Review and outlook: 1979-80

Business: the expansion slows

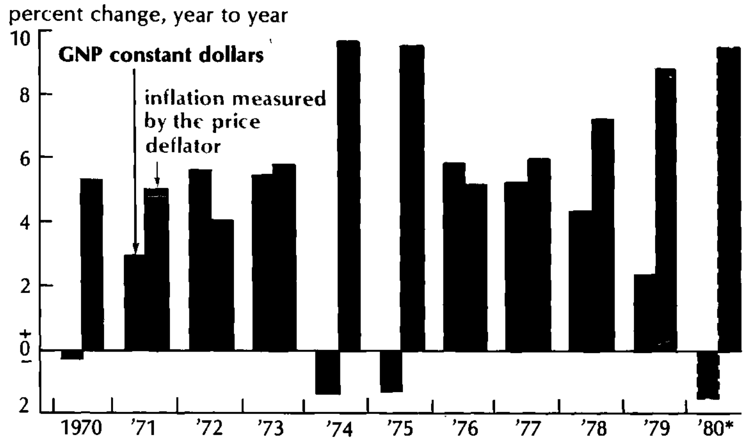
Despite sharp cutbacks in the auto and housing industries, the economy finished 1979 surprisingly strong. Employment continued to rise. Industrial production remained on a high plateau. Business capital spending remained vigorous. And consumers continued to spend freely on most items.

Early in 1980, however, evidence began to accumulate that a cyclical downturn was, at long last, under way. Manufacturers' order backlogs had begun shrinking in the fourth quarter. Surveys of consumer and business attitudes showed widespread foreboding for the new year.

The Midwest did not fare generally as well as the nation in 1979. The difference reflected, in the main, concentration of motor vehicle production in Michigan and Indiana. Centers specializing in vehicles and components had recessions starting in the spring. Activity continued high in most centers specializing in producer goods, Milwaukee, for example. But the picture was marred by labor disputes in the farm and construction equipment industries. Lengthy strikes depressed incomes in affected areas. Also contributing to the relatively poor performance of the Midwest was the greater decline in housing construction, partly a result of three successive severe winters.

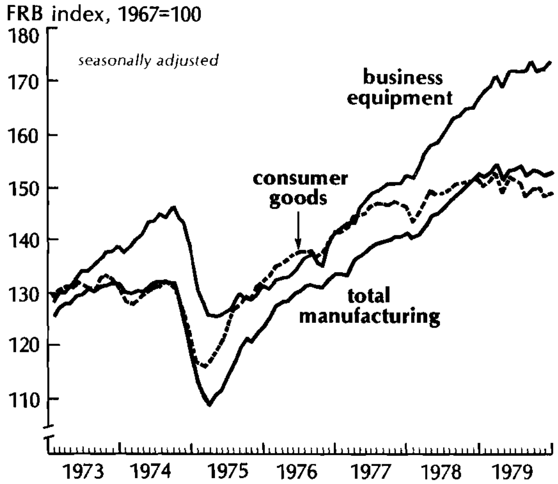
While employment and production were better last year than most observers expected, price inflation exceeded the highest rates expected even by pessimists. The turmoil in Iran touched off a rapid escalation of world oil prices that played a large role in boosting U.S. price indexes. But oil stringencies were only part of the problem. Other factors were government deficits, spreading government regulation of business, excessive growth in private credit, large increases in worker compensation in the face of declining worker productivity, and restrictions on the use of natural resources.

Inflation has accelerated while real growth has slowed



*Projected.

Industrial production has been on a high plateau



Caution pays off

Forecasts of an impending recession were heard frequently in late 1978. Some analysts believed the decline would start early in the new year. As 1979 unfolded, the economic picture was confused by severe winter weather, oil stringencies, and a series of unsettling developments abroad. Recession-minded forecasters responded by pushing the date further and further ahead.

Memories of the sudden decline in demand that hit business in the fourth quarter of 1974 are still fresh. Inventories that seemed reasonable as long as sales were rising suddenly became burdensome in late 1974. Order backlogs that had appeared firm melted away in a rash of cancellations. Capital goods producers, particularly, were caught in this predicament. Market gluts quickly replaced the shortages of the spring and summer.

Managers kept a tight rein on inventories all through 1979. High carrying costs, reflecting record interest rates, provided an additional incentive to avoid excess accumulations. Most manufacturers chose not to boost production if use of high-cost marginal resources was required. Both buyers and sellers were more careful than in 1974 in placing and accepting orders for items with long lead times.

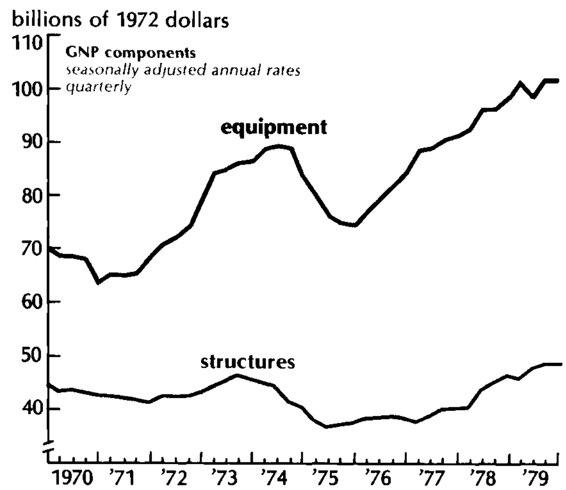
Lean inventories and order backlogs free of duplications help explain why the economy did not skid downward in 1979, despite severe strains in some sectors. Conservative mananagment policies will also tend to moderate the adjustment that seems to be under way now.

Output and prices

The gross national product, spending on goods and services plus additions to inventories, totaled almost $2.4 trillion in 1979, 11.5 percent more than in 1978. But with prices averaging 9 percent higher, the increase in physical volume was only about 2.5 percent. Increases in real GNP have been less every year since 1976, the first full year of recovery after the 1974-75 recession. While growth in output has slowed since the 6 percent gain in 1976, price inflation has accelerated every year. Last year's 9 percent price rise was the largest since 9.5 percent in 1974 and 1975.

Transportation, manufacturing, and construction were hampered in the first quarter last year by extreme cold and winter storms that afflicted most of the northern states, es-

Business investment rise continued through 1979



pecially the great industrial areas of the Midwest and Northeast. Nevertheless, measured by real GNP, activity increased slightly during that period.

As the weather improved, the economy faced a new problem—shortages of gasoline and diesel fuel associated with the cutoff of oil shipments from Iran. Long lines of vehicles formed at gas stations, especially on the East and West coasts. Motor transport was slowed by the reduced availability of diesel fuel, and the slowdown was reinforced by strikes of independent truckers protesting high fuel prices and private rationing.

Fuel prices rose sharply, with gasoline up more than 40 percent in the first half of the year. In June, per-gallon prices passed the $1 a gallon mark for the first time. Higher prices for fuel and, even more, concern over ability to obtain fuel had a dramatic effect on some sectors. Sales of large cars, light trucks, and recreational vehicles plummeted. Tourism was hard hit. Housing sales were also affected, especially in areas far from urban centers.

The upshot was a one-quarter recession. Real GNP declined in the second quarter at an annual rate of about 2 percent.

The third quarter saw a modest revival. Fuel supplies improved, mainly because of conservation. Construction crews made up most of the time lost during the winter. But businessmen and consumers were still cautious in making new commitments.

Improvement in activity in the third quarter appeared at first to be mainly a reaction to problems encountered earlier in the year, with the underlying trend still down. But further growth was apparently achieved in the fourth quarter. Final sales were buoyed by business spending on plant and equipment and consumer spending on nondurable goods and services.

In retrospect, the economy stood up well to the weather and fuel problems of 1979. But the effects are far from over. Nearly all doubters are now convinced that energy stringencies are real and likely to become more pressing in years to come. The impact on patterns of consumption and business investment will be profound.

Consumer price rise accelerates

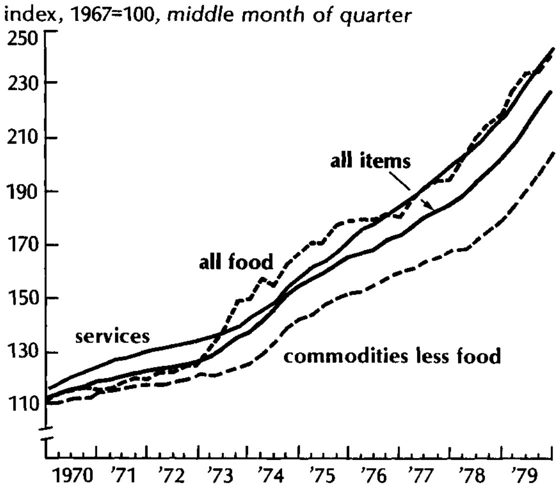
The Consumer Price Index (CPI) for all urban consumers averaged 11.3 percent higher than in 1978, a substantially faster rate of rise than for the general price level measured by the GNP deflator. Mainly reflected in the difference are the fixed weights for the CPI, which do not vary as consumers adjust to changes in relative prices. The deflator is weighted every quarter. Also, the CPI assigns more importance to costs of fuel and homeownership, both up sharply last year.

Trends in the CPI are crucially important, because the index is used in automatically escalating wages and other payments covered by cost-of-living adjustments (COLAs), often in addition to other agreements to increase compensation. Even without a contractual obligation, employers may look to the CPI as a guide when raising wages or pensions. COLA adjustments, becoming steadily more common, have the effect of building in past inflation and fueling future inflation.

Up from 7.7 percent in 1978, the 11.3 percent rise in the CPI last year was almost twice the rise in 1976. It slightly exceeded the rise of 1974, then by far the largest for any year since

The rise in the Consumer Price Index accelerated last year

index, 1967=100, *middle month of quarter*



World War II price controls were removed in 1946.

In November, the CPI was 12.6 percent higher than a year earlier. Unlike some years, the main culprits were not costs of food and medical care, both rising less than 10 percent. Apparel rose less than 4 percent. The main culprits were energy, up 36 percent, and homeownership, up 18 percent. For many families, these costs rose much more, particularly if they heated with oil or negotiated a new home mortgage.

Unlike a year ago, few analysts expect consumer price inflation to moderate this year. Higher oil and natural gas costs are only partially reflected in retail prices so far, and further increases in basic fuels are inevitable. Housing is in short supply, with costs rising rapidly. Advancing incomes enable many consumers, however, to maintain their buying patterns without difficulty.

Employment and spending

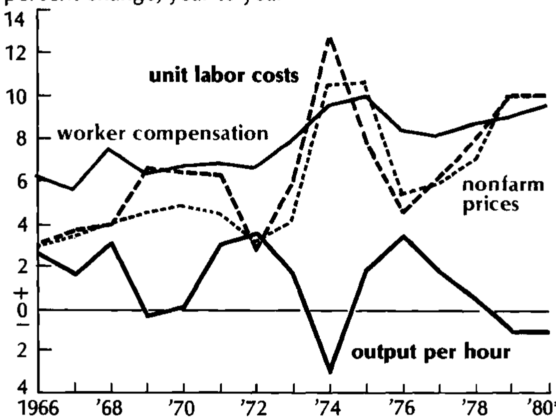
Despite sizable layoffs in the motor vehicle industry, jobs remained plentiful throughout 1979, except for depressed inner-city areas. Take-home pay of most autoworkers was maintained, temporarily at least, by public and private unemployment benefits.

Total employment rose 300,000 in December to reach 98 million. The 12-month rise was 2 million, after increases of 3 million in 1978 and 4 million in 1977. Since 1975, employment has risen an unprecedented 13 million. Unemployment, people without jobs and seeking work, was estimated at 5.9 percent of the labor force in December, about the average for the year, and well below the 8.5 percent average for 1975.

Personal consumption expenditures rose almost 12 percent in 1979, slightly more than in each of the three previous years. In real terms, the rise was only about 2.5 percent, however, the smallest increase since 1975. Higher consumption expenditures mainly reflected higher disposable (after-tax) income, up almost 11.5 percent last year. But a drop in the savings rate also helped. Savings is defined as disposable income not spent on consumption. Savings dropped to 4.5 percent of disposable income last year, down from 5 percent in 1977 and 1978 and over 7 percent in the early 1970s, to the lowest rate since 1949.

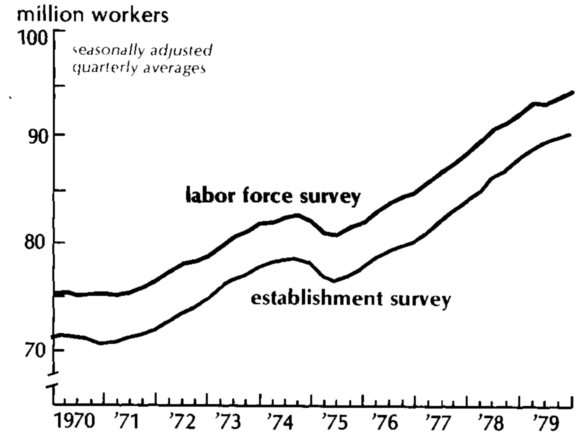
The low savings rate of recent years partly reflects heavy use of instalment credit, and sometimes mortgage credit, to finance consumer purchases. Willingness to incur debt, in turn, reflects both confidence in future income and the belief that inflation will continue to erode the buying power of money.

Large wage gains and poor productivity boost costs and prices



*Projected.

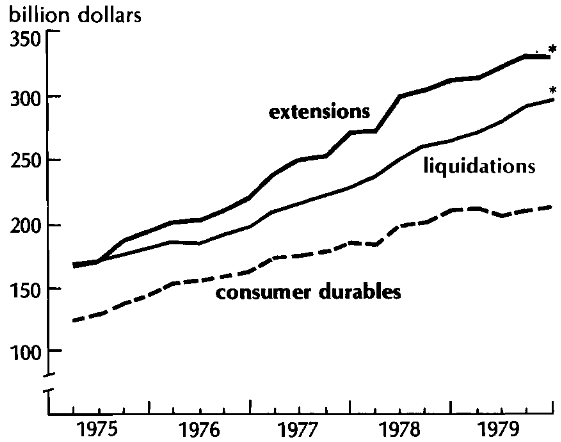
Nonfarm employment shows vigorous growth



Most households are protected, more or less, against the risks of sickness, old age, and unemployment. Many also benefit from government subsidies for food, housing, heating, transportation, and education. The preference for spending over saving fuels inflation both by adding to total spending and by reducing the volume of funds available for investment.

Because employment is expected to decline in 1980, at least in the first half, growth in consumption spending is likely to moderate. Individual incomes, however, are likely to grow faster. Total compensation per hour in the private economy, including nonwage income, rose 9 percent last year—more than in any year since 1975. The 7 percent guideline for increases in compensation, a dampening influence on some sectors last year, is expectd to be raised. Unions are increasingly militant and successful. Pressure to meet union gains in nonunion sectors is growing. Partly because of leveling or declining output, productivity changes are likely to continue to be small or negative. As a result, increases in compensation will tend to be fully reflected in unit labor costs and, therefore, selling prices.

Instalment credit growth outpaced outlays in consumer durables



*Estimated.

Construction and housing

Outlays on new construction increased about 9 percent last year. Corrected for inflation, however, the data show construction down about 3 percent. Broad categories of construction showed remarkable differences. Nonresidential private construction was up about 8 percent in real terms. Residential construction was down 6 percent, and public construction was down 10 percent.

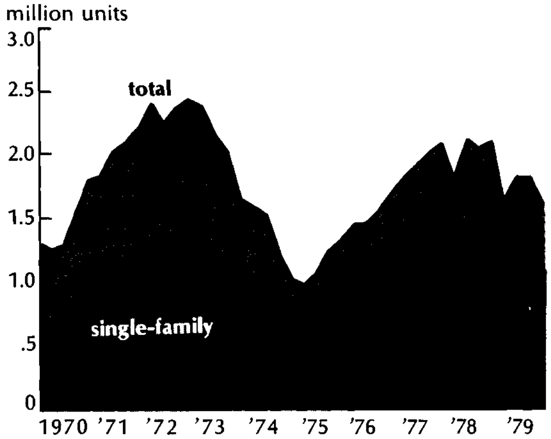
Within the nonresidential private sector, construction of office buildings soared 25 percent in real terms. Stores and other commercial structures were up 14 percent. The boom in office buildings, a revival after the sharp drop of the mid-1970s, was concentrated in the downtown areas of major cities, with Chicago a leading example.

As in past periods of higher interest rates, housing was affected more than other types of construction. New housing construction had held up surprisingly well in 1978 despite tightening credit markets as thrift institutions tapped new sources of funds through sales of money market certificates and "jumbo" CDs. Also, a large volume of securities collateralized by home mortgages were sold in the capital markets.

About 1.7 million new residential units were started in 1979, down 16 percent from 1978 and well below the 1972 peak of 2.4 million. Starts were down more than 40 percent in the Chicago area and about 28 percent in the North Central region. The larger decline in this region reflects relatively slower growth, less speculative building, more conservative lending practices, and the bad weather of recent years.

The construction outlook for 1980 is for continued strength in nonresidential building, at least for the first half. Contracts have already been awarded for most of this work and firm financial commitments are outstanding. New mortgage loan commitments, however, were hard to obtain for any kind of construction project in late 1979 as record-high interest rates attracted funds to the short-term money markets. As a result, nonresidential construction may slow later this year, despite a scarcity of high-quality, well-

Housing starts begin downward trend



located commercial and industrial buildings.

Public construction will be sluggish again this year, depending in part on the release of funds for federally sponsored programs. Most municipalities have a long list of needed projects that they have been unable to finance. Arresting the deterioration of roads and bridges throughout the country will require billions of dollars, but funds are lacking now, partly because of reduced collections of fuel taxes.

Residential construction was dropping sharply in late 1979, even with the allowances for seasonal trends. Most analysts are forecasting starts on 1.4 million units this year, with the annual rate maybe as low as 1.2 million in the first or second quarters. Even so, that will be better than the 1972-75 period, when starts dropped more than 50 percent.

Federal subsidies will directly aid starts of 200,000 units in 1980, mainly apartments. Any easing of credit will help the private market. No large volume of unsold single and multifamily units overhangs the market as in 1973-74. An accelerating rate of household formations requires a high level of residential construction to prevent a serious housing shortage in the years ahead.

Government: federal government focuses on inflation and energy

Fiscal policy of the federal government was aimed all year at attacking inflation. The Economic Report of the President and the administration's budget message for fiscal 1980, both presented to Congress in January, showed the attack was to be carried out along two related lines.

- The federal deficit was to be progressively reduced, reaching a balanced budget in fiscal 1981.
- Budget outlays were to be reduced as a proportion of GNP from 22.1 percent in 1978 to 21.2 percent in 1980 and 20.3 percent in 1982.

When these plans were laid a year ago, the administration expected unemployment to average 6.2 percent for 1979 and inflation, as measured by the consumer price index, to run about 7.5 percent. On the basis of these expectations, the administration had forecast outlays of $493.4 billion for fiscal 1979 and a deficit of $37.4 billion, about $11 billion less than the fiscal 1978 deficit.

Fiscal 1979—the outcome

For the first time in several years, federal spending was close to the estimate made in January. When the fiscal year ended in September, actual outlays were $493.6 billion, only $200 million less than expected nine months earlier. It seems likely, however, that had it not been for rapid inflation and higher interest rates, the shortfall of expenditures from the levels projected (a regular event for the past several years) would have occurred again in fiscal 1979. As late as July, the Office of Management and Budget was estimating outlays $3 billion higher than they turned out.

The combined impacts of lower unemployment and higher inflation raised revenues over the expected $456 billion to an actual $465.9 billion, leaving a deficit of $27.7 billion, nearly $10 billion less than the January forecast. When the budget for fiscal 1979 was first presented in January 1978, the proposed deficit was $61 billion. The difference between the deficit originally proposed and the actual deficit represents a significant change in the administration's view of how fiscal policy should be used to affect the general economy.

Increased revenue sources

Major tax changes reducing income tax rates for individuals and corporations but increasing payroll taxes became effective January 1, 1979. Because of the way income taxes are paid, the full impact of the changes did not show up completely in fiscal 1979 or even calendar 1979. Final settlement of 1979 personal income taxes will not be made until April 1980. Corporations will not settle until June 1980. It is estimated, however, that total receipts for fiscal 1979 were $11-$12 billion less than if the rates had not been reduced.

With the differences in timing taken into account, the increase in personal income tax receipts was over 20 percent more than in fiscal 1978. Withheld income taxes, which make up about three-fourths of all income tax receipts and are closely related to wage and salary payments, rose 18.2 percent. During that time, wage and salary payments rose just under 12 percent.

Thus, despite the tax cut, which lowered the withholding payments at any given salary level, the progressiveness of the taxes with income combined with higher salary and employment levels to raise personal income taxes substantially. Some analysts suggest that the tax withholding levels understated the effect of the tax reduction so that refunds this spring may be higher than usual.

Similar increases were made in receipts from Social Security taxes. The basic tax rate was increased only slightly, from 6.05 percent in calendar 1978 to 6.13 percent in 1979. The maximum income on which the tax was due increased, however, from $17,700 to $22,900, with the result that revenues went up to 15.5 percent.

Corporate income tax payments did not go up as much. They rose a little over 9 percent, about the same as in fiscal 1978, and less than they would have without the tax cut.

Personal income and payroll taxes provide the main receipts. Corporate income taxes are the third largest source. Together, these three tax sources provided over 86 percent of the tax revenue in fiscal 1979, up steadily each year from just under 84 percent in 1976.

Where the federal money went

Income maintenance programs still make up the largest single classification of federal spending, as they have since they first exceeded defense spending in fiscal 1974. Close to a third of net federal spending went for income maintenance in fiscal 1979. That was nearly $45 billion more than went for national defense. Of the $160.5 billion spent on income maintenance, payments generally thought of as Social Security (federal old age and survivor benefits and federal disability payments) accounted for the largest share. Up more than over 11 percent from fiscal 1978, they exceeded $100 billion for the first time.

The third largest outlay was $52.6 billion paid for interest expenses, up 19.5 percent from 1978. Next was expenditures on health, at $49.6 billion, up 13.6 percent. Except for spending on education, training, employment, and social services, no other category of spending was as large as 5 percent of net total outlays.

In a few categories, spending was less than in fiscal 1978. Agriculture outlays, for example, were down about 16 percent to $6.4 billion. Spending on commerce and housing credit was also down, as were outlays for community and regional development.

The outlook—fiscal 1980 and beyond

The objectives of progressively lower deficits leading toward balanced budgets and lower government spending as a share of GNP remain in the forefront of the administration's fiscal plan. It now appears unlikely, however, that the budget can be balanced before fiscal 1982. When fiscal 1980 began, both the administration's projections and the second congressional budget resolution suggested a deficit in the neighborhood of $30 billion. Recent estimates indicate the deficit is more likely to approach the $40 billion level.

Expectations vary slightly, depending on assumptions about the general economy. Receipts will also depend on the final version of the "windfall profits" tax on the oil industry. Outlays will be effected by how fast receipts from the tax are appropriated to new spending.

The dependence of both receipts and outlays on general economic conditions combined with the cost of the Soviet grain embargo and the impact of the problems in Iran and Afghanistan suggest that the deficit will be larger than either Congress or the administration originally expected.

Some private political observers suggest that, as 1980 is an election year, there may be a tax cut of as much as $30 billion. The administration has consistently taken the view, however, that a tax cut would be a severe setback in the fight against inflation, and there has been no significant work on legislation to enact such a cut.

Barring far worse performance of the economy than expected in the next few quarters, it seems unlikely that a tax cut could be enacted in time to have any significant effect on fiscal 1980. Even a tax reduction bill passed before the November elections with retroactive provisions would have most of its effect in fiscal 1981.

Maybe more significant than receipts, outlays, and the deficit expected for fiscal 1980 is the shift in priorities for 1980 and the years beyond. Almost every year since the Viet Nam War, the proportion of the budget allocated to defense has declined. Adjusted for inflation, defense spending has stayed relatively flat since 1973.

Beginning in 1980, it is planned for defense outlays to increase 3 percent a year, after adjustment for inflation. Spending could increase even faster in later years. Plans call for budget authority (allocation of funds for spending in future years) to increase 4.5 percent in fiscal 1981. Increases in defense spending combined with pressure to lower total government spending relative to GNP means spending on categories other than defense must increase significantly slower than growth of the total economy. Since many programs, particularly Social Security, have legislated ties to the inflation rate, there will be severe pressure to reduce programs funded year to year.

With the emphasis on defense and the pressure for a balanced budget coming together in an election year, establishing a program for fiscal 1981 could entail a difficult struggle. The President's budget message in late January is expected to call for a deficit of about $15 billion, few new spending programs, and rather tight limits on existing programs other than defense.

The energy program

Shortly after midyear, the President outlined a modified and extended energy program. The program still stressed conservation as a major means of reducing demand for energy. It also stressed accelerated development of a subsidized synthetic fuel program, however, added funds for public transportation, solar and other unconventional energy sources, a stepped-up shift to coal, financial assistance to low-income families, and a board to expedite the various review and environmental procedures to speed construction of energy facilities. The program was to be financed entirely by the "windfall" oil profits tax, actually an excise tax on domestic oil production, the tax being tied to the cost of imported oil and graduated according to when the oil was discovered.

Introduction of the program came when the Three Mile Island incident, long gasoline lines, and the rapid runup (and instability) in imported oil prices made the need for putting together a complete energy plan generally accepted.

The year ended with three major bills essential to implementation of the program in Senate-House conference committees: the Windfall Tax Bill, which in its final form may implement other aspects of the program as well; the Energy Mobilization Board Bill, which would create a board with power to expedite major energy installations; and the Energy Security Corporation Bill, which would set up the means of financing and controlling synthetic fuel production.

Although none of these elements of the administration's program are likely to take quite the form proposed in the President's energy message, they will represent a major move along the lines he proposed. It could be well into the second session of Congress, however, before full details of the energy program are complete.

State and local government

Measured on the national income account basis, state and local governments generally operated at near-balance in 1979, though not as comfortably near as in 1977 or 1978. Their overall surplus in 1979 has been estimated at about $24 billion, down about $3 billion from 1978. As this surplus was less than the surplus expected in their social insurance funds, they had an operating deficit of possibly $2-$3 billion, instead of the operating surpluses of the previous two years.

Total receipts increased about 7 percent. Outlays increased about 8.5 percent. As this rate of increase in spending was about the same as the inflation rate applicable to state and local government, there was almost no growth in spending measured in constant dollars.

Some other state and local governments followed up on California's Proposition 13 movement to limit tax or spending increases. The tax revolt, however, did not become the national movement some observers were forecasting a year ago.

California took another step toward fiscal austerity by passing a second proposition restricting spending. Local governments in California can no longer increase spending faster than the combined rise in inflation and the population served, without approval by referendum.

Some local governments continued to have financial problems. The most serious was in Chicago, where the public school system was unable to sell short-term notes in November after a close examination of its prospectus caused the Board of Education's credit rating to be lowered. While the problem in Chicago is not of the magnitude of New York City's problems, the procedures that led to it were much the same—persistent use of funds assigned to capital costs and previously incurred debts to meet operating expenses.

The school system was unable to meet its payroll for the second half of December. Estimates suggest the system will need between $350-$400 million to pay outstanding debt and operate the rest of the school year. Meanwhile, some combination of higher income and lower outlays is needed to put the system in sound financial condition. The most likely source of the income needed is an increase in the property tax rate, already at the legal ceiling.