

FEDERAL BUDGET POLICIES OF THE 1970s:
SOME LESSONS FOR THE 1980s

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At the close of the 1970s, the public and the politicians alike perceive inflation as the foremost economic challenge of the day. Other important economic and social issues will carry over into the 1980s; forsaken claims will be revived and new demands are bound to surface. But our effectiveness in coping with all these -- in fact the very survival of this country's traditional economic, social, and political structures -- may well depend on our ability to contain and control inflation in the coming decade.

There is a growing belief that inflation control may require fiscal restraint, a slowing of government spending, a reduction in the size of the realized budget deficit. Yet, as we approach the threshold of the 1980s, I can think of at least five major policy issues in search of solutions, each of which would place new claims on our fiscal resources.

- o Half a decade after the initial "energy crisis," we are still in search of an energy policy that generates widespread public and political support for economically viable solutions.

- o Our efforts to channel the hardcore unemployed into the mainstream of our economy have yet to succeed.

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o Success in slowing the nuclear arms race -- even if attained through SALT II -- may have to be bought at the cost of accelerating defense spending for years to come.

o Welfare reform has been the subject of several aborted proposals of the 1970s; it is bound to resurface as a major issue in the 1980s.

o National health insurance -- a major unfulfilled social promise of the 1970s -- is high on the public agenda of the coming decade.

It is all too easy to add to this list of enlarged public claims -- even at a time when inflation control is our top priority and budget restraint is promulgated. (Note that I have omitted any mention of "safety" or "environmental issues.") Such are the complexities and contradictions of budgetary policy which would seem to place inflation control practically beyond our reach.

Yet my monetarist friends are able to collapse the social and political complexities of inflation control into the simple issue of "monetary integrity." To them, the deep-seated inflation of the last decade-and-a-half is strictly a monetary phenomenon. Its "cause" (like that of every inflation) was excessive monetary growth reinforced, perhaps, by a few nasty "shocks," such as the oil price escalations of 1973 and 1979. Its "cure" (like that of every inflation) is secured through a persistent slowdown in money growth. On a purely technical level, the monetarists have, of course, all the answers. In fact, some of my own econometric exercises have tended to reconfirm their valuable, if somewhat simplistic, generalizations.¹

¹Michael E. Levy, assisted by Steven Malin, International Influences on U.S. Inflation, 1971-1976, a study prepared for the U.S. Department of Commerce, September 7, 1977 (unpublished, available from the author).

However, even if they were formally correct, these simple monetary propositions would tell us nothing about the changes in social attitudes and national priorities which generated the political pressures that bent the economic structure and drove the monetary printing press. They provide no clues as to how and why the economic and social structure was changed and whether this process is reversible or cumulative.²

By contrast, analysis of "budgetary policy," such as it is, promises to shed some light on these unanswered questions, because the government budget is a fulcrum of social and political change. Unfortunately, it is difficult, at best, to chart a course of fiscal and budgetary policy over years and decades. In fact, one may even question the existence of a meaningful "course" other than the drift created by the complex and contradictory forces and events that shape the federal budget from year to year.

Obviously, if this "drift" were governed by a powerful current and if "bends" in this current could be discerned, we should expect far-reaching economic implications, because the federal budget powerfully touches all social groups, all segments of our economy. I have interpreted my assignment as the search for such bends in the current.

²For more formal analyses that question the independent contribution of money growth in "explaining" the inflationary process, see, for example, Franco Modigliani and Lucas Papademos, "Targets for Monetary Policy in the Coming Year," Brookings Papers on Economic Activity, 1:1975, pp. 141-63; George L. Perry, "Slowing the Wage-Price Spiral: The Macroeconomic View," esp. pp. 45-46, in Curing Chronic Inflation, Arthur M. Okun and George L. Perry, eds., The Brookings Institution, Washington, D.C. 1978; also Martin Neil Baily, ibid., p. 58.

VIETNAM: THE ORIGINS OF U.S. INFLATION

There is widespread agreement that the persistent U.S. inflation of the last decade-and-a-half got under way in 1965 as "Keynesian" excess demand inflation.³ In 1965, rapidly escalating defense expenditures for the Vietnam War were superimposed on a full-employment economy that was on the verge of a private investment boom. Not only did we fail to enact timely tax increases (until the belated ten-percent surcharge of 1968-1969), but our exuberant "guns and butter" (or "guns and Great Society") policy added new and rapidly escalating civilian programs (Medicare, Medicaid, Food Stamps, Job Corps, Model Cities).

Vietnam War costs rose rapidly from about \$100 million in fiscal 1965 to almost \$29 billion at their peak, in fiscal 1969.⁴ Total defense expenditures rose by nearly \$32 billion, or 67 percent, during this period; and the share of GNP devoted to national defense advanced from 7.2 percent in fiscal 1965 to 9.5 percent in fiscal 1968 -- its high for the decades of the 1960s and 1970s.

Yet it would be a mistake to attribute the persistence of U.S. inflation first and foremost to the Vietnam War -- even if one's time horizon is limited to the period preceding the oil crisis of late 1973.

³E.g., see Perry, loc. cit., p. 23. Note, however, that some monetarists have pointed out that the onset of this inflation was preceded by about two years of what was considered at that time rapid monetary growth.

⁴These are "full-cost" estimates. For further details and for "incremental-cost" estimates, see Michael E. Levy with Juan de Torres, Delos R. Smith and Vincent Massaro, The Federal Budget: Its Impact on the Economy, fiscal 1973 edition, The Conference Board, New York, 1972, esp. pp. 26-27.

From fiscal 1969 through fiscal 1973 annual expenditures for Vietnam dropped by about \$18 billion in current dollars -- the decline in real terms was, of course, much greater -- while total defense expenditures declined by nearly \$5 billion. The share of GNP devoted to national defense dropped from its 1968 peak of 9.5 percent to 6 percent in fiscal 1973 and continued to decline to 5 percent by fiscal 1979. Yet the large Vietnam "peace dividend" of the early 1970s brought no end to U.S. inflation. When the 1970 recession barely reduced the inflation rate, a ninety-day wage and price freeze was introduced on August 15, 1971. It followed by four phases of wage and price controls that lasted through the third quarter of 1973. (The final decontrol phase ended in April 1974.) Yet these controls brought, at best, a modest and inadequate respite, before the quadrupling of OPEC oil prices pushed the economy into double-digit inflation in 1974.

"SHOCKS" AND THE INFLATION OF THE 1970s

A significant part, if not a major one, of the inflation surge of 1973-1974 that resulted in double-digit inflation has been attributed to special factors -- "shocks" of a largely international nature. Three distinct inflationary influences deserve to be distinguished:

- o The depreciation of the external value of the dollar. (It got under way around mid-1970 and accelerated after the closing of the "gold window" on August 15, 1971, hitting bottom in July 1973.)
- o The escalation of agricultural commodity prices, particularly grains, from late 1972 through 1973. (It was caused largely by the prior depletion of U.S. agricultural stocks, the temporary disappearance of the Peruvian anchovies, bad weather and poor crops in many

parts of the world in 1972, the "Russian wheat deal" of 1973, and the worldwide boom that raised consumption of high-protein foods.)

o The sharp rise in the prices of fuels and some industrial commodities, but mainly the quadrupling of OPEC oil prices during the last quarter of 1973.

Elsewhere I have described these special events and reviewed the best available evidence as to their impact on U.S. inflation.⁵ This combined inflationary impact seems not to have been significant before mid- or late 1972. It increased rapidly thereafter, appears to have peaked during the second half of 1974, and faded during the second half of 1975.⁶ On the basis of econometric estimates, I concluded that "the joint impact of these major identifiable 'international shocks' accounted for about 5.5 percentage points -- or roughly 60 percent -- of the dramatic increase in the inflation rate of the implicit GNP deflator from about 3.5 percent (annual rate) in the second half of 1971 to around 12.5 percent in the second half of 1974. The elimination of this shock-induced inflation during 1975 accounted for over 70 percent of the decline in the inflation rate of the GNP deflator to an average of about 5 percent by the second half of 1976."⁷

Research evidence developed more recently leads me to believe that these estimates of international influences on U.S. inflation may well represent upper limits of these "shock effects." In any case, the

⁵Michael E. Levy, assisted by Steven Malin, International Influences on U.S. Inflation, 1971-1976, op. cit., esp. chap. 1.

⁶Ibid., chap. 4, esp. Table 10.

⁷Ibid., p. 8.

evidence suggests that U.S. inflation would have remained substantial throughout the first half of the 1970s -- though well below the double-digit level -- even in absence of these special price-escalating international developments. In fact, a convincing case could be made that the "basic" inflation rate embedded in the U.S. economy was trending higher, irregularly but persistently, during the last decade-and-a-half and that this uptrend was masked mainly by temporary deviation caused by the controls of the early 1970s on the one hand, and by special international shocks on the other.⁸ Not even the 1974-1975 recession -- by far the most severe of all postwar declines -- was able to brake this long-term (1965-1979) uptrend of U.S. inflation rates.

"INFLATIONARY EXPECTATIONS" AND "INFLATION INERTIA"

Most econometric models designed to explain this persistence of U.S. inflation have assigned a major role to "inflationary expectations" that influence future wage agreements and pricing patterns, and to increased "inflation inertia" (a concept which implies simply that the longer inflation persists, the more persistent it becomes). In the words of one leading expert "the significance of ongoing inflation has risen together with the rising rate of inflation."⁹

To the layman, this may seem a bit like a dog chasing its own tail, but for the econometrician, the loop has been closed: econometric

⁸This uptrend is clearly illustrated by Perry, *loc. cit.*, esp. p. 24, Table 1, when the two periods labelled "Controls (1972-73)" and "Food-fuel explosion (1974-75)" are excluded. The latest international shocks came from the rapid slides in the value of the dollar in 1978 (until November) and in 1979 (May through October), and from the 1979 round of OPEC oil price increases.

⁹Perry, *loc. cit.*, p. 37.

requirements for a technical "explanation" have been satisfied. The end result of these elaborate econometric exercises is a widely accepted model -- Perry calls it a "mainline model" -- that explains 15 years of accelerating U.S. inflation on the basis of a few initial years of excess demand, a few years of price escalations caused by special "shocks," and a lot of "inflationary expectations" and "inflation inertia" designed to link and extend these inflationary spurts and to bridge all the intervening years when inflation should have subsided -- but did not.¹⁰

I would like to propose a somewhat different approach: a search for fundamental changes in our economic and social system that appear to have originated in the mid-1960s and persisted -- if not gained momentum -- during the past decade-and-a-half. If such structural changes could be identified, and if they carried strong inflationary implications, they would go a long way toward explaining the persistence of inflationary expectations and the increase in inflation inertia. Analysis of U.S. budgetary policies of the last two decades proves to be extremely useful in this search.

¹⁰Leading supporters of the "mainline model" are well aware of this difficulty. Thus, Perry notes: "From 1975 through 1977, all available measures of tightness in either labor markets or product markets registered ample slack. And no large upward movements have occurred in particular components of the price level since the Organization of Petroleum Exporting Countries increased oil prices in 1974. Yet despite all these disinflationary developments, the rate of inflation, by any broad measure, has continued at a historically high rate and now shows signs of creeping still further upward."

U.S. BUDGETARY POLICY: LOOKING FOR TRENDS

Analyses of budgetary policy often tend to be too global in approach, focusing mainly on what is perceived to be the overall expansionary (or restrictive) impact of the budget on the economy. Because of our narrow preoccupation with "fiscal policy" as a major neo-Keynesian tool for economic stimulation (or restraint), we have tended to lose sight of the more complex ways in which the size, composition, and rate of growth of the federal budget may affect the economic system. Moreover, the tendency to focus on short periods -- usually a single fiscal year or two -- and excessive reliance on simple, rather inadequate, measures of "fiscal impact" (such as the "full-employment budget surplus") has compounded the myopia of traditional fiscal analysis.

Since I have chosen U.S. inflation as the focus for the present review of federal budgetary policies, I am concerned mainly with longer-term trends and their implications, rather than with short-term fiscal impact. Such an analysis should pay special attention to those budget components that tend to create special inflationary pressures. It seems to me that national defense spending and transfer payments to individuals deserve special attention in this context.

Defense expenditures have an inherent inflationary tendency. They create employment and income, but do not produce any "market goods," nor do they yield the kind of "public benefits" that are perceived by the "average consumer" as an immediate enhancement of well-being (as, say, public spending for health care, education, or police and fire protection). This inflationary tendency of defense spending

becomes, of course, particularly pronounced in the case of war expenditures.

Among civilian programs, transfer payments to individuals give rise to special inflationary pressures. Designed to redistribute income within the private sector (often in favor of the poor and the needy), transfer payments tend to increase short-term inflationary pressures if the income gainers tend to spend a higher proportion of their marginal income than the "contributors" (as is usually the case). More important for the present analysis, these transfers tend to generate longer-term inflationary pressures in at least two distinct ways:

- o They impair incentives to work and to invest among the "contributors," if not also among the income gainers.¹¹ Reductions in productivity gains and in growth of real GNP are the more obvious inflationary consequences.

- o If the "contributors" consider themselves reluctant losers (rather than "voluntary donors") -- as may often be the case -- they will strive to recapture what they consider their "rightful" (e.g., traditional or expected) share of real income, or real growth. If the "losers" are concentrated in the productive sector of the private economy, while the income gainers are mainly nonproducers, this attempt at "recapturing rightful shares" will manifest itself in wage and price escalations.

¹¹The list of theoretical studies and empirical research on disincentive effects on "income gainers" from unemployment insurance and welfare payments is too extensive for review here. Lately, additional evidence on this subject has become available from analyses of various "negative income-tax experiments."

With these analytical considerations in mind, I have reviewed trends in total federal budget outlays as well as national defense expenditures and transfers to individuals.¹² The results are summarized in Chart 1 and Table 1. Unemployment compensation has been excluded from transfers to individuals as shown there (but not from my own detailed analyses) because its large cyclical fluctuations tend to mask the trends that concern us here.

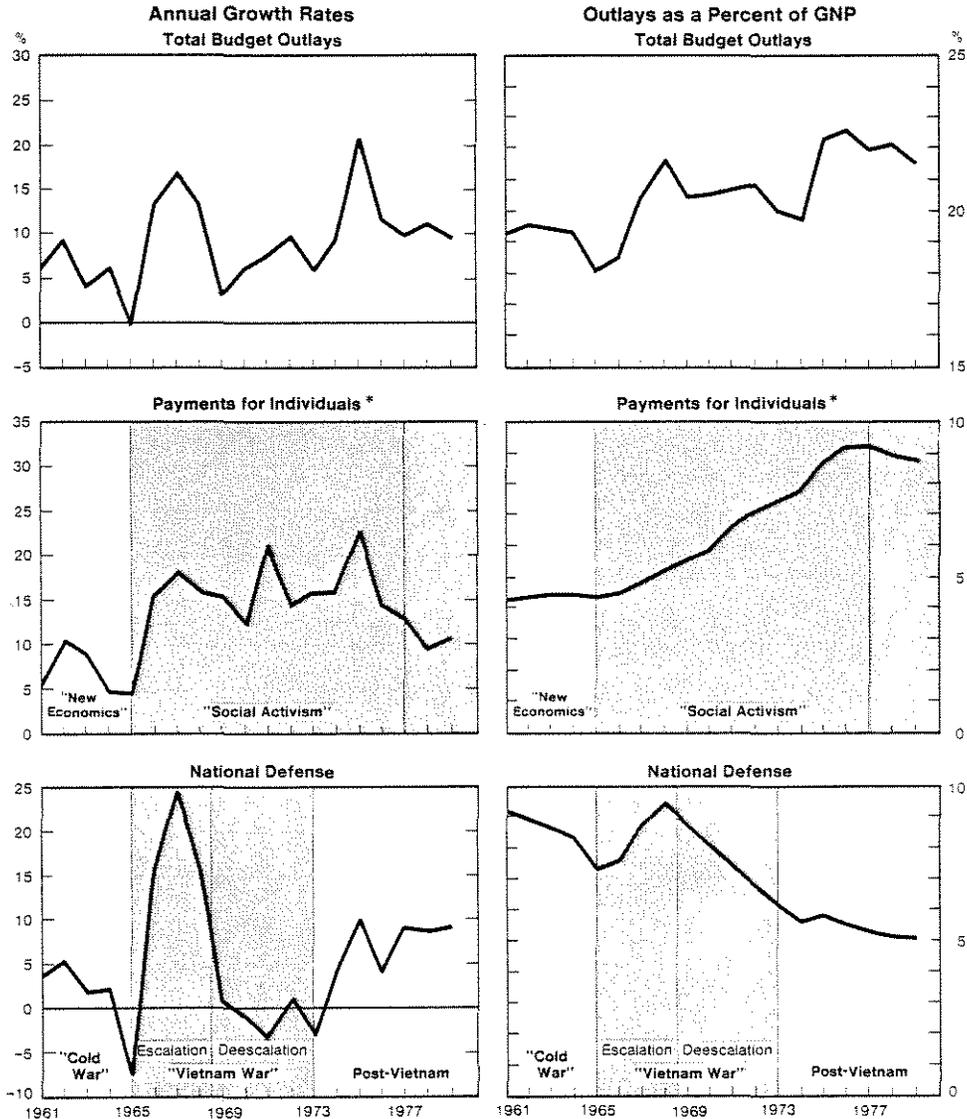
FOUR PHASES OF NATIONAL DEFENSE SPENDING

National defense expenditures of the 1960s and 1970s may be divided into four distinct phases: (1) the "cold war" phase preceding Vietnam; (2) the escalation phase of the Vietnam War (fiscal 1966 through 1968); (3) the de-escalation phase until the completion of the troop withdrawal in February, 1973; and (4) the recent post-Vietnam phase. Only during the escalation phase did defense spending grow much faster than GNP; during the pre-Vietnam phase of the early 1960s, it barely advanced, and during the deescalation phase it declined rapidly (see Chart 1 and Table 1). More recently, the growth rate of defense spending has accelerated, but it has remained below the growth rate of GNP. If this latest uptrend continues (as is suggested by the current political climate and initial congressional debates of the SALT II

¹²For the analysis of transfers to individuals, unpublished tabulations from the Office of Management and Budget on direct and indirect "payments for individuals" were used, rather than federal transfer payments to individuals as tabulated for the national-income-accounts (NIA) budget. The former data are more appropriate for the analysis at hand, since they include, for example, both Medicare and Medicaid, while the NIA data treat Medicaid as a purchase of health services by state and local governments.

Chart 1.

FEDERAL BUDGET OUTLAYS BY MAJOR COMPONENTS, FISCAL 1961-1979



* Includes all direct and indirect transfer payments, except unemployment compensation, which was excluded here as the major cyclical component.
Sources: Office of Management and Budget; The Conference Board.

Table 1
Selected Data for Analysis of Federal Budget Policy, Fiscal 1961-1979

	<u>1961-65</u> <u>Average</u>	<u>1966-79</u> <u>Average</u>	<u>1961-65</u> <u>Average</u>	<u>1966-69</u> <u>Average</u>	<u>1970-73</u> <u>Average</u>	<u>1974-79</u> <u>Average</u>
Annual Growth Rates						
Total Budget Outlays	5.2	10.8	5.2	11.9	7.6	12.3
Payments for Individuals*	6.6	15.3	6.6	16.1	15.9	14.5
National Defense	1.1	6.7	1.1	14.1	-1.6	7.4
Productivity	3.2	1.6	3.2	2.4	2.0	0.7
Real GNP	4.2	2.9	4.2	4.6	3.2	1.6
Inflation (Implicit GNP Deflator)	1.5	5.9	1.5	3.6	4.9	8.0
Percent of GNP						
Total Budget Outlays	19.1	21.0	19.1	20.3	20.5	21.7
Payments for Individuals*	4.3	7.1	4.3	5.0	6.7	8.8
National Defense	8.5	6.8	8.5	8.7	7.1	5.4
Budget Deficit	0.8	1.7	0.8	1.1	1.5	2.3
Fiscal Thrust	1.4	2.0	1.4	1.5	1.8	2.5
Expenditure Component	1.0	2.1	1.0	2.2	1.7	2.3
Revenue Component	0.4	0.0	0.4	-0.7	0.2	0.1

*Includes all direct and indirect transfer payments, except unemployment compensation, which was excluded here as the major cyclical component.

Sources: Office of Management and Budget; The Conference Board.

agreement), a point may soon be reached when the share of GNP devoted to national defense will be rising again.

But with the exception of the early Vietnam War escalation -- its contribution to the inflation of the second half of the 1960s was discussed earlier -- defense spending as a percent of GNP has been declining. The decline in the share of GNP devoted to national defense could have been expected to moderate (rather than stimulate) inflationary pressures during the 1970s.

TRANSFER PAYMENTS: THE BEND IN THE TREND

Transfers to individuals present a drastically different picture. Fiscal 1965 marks a clear dividing line between the moderate growth of these transfers during the first half of the decade and the much higher growth rates that began with fiscal 1966 and lasted at least through fiscal 1977 (see Chart 1). During fiscal years 1978 and 1979, the growth of transfers to individuals slowed significantly. The share of GNP redistributed through federal transfer programs rose rapidly and persistently from 4.2 percent in fiscal 1965 to 9.1 percent in fiscal 1976 and 1977; it declined slightly during fiscal years 1978 and 1979. Clearly, it is much too early to tell whether fiscal 1977 marked the end of the rapid-growth phase of these transfers and the beginning of a new phase of relative containment, or whether it represents simply a brief "pause." Whether pause or change, this is the first noticeable downward deflection in a trend that started in fiscal 1966.¹³

¹³Note that payments for individuals grew at an average annual rate of 15.3 percent during fiscal 1966-1979, compare with 6.1 percent during fiscal 1961-1965. As a percent of GNP, these payments averaged 4.3 percent in fiscal 1961-1965, 5 percent in fiscal 1966-1969, 6.7 percent in fiscal 1970-1973, and 8.8 percent in 1974-1979 (see Table 1).

Clearly, fiscal 1965 marked a watershed for transfer programs: it was the end of the "New Economics" and the beginning of a new "Social Activism."

The relatively moderate growth of transfers to individuals during the first half of the 1960s reflected the basic policy approach to the Kennedy Administration's "New Economics." The acceleration of real growth and the reduction in the unemployment rate were to be achieved through stimulation of the private sector, rather than through public programs and an expansion of the government sector. The major policy tools were the liberalized depreciation of 1962, the investment tax credit of 1963, and the corporation and personal income tax cuts of 1964 and 1965. The New Economics proved remarkably successful. During fiscal 1961-1965, the unemployment rate declined gradually toward the 4 percent full-employment target (as defined in the 1960s), real GNP grew at an average annual rate of 4.2 percent and annual productivity gains averaged 3.2 percent. All these were far better performances than those obtained during the 1970s, yet price stability was preserved right up to the onset of the Vietnam War.

The assassination of President Kennedy in 1963 and, in its wake, the assumption of power by Lyndon B. Johnson, the passage of the Civil Rights Act in 1964, and the burning of the inner cities during the long, hot summer of 1965, ushered in a new era of "Social Activism." President Johnson -- one of the great parliamentarians of this century and a great admirer of President Roosevelt's New Deal -- secured the passage of far-reaching new social and economic legislation; this included the Economic Opportunity Act of 1964, the Permanent Food Stamp Act of 1964, the Social Security Amendment of 1965 which created

"Medicare" and "Medicaid," and the Demonstration Cities and Metropolitan Development Act of 1966 which established the new "Model Cities" program.

Many of the new federal programs took the form of transfers to individuals and expanded at a very rapid pace even during the 1966-1968 expansion phase of the Vietnam War. In fiscal 1965, federal expenditures for Food Stamps, Medicare and Medicaid were negligible; by fiscal 1968, they amounted to \$0.2 billion, \$5.3 billion, and \$2.0 billion, respectively; and by fiscal 1978, the latest year for which actual data (rather than estimates) are available, they had risen to \$5.5 billion, \$25.2 billion, and \$10.7 billion -- for a combined total equal to 2.0 percent of GNP.

This rapid expansion of social programs with heavy reliance on transfer payments extended from the second half of the 1960s through the 1970s. After repeated large adjustments in Social Security benefits far in excess of inflation, the entire Social Security program was put under the umbrella of a cost-of-living escalator clause in 1975, while real after-tax take-home pay of many workers and real returns on investment were lacking such protection and declined during a major part of the 1970s.

Rapidly growing transfers, mainly from the producing to the non-producing sectors (such as the retired, the disabled, the nonworking poor), were financed in what would appear to be highly inflationary ways:

- o By frequent large increases in Social Security taxes which are, in the view of many economists, among the most inflationary taxes.

o By large budget deficits that contributed to excessive money growth.¹⁴

o By inflation itself which fattened the federal government's income-tax take, while eroding real after-tax purchasing power of workers and real after-tax return on investment.

The limited statistics available on the subject tend to confirm this erosion of real purchasing power of the producing sector. For example, real after-tax weekly earnings of nonfarm production workers -- the best measure available from the Bureau of Labor Statistics -- grew at an average annual rate of 2 percent during 1948-1965, as compared with 0.1 percent during 1966-1978 (see Chart 2). Even after allowing for all the limitations of these data, the sharp erosion since

¹⁴While there is no simple, positive, short-term relationship between budget deficits and inflation (e.g., deficits may be induced or enlarged by a recession which also tends to curtail inflation), persistent high budget deficits during relatively prosperous periods exert strong upward pressure on money growth. This linkage was illuminated during the September 5, 1979 testimony of Paul Volcker, Chairman of the Federal Reserve Board, before the House Budget Committee.

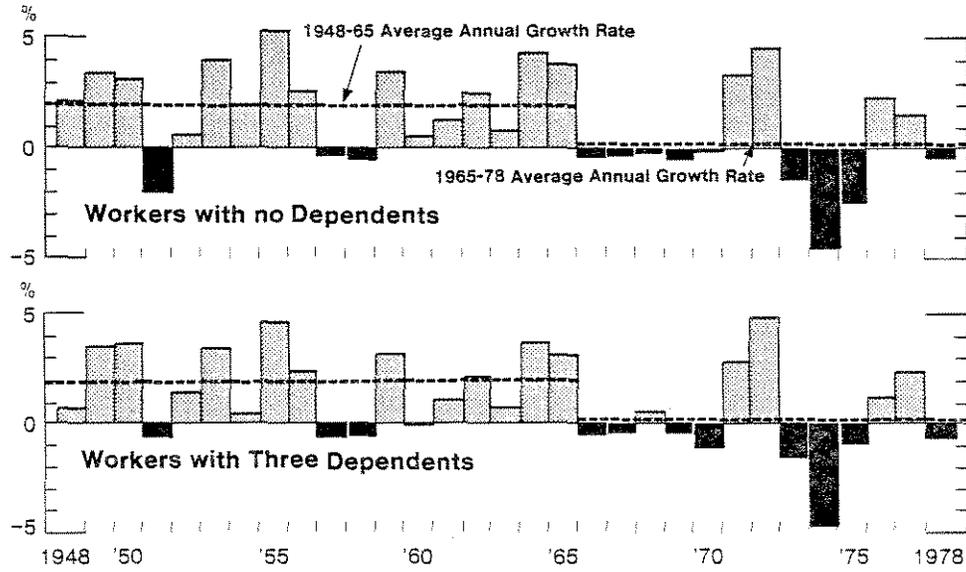
Representative Simon: "There are those who say there is no relationship between money supply and the money supply policies of the Fed and our deficits?... How do you describe it and what kind of relationship is there between that increase in the money supply and the deficits?"

Mr. Volcker: "The degree to which the budgetary deficit puts pressure on the Federal Reserve, puts pressure on the credit markets and through the credit markets pressure on the Federal Reserve to increase the money supply, depends a great deal on what else is going on. And the relationship becomes much more difficult in a boom period than in a recession period. But all things equal, over a period of time, the deficit means at the very least that credit markets will be tighter than they otherwise would have been with a constant Federal Reserve money-supply target and that the money-supply target will have to be increased, which in turn has inflationary repercussions."

Chart 2.

ANNUAL PERCENT CHANGES IN REAL AFTER-TAX WEEKLY EARNINGS

Private Nonfarm Production Workers



Sources: Bureau of Labor Statistics; The Conference Board.

1965 is obvious. In its 1979 Annual Report, the Council of Economic Advisers discussed the erosion of investment incentives and stressed the need for stimulating investment.¹⁵ After reviewing four alternate measures of profitability, the CEA concluded: "Of the four measures of profitability, only one, the rate of return on stockholders' equity, has regained the 1955-70 average. The other three are well below the 1955-70 average and still further below the average for 1962-66, when investment outlays rose very strongly."¹⁶

Not only were investment incentives eroded in the 1970s, but a large and increasing amount of investment had to be devoted to "non-productive uses" in order to meet new safety and environmental regulations. In this setting of poor real after-tax gains for workers and low investment incentives, productivity and real growth could be expected to suffer. In fact, average productivity gains have been declining steadily since the first half of the 1960s and real growth of GNP during the 1970s averaged well below that of the previous decade. (For details, see Table 1.)

Thus, not only did the federal government redistribute a steadily rising share of real income -- mainly from the producers to nonproducers -- but this redistribution appears to have contributed to, and was in turn affected by, a slowdown in real growth. Thus, workers conditioned during the 1950s and early 1960s to sizable real-income

¹⁵Op. cit., pp. 124-34. The CEA concluded: "If the investment needed to reach our economic goals in 1983 is to be realized, policy actions are required that will strengthen investment incentives and reduce investment costs and risks" (p.130). It went on to recommend "tax reductions designed to strengthen investment incentives."

¹⁶Ibid., p. 129.

gains were doubly disappointed as they received a smaller part of a more slowly growing pie. In such an environment, attempts to restore real gains of workers through higher wage demands, and to shore up profitability through price increases, could be expected to recur frequently, since they were bound to fail against the power of the federal government to enforce its own priorities.

In the struggle to recapture a "fair share" of real income growth (probably based on the patterns of an earlier and happier period), strongly positioned groups could be expected to do better than those in relatively weaker bargaining positions. Thus, highly paid skilled workers and strong unions would experience less erosion of real gains than unskilled or unorganized labor. Some recent evidence presented by Perry indicates that this is precisely what happened in the 1970s. He concludes that "for the eight years as a whole (1970-77), union wages have risen an average of 1 percent a year faster [than average wages]. But while they have outpaced average wages over this period, the 1.7 percent average annual increase in real wages in the union sector during the 1970s just maintained the average rate of real wage increase of the previous decade."¹⁷

During the 1970s, the federal government -- unwilling to adjust its own inflationary policies and priorities -- applied wage and price freezes and controls intermittently. These "incomes policies" were intended to suppress inflationary pressures from the private productive sector that had been created, or at least intensified, by the government's own policies. In order to minimize the political

¹⁷Loc. cit., pp. 31-32.

pressures that arise from large and frequent tax increases (and that ultimately led to the "taxpayers' revolt" of the late 1970s), the federal government relied mainly on increases in Social Security taxes (which are less "visible" and create less popular resistance than income taxes), on the inflationary feedback that swells income-tax receipts as it erodes real after-tax buying power, and on deficit financing. During fiscal 1961-1965, annual federal budget deficits as a percent of GNP averaged 0.8 percent; this percentage rose steadily to 1.1 percent during fiscal 1966-1969; 1.5 percent during fiscal 1970-1973; and 2.3 percent during fiscal 1974-1979 (see Table 1).

FISCAL POLICY: THE EXPANSIONARY "FISCAL THRUST" OF THE 1970s

I have sketched some of the processes through which the diversion of an increasing share of GNP to transfers (mainly from the producing to the nonproducing sector) added inflationary pressures after 1965. Implicit in this analysis were the following two propositions:

- o Direct and indirect transfers to individuals, jointly with national defense spending, dominated the patterns of fiscal growth over the last decade-and-a-half. (But except for the Vietnam escalation phase, transfers were by far the most prominent component shaping fiscal growth.)

- o The budgetary policies and processes described here resulted in far more expansionary budgets in the 1970s than had been the case in the previous decade. Moreover, this increased expansionary thrust originated from rapidly growing spending programs (mainly transfers), rather than from tax reductions.

The extent to which the first proposition is true may be gleaned from Chart 1. To my knowledge, the second proposition is new and has, so far, been unproven. Therefore, it calls for empirical investigation and evidence.

Until recently, I had suspected but had been unable to document satisfactorily that, on the average, fiscal policy of the 1970s had been more expansionary. With the cooperation of the Bureau of Economic Analysis of the Department of Commerce, I have been able to develop reasonably consistent (preliminary) quarterly and annual estimates of "fiscal thrust" back to fiscal 1959 -- just in time for this meeting (see Table 2).¹⁸ This measure consists of an "expenditure component" which measures change in autonomous government expenditures,¹⁹ and a "revenue component" which measures the initial revenue loss (expansionary (+)) or revenue gain (restrictive (-)) from structural changes in tax provisions (rates or base). Each component, as well as total "fiscal thrust" (their sum) is best measured as a percent of GNP, in

¹⁸I coined the term "fiscal thrust" in 1974 when I published my first annual estimates in The Federal Budget: Its Impact on the Economy, The Conference Board, New York, 1974, fiscal 1975 edition, p. 12. My first quarterly estimates were published in 1976 (op. cit., fiscal 1977 edition, p. 11). The measure itself is, of course, derived from Keynesian macroeconomic analysis. Previous uses of similar measures may be found in William H. Oakland, "Budgetary Measures of Fiscal Performance," Southern Economic Journal (April 1969), pp. 348-58; E. Gerald Corrigan, "The Measure and Importance of Fiscal Policy Change," Federal Reserve Bank of New York Monthly Review (June 1970), pp. 135-45; Paul W. McCracken, "Federal Budget Discipline and National Priorities of the 1970s," in Michael E. Levy, editor, Major Economic Issues of the 1970s, The Conference Board, New York, 1973, esp. p. 9.

¹⁹National-income-accounts (NIA) budget data were used; induced expenditures (mainly regular unemployment compensation) are excluded; and long-lead defense expenditures are adjusted from their "delivery basis" to a timing that reflects more closely actual production.

Table 2
Quarterly and Annual Estimates (Preliminary) of "Fiscal Thrust" and Its Major
Components, Fiscal 1959-1980¹

(NIA budget data; \$ billion at seasonally adjusted annual rates)

	Expenditure Contribution ²		Tax-change Contribution ²		Fiscal Thrust ³		As a % of GNP		Fiscal Thrust ³	
	(1)	(2)	(3) = (1) + (2)	(4)	(5)	(6) = (5) + (6)				
FY 1959	3.5	-0.9	2.6	0.74	-0.18	0.55				
III	5.3	0.3	5.6	1.17	0.07	1.24				
IV	1.6	0.2	1.8	0.34	0.05	0.39				
I	-2.3	-1.4	-3.7	-0.48	-0.29	-0.77				
II	-1.1	0.0	-1.1	-0.22	0.00	-0.22				
FY 1960	1.5	-2.6	-1.1	0.30	-0.52	-0.22				
III	1.2	0.0	1.2	0.25	0.00	0.25				
IV	0.2	-0.6	-0.4	0.04	-0.12	-0.08				
I	-0.5	-2.0	-2.5	-0.10	-0.39	-0.49				
II	0.6	0.0	0.6	0.12	0.00	0.12				
FY 1961	10.2	-0.4	9.8	2.00	-0.07	1.93				
III	1.8	-0.1	1.7	0.36	-0.02	0.34				
IV	2.0	0.0	2.0	0.40	0.00	0.40				
I	2.7	-0.3	2.4	0.53	-0.06	0.47				
II	3.7	0.0	3.7	0.71	0.00	0.71				
FY 1962	7.1	0.7	7.8	1.30	0.13	1.43				
III	1.2	0.0	1.2	0.23	0.00	0.23				
IV	1.0	0.0	1.0	0.18	0.00	0.18				
I	5.4	0.3	5.7	0.98	0.05	1.03				
II	-0.5	0.4	-0.1	-0.09	0.08	-0.01				
FY 1963	4.3	-2.4	1.9	0.75	-0.42	0.33				
III	2.2	0.0	2.2	0.38	0.00	0.38				
IV	1.9	0.2	2.1	0.33	0.04	0.37				
I	-0.2	-2.5	-2.7	-0.03	-0.44	-0.47				
II	0.4	-0.1	0.3	0.07	-0.02	0.05				
FY 1964	5.3	10.1	15.4	0.86	1.64	2.50				
III	-1.0	0.0	-1.0	-0.17	0.00	-0.17				
IV	5.3	0.1	5.4	0.87	0.01	0.88				
I	0.6	4.6	5.2	0.10	0.74	0.84				
II	0.4	5.4	5.8	0.06	0.86	0.92				
FY 1965	2.1	3.4	5.5	0.32	0.52	0.84				
III	0.0	-0.1	-0.1	0.00	-0.01	-0.01				
IV	-0.7	0.0	-0.7	-0.11	0.00	-0.11				
I	0.2	1.7	1.9	0.03	0.26	0.29				
II	2.6	1.8	4.4	0.38	0.27	0.65				
FY 1966	19.9	-2.1	17.8	2.75	-0.29	2.46				
III	5.8	2.9	8.7	0.83	0.42	1.25				
IV	3.4	0.2	3.6	0.48	0.02	0.50				
I	7.2	-5.0	2.2	0.98	-0.68	0.30				
II	3.5	-0.2	3.3	0.47	-0.03	0.44				
FY 1967	21.2	-2.3	18.9	2.74	-0.30	2.44				
III	7.1	-0.5	6.6	0.94	-0.07	0.87				
IV	4.8	-0.2	4.6	0.62	-0.02	0.60				
I	6.9	-1.9	5.0	0.89	-0.25	0.64				
II	2.4	0.3	2.7	0.30	0.04	0.34				
FY 1968	20.4	-5.2	15.2	2.46	-0.63	1.83				
III	2.0	0.0	2.0	0.25	0.00	0.25				
IV	5.6	0.2	5.8	0.68	0.03	0.71				
I	3.3	-5.5	-2.2	0.39	-0.65	-0.26				
II	9.5	0.1	9.6	1.10	0.01	1.11				
FY 1969	7.3	-14.8	-7.5	0.81	-1.64	-0.83				
III	-0.3	-6.3	-6.6	-0.03	-0.72	-0.75				
IV	2.7	-1.0	1.7	0.30	-0.11	0.19				
I	1.5	-7.1	-5.6	0.16	-0.77	-0.61				
II	3.4	-0.4	3.0	0.37	-0.05	0.32				
FY 1970	16.2	5.8	22.0	1.69	0.60	2.29				
III	0.1	3.6	3.7	0.01	0.38	0.39				
IV	4.3	-0.4	3.9	0.45	-0.04	0.41				
I	0.9	3.1	4.0	0.09	0.32	0.41				
II	10.9	-0.5	10.4	1.12	-0.05	1.07				

Table 2 (continued)
Quarterly and Annual Estimates (Preliminary) of "Fiscal Thrust" and its Major Components, Fiscal 1959-1980¹
(NIA budget data; \$ billion at seasonally adjusted annual rates)

	As a % of GNP						
	Expenditure Contribution ² (1)	Tax-change Contribution ³ (2)		Fiscal Thrust (3) = (1) + (2)	Expenditure Contribution (4)	Tax-change Contribution (5)	Fiscal Thrust (4) = (5) + (6)
FY 1971	14.9		7.9	22.8	1.46	0.77	2.23
III	—1.7	6.7		5.0	—0.17	0.67	0.50
IV	3.6	—0.3		3.3	0.36	—0.03	0.33
I	6.7	1.8		8.5	0.65	0.17	0.82
II	6.3	—0.3		6.0	0.60	—0.03	0.57
FY 1972	23.6	—5.1		18.5	2.12	—0.46	1.66
III	1.4	2.6		4.0	0.13	0.24	0.37
IV	3.7	—2.3		1.4	0.34	—0.21	0.13
I	11.7	—8.0		3.7	1.04	—0.71	0.33
II	6.6	2.6		9.4	0.59	0.22	0.81
FY 1973	18.3	—4.8		13.5	1.48	—0.39	1.08
III	—4.9	1.9		—3.0	—0.41	0.16	—0.25
IV	21.4	0.4		21.8	1.75	0.04	1.79
I	1.6	—7.5		—5.9	0.12	—0.59	—0.47
II	0.2	0.4		0.6	0.02	0.03	0.05
FY 1974	31.0	—3.5		27.5	2.28	—0.26	2.02
III	2.3	0.2		2.5	0.17	0.02	0.19
IV	7.0	0.5		7.5	0.52	0.03	0.55
I	7.5	—4.4		3.1	0.55	—0.32	0.23
II	14.2	0.2		14.4	1.01	0.02	1.03
FY 1975	60.0	—1.4		58.6	4.12	—0.10	4.02
III	14.0	0.2		14.2	0.98	0.01	0.99
IV	3.4	—2.8		0.6	0.23	—0.19	0.04
I	23.9	—1.8		22.1	1.64	—0.12	1.52
II	18.7	3.0		21.7	1.25	0.20	1.45
FY 1976	26.0	12.9		38.9	1.60	0.79	2.39
III	9.0	39.8		48.8	0.56	2.54	3.12
IV	13.0	—30.6		—17.5	0.81	—1.91	—1.10
I	4.4	—0.6		3.8	0.27	—0.04	0.23
II	—0.4	4.3		3.9	—0.02	0.25	0.23
III T.Q.	5.9	—0.7		5.2	0.34	—0.04	0.30
FY 1977	46.9	7.0		53.9	2.54	0.38	2.92
IV	19.1	—3.2		15.9	1.09	—0.18	0.91
I	1.2	4.0		5.2	0.07	0.22	0.29
II	9.6	2.5		12.1	0.51	0.13	0.64
III	17.0	3.7		20.7	0.88	0.19	1.07
FY 1978	32.0	—9.3		22.7	1.55	—0.45	1.10
IV	12.9	—4.1		8.8	0.65	—0.20	0.45
I	4.4	—0.3		4.1	0.22	—0.02	0.20
II	2.7	—0.2		2.5	0.13	—0.01	0.12
III	12.0	—4.7		7.3	0.56	—0.22	0.34
FY 1979	45.9	9.8		55.7	1.99	0.42	2.41
IV	17.8	—2.4		15.4	0.80	—0.11	0.69
I	6.0	15.8		21.8	0.26	0.69	0.95
II	8.0	—1.7		6.3	0.34	—0.07	0.27
III prel.	14.1	—1.9		12.2	0.59	—0.08	0.51
FY 1980	33.7	—0.1		33.6	1.36	0.00	1.36
IV est.	10.8	—8.8		2.0	0.45	—0.37	0.08
I est.	7.1	9.7		16.8	0.29	0.40	0.69
II est.	4.8	—0.6		4.2	0.19	—0.02	0.17
III est.	11.0	—0.4		10.6	0.43	—0.02	0.41

¹Author's preliminary estimates derived from the best available published and unpublished sources. Data revisions and refinements have not yet been completed.

²Increases (+) or reductions (—) in "adjusted" NIA budget expenditures. Adjustments include subtractions of changes in "regular" unemployment benefits and of the NIA "defense timely adjustment."

³Initial increases (—) or reductions (+) in tax revenues resulting from structural changes in tax bases or rates, based on best published and unpublished estimates from the Treasury Department and the Bureau of Economic Analysis. Timing of the effect of the increases in the tax base on the employee's part of contributions to social security has been changed by author to concentrate this increase mainly in the last two calendar quarters.

T.Q.—Transitional quarter

Sources: Bureau of Economic Analysis; The Conference Board.

order to permit historical comparisons and minimize inflation-induced distortions of these measures.²⁰

In short, fiscal thrust and its components are designed to measure the initial expansionary impact originating from the federal budget to which the traditional Keynesian multipliers could be applied (or which could trigger fiscal simulations in econometric models.)

What concerns us for the present analysis are not so much the quarterly, or even the annual, levels or changes in fiscal thrust, but rather the average degree of stimulation of the budget over the broad longer time periods distinguished here. The results, summarized in Table 1, confirm the proposition that, on balance, the budgets of the 1970s were more expansionary than those of the 1960s, largely as the result of much faster spending growth.

Fiscal thrust averaged 1.4 percent of GNP during fiscal 1961-1965, compared with a 2.0 percent average for fiscal 1966-1979. Within the latter period, average fiscal thrust rose from 1.5 percent of GNP during fiscal 1966-1969 to 1.8 percent during fiscal 1970-1973 and 2.5 percent during fiscal 1974-1979. The expenditure component was dominant throughout. But tax cuts provided significant stimulation during the period of the "New Economics"; tax increases provided belated and limited restraint during the escalation phase of the Vietnam War (partially off-setting the "guns and Great Society" spending); and tax changes were nearly neutral over the course of the 1970s.

²⁰A "weighted fiscal thrust" could be constructed (analogous to the "weighted full-employment budget surplus"), but the complications created by such a refinement are hardly warranted in the light of the use of any simple overall measures of fiscal impact and the crudeness of the basic estimates.

THE NEW "SOCIAL REGULATION"

Changes in the composition and growth of the federal budget and its components were not the only inflationary manifestations of what has been termed here a new "social activism." The same emphasis on social welfare and on the consumer, rather than on real growth and the producer, gave rise to a new wave of "social regulation" in the mid-1960s and the early 1970s.²¹ The impetus came from consumer groups, environmentalists, labor unions, civil rights advocates and diverse public interest groups, who felt that the traditional regulatory agencies were not achieving "social goals," such as product safety, clean air and water, equal employment opportunities, safer and healthier working conditions.

In response to these public pressures, twenty new "social regulation" agencies have been created since 1970. Among these, the most important ones are the Consumer Product Safety Commission, the Environmental Protection Agency, the Equal Employment Opportunity Commission, and the Occupational Safety and Health Administration. These new agencies charged with social regulation were among the most prominent "growth industries" of the 1970s; their full-time staff increased from 17,324 in fiscal 1970 to 69,258 in fiscal 1979 (86 percent of the federal government's total regulatory staff). The administrative and

²¹For further discussion of the evolution of new "social regulation" and some cost estimates, see Michael E. Levy, assisted by Delos R. Smith and Steven Malin, The Federal Budget: Its Impact on the Economy, fiscal 1980 No. 2, pp. 12-14. For an encompassing critical review of the impact of government regulation, see Murray L. Weidenbaum, Business, Government, and the Public, Prentice-Hall, Inc., Englewood Cliffs, N.J., 1977; also Murray L. Weidenbaum, The Impacts of Government Regulation, Working Paper No. 32, Center for the Study of American Business, Washington University, St. Louis, July 1978.

reporting costs imposed on businesses grew accordingly. More important, business had to divert large and increasing amounts of cash flow and capital into investments designed mainly to achieve compliance with new social regulation. A major part of these investments -- regardless of whatever their social benefits -- was "unproductive" in terms of our traditional measures of real output and productivity. In fact, according to the best available estimates, productivity of the nonresidential business sector was 1.4 percentage points lower in 1975 than it would have been under the regulatory conditions of 1967.²²

The tendency of the new "social activism" to pursue socially desirable goals without any proper regard for economic implications, without due consideration of benefit-cost relationships, also has been felt in the regulatory area. Excessively short deadlines for meeting regulatory standards, detailed prescriptions of specific technological solutions, absolute prohibition of the use of certain substances or processes have often raised marginal compliance costs well in excess of marginal benefits.²³ Consequently, the new social regulation -- regardless of whatever its social merits -- has been highly inflationary. In its 1979 Annual Report, the Council of Economic Advisers

²²Edward Denison, "Effects of Selected Changes in the Institutional and Human Environment upon Output per Unit of Input," Survey of Current Business, January 1978, pp. 21-44.

²³For a discussion of these problems, see the section on "Regulatory Reform" in the 1978 Annual Report of the Council of Economic Advisers (pp. 206-216); also the section on "Regulatory Policy" in the 1979 Annual Report of the CEA (pp. 85-91).

described the dynamics of the inflationary process induced by the new social regulation in the following way:

Once incurred, the costs of regulatory actions enter into the wage- and price-setting mechanisms of the economy. Most of the costs of regulatory action show up not as governmental budget expenditures, but as increased costs to industry. Acceptance of higher prices relative to wages and other money incomes is the way in which society pays for the benefits of social regulation. In fact, however, our economic institutions and measures of prices do not distinguish between these sources of price increases and others. Individuals and groups try to escape paying the costs of regulation by increasing wages and other forms of income to match the higher prices. The result is an additional round of price increases. But the costs of regulation cannot be avoided, and widespread attempts to do so simply add to inflation.²⁴

SOME LESSONS FOR THE 1980s

My journey along the inflation road of the last decade-and-a-half has ended with a thesis, rather than with solid conclusions. The search for an explanation of the largely unexplained aspects of our inflation (or of the "excessive" money growth, if you will) -- its duration, persistence and steady escalation -- uncovered basic changes in social and political orientation and in our public policy. These changes -- I referred to them as a new social activism -- originated in the mid-1960s and gained momentum in the 1970s. This social activism manifested itself in increased reliance on the federal government to achieve socially desirable goals through new, or enlarged, budgetary and regulatory programs. The consumer and "social benefits" were stressed, often at the expense of higher costs, slower real growth and lower productivity gains. Among consumers -- many of whom are, after

²⁴Op. cit., p. 87.

all, producers as well -- these new social benefits were often to be focused on the nonproducers (who tend to be perceived as "more needy" and, hence, more deserving of "social benefits").

The "costs" of this new social activism included increased disincentives to work and to invest, slower growth of real GNP, and lower productivity gains. A main result was a persistent increase in inflationary pressures of our entire economic system.

If this thesis has any merit, if it contributes in any significant way to the explanation of the ongoing U.S. inflation, the implications are clear: Successful inflation control depends on removal of the fundamental causes of U.S. inflation. Fiscal and monetary policy restraint, while necessary, will not be sufficient. New policies to encourage greater productive efforts and faster real growth will be essential, if price stability is to be restored in the 1980s.