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The State of the Nation

Mr. Reagan stands alone among recent Presidents for not proposing measures designed to deal with an ongoing recession. He appears to be counting on the measures enacted last summer to foster a sound recovery soon. The actual budget deficit this year will be determined mainly by business-cycle and price trends. It is unlikely to be greatly affected by tinkering with taxes or spending during this session of Congress. The large projected Federal budget deficits in the more distant future mainly reflect a reduction in the projected rate of price increases, rather than the current recession or the tax cuts. The administration continues to project a robust business-cycle expansion during the remainder of its term. President Reagan could be vindicated by such a business-cycle expansion, but it will have to come soon to preserve the reputation of his administration and party.

As we described in last week's *Research Reports*, the latest economic data provide some grounds for optimism, although production, employment, and sales are still decreasing. The present phase of the business cycle is frightening to many Americans. Their concerns about the economy may be akin to those of passengers in an airplane encountering an "air pocket": they want to believe the mechanism will work, but they fear it will not. Such fears about the economy may be the most important aspect of the present "state of the Union" for many politicians.

On January 25, President Reagan delivered his State of the Union Message to Congress with his usual polish and poise. It included the generalizations and "applause lines" typical of the genre. From an economic standpoint the speech was more noteworthy for what was not said than for what was said. Mr. Reagan stands alone among recent Presidents for not proposing emergency measures designed specifically to deal with an ongoing recession. He apparently believes that the measures enacted during his first year in office are sufficient: "The program for economic recovery that is in place will pull the economy out of its slump. . . ."

Despite reportedly intense pressures from his advisors, President Reagan did not propose any new taxes or tax increases (except for some relatively minor closing of "loopholes" and a tightening of certain collection procedures), nor did he propose any further deregulation of natural gas. The latter presumably would have increased Federal tax revenues via higher personal and corporate income tax payments by gas producers even if there were no associated special excise similar to the so-called windfall profits tax on domestic crude oil production. The President also did not propose any major new programs to deal with increasing joblessness or with other adverse effects of the recession. Instead, he put forth a long-range program to alter the present responsibilities and relationships of the Federal and state and local governments.

"The New Federalism"

President Reagan cited the growth of Federal programs for "grants in aid" to state, county, and municipal governments, as the reason why the Federal Government has become "more pervasive, more intrusive, more costly, and above all more unaccountable." His proposed remedy for this situation is to have the Federal Government assume (starting in fiscal 1984) "full responsibility for the cost of the rapidly growing Medicaid program to go along with its existing responsibility for Medicare," and to have the states "simultaneously take full responsibility for Aid to Families with Dependent Children and food stamps."* These changes, which he called a "single bold stroke," will include the dedication of the full proceeds from certain Federal excise taxes to a "grass roots trust fund that will belong, in fair shares, to the 50 states." By 1988, "the trust fund will start to phase out, eventually to disappear, and the excise taxes will be turned over to the states. They can then preserve, lower, or raise taxes on their own and manage these programs as they see fit." The President also proposed the creation of "urban enterprise zones," which presumably would be exempt from some taxes and regulations and would be the subject of other special economic incentives.†

Of course, the President only proposes new legislation; the Congress disposes of it. Therefore, how the President's "New Federalism" will be shaped when – if ever – it becomes law is not now possible to say. Indeed, the President has yet to disclose the details of his own plan.

As a political move, the President's New Federalism has been successful to date by deflecting media and political attention from the disappointing condition of the economy to another new initiative. If the President did not have such a new program to talk about, he easily could have slipped into a defensive posture, trying to explain why the economy was in a recession in spite of favorable Congressional action on most of his economic initiatives last year and in spite of his promise that such favorable action would spur economic activity. Had the President done that, he would have appeared weak and indecisive. The New Federalism enabled him to enhance his image of being creative and bold in his plan to return power to the states from Washington.

Without knowing the details of the New Federalism and how Congress will dispose of the President's initiative, we can only speculate about its implications. From the

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* Medicare is for the elderly regardless of means, while Medicaid is for indigents regardless of age.

† We will not comment on this proposal here, except to note that we believe that regulations and taxes should be applied to the entire Nation because the entire Nation is, or should be, an "enterprise zone." Attempts to foster enterprise in some locations distort the market and result in overall losses in excess of any localized gains.

perspective of efficiency, it surely seems advisable to locate in one level of government, rather than two, total responsibility for particular programs. The much greater possible benefit is the removal of some hands from the Federal till, which – unlike state tills – seemingly never runs out of money because of the Federal Government's ability to run budget deficits year after year and to finance them with Treasury borrowing.

Having experienced enormous difficulty last year getting Congressional passage of social-welfare spending restraint that even was clearly too little, fiscal conservatives within the administration may have concluded that the only way to limit the total of social-welfare spending is to reduce the number of such programs funded Federally. Programs funded at the state level simply cannot be run continually in deficit. State legislators must raise tax revenues to cover spending. But widespread taxpayer anger about high taxes almost surely precludes raising taxes much higher, which effectively would limit social-welfare spending funded at the state level. That would not affect the programs to be transferred totally to the Federal Government, but those with a claim to the Federal till would be fewer in number at least.

The transfer of the food stamp program to the states offers another possibility for more effectively controlling such spending. Federal food stamp expenditures more than doubled during the 5 fiscal years, 1977 to 1981, from about $5.4 billion to about $11.0 billion, and are projected to continue to rise sharply unless changes are made in the program. One reason why this program is especially difficult to restrain at the Federal level is that it is politically popular among usually warring factions – the Western farm states and Northeastern urban states. Thus, there is no effective political opposition to rapid growth of the program. If the food stamp program is transferred to the states, the state budget limits discussed above will come into play, and neither faction – farm representatives or big-city representatives – will benefit from the support of the other. Food stamps would be the problem of the individual states.

The foregoing are some possible ways by which the New Federalism may lead to better control of Federal spending. There no doubt are others. Yet, since it is such a break from the long-term trend toward more Federal power and is against so many special interests, it may well not be enacted in a form the President seems to have in mind. However, the President has confounded the pundits and prevailed against apparent long odds before. It probably would be economically beneficial if he did in this instance as well.

The Reagan Programs, the Recession and the Deficit

"Anti-recession" legislation is usually more valuable to politicians, who wish to appear responsive to constituents' concerns, than to the economy. By attempting to reverse a recession, such measures are designed to hamper the very processes needed to form the basis for recovery. Frequently they also adversely impact the subsequent expansion, because the recession often has ended before the anti-recession measures have been implemented. Thus the President's refusal to submit an anti-recession program probably is no less useful to the immediate situation than the actions of his predecessors in similar circumstances, and it has the distinct economic advantage of not impeding cyclical adjustments or initiating more long-term Government interference into markets.

Some economic steps similar to past efforts to "prime the pump" already are in place, having been enacted last year before the recession took hold. Withholding taxes for Federal income taxes were reduced 5 percent last October 1 (which will be translated into a 1.25 percent tax credit on 1981 returns) and they will decrease another 10 percent this July. Personal income tax rates for the second half of 1982 will be about 15 percent less, on average, than when the recession began, an amount that probably will exceed "bracket creep" by then. In this sense, the usual purported Government remedy for a recession, putting more money in the hands of consumers, already has been prescribed.

This has put the administration's opponents, who are mainly former advocates of big spending and big deficits, in a curious position. They point to the scheduled tax rate reductions as the cause of projected budget deficits and now are recommending tax increases during a recession, a policy that has not been tried since 1929-32. The President, refusing to be taken in by this ruse, rejected such proposals saying, "Raising taxes won't balance the budget. It will encourage more government spending and less private investment. Raising taxes will slow economic growth, reduce production, and destroy future jobs, making it more difficult for those without jobs to find them and more likely that those who now have jobs could lose them."

The sharp increase in the estimated deficit for the current fiscal year, from an original estimate of $45.0 billion to the current estimate of $98.6 billion, is the result of the recession. However, the widening budget deficits for fiscal years 1983 and 1984 and beyond reflect a reduction in the projection of the price level for those years much more than the effects of either the recession or the tax cut. Earlier forecasts of increases in the Consumer Price Index (CPI) were for increases of 11.1 percent during 1981, 8.3 percent during 1982, 6.2 percent during 1983, and 5.5 percent during 1984. In commenting on the tax bill last August, we observed:

> The administration's forecast of annual decreases in the rates of price increases defies all historical experience. The rate of price change fluctuates with the business cycle. If there is no recession during the years shown (and the administration does not foresee one; they never do), the rate of change of prices should begin to accelerate well before the fourth year of business expansion. If a recession does occur, the rate of price change would probably decrease more rapidly than forecast, and begin to increase after the next expansion is established.

The actual rate of increase in the annual average CPI for 1981 from that for 1980 was 10.4 percent (0.7 percentage point less than projected), but the annualized rate of increase during the 3 months ended December was 5.3 percent (3.0 percentage points less than projected for 1982). The current forecasts of budget deficits are based on projected increases in the CPI of 6.6 percent for 1982, 5.1 percent for 1983, and 4.7 percent for 1984. These lowered price change estimates mean that the administration's estimate of 1984 GNP is 5 percent (or $215 billion) less than it was when the "Program for Economic Recovery" was drawn up in early 1981. This 5 percent reduction is entirely due to smaller projected price increases; the official estimate of real 1984 GNP has changed little. Since income tax rates will not be indexed until 1985, a substantial part of that "missing" $215 billion inflationary increase in 1984 GNP had been expected to wind up in the Federal coffers then.

Our earlier comments now apply in reverse. If a business-cycle expansion begins in 1982, the rate of increase of consumer prices may be expected to begin to accelerate by 1984 or earlier, and this would tend to reduce the deficits. Large Federal deficits plainly have adverse implications. They take savings from productive assets if they are financed by genuine borrowing, or they promote inflating if they are financed by newly created purchasing media. Congress will have to address the problem of the large deficits projected for fiscal years 1983, 1984, and beyond. By refusing to request a tax increase, President Reagan has forcefully focused the debate on the need to cut spending.

Mr. Reagan's efforts to reverse the trends of the past 50 years or so have been economically marginal. Despite the much discussed "cuts" in Federal spending and taxes, in most instances these are "cuts" only with respect to what they would have been if no action had been taken. Government tax revenues and spending have continued to increase, and are projected to continue to increase. Surely this is the case in absolute dollar amounts, and it may be so as a proportion of economic activity as well. Even though they have been limited to date, Mr. Reagan's efforts to reduce the size and role of government do represent a break with the past. Unfortunately, whether or not his limited steps will be viewed as sufficiently successful to permit further steps now seems to hinge on the near-future trend of general business activity, which in large part is a reflection of older policies, not current policies.

The Outlook

Constant-dollar GNP fell at an annual rate of 5.2 percent during the fourth quarter of 1981. (This was of course a much smaller drop, 1.3 percent, on a quarter-to-quarter basis.) As in all recessions, this decrease reflected, in part, the fact that production outpaced sales as the recession developed. This resulted in unintended inventory accumulation. By the last quarter of 1981, significant production decreases were needed to bring output below sales. It appears that such cuts continued into 1982. If and when sales become larger than output, inventory liquidation, coupled with an abatement of price increases, could lead to a reduction of short-term borrowings by businesses, which would tend to lower interest rates. Among other things, lower interest rates could lead to a weakening of the dollar against foreign currencies, making U.S. products more competitive for both foreign and domestic buyers, as well as fostering increased demand for housing, autos, and capital goods. This is neither the only possible "way out" of the current recession nor the only way in which this or any other recession occurs. Yet, the start of business-cycle expansions usually has been sudden, as trends in specific economic activities that had been unfavorable, or had been viewed unfavorably, quickly reversed themselves.

Mr. Reagan would seem to be resting the reputation of his administration and his party on a quick reversal of short-term economic trends similar to that outlined above. He is somewhat in the position of Ludwig Erhard in 1948. General Clay, the head of the occupation forces in Germany, questioned the wisdom of Erhard's program saying, "Herr Erhard, my advisors tell me you're making a terrible mistake." Erhard reportedly replied, "Don't listen to them General, my advisors tell me the same thing." The "German miracle" vindicated Ludwig Erhard, and future developments may vindicate Ronald Reagan. However, such an outcome is by no means assured, particularly since Mr. Reagan's attempts to reduce the economic role of government do not approach those of Erhard.

Moreover, since the price of money (interest rates) has been and remains the single most unusual aspect of recent business-cycle changes, Mr. Reagan's failure to deal forcibly with the money question by reforming the fiat dollar could well prove to be the greatest weakness of his program. The absence of a sound purchasing medium may be the missing ingredient for the prompt recovery that President Reagan is counting upon.

GOVERNMENT EMPLOYMENT

The number of government employees decreased during 1981 for the first time since at least 1947. The Reagan administration's policies of reducing the role of government almost surely accounted in part for this decrease; however, there were some indications of a change in trend before Ronald Reagan was elected President. In relation to the population as a whole, the 1981 decrease simply accelerated a downward trend of government employment that began several years ago.

Government employment increased an average of nearly 350,000 persons per year during the 30 years prior to 1981, according to the U.S. Labor Department's estab-

Chart 1
GOVERNMENT EMPLOYMENT
(Annual Averages)

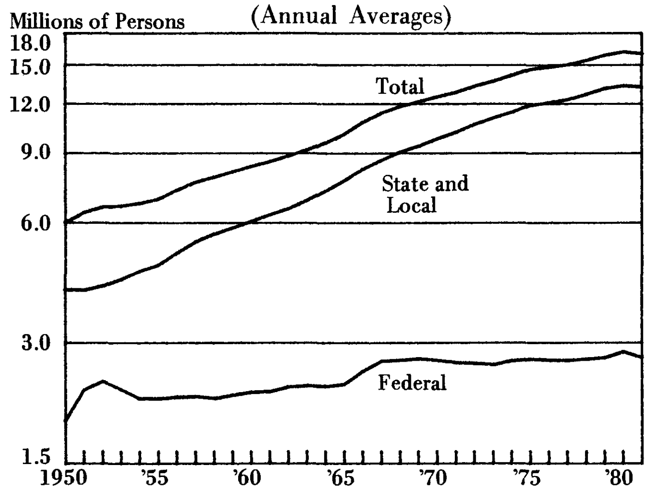
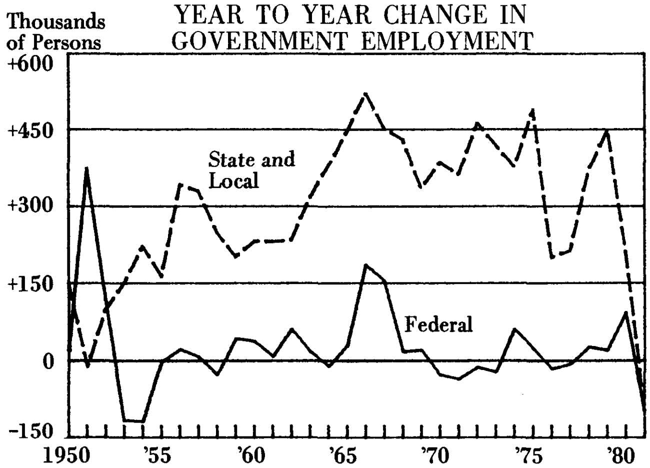


Chart 2
YEAR TO YEAR CHANGE IN
GOVERNMENT EMPLOYMENT



Note: Data for Charts 1 and 2 are based on the annual averages of the monthly survey of payroll employment at nonagricultural establishments.

lishment survey.* Such employment increased an average of 330,000 persons per year during the years 1977 through 1980, when Jimmy Carter was President. As the accompanying charts show, government employment decreased during the year just ended. The number of persons on government payrolls averaged 16,052,000 during 1981, 217,000 fewer than during 1980. Although this decrease is small, it is significant. *It is the first reduction in government employment reported for any year since at least 1947.*

Although this reversal of an uninterrupted upward trend coincided with Ronald Reagan's first year in office, other factors probably account for the 1981 decrease as well as President Reagan's focus on reducing the role of government in American life. As is shown in Chart 1, the number of Federal employees decreased slightly during 1970-73, after a sharp rise when most of Lyndon Johnson's "Great Society" programs were implemented in the mid-1960's. Chart 2 shows that the 1981 decrease in the number of Federal employees was much larger than those of 1970-73 and was approximately equal to decreases during each of the first 2 years of the Eisenhower administration, 1953 and 1954.

The reported number of Federal employees almost surely understates the number of persons paid with Federal funds. An estimated 800,000 to 1,000,000 lawyers and other "experts" are routinely hired by Federal departments as "consultants" and "outside contractors." It is not clear if such employment increased or decreased in 1981.

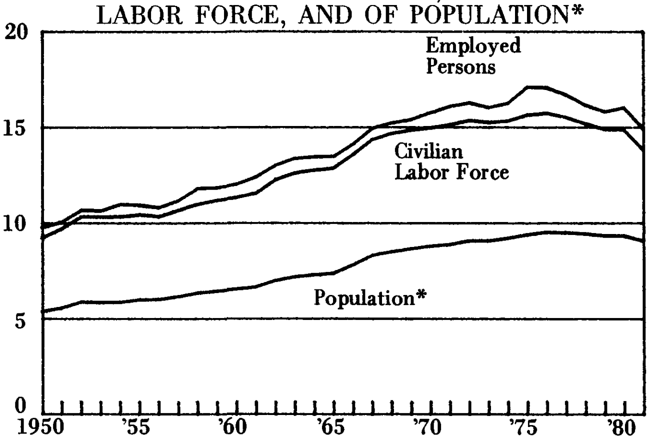
Moreover, "grade creep" is rampant in the Federal bureaucracy. Although their numbers have changed little over the years, the number of "chiefs" has continuously increased in relation to the number of "Indians." According to Professors James Bennet and Manuel Johnson, only 6 percent of Federal employees were classified as GS-13 ("middle managers") or higher in 1959, but 14 percent were so classified in 1978.† And the old idea that one must sacrifice income for job security when taking a government job simply does not apply any longer. According to a study by the Chamber of Commerce conducted last year, average Federal employee compensation was more than the average equivalent private sector compensation, by $2,661 in salary and $2,853 in benefits. Thus, the cost to taxpayers of Federal employees as a group has not necessarily paralleled changes in their numbers.

The above discussion referred to Federal Government civilian employees. As Chart 1 shows, most government employees are employed by state and local governments. According to the establishment survey, state and local governments employed 100,000 fewer persons, on average, during 1981 than during 1980. This was an enormous swing in state and local government hiring. State and local governments reported an increased number of employees during every year since 1951, increases that averaged over 300,000 per year for the years 1977 through 1980.

There can be little doubt that the Reagan administration's policies played some part in this change at the state and local level, since many state and local employees are involved in Federally mandated programs and are often paid with Federal dollars. However, the situation at the state and local level also has been influenced by "taxpayer revolt" in many states, and the baby bust has resulted in greatly decreased school-age populations, which local authorities have belatedly come to recognize as requiring fewer schools and teachers.

In terms of government employment in relation to society as a whole, the Reagan administration's achievements in reducing the role of government, if any, simply accelerated trends that began several years ago. Chart 3 shows the number of government employees as a percent of all employed persons, the civilian labor force, and of the population ages 16 and over. This chart reveals that in these terms government employment peaked in 1975 and 1976 and recently was at levels of about 10 to 15 years ago. These data offer some encouragement to producers in the private sector who, in the end, fund through taxes the bulk of government employees' pay. Even after the recent decreases more than one out of seven working persons was employed by government.

Chart 3
GOVERNMENT EMPLOYEES AS A PERCENT OF ALL EMPLOYED PERSONS, OF CIVILIAN LABOR FORCE, AND OF POPULATION*



* Noninstitutional population ages 16 and over.

Note: Data are based on the annual averages of the monthly household survey of employment status.

PRICE OF GOLD

	1981	1982	
	Feb. 12	Feb. 4	Feb. 11
Final fixing in London	$490.25	$383.75	$380.00

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* Employment statistics are derived from two U.S. Labor Department surveys conducted monthly. One survey is of a sample of nonagricultural establishments and the other is of a sample of households. The establishment survey is considered to be more accurate because the sample is a larger part of the total. It has flaws, however. It often is revised; it double counts persons who hold more than one job; and it excludes self-employed persons and all employed in agriculture. The household survey is more comprehensive in that it includes agricultural employment, self-employed persons, and those not employed. With respect to total government employment, the estimate derived from the establishment survey is slightly higher than that derived from the household survey, presumably because some persons hold more than one government job. Furthermore, the difference between the two surveys fluctuates, possibly because of sampling errors in the surveys and because the number of "double dippers" changes over time. The household survey does not distinguish between Federal and state and local employment.

† See their book, *The Political Economy of Federal Government Growth 1959-1978*, published by the Center for Free Enterprise, Texas A & M University, College Station, Texas 77843. Price: $12.95 hardcover; $4.95 paperback.

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