activity and employment in a way that would normally be expected. Even if such policies should succeed in accelerating the recovery in the short run, it would be difficult to decelerate from unusually rapid growth rates to sustainable rates without running the risk of amplifying future fluctuations in economic activity.

There is a lesson to be drawn from past policy mistakes. The history of monetary and fiscal policies demonstrates that we have a great deal to learn about implementing discretionary policy changes. Our ability to forecast is at best imperfect, especially in an increasingly complex and interdependent world, and the difficulties in forecasting grow larger as we extend the period for which the forecast is made.

This is a significant problem because of the time lags involved in altering the pace of economic activity through discretionary monetary and fiscal actions. There is a perception lag in diagnosing the problem, a reaction lag in selecting the appropriate response, and an implementation lag in having the policy prescription accepted and put into effect through our political and administrative process.

We also lack reliable estimates of how long it takes before the economy responds to policies once they are undertaken and how large the response will be. This is especially true now because the high rates of inflation in recent years have made price expectations a much more important determinant of consumer and business behavior than they formerly were, but there has not been sufficient experience to pin down how inflationary processes affect key relationships within the economy.

With respect to fiscal policy there is the additional complication that countercyclical increases in Government expenditures are difficult to check during later upswings. Because countercyclical policy changes may be slow to take hold and then hard to reverse, their effects may extend well past the time when they are most needed. Consequently a significant danger exists that, instead of smoothing economic fluctuations, discretionary changes in policy aimed at demand management may themselves become a source of economic instability.

The proper conclusion is not that we should forswear the use of discretionary policy. Some external shocks to the economic system can and should be offset.

Furthermore, provided the growth in Federal outlays becomes more moderate than in the years just past, occasional discretionary adjustments of the income tax schedules are called for in order to prevent excessive growth in Federal taxes. In fact these changes may have to be more frequent if the rate of inflation continues at a somewhat higher average level than at comparable levels of economic activity in the past. Thus, discretionary policies do have an important function in our economic system. But we must be mindful of the great difficulties in successfully executing countercyclical policies.

What is called for in our judgment is a steadier course in macroeconomic policies than has been followed in the past. We should set policies broadly consistent with sustainable long-term noninflationary growth and try to limit the size and duration of any policy deviations that promise short-term benefits but risk interfering with our long-run goals.

The severity of the recent recession does call for maintaining stimulative economic policies to accommodate an expansion of real output at a rate above

that sustainable in the long run but departures from the policies that are appropriate in the long run should be moderate. If we do not commit ourselves to a gradual recovery over a period of years, we may increase economic instability and lose our chance for sustainable growth, which we believe offers the safest and surest route to full employment in future years.

Monetary and Fiscal Policies

It is much easier to enunciate the general principle of stability in policy than to apply it to specific circumstances. The challenge to current monetary and fiscal policy is to set the stage for a gradual transition from stimulation, which is still needed in the current year, to a set of policies appropriate for long-run growth.

The monetary authorities recognize that the present levels of output and employment are still very far from satisfactory. Yet concern with the achievement of greater economic stability in future years suggests that any rate of growth in money which is at the upper limit of the tolerance range announced by the Federal Reserve (7½ percent for MI, 10½ percent for M2), could not be maintained indefinitely if progress toward lower inflation rates is to continue.

The thrust of fiscal policy will also have to change gradually. Fiscal policy became more expansionary when the recession worsened and unemployment mounted in 1974 and in early 1975. Over the near term, these expansionary fiscal policies will be maintained as most of the provisions of the Tax Reduction Act of 1975 have been extended from the end of last year to the middle of this year through the Revenue Adjustment Act of 1975.

Well before passage of that act, the President directed the Office of Management and Budget to examine ways to slow the growth in Federal expenditures so as to prevent further increases in the Government's role in allocating our resources. He further directed that any savings be refunded to taxpayers in order to maintain gains in private purchasing power and employment.

The budget which the President has proposed provides for a marked deceleration in the growth of Federal spending, as outlays are to be held to $394 billion in fiscal 1977, which ends in September of next year. Starting in July 1976, taxes are to be cut by about $28 billion relative to what they would be under 1974 law. Because of the recovery, Federal receipts are then expected to grow over three times as fast as outlays between fiscal 1976 and fiscal 1977 causing the deficit to fall by more than $30 billion.

However, the full-employment balance, on a national income accounts basis, will show little change during calendar 1976 from the $6-billion deficit estimated for the second half of last year. In this way the fiscal policy stimulus will be maintained throughout 1976. It will then be reduced in 1977 because of the proposed increase in Social Security tax rates and the much faster rise in individual income tax receipts than Federal expenditures.

At the present time, with substantial reserves of labor and capacity available, consumption and investment are complements, not substitutes. Indeed, public expenditures in excess of tax receipts are needed to absorb the excess of private saving over private investment demand at current levels of economic activity. In 1977 and beyond, however, private investment and publicly supported consumption will become increasingly competitive.

To avoid inducing a policy and output mix that is incompatible with the requirements of long-term economic growth, fiscal stimulus must be diminished gradually during coming years. Without greater fiscal restraint, the saving flows available for private capital formation might eventually become too small. Furthermore the danger of intensifying inflationary pressures under such conditions would preclude expanding the money supply sufficiently to finance both the Government deficits and the needed improvements and growth in our industrial capacity.

It is this public-versus-private allocation problem to which the President's program tying a $28 billion cut in the growth of Federal outlays to a comparable cut in taxes is addressed. The source of the problem has been the rapid growth in nondefense budget expenditures in recent years. During the 1960's some growth in the share of national resources allocated to the nondefense expenditures of the Federal Government was considered desirable in order to alleviate poverty and to accomplish other important social goals. Further growth in the ratio of public expenditures to total output, however, directly bears on fundamental issues concerning the efficiency of the economy, equity for the working population, and the scope for private decision making in our economy.