The Economic Outlook

PROGRAM ANALYSIS DIVISION
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CURRENT SITUATION
EXPECTED GNP
EMPLOYMENT AND PRICES
BUDGET PROPOSALS

THE ECONOMIC OUTLOOK: FIRST QUARTER PERSPECTIVE

April 25, 1978

For the second consecutive winter, weather and energy played major roles in the performance of the economy and dominated the short-term economic outlook. Blizzards, floods, and the coal strike had a definite depressing influence upon the economic record for the first quarter of this year.

Several implications of these short-run disruptions for the economic outlook are discussed in this review. The mid- and long-range prospects for the economy are also presented. This review addresses the following concerns:

-- the current economic situation;

-- expected performance of GNP, employment and inflation during the first quarter of 1978;

-- the fiscal initiatives contained in the President's budget proposal.

THE ECONOMIC RECORD FOR 1977

During 1977, gross national product (GNP), the market value of the nation's output of goods and services, grew by 10.7 percent--slightly less than the 1976 rate of 11.6 percent. After adjustment to exclude price increases, the economy expanded by 4.8 percent--slightly less than the 6.0 percent recorded in 1976.

Key economic indicators for 1977 demonstrated some quarterly variation but generally the results for the year were favorable. These patterns are presented in Table I.

Table 1

The Quarterly Pattern of Economic Activity, 1977
(annual compound rates of growth)

	I	II	III	IV
GNP	13.2	13.7	10.2	9.9
Implicit price deflator	5.3	7.1	4.8	5.9
Real GNP	7.5	6.2	5.1	3.8
Real final sales	3.8	5.1	4.4	6.0
Real personal consumption	5.1	1.8	3.0	9.3
Unemployment (percent of labor force)	7.5	7.1	6.9	6.6

The most volatile quarterly movements in 1977 were in the rate of inflation as measured by the GNP deflator. The growth rate of real GNP declined during each quarter of the year, but this trend is not, by itself, an indication of a poor economic outlook. The rate of growth of output remains above the long-run trend and the economy continues to improve.

The difference between real GNP and final sales is the amount of current production going into or out of inventories. Real final sales during 1977 showed a much more erratic pattern than GNP and ballooned in the fourth quarter. This, in turn, implies that inventory changes were also irregular with net additions to inventory stocks during the first three quarters and withdrawals during the fourth. During 1977, inventory behavior continued to be extremely sensitive to changing economic expectations.

A comparison of the changes in real personal consumption and final sales shows the continuation of two patterns of the current economic recovery. First, consumers are spending most of their increased incomes and this has provided the primary source of extra demand. The personal savings rate has declined to historic lows. Second, spending to acquire new capital stock remains a relatively low proportion of our national output.

THE CURRENT ECONOMIC SITUATION

The majority of economic forecasters expect real GNP to grow between 4.5 and 5.0 percent during 1978. However, the performance of the economy in the first quarter of 1978 will be substantially less than for the calendar year. The primary reasons for the poor performance are the weather and the fuel situation. The seasonally adjusted index of industrial production for January and February averaged half a percent below fourth quarter 1977 and expenditures for construction in January were 3.0 percent lower than in the preceding quarter. Sales of domestic autos also have been lagging behind expectations since November, and this caused a build up in dealer inventories, especially in downsized models. Much of the production lost during the first quarter due to the weather and coal strike will be recovered by spring or early summer. If so, real income gains have just been delayed. A poor performance for the first quarter should not be misinterpreted as a sign that the economy is in need of more stimulation. Last year, a very early and mild spring throughout the nation offset the winter problems.

THE UNEMPLOYMENT SITUATION

The national unemployment rate for the month of March was 6.2 percent up slightly from 6.1 percent in February. Monthly unemployment figures are based upon a household survey, used by the Census Bureau and the Bureau of Labor Statistics (BLS). This survey is taken during the week which includes the 12th day of the month. The February measure was taken after the worst of the blizzard conditions had passed and before power shortage layoffs became too threatening. Therefore, the February rate probably provides a good indication of the real state of the national labor market.

There have been a number of strong trends developing in the labor market. Between January of 1977 and 1978, the population (15 years of age and over) grew by 2.5 million people, the civilian labor force grew by 3.4 million, and employment increased by 4.2 million persons. Newly employed persons significantly outnumbered new entrants into the labor force; but over the year the monthly changes in seasonally adjusted employment did not always reflect the trend. After the December data was analyzed, BLS recomputed the seasonal adjustment factors for the year. Only then did the large increases in employment stand out; this surge in employment in the fourth quarter of 1977 was reconfirmed by modest monthly declines in unemployment during the first quarter of 1978. Prospects for more improvement in the spring and summer remain high.

Labor force analysts have not come to a full understanding of why the fourth quarter spurt in employment occurred. In spite of the erratic changes in the level of economic activity, there were few current signals that major inroads into the pool of the unemployed were being made. Of the 4.2 million person increase in employment in 1977, CETA jobs account for only about 400,000.

One statistical clue to the market situation appears in a second source of data on employment. Information on nonagricultural wage and salary employment from "jobs data" differs dramatically from national household survey data. The difference between these sources of data has increased substantially during the last year; the number of persons reporting employment in the household survey exceeds the number of wage and salaried jobs by about 9 million persons, a million more than last year.

Two sources may account for this variance. First, with the economy improving, more new businesses are being started. These are frequently self-employment ventures which, at first, use unpaid family labor and thus are not counted in the "jobs data." The second explanation may arise from the trend toward two-worker households. The number of wives working today may, in part, reflect a substitution of the woman's job for a second job for the husband. This would cause the employment status of the family unit to increase by one in the household survey.

PRICE PATTERNS

During 1977, the consumer price index (CPI) increased at an annual rate of about 6.5 percent. By this same measure, the rate of inflation for the last quarter of 1977 was 4.5 percent, indicating a substantial reduction during the year. However, the wholesale price index, which reports movements in the cost of business purchases, rose in the last quarter of the year. Price developments in the first months of 1978 seem to indicate that rising wholesale prices have been transmitted through to the retail level and are being reflected in the January and February consumer price indexes which increased at annual rates of 9 percent and 7 percent, respectively.

The question of which price index should be used to measure inflation has now become even more cluttered. BLS has had long standing plans to broaden the types of consumers included in the statistical base when the consumer price index was revised and updated. January 1978, was the first occasion of the publication of this new statistical series. However, public pressure for continuation of an index with coverage similar to the old series was strong enough to persuade BLS not to discontinue it. As a result, through June of 1978 there will be three consumer price indexes. The new index measures price change of a 1971-72 mix of goods and services purchased by all types of urban consumers (CPI-U); a new-old index (CPI-W) measuring the change in price of a 1971-72 mix of purchases of urban clerical and wage earning consumers; and finally, the old index which measures price change for a 1960-61 market basket of clerical and wage earner purchases. This latter index provides a transition and will be dropped in June.

The proliferation of price measures is of more than academic interest. It has been estimated that more than 50 million recipients of Government benefits receive payments which are legislatively tied to the consumer price index. An additional 9 million workers in the private economy are covered by union contracts which have escalator clauses based upon changes in the CPI. Moreover, these union wages tend to set the trend for other wage rates. Conflicts could be caused by divergence in the new indexes, which assume different weights for various budget items because they are composites of different groups of consumers. The Administration has proposed legislation which would substitute the broader CPI-U wherever the consumer price index is currently used in Federal indexed programs.

THE 1979 BUDGET

The President's budget calls for budget authority of $568.2 billion for fiscal year 1979. Federal outlays under this budget are estimated to be $500.2 billion, and a budget deficit of $60.6 billion is estimated. The estimated deficit for next fiscal year is approximately equal to the deficit expected this year and implies continuing Federal efforts to provide fiscal stimulus to the economy. The new budget projects an increase in budget authority relative to outlays. This reflects the introduction of a number of new programs, such as welfare reform, for which spending will increase in the years beyond 1979. However, 78 percent of the $45 billion increase in estimated outlays between the 1978 and 1979 budgets is in "uncontrollable" items. That is, approximately $35 billion is required to meet the additional costs of previously legislated programs and to cover expected price increases over the life of the budget.

Federal outlays are estimated to grow just under 10 percent in the new budget. This is a continuation of the trend rate of growth which has been experienced in recent years.

Much of this growth is the result of increases in prices rather than increases in the share of the Government in the economy. Adjusted for price change, Federal spending as a percent of gross national product is projected to be 20.5 percent in fiscal 1979 compared with 20.6 percent in 1977 and 21.3 percent in 1967.

The composition of the budget makes only modest adjustments from trends in recent years. Some effort to contain the proportional growth in payments to individuals, which had grown from 25 percent of outlays in 1967 to 45 percent in 1977, is evidenced by the 1978 allotment of just under 43 percent of budget outlays. The stabilization of the share of the budget devoted to payments to individuals also allows for a small increase in defense spending--primarily in weapons procurement. The 1979 budget does not include any allowance for the introduction of a national health insurance program.

For the current fiscal year, the difference between projected and actual Federal expenditures, the so-called "shortfall," is expected to moderate. Estimates of expenditures at the first quarter rate would put total outlays at about $453.5 billion, $8.7 billion short of OMB's original projection. The noticeable shortfalls in recent years have been attributed, in part, to the rate of expansion and change in the composition of the budget. The 1979 outlays forecast, which contains very little funding for new initiatives, is more likely to be on target than recent budgets. This assumes, of course, that the Administration's economic forecast is close to the mark. In addition, however, OMB has recently acknowledged a systemic problem in the estimates which appears to result in a consistent bias toward overestimation of outlays.

1978 TAX DEVELOPMENTS

The Administration has four major new initiatives to account for on the revenue side of the Federal budget:

- -- the recently implemented changes in the Social Security tax and benefit structure (which may be revised again);
- -- the proposed tax and tax rebate provisions of the energy legislation;
- -- the earned income tax section of the welfare reform; and
- -- the President's 1978 Tax Program.

Although each of these programs reflects an approach to specific problems, the economic ramifications of all must be considered together because net effects of the tax structure ultimately determine the impact of these provisions on both taxpayers and Government revenues.

The new Social Security laws were enacted to change benefit computations in the system and to provide additional revenues. The energy legislation is designed to raise the relative price of oil, natural gas, and activities which use relatively large amounts of these fuels, by providing incentives for transition to fuel sources besides oil and gas. To accomplish these goals without disrupting the national economy, a series of taxes on production and use of oil and gas are to be instituted and these revenues are to be reinjected into national income through offsetting tax rebates and refunds. The earned income tax credit aspect of the welfare reform package is supposed to help accomplish the twin goals of providing full Federal funding of the welfare system and insure equitable and effective work incentives to the working low and moderate income population. Finally, the President's 1978 Tax Program is designed to offset the fiscal drag generated by rising Social Security taxes and by progressive income taxes under conditions of inflation and to provide a measure of fiscal stimulus to the national economy.

During the first full calendar year of implementation, the new tax program is estimated to provide $24.5 billion of net tax reductions. Two billion dollars of this reduction is from the elimination of the Federal telephone excise tax and modification of the unemployment payroll tax. The remaining $22.5 billion is to be achieved by complex manipulation of both individual and corporate income tax provisions. For individuals, net tax reductions are estimated to be $16.8 billion; the major changes will be the substitution of a $240 tax credit for both the $750 personal exemption and the $35 general tax credit, and a general rescheduling of tax rates. There is also proposed a series of tax reforms which are reductions in allowable itemized deductions and limitations on tax shelters and preferences. Both of the latter are estimated to increase tax revenues--by $5.8 billion from changing itemized charges and $.9 billion by changing tax preferences.

Revisions to the corporate tax schedule are estimated to amount to a net revenue reduction to the Treasury of $5.7 billion. This is achieved by cutting corporate income tax rates (resulting in a revenue decrease of $6.0 billion), liberalizing the investment tax credit provisions (for an estimated revenue loss of $2.4 billion), and reducing business tax preferences (for a revenue gain of $2.6 billion). The

Administration wants most of the tax program initiated with the new fiscal year in October 1978, but a few of the provisions would be implemented in subsequent steps. The Administration proposes that the investment tax credit modification be retroactive to January 1, 1978.

The number, complexity, and overlapping nature of all the combined tax changes makes it difficult to evaluate their net effect on the economy as a whole. Some of the Administration's recent proposals may turn out to be substitutes for earlier proposals. This is the explicit case with respect to Social Security and individual income tax, where one of the justifications for the income tax reduction is to offset the effects of higher payroll taxes. Also the level of tax-free income recommended in the welfare reform program is lower than the minimum tax bracket recommended in the President's tax program. This suggests that the Administration thinks that this segment of welfare reform is more easily accomplished if coupled with other tax reductions.

THE OUTLOOK

The immediate economic outlook should show a brisk increase in the pace of production activity that will offset the winter slowdown caused by the weather and the coal strike. Most of this increased economic activity should take place during the second quarter of the year. After the second quarter, the pace of activity should moderate, but the current recovery should be sustained through the third and fourth quarters of 1978. The unemployment situation should show some moderate improvement. However the pace of price inflation may exceed the 1977 rate of 6 percent, and several forecasts have been revised upward to the 7 percent range for 1978.

The international economic situation and the current crisis of the dollar in international financial markets will be the subject of our next Economic Outlook Report.